

Designating Systemically Important Financial Institutions: Balancing Costs and Benefits

Testimony before the House Financial Services Subcommittee

on Financial Institutions and Consumer Credit

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Thank you for the opportunity to testify again today, this time on systemically important non-bank financial institutions. I should note that while I am a Fellow at the Brookings Institution, my testimony today is solely on my own behalf. Brookings does not normally take policy positions as an institution.

In Dodd-Frank, Congress wisely gave regulators a wider mandate to oversee systemically important financial institutions (SIFIs). These institutions are the ones most capable of triggering financial crises through mistakes or bad luck, due to their importance as financial intermediaries and their interconnections with the rest of the financial system. As such, they merit more attention from regulators, more tools should be available for regulatory intervention, and they should be held to a somewhat higher standard of financial conservatism.

The need for closer supervision is not erased by the steps that have been taken to reduce the potential for government bailouts of failing institutions. First, because it is impossible to totally eliminate the potential for a financial crisis to be severe enough to merit further taxpayer-financed rescues. Second, because even if this goal were achieved, so that creditors and shareholders picked up all the losses with no help from taxpayers, a serious financial crisis would still lead to a severe contraction of credit, sending the economy into a deep recession, such as we just experienced. You will recall that the recent recession cost taxpayers far more than did the bailouts.

Banks are among the most likely institutions to be systemically significant, but other types of financial institutions can certainly be SIFIs and it is good that Dodd-Frank recognized this. Prior to this legislation, it was very difficult for the regulators to track the systemic risk of non-bank financial institutions, much less affect the level of that risk.

Robert Litan and I wrote an extensive paper on non-bank SIFIs, to which I refer the members for a fuller explanation of my views.

(http://www.brookings.edu/papers/2011/0116_regulating_sifis_elliott_litan.aspx). Today's testimony will focus on a few key beliefs about how to identify and regulate non-bank SIFIs and some thoughts on the proposed regulations.

First, no part of the financial industry should receive an automatic exclusion from SIFI designation. There is too much danger of a firm taking advantage of its legal form to acquire the importance of a SIFI without the appropriate oversight. Regulatory arbitrage is a fact of life against which we must guard.

Second, there are no absolutes in determining systemic importance. There are multiple ways of measuring the level of significance and no clear consensus on the exact methods, which is why the proposed rules allow for considerable judgment. Even within a single measurement approach, there are

degrees of systemic importance, with no bright line where an institution flips from unimportant to important. In essence, the entire SIFI concept, like much of regulation, is about costs and benefits. The benefits of the improved information, more careful supervision, and higher capital and other safety margins must outweigh the costs of imposing the extra regulation.

Third, as a result, we must strive for the right balance between the dangers of over-designation and under-designation. Clearly, as many as possible of the true SIFIs should be captured in the formal designation process, since oversight of the financial system as a whole will be stronger with the right information and with the regulatory tools to ensure safe operations of the key institutions. However, there are also costs to naming a firm as a SIFI when it does not really merit that designation. The additional level of regulation, and the higher required safety margins, will make credit and other financial products more expensive, which is only worthwhile if there is an increase in systemic safety that more than offsets the costs.

The subcommittee's invitation letter asked specifically about one part of this trade-off, which is whether there will be a market advantage for those firms that are designated as SIFIs. Some have raised the possibility that a firm which is named as a SIFI will have an implicit government guarantee, or at least seal of approval, which will give them a competitive advantage on their funding costs and their ability to sell products. I do not believe this to be a significant issue. Those firms likely to be designated as SIFIs are already viewed by the markets as being safer because of their larger size and importance. This perception sometimes includes a residual belief in the possibility of a government rescue, despite the steps Congress and the regulators have taken to counter this belief. My experience in the financial markets, where I was an investment banker for almost twenty years, convinces me that the marginal effect of a formal designation would be small. Regardless of my own views, both the managements and investors of firms potentially designated as SIFIs are sending very strong signals that they see such a designation as a negative. I can assure you that a number of those firms are working very hard to avoid designation, as you have doubtless noticed yourselves. It seems very unlikely that this would be the case were there a significant financial advantage to the designation.

Fourth, the additional oversight applied to non-bank SIFIs must be appropriate to the systemic risk they represent and be coordinated as effectively as possible with their existing regulation. Ideally, the regulatory framework for non-bank SIFIs would be designed in parallel with the designation process, to facilitate the cost/benefit analysis inherent in choosing whether to subject a firm to the rigors of designation. Unfortunately, the deadlines in Dodd-Frank push the regulators towards designating the SIFIs prior to deciding exactly how to regulate them. This creates uncertainty as to whether the regulation in practice will inadvertently harm desirable activities by those firms.

Fifth, similar activities should be regulated in similar ways with similar safety margins, to the extent possible, regardless of the legal form of the institution doing the activity. Otherwise, it will be easy to fall prone to regulatory arbitrage as well as the inefficiencies that are produced by arbitrary differences in competitive advantage.

Evaluating the proposed rules in light of these key points, the regulators appear to be generally on the right track, although there is a great deal that cannot be judged yet. The rules focus on the right set of sources of systemic risk and they recognize the need to carefully consider the specific facts and to apply considered judgment to questions that are inherently somewhat subjective. It makes sense that the regulators are casting a wide net in the initial phase, to determine which institutions they will need more information about. As I have stressed, there are no straightforward quantitative methods to find the answers here, so there is a need to gather information on a wide range of candidates for designation, in order to assess each in a deeper way. I am sure that everyone would prefer that there existed a straightforward numerical test that could be used for the final determination, but the situation is much too complex to avoid the application of substantial amounts of human judgment.

The regulators have also said the appropriate things about recognizing the diversity of business models in different parts of the financial system, although there remains cause for concern as to whether this will be reflected fully in actual practice. For example, the stress tests applied to banking groups appear, at least from what I can glean from news reports, not to have taken sufficient account of the differences between MetLife's insurance operations and the banking businesses that were the core of all the other groups subject to the full test. Hopefully, this was a byproduct of the specific circumstances and not an indicator of the broader approach regulators will take.

In my view, there are currently no true SIFIs in most of the financial sectors, including: private equity, venture capital, hedge funds, property-casualty insurance, and mutual funds management, with the possible exception of money market funds. This is not a matter of principle, but rather due to the fact that these are sectors which tend to generate quite low systemic risk per dollar of assets and none of them have enough assets for their absolute risk to come close to systemically important levels. It is possible that one or more of these sectors could develop SIFIs over time, particularly in the hedge fund sector where there is a wide range of business models. Therefore, as noted earlier, a blanket exception by class of institution is inappropriate.

It is possible that SIFIs might exist among money market funds, since they can be of large size and their activities are somewhat analogous to deposit-taking, potentially giving them a great economic importance in a crisis. I have not studied money market funds sufficiently to reach a conclusion as to whether there is presently a SIFI among them. Regardless of the status of individual funds or funds managers, though, money market funds in aggregate clearly have systemic significance and it is good that their structure and regulation is being carefully considered through other processes at the moment.

I do believe that there are probably several SIFIs among the largest life insurers. These firms, like banks, are financial intermediaries that take funds from the public and operate with quite substantial leverage compared to a non-financial firm, and therefore are prone to some of the same risks as banks. At the same time, their business models tend to generate less systemic risk, particularly because they have much longer liabilities than banks do, giving them considerably more time to react to problems without being forced into a fire sale of assets. Thus, life insurers do generate systemic risk, but substantially less risk per dollar of assets than is true for banks. Some insurers are so large, however, that their size more

than makes up for their low risk generation per dollar of assets. As a separate matter, political and bureaucratic pressures are quite likely to result in SIFI designation in order to underline that the FSOC has taken its responsibility seriously to designate non-bank SIFIs.

It is very important, however, that any life insurers designated as SIFIs should be regulated in a manner consistent with the major differences between insurance and banking. The regulators appear sincere in wanting to do this, but it remains a question as to whether ingrained ways of viewing the world may make it difficult to make the full transition in viewpoint in time for the initial SIFI regulations for non-banks. It may become a cumbersome iterative process of starting with regulations that are far from a perfect fit and working out improvements over time, which would be a shame.

The finance company business model is one that can generate even more systemic risk per dollar of assets than banking does. There is a similar maturity mismatch between short-term borrowings and medium- to longer-term loans, but the wholesale nature of the finance company's funding model makes them even more vulnerable to runs than banks are. In fact, this vulnerability largely eliminated the big finance companies in the crisis or forced them to adopt a banking-type business model that brings them into effective SIFI status already. There is one well-known exception among the large finance companies which I strongly assume will be designated as a non-bank SIFI.

In sum, designating non-bank SIFIs is by its nature a complex endeavor that requires a careful balancing act and substantial human judgment. The rules proposed by the regulators generally reflect those considerations and I believe that the resulting uncertainty about the ultimate outcomes is unavoidable, unless we either abandon the effort to designate such SIFIs or use cruder measurements that would almost certainly produce worse results. I am more concerned about whether those non-banks that are designated as SIFIs will be regulated in a way that fully reflects their differences with banks, but I am hopeful that this can eventually be worked out.

Thank you again for the opportunity to testify today. I look forward to your questions.