May 13, 2019

Secretary Steven T. Mnuchin
U.S. Department of the Treasury
Financial Stability Oversight Council
1500 Pennsylvania Avenue NW, Room 2208B
Washington, DC 20220

Chairman Jerome H. Powell
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (RIN 4030-ZA00)

Dear Secretary Mnuchin and Chairman Powell,

We are writing in response to Treasury's request for comment on proposed amendments to its interpretive guidance regarding its authority to require supervision and regulation of certain nonbank financial companies.

As the two previous Chairs of the Financial Stability Oversight Council and as the two previous Chairs of the Federal Reserve Board, we write to express our significant concerns with the proposed interpretive guidance released by the Financial Stability Oversight Council (FSOC). We write based on our experience through the financial crisis and its aftermath and with appreciation for the difficulty of putting the Dodd-Frank Act's statutory authorities into practice.

We caution against taking the steps outlined in the proposed guidance. We believe that these steps – in design and in practice – would neuter the designation authority. Though framed as procedural changes, these amendments amount to a substantial weakening of the post-crisis reforms. These changes would make it impossible to prevent the build-up of risk in financial institutions whose failure would threaten the stability of the system as a whole.

It is our belief, consistent with the Dodd-Frank Act, that any financial firm whose material distress or failure could result in a significant threat to financial stability should be subject to enhanced prudential supervision. This cannot rely on a determination that failure is probable; nor can it wait until the point that failure is inevitable. We should not need to wait for cracks in the foundation to appear before recognizing that building inspectors must spend more time on the

largest and most complex buildings. The overwhelming lesson of our experience in the financial crisis is that uncertainty pervades all decision making, especially when financial risks are developing in real time. Even in the months leading up to the crisis, it was not clear which financial firms were most at risk of failing nor was it clear how the risks from the failure of those firms would impact other financial institutions, financial markets, or the economy as a whole.

Although there is a lot that is uncertain about the dynamics of a financial crisis, some things are certain. A fundamental feature of a market oriented, innovative financial system is that – over time – risk will migrate around the prudential constraints that apply to banks, shrinking the effective scope of those defenses, and leaving the overall financial system more fragile. This is what happened in the decade leading up to the crisis, and the failure of prudential regulation to prevent this is a critical reason why the crisis was so severe and challenging to manage.

In this letter, we briefly review the history and the role of the nonbank designation authority in the Dodd-Frank Act. We then explain how this authority was used when we served as members of the FSOC and the importance of the authority to its ongoing mission. Finally, we outline specific concerns with the proposed guidance and the damage that these changes would have on our nation's ability to safeguard the financial system and economy.

1. Designation Authority in the Context of the Crisis and the Dodd-Frank Act

The failure of nonbank financial companies was central to the propagation of risk from the financial system to the U.S. economy, international financial markets, and the global economy as a whole during the crisis. The story of the crisis is a cascading cycle of market losses causing the failure of highly leveraged financial companies, which in turn caused further market disruptions, and additional failures. The crisis created an immediate impact in lost wealth and started a near free-fall in the US economy that was only arrested by extraordinary and unprecedented legislative and regulatory action and aggressive monetary and fiscal policies. Even so, academic estimates put the cost of lost output as large as a full-year of US GDP.[1]

It is now clear that the lack of supervision and oversight of interconnected nonbank institutions contributed to increased risk taking by these companies in the lead up to the crisis. While in the course of the crisis, lack of oversight increased uncertainty about the nature of their risk taking and made government policy less certain and effective in response.

[1] David Luttrell, Tyler Atkinson and Harvey Rosenblum, "Assessing the Costs and Consequences of the 2007-09 Financial Crisis and Its Aftermath," Federal Reserve Bank of Dallas, Economic Letter Vol. 8, No. 7, September 2013.

Moreover, it would have been difficult to predict ex-ante which of these companies would be central to the path of the crisis even as late as 2006 or 2007. In part, this is because the risk-taking activities of these companies can and did change rapidly in the years preceding the crisis. But more importantly, the path of a crisis is highly dependent on the state of the economy and the state of the financial markets as it unfolds. What is known and can be assessed in advance are the fundamental characteristics of the companies whose failure could threaten financial stability. These included:

- High leverage
- Reliance on short-term financing
- Significant and complex interconnections with other financial firms
- Complex corporate structures that cut across national boundaries
- Lack of comprehensive supervision

Part of the legislative response to these issues in the wake of the crisis was the creation of the FSOC, providing the FSOC with a mandate to monitor the financial system for emerging risks, make recommendations to Congress and to regulators (activities authority), and when appropriate, to determine that certain large, highly leveraged nonbank financial institutions should be subject to consolidated supervision by the Federal Reserve (designation authority).

This designation authority was designed to directly address the risks posed to the financial system by nonbank financial companies and requires regulators to act if they deem a financial institution to be a potential threat to the system. Importantly:

- It was designed to be pre-emptive: recognizing that supervision and regulation will only be effective if it is in place prior to a crisis.
- It was designed to be based on risk: recognizing that legal characteristics like dominant line of business, direct regulatory status, and corporate form were not reliable indicators of risk as the crisis played out.
- It was designed to focus on corporate entities: recognizing that for each of the nonbank financial companies that played important roles in the crisis, there was no one single activity that caused the failure, and no one activity that propagated risk through the system. Rather, multiple high-risk activities combined with corporate structure and financing decisions created the problems.
- It was designed to be flexible based on the judgment of a body of regulators: recognizing that the next crisis would not be identical to the last one, or to any previous one. Therefore, it would require a multi-disciplinary perspective to understand potential emerging risks within a corporate entity and to understand the potential pathways for a nonbank financial company's failure to threaten U.S. financial stability.

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. At its core, designation authority helps change the framework for financial regulation from a rigid, corporate charter-based framework, to a risk-based framework that recognizes the perimeter of the supervised financial system must be flexible in order to prevent another financial crisis.

2. The Use of Designation Authority

In the course of our leadership of the FSOC, the designation authority was used only four times to designate nonbank financial institutions: GE Capital, AIG, Prudential, and MetLife. Two of these companies became highly distressed during the crisis and contributed to the weakening of many other financial firms with which they were connected. In addition, at the time of designation, both Prudential and MetLife were larger, more highly levered, had higher amounts of short-term financing, and were more global than AIG. GE Capital was de-designated by the FSOC after it restructured its business to become a more traditional captive financing business.

During the initial set up of the FSOC, we spent significant effort gathering comment and outlining a transparent process for designation, including finalizing interpretive guidance in 2012 and revising that guidance based on industry and other stakeholder engagement and feedback in 2015. No companies have been designated since the revised guidance in 2015. Under the Trump Administration, the FSOC has determined to remove AIG and Prudential from Federal Reserve supervision and the Trump Administration has declined to appeal a district court ruling in favor of MetLife, in which MetLife challenged its designation.

The proposed guidance asks if the FSOC's procedures should be adjusted to align with the district court ruling. We believe that the Trump administration was incorrect in declining to appeal and that alignment with the district court decision would be contrary to the statutory framework and would lead the FSOC to adopt a standard that is unworkable – effectively neutering this authority.

The statutory framework gives the FSOC the tools and the mandate to respond when risks migrate to financial institutions where prudential oversight is absent and therefore where regulators would be likely to miss the warning signs of an oncoming failure. The framework clearly states that the FSOC has a duty to impose enhanced prudential standards when it determines that a company *could* pose a risk to financial stability if it fails. The FSOC does not need to predict either a specific probability of failure, nor does it need to predict a specific mechanism for that failure. Congress omitted any requirement or discussion of a cost-benefit analysis. The statutory considerations are designed to be flexible enough to adapt to risks and

changing business models that will emerge as the financial system changes.

To this statutory framework, we added additional procedural elements to increase transparency and opportunities for engagement with companies. Moreover, amendments to the guidance in 2015 clarified opportunities for significant two-way dialogue. The FSOC has also made clear that companies can bring proposals forward regarding their business model or activities to address potential risk concerns, and potentially delay or make designation unnecessary.

In practice, the process for designation took 1.5-2 years for each of the companies that was considered -- including review of thousands of pages of documentation provided by each company, dozens of meetings with the companies under review, and consultations with current regulators. Each company received a multi-hundred page confidential determination memo which they were able to review and challenge before a final decision was made. Upon request, each company was also granted a hearing before the Council.

A similar process, though with *fewer* procedural safeguards, was used eight times for financial market utilities and was not challenged nor the subject of controversy.

3. Designation Authority and the Ongoing Mission of the FSOC

The designation authority of the FSOC is an integral part of its overall mission because it recognizes that different challenges require different types of policy action and also that certain risks within individual corporate entities may cut across regulatory boundaries.

Much of the post-crisis regulatory framework outlined in the Dodd-Frank Act was focused on establishing standards for market-based activities. Risk retention requirements for securitizations were applied to the market as a whole; margin requirements for swaps were applied to the market as a whole. Where risks are diffused among a broad set of market participants and the risks can be effectively mitigated at that level, the post-crisis statutory framework set out directives and new statutory authority for activity-based regulation.

The FSOC's members have also demonstrated their ability to effectively review and address activity-based concerns within their mandate. For example, the FSOC worked with the SEC to publicly advocate and then implement money-market fund reforms. Activity-based rules, guidance, and supervision will often be the best choice to reduce risks in the system. In our experience this was true when we examined a number of asset-management activities and broader risks from cybersecurity.

But activity-based approaches cannot address risks that are tied to the funding, leverage, and combination of activities within a corporation. To illustrate, consider the example of Lehman Brothers heading into the crisis: the span and magnitude of Lehman's activities that played a key role in the crisis included its roles in the subprime mortgage backed securities markets, commercial real estate financing, credit derivatives, and issuance of commercial paper in money markets. As Lehman failed, the impact on money market funds was related to weaknesses in the liquidity standards and concentration limits governing those funds. Uncertainty about Lehman Brothers' failure was exacerbated by dubious transactions known as repo 105, which allowed the firm to hide tens of billions of dollars of leverage off its balance sheet. In fact, regulations addressing each of these activities have been pursued since the crisis but some of those rules, for instance SEC derivatives rules, have still not been completed a decade later and many of them required statutory changes to give regulators new authority.

Even with these activities-based rules, none of them would have affected Lehman's ability to reach 31x leverage ratios or to operate with dangerously thin levels of liquidity. Without designation authority, standards on capital and liquidity cannot be imposed on a nonbank financial company. The designation authority enables the tools of safety and soundness, and the nature of safety and soundness oversight is that it applies to the operations of a firm as a whole. Designation also contributes to market discipline. If a nonbank from a weakly regulated corner of the financial system becomes large and deeply interconnected with the rest of the financial system, and investors perceive that its failure would cause considerable harm to the American economy, they will inevitably place some odds on the firm being bailed out. This lowers the firm's funding cost, giving it an advantage over competitors, and allowing it to grow further. Designation can stop this kind of self-fulfilling prophecy.

As the statutory response to the crisis was developed, it was clear that we needed better and stronger tools to prevent a crisis. Congress created the FSOC with both designation authority and the authority to review and make recommendations regarding activities, with the flexibility and responsibility that each should be used when appropriate. Members of the FSOC must focus their expertise not only on how to identify risks, but also to choose what authorities to use to address that risk. Congress did not intend for one authority to be used as a prerequisite for the other. It is contrary to the statutory duties of the FSOC to needlessly limit the tools that Congress provided them in order to pursue its mission.

4. Potential Damage from the Steps outlined in the Proposed Guidance

The FSOC's proposed interpretive guidance would make four significant changes to the process for designating nonbank financial companies.

1. That designations will only take place after an "activities-based" review has run its course;
2. That designations will consider not just the potential impact of the failure but also the likelihood of that failure;
3. That designations will only happen if a cost-benefit analysis demonstrates that the costs of the regulatory burden to the firm are "justified by" the benefits in increased stability; and
4. That the revised process would allow firms to make managerial and business decisions in response to Council concerns in order to provide a "pre-designation off-ramps"

Appropriate enhancement of procedures and engagement with firms under consideration for designation is appealing, but following this revised approach would make designations an unworkably lengthy process in the best case. They would require the FSOC to base its decision on a falsely precise framework of cost-benefit analysis and the ability to estimate likelihood of failure. They would require the FSOC to engage in inappropriate interaction with the business strategy of firms and drastically increase the potential for designation decisions to become market moving events that provoke instability.

Based on our experience, we believe that following the steps outlined in the guidance would mean that the process would take 6 years or more: Pursuing any activities-based review would take at least two years to conduct, effectuate and review. Committing to give firms time to propose, change and implement business strategy decisions would take an additional two years. And the existing process, even without additional analytical requirements in the proposed guidance took two years to complete. Even supervisory or guidance-based regulatory action would take months to design and implement and could take years to evaluate. Writing of new regulations would take at least two years. We note that some agencies have still not completed statutorily required rulemakings under the Dodd-Frank Act, let alone discretionary rulemakings that are not specifically mandated. In addition, a commitment to giving firms an opportunity to propose business changes in response to FSOC concerns in advance of designation could extend the timeline indefinitely, as the FSOC would need to wait for those business actions to be planned, taken, and then analyzed in the context of the concerns. At a minimum, we would expect that a firm considering material business changes would take 6-12 months to plan those changes, discuss them with the Council, and then another 6-12 months to execute those plans.

A six-year process is unworkable given the realities of financial markets. To understand the potential impact of the proposed procedures on risk in the system, consider that AIG's derivatives group, known as AIG FP, quadrupled in size between 2002 and 2005. As the Lehman Brothers example illustrates, even a two-year period can result in enormous changes to an individual company's profile. Lehman's rapid increase in exposure to illiquid and risky real

estate assets grew significantly in 2006 and 2007. During this period, overall balance sheet assets grew nearly 70% to $691 billion from $410 billion, while gross leverage ballooned to 31x from 24x. This increased exposure altered the footprint and transmission mechanisms of the firm on the eve of the crisis, increasing the investment bank's susceptibility to distress in the real estate market.

Our second concern pertains to the requirement to consider the likelihood of failure in the context of a designation decision. It's helpful to consider an analogy to nuclear power plants. We certainly don't impose stringent safety guidelines only on those plants that appear to be on the verge of a meltdown – it doesn't do much good at that point. Such an event would be catastrophic, so we impose stringent safety guidelines on healthy operations to prevent such a facility from experiencing distress and to ensure that if distress occurs it is manageable. As with nuclear power plants, if we wait until failure is reasonably likely at a firm, it's too late to do much about it. For this reason, the Dodd-Frank Act clearly requires that we assume the material financial distress of a firm and determine whether a firm in the midst of such distress could pose a threat to financial stability.

In addition, there are a host of practical challenges in assessing the likelihood of a firm's distress: the distress or failure of large firms occurs so rarely that estimates of their likelihood will inherently be imprecise. Moreover, as the previous discussion shows, experience proves that markets and regulators often fail to foresee the vulnerabilities of individual firms until fairly late. The market-implied probabilities of default of AIG, Fannie, and Freddie were extremely low even into 2007, when the crisis was already unfolding. For designation to strengthen the financial system, it should be deployed sufficiently early so that companies have time to accrete capital naturally and to develop resolution plans – something that can take several years.

Our third concern with these proposed changes is the false precision implied by the cost-benefit analysis standard. The framework of designation is preventive. The costs imposed by the potential failure of a nonbank to the financial system depends on the overall state of the economy and financial system at the time. There is no realistic way to predict probability of a specific firm's role in a specific financial crisis, especially in a context where financial crises are once-in-a-generation events. The proposed guidance's emphasis on comparing an analysis of an individual firm's economics to overall benefits to the system is inappropriate. Moreover, the cost to the firm of designation will depend critically on the changes to the firm's activities, capital structure and so on required by the particular supervisory and regulatory regime put in place upon designation. In each case of designation to date, the Federal Reserve did not have a complete supervisory and regulatory program ready for the firm at the time of designation. Moreover, the Federal Reserve is statutorily required to tailor those standards to the operations and risks of the designated firm.

Our fourth concern with the proposed guidance is that it suggests the need for inappropriate interaction between regulators, firms and business strategy. A general principle of financial regulation is that regulators should set standards for activities and companies, but that management teams, employees and shareholders should make choices about business strategy within the context of those standards. The FSOC's responsibility is to evaluate a company based on its activities and risk profile and to determine whether a company meets the statutory standard and, if so, to require supervision. However, we note that in most scenarios, the FSOC and the company will have differing views of the risks, and the off-ramp conversations proposed in guidance would likely be contentious – increasing litigation risk in an environment where there is no statutory basis and no clear legal framework.

Finally, a requirement to assess that a firm's distress is sufficiently likely would make designation a signal of serious concerns about a firm's financial health. Investors and counterparties will assume that regulators have more and better information and have concluded that there are serious concerns regarding the likelihood of a particular firm's failure. That pattern would be self-defeating on its own terms: being required to assess the likelihood of failure as a key component of the designation would mean that it would be very difficult to designate a healthy firm; but designating a firm that is already weak would mean it would be too late for designation to help. In fact, when firms were designated, they had explicit conversations with FSOC staff members expressing their concerns about market reactions, and in which they asked that the designation letter state clearly that the Council was not making a judgment about the firm's health. As a result, each designation letter explicitly included a prominent statement that "The Council's final determination does not constitute a conclusion that [the designated firm] is experiencing material financial distress."

5. **Lessons from Experience**

All financial crises are characterized by uncertainty -- uncertainty about the catalysts of crisis, the vulnerability of the system to crisis, the probability of failure of individual firms, the dynamics of contagion, and the potential costs of failure. The judgement reached by Congress in the aftermath of the crisis was to create a stronger set of safeguards against crisis, that could adapt over time to the shifting nature and locus of risk in a dynamic, innovative financial system. Regulation of course carries burdens for individual firms, but these consequences have to be measured against the tragic and indiscriminate costs of a crisis. Financial regulation has to be designed to require firms to internalize the potential for some of the broader economic costs of failure.

This crisis caused severe and lasting damage to hundreds of millions of people and tens of thousands of businesses. Much of this damage could have been prevented if we had in place a

stronger set of safeguards across the financial system. The safeguards that exist today are stronger, but the they still only apply to part of the financial system. And the protections they afford will erode over time, as risk migrates and innovation advances. For any system of regulatory protections to be effective, it's reach has to extend to where there is risk to the stability of the entire financial system, and it has to be able to evolve with the market. There is no credible way to anticipate the catalyst or the dynamics of crisis, to be able to determine what types of failure might precipitate panic, or to know in advance the magnitude of damage that might be associated with distress. In the severe crisis, it may not be possible for banks subject to prudential supervision to withstand the effects of failure of companies that are not. Nor is it likely that stronger firms will be able to expand lending capacity to compensate for the loss of capacity created by the failure of large nonbank financial institutions. Regulation creates the opportunity and the incentives for arbitrage and avoidance, and as a result the perimeter of those safeguards needs to be able to evolve over time. If not, the power of the safeguards will be weakened, and the overall financial system will be more fragile and vulnerable to crisis.

Designation authority is an important part of the necessary defenses against future crisis. We hope the FSOC will preserve that authority, consistent with the objective established by Congress.

Sincerely,

Timothy F. Geithner
Former Secretary of the Treasury

Jacob J. Lew
Former Secretary of the Treasury

Ben S. Bernanke
Former Chair of the Board of Governors
of the Federal Reserve System

Janet L. Yellen
Former Chair of the Board of Governors
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