United States Senate
WASHINGTON, DC 20510

July 27, 2023

Hon. Janet Yellen
Chairperson
Financial Stability Oversight Council
1500 Pennsylvania Avenue NW
Washington, DC 20220

Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies; Analytic Framework for Financial Stability Risk Identification, Assessment, and Response (RIN 4030-[XXXX]).

Dear Secretary Yellen:

We write in support of the Financial Stability Oversight Council's (FSOC) proposed updates to its analytic framework and interpretive guidance on designating nonbank financial companies for supervision and regulation by the Federal Reserve (the Proposal). The Proposal will help regulators proactively curb risks at loosely regulated "shadow banks" whose failures could threaten the economy and leave taxpayers on the hook.

I. Vulnerabilities in the financial system from the lack of regulation and transparency at shadow banks have grown following the 2008 financial crisis.

Shadow banks provide similar services as banks, but do so without the oversight and regulation that limit banks' risks to our economy. In 2008, the catastrophic failures of large shadow banks like Lehman Brothers, Bear Stearns, and AIG crashed the economy and required taxpayers to step in with extraordinary assistance. The lack of regulatory tools for shadow banks made it difficult for the government to effectively limit the risks behind the crisis. Congress bolstered regulators' toolkit by creating the FSOC in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) and giving it a simple mission: to determine which shadow banks were large and risky enough to threaten U.S. financial stability and warrant prudential regulation and consolidated supervision by the Federal Reserve.

Unfortunately, not a single shadow bank is currently subject to regulation and supervision through the tools the Dodd-Frank Act created. While the shadow banking sector has grown to rival the traditional banking system, it remains opaque and unregulated. According to the Financial Stability Board, the financial assets of the shadow banking sector accounted for nearly 50% of the global financial system in 2021, up from around 42% in 2008. Yet no single regulator oversees all of the activities at the largest shadow banks to ensure that each institution manages risk across its entire operation.

This is true even as today's shadow banks, especially large asset managers, have pushed into new frontiers following the 2008 financial crisis. They have strayed far from their private equity roots and now combine hedge funds, direct lending, private credit, and insurance under one roof. They own companies and drive consolidation in a wide range of businesses, including single-family housing to dental practices to car washes to nursing homes. In combination, all of these activities create new risks that may threaten financial stability if left unaddressed.

II. The Proposal would address these alarming vulnerabilities by giving regulators the tools to subject the largest and riskiest shadow banks to prudential regulation and consolidated supervision.

The Dodd-Frank Act created the FSOC to plug the gap in regulation over these shadow banking institutions, protecting the real economy and American households and businesses from significant risks lurking in opaque corners of our financial system. As Ben Bernanke, the former Chairman of the Federal Reserve, testified in 2010, "statutory gaps have been addressed by the [Dodd-Frank Act]. . . . Under the new legislation, all systemically critical financial institutions, *including those that are not bank holding companies*, will be subject to consolidated supervision" (emphasis added).[1]

But the tools in the Dodd-Frank Act have not been used to curb the risks from today's shadow banks. In part, that is because your predecessor dismantled the FSOC's authority to designate shadow banks for regulation and supervision by the Federal Reserve. Through guidance issued in 2019 (the 2019 Interpretive Guidance), then-Secretary Mnuchin created a tangled web of procedural requirements that protected shadow banks by impeding the FSOC's ability to leverage its designations authority. For instance, before designating a shadow bank for regulation and supervision, the FSOC must first calculate a shadow bank's likelihood of failure and conduct an extensive cost-benefit analysis. Tied in this red tape, FSOC has essentially lost its authority to impose guardrails on shadow banks, putting our economy at risk.

The Proposal would fix this problem by empowering the FSOC to use nonbank designations as a forward-looking tool that allows regulators to detect and address risks before they spiral out of control. That's important to protect the economy and taxpayers from risks that would otherwise fall through gaps in existing functional regulation. For example, a shadow bank's insurance activities may be regulated by a state agency while its brokerage activities may be regulated by the federal Securities and Exchange Commission (SEC). But neither regulator has a mandate to evaluate the effects of a firm's failure on the financial system as a whole. The Proposal positions the FSOC to proactively designate the entire enterprise for oversight, when appropriate, while maintaining a strong, cooperative relationship with the functional regulators, like the states and the SEC.

And by bolstering the FSOC's designations authority, the Proposal also helps the Council address cross-cutting risks across financial firms. We have seen time and time again how trouble in one part of a financial company can spread rapidly. Because shadow banks often operate and

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[1] Statement by Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, before the Financial Crisis Inquiry Commission, September 2, 2010.

manage their businesses on an integrated basis, neither a siloed regulatory approach nor an approach that focuses on broad activities is sufficient. Risks, particularly funding and liquidity risks, cross legal entities and business lines. If unaddressed, these risks can spread to other financial intermediaries like fintech companies that rely on larger nonbanks for funding. Consolidated supervision and regulation by the Federal Reserve will crack down on common regulatory arbitrage strategies by closing avenues to shift activities to unregulated or offshore subsidiaries and affiliates.

III. Cost-benefit analysis of shadow bank designations is contrary to the Dodd-Frank Act and fails to adequately capture the benefits of financial stability to the economy.

The Proposal wisely eliminates the requirement in the 2019 Interpretive Guidance that the Council conduct a cost-benefit analysis of a proposed nonbank designation. As noted earlier, this obligation is at odds with the text of the Dodd-Frank Act. This law established an extensive legislative framework for designations, including eleven statutory factors for the FSOC to consider in making a designation determination. All of these factors pertain to a firm's risk profile, while none pertains to the costs and benefits of designation. The omission of a cost-benefit factor from the statute is deliberate. The statutory text reflects Congress's judgment that whenever a firm is large and risky enough to "pose a threat to the financial stability of the United States,"[2] additional supervision will be beneficial. The Dodd-Frank Act tasks the Council with gauging risk, not with quantifying the specific benefit of further supervision.

Moreover, the practical effect of requiring cost-benefit analysis is to stack the deck in favor of the financial industry and against financial stability. The costs of additional regulation are immediate and concrete, making them easy for firms to quantify. But the benefits of avoiding a company's failure are necessarily hypothetical, even if potentially enormous. The imposition of a cost-benefit analysis requirement makes it difficult for the FSOC to exercise its statutory authority over risky shadow banks, even while it is difficult—if not impossible—to conduct a meaningful cost-benefit assessment in the first place.

IV. Congress did not require the FSOC to assess the likelihood of a shadow bank's failure prior to placing a shadow bank under regulation and supervision.

The FSOC must be empowered to act before risks build up and threaten the financial system. That is precisely why the Dodd-Frank Act requires the FSOC to designate a nonbank financial company if it determines that "material financial distress . . . could pose a threat to the financial stability of the United States."[3] But the 2019 Interpretive Guidance departed from Congressional intent by requiring the FSOC to assess the likelihood that a firm would experience financial distress before subjecting it to supervision and regulation.

Congress required that the FSOC presuppose financial distress and then evaluate what consequences would follow—an approach shaped by the spectacularly quick, unforeseen failures that occurred during the 2008 financial crisis. In the years immediately before AIG, Bear Stearns, Countrywide, Lehman Brothers, and other large and interconnected nonbank financial

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act § 113(a)(1), 12 U.S.C. § 5323(a)(1) (2010).
[3] *Id.*

companies collapsed, few analysts or models forecasted these failures. Then-Federal Reserve Chair Bernanke testified before Congress in 2007 that the brewing crisis in the housing market "seem[ed] likely to be contained."[4] In other words, prominent regulators failed to recognize flaws in the financial system that led to economic disaster.

The lesson of the financial crisis is that firms that appear healthy can quickly come to the brink of failure. By eliminating an assessment of a firm's likelihood of failure, the Proposal would help to bring systemically risky nonbanks into the regulatory perimeter, where risks can be managed before they become likely to blow up the financial system.

Publicly evaluating the likelihood of distress could undermine financial stability. Under the current guidance, a designation means the government has concluded that a company is financially risky. That may spread panic among customers and counterparties, leading to reassessments of an entity's risk profile that results in rapid withdrawals of funding or liquidity, similar to what occurred with Silicon Valley Bank. Regulating potential risks without regard to their likelihood avoids this outcome.

V. The FSOC should expressly consider risks to the credit needs of underserved communities in its identification and assessment of potential risks to financial stability.

We encourage the FSOC to expressly consider risks to the credit needs of underserved families when identifying and assessing potential financial stability risks under the analytic framework. In reviewing financial stability risks, Congress required the FSOC to consider a shadow bank's role "as a source of credit for low-income, minority, or underserved communities," as well as how its failure would affect credit availability in those communities.[5]

Risks to underserved communities can constitute risks to financial stability. In fact, the effects of the two most recent economic crises were most acutely felt by ordinary homeowners who suffered foreclosures and Main Street companies whose customers evaporated. It is not enough for the financial system to work for the benefit of Wall Street institutions and intermediaries; it must also be resilient enough to support families and small businesses. We urge the FSOC to state that it will give threats to the credit needs of marginalized communities significant weight in evaluating and curbing threats to financial stability, consistent with the statutory factors in the Dodd-Frank Act.

VI. Conclusion

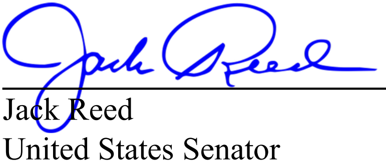
The authority to bring nonbanks into the regulatory perimeter is the most important, yet least used tool in the Dodd-Frank Act. We fully support the FSOC's proposal to reinvigorate it. Doing so will turn the page on the Trump Administration's deregulatory approach, which shielded the Nation's largest financial institutions from tougher rules and greater transparency. It

[4] The Economic Outlook, Hearing Before the Joint Econ. Comm., 110 Cong. 111 (2007) (Statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.).
[5] Dodd-Frank Wall Street Reform and Consumer Protection Act § 113(a)(2)(E), 12 U.S.C. § 5323(a)(2)(E) (2010).

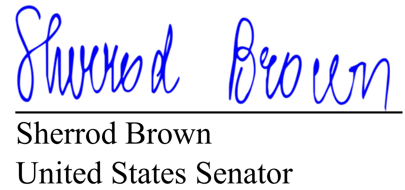
is far past time for the FSOC to use the authorities that Congress provided to keep pace with new and emerging financial stability risks coming from shadow banks.

Thank you for your consideration of these comments.

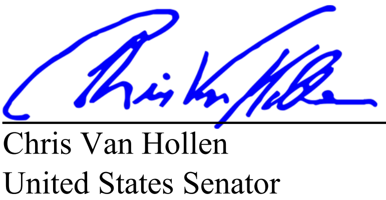
Sincerely,



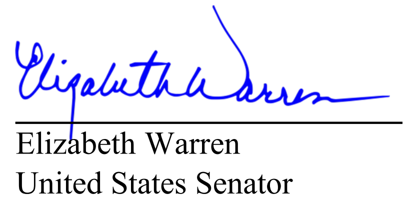
Jack Reed
United States Senator



Sherrod Brown
United States Senator



Chris Van Hollen
United States Senator



Elizabeth Warren
United States Senator