The Systemic Risk Council

Secretary Steven T. Mnuchin
US Department of Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

SUBMITTED VIA COURIER

February 23, 2018

Re: A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS (October 2017); ASSET MANAGEMENT AND INSURANCE (October 2017)

Dear Secretary Mnuchin

This letter sets out the Systemic Risk Council's response to the US Treasury's October 2017 Report on the regulatory regime for capital markets and its subsequent October 2017 report on the regulation of asset management and insurance (collectively, the UST Reports).[1]

In a nutshell, we welcome the Reports but we are concerned that they do not address significant gaps in the current arrangements for maintaining a stable financial system. With three of the planned four reports required pursuant to Executive Order 13772 now completed, there is a risk that stability issues will be neglected in any reforms pursued via Congress or the regulatory agencies.

After welcoming some specific UST recommendations relevant to stability, we set out an approach to thinking about stability beyond the core banking system that we recommend to the Treasury and other US policymakers. This includes identifying markets on whose resilience the economy relies, and giving all relevant US agencies a statutory mandate to preserve a stable financial system.

[1] US Department of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets* (Oct. 2017); US Department of the Treasury, *A Financial System That Creates Economic Opportunities: Asset Management and Insurance* (Oct. 2017).

Welcome parts of the UST Reports

Most of the substance of the two UST Reports is concerned with how to trade-off objectives like capital formation, market efficiency, and investor protection. Views on those trade-offs inevitably vary, and it is no surprise that a new administration should want to strike a different balance. Among those UST recommendations that are broadly relevant to the stability of the financial system, the Systemic Risk Council (SRC) welcomes the following:

Report on Capital Markets:

- The general principle of reducing complexity in the regulatory regime;
- The parallel principle that US regulators should distinguish between securities and derivatives only on the basis of economic substance, including functions delivered, not legal form;
- The exhortation to market regulators that they step back from claiming extra-territorial jurisdiction, not least since that invites tit-for-tat responses from foreign authorities which would fragment the international marketplace and impede international cooperation necessary to maintain stability;
- The recommendation to the Federal Reserve Board that it seriously consider granting reserve (or other deposit) accounts to systemically significant providers of financial infrastructure (notably, clearing houses);
- The recommendation that US regulators participate actively (and, we would add, openly) in international crisis-management groups for central counterparties; and
- The recommendation that US regulators urge the international standard setters to engage actively with stakeholders, although we would add that this must go beyond the industry and its lobbyists to include members of the public and small and medium-sized businesses.

Report on Asset Management and Insurance:

- The recommendation that US regulators participate in international standard-setting and policy-making bodies;
- The emphasis on cyber risk; and
- The recommendation that the Securities and Exchange Commission (SEC) introduce a regime for vanilla Exchange-Traded Funds (which we take to mean unlevered ETFs invested in cash-market instruments that are not opaque, complex or illiquid).

The need for a resilient financial system goes beyond banks

Those details aside, the SRC has a major concern about these two UST Reports. They neglect the vital importance of financial stability to the Administration's goals: a resilient financial system is a precondition for achieving the Administration's seven principles for regulating the US financial system.[2] Choice, efficiency and economic growth are hard to maintain if an economy cannot rely on the availability of core financial services through thick and thin.

Rebuilding and maintaining a resilient financial system has been the central objective of the reform program since the collapse in late 2008. In short, this means a system that is able to maintain the provision of core financial services in the face of big shocks and disturbances.

For policymakers, that is a more useful way of thinking about 'stability' than whether booms and market crashes can be avoided. That is partly because, with the best will in the world, while they can play a useful role in informing the scenarios subjected to stress testing (see below), early-warning systems are unlikely to be sufficiently robust given the range of forces that can knock the economy off course or bring down key intermediaries. But, more positively, this approach directs attention to the need to determine how resilient different parts of the financial system should be. To date, that debate has revolved largely around banks and, to a lesser extent, a few non-bank intermediaries and infrastructure-providers, such as central counterparty clearing houses (CCPs), to the relative exclusion of markets and activities. This risks leaving the system as a whole more vulnerable than elected policymakers intend or the public should realistically expect (as occurred in the run up to 2007/08 when derivative counterparty exposures were largely ignored). And it risks unelected policymakers seeing their task in terms of macro-credit cycles rather than as embracing the need to ensure that core services could withstand a wide range of shocks, including cyber-attacks.

Market resilience is a gap in the international reform program

This gap is by no means confined to the US. As things have turned out, it has ended up being a feature of the international reform program. In a statement to G20 finance ministers and governors issued around a year ago, the SRC summarised the core of that program in the following terms:[3]

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[2] Executive Order 13772.

[3] The Systemic Risk Council, Statement to the Finance Ministers, Governors, Chief Financial Regulators, and Legislative Committee Leaders of the G20 Countries (Feb. 27, 2017), *available at* http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2017/02/Systemic-Risk-Council-Policy-Statement-to-G20-Leaders.pdf.

The five pillars of the reform program have been:

1) mandating much higher common tangible equity in banking groups to reduce the probability of failure, with individual firms required to carry more equity capital, the greater the social and economic consequences of their failure;
2) requiring banking-type intermediaries to reduce materially their exposure to liquidity risk;
3) empowering regulators to adopt a system-wide view through which they can ensure the resilience of all intermediaries and market activities, whatever their formal type, that are materially relevant to the resilience of the system as a whole;
4) simplifying the network of exposures among intermediaries by mandating that, wherever possible, derivatives transactions be centrally cleared by central counterparties that are required to be extraordinarily resilient; and
5) establishing enhanced regimes for resolving financial intermediaries of any kind, size, or nationality so that, even in the midst of a crisis, essential services can be maintained to households and businesses without taxpayer solvency support—a system of bailing-in bondholders rather than of fiscal bailouts."

While pillars 2-4 look beyond the world of *de jure* banks, relatively little has been done in practice to produce a general policy framework; various market-specific measures have been introduced but, absent a broader framework, risk creating incentives for stability-threatening, resilience-eroding activity to migrate elsewhere.

To begin with, material progress is not yet manifest in three areas of incomplete work highlighted by the SRC in our Statement a year ago:

- putting in place effective resolution regimes and plans for clearinghouses given their mandated role puts them at the center of capital markets;
- a substantive regime for those "shadow banking" activities and intermediaries that represent a material risk to stability; and
- the role of government-guaranteed agencies and intermediaries in creating risks to stability via distortions in credit markets.

Beyond those particular gaps, however, lies a more general problem in framing policy for resilience in markets and among non-banking intermediaries. The broad thrust of the latest UST Reports is that the focus should be on 'activities' rather than on 'institutions' (see below), but how to do that is left unclear.[4]

[4] Capital Markets Report, passim; Asset Management and Insure Report at 7.

Shadow banking versus 'market-based finance'

That finds expression in, for example, the UST's strong preference for the term 'market-based finance', arguing that 'shadow banking' has developed a pejorative connotation that impedes balanced analysis.[5] Be that as it may, the label 'market finance' is no less a rhetorical device, but one intended to convey something positive irrespective of substance. To give only one example from the many vulnerabilities that contributed to the 2007 phase of the Great Financial Crisis, Structured Investment Vehicles (SIVs) were plainly manifestations of market finance since they funded themselves in the capital markets and invested their resources via the markets.

Part of the problem is that there are no neat lines between *de jure* banks and other forms of intermediation. Anyone with a high-quality bond portfolio can, in effect, construct ("roll their own") banking business by using the repo or securities-lending markets to loan out their bonds against cash at call and investing the proceeds in a portfolio of illiquid, opaque credit instruments such as loans or low quality bonds. The fragility of the consequent structure was on display during AIG's problems in late-2008.[6]

For essentially the same reasons, the SRC disagrees with the UST that the SEC should abandon its plans to introduce quantitative constraints on funds' liquidity risks.[7] The principles-based approach advocated by the UST Report would risk amounting to nothing much, as is evident from the approach to banking entity liquidity in the years before the crisis. Introducing minimum requirements does not preclude their being sensitive to the opacity and illiquidity of funds' portfolios.

But the problem is not limited to specific non-banks becoming bank-like in their functions and significance. The SRC wants to suggest that the US authorities should be bothered about the resilience of markets themselves.

Systemically significant markets

In framing any such policy, it is important to distinguish: (i) between markets that serve end users and those on which intermediaries themselves depend; and (ii) between social costs that build over time and those that are severe and occur immediately when a market breaks down.

For example, while the social costs of an equity market being closed for a single day would not compare with the social costs of the payments system breaking, they would

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[5] Asset Management and Insure Report at 63.
[6] Federal Reserve Bank of New York, *Shadow Banking*, Staff Report No. 458 (July 2010, *Revised February 2012*).
[7] Asset Management and Insurance Report at 34.

obviously mount the longer the market was closed. At the other end of the spectrum, the banking system could barely function without the continuous availability of the short-term wholesale interbank money markets which allow individual banks to balance their books with each other and so enable competition in banking services. The policy response to the latter kind of problem has become familiar over the past two centuries: the availability of lender-of-last-resort assistance from the central bank to sound banking institutions. The policy response to fractured or frozen capital markets is still less well established.

For capital markets important to end users (businesses and households), the costs of closure depend in part on the availability of ready substitutes, including resorting to banks. The fewer the substitutes --- and thus, among other things, the more constrained banks are --- the more important it is that capital markets stay open. This is a matter of both *ex ante* design and *ex post* mitigants.

In summary, the aim should be to identify what might be termed 'systemically significant markets' that need to be especially resilient, and to pin down the particular vulnerabilities in any such markets that need to be addressed. Such vulnerabilities might lie in market structure, its physical or legal infrastructure, the underlying instruments, or the institutions acting as intermediaries.

Designating systemic institutions: the importance of resolution policy

Consistent with that, as noted above, the UST favours a focus on 'activities' rather than on 'institutions'. The SRC agrees that that is where policy analysis should begin, but not that it must *always* end there. Policy should depend on the facts rather than on a doctrinal commitment that no non-bank intermediary can ever be 'systemic'. Most obviously, if an activity were regarded as 'systemically significant' but the activity in question was dominated by one intermediary with high barriers to entry, it would be hard not to conclude that that intermediary was 'systemically significant'.[8] If reducing the barriers to entry would take time or could be achieved only at the cost of frequent failures among vulnerable firms, regulators would surely need to ensure the resilience of the dominating intermediary. The same goes for a market dominated by a handful of intermediaries where the withdrawal of any one of them would directly or indirectly entail large costs for users or for the wider economy.

For that reason, the SRC recommends that the Dodd Frank provision enabling supervisors to stress-test investment vehicles should not be repealed. It might be needed.

[8] In this context, we regard investment and insurance vehicles, funds etc as intermediaries, but not pure management companies that do not participate in financial markets as principals.

So far as intermediaries are concerned, the relevant test here is the social costs of distress or failure. Practically, this amounts to asking (a) whether there are ready substitutes and if not, (b) whether the institution could be resolved in an orderly way without fiscal support to its solvency. That test should be applied by the relevant authorities to insurance companies, reinsurance companies, asset management vehicles, and so on. We did not see that recognised in the UST Reports. Given that, with the best will in the world, systemically significant intermediaries will not always be identified in advance, meaning US policymakers should ensure that there are effective resolution regimes for all types of intermediation. Already late in ensuring that CCPs are resolvable, US policymakers need to go further in ensuring resolvability policy extends to wherever it is needed across the system.

As already signalled, however, the SRC completely agrees with the UST that the absence of individual intermediaries that are systemically significant does not imply that the activities and markets in question are not systemically significant. Activities can be systemic even when individual institutions are not.

That being so, the SRC draws a number of implications from the UST Reports' discussion of the regulation of capital markets, including on: the statutory objectives of the SEC and the Commodity Futures Trading Commission (CFTC), securitization markets, margin requirements for uncleared derivatives, infrastructure-providers' access to the Fed, and market maker of last resort.

<u>The SEC and the CFTC should each have a statutory objective to ensure the resilience of the financial system</u>

The two US market regulators, the SEC and the CTFC, are absolutely vital to maintaining a resilient US (and international) financial system. The SEC is responsible for regulating and supervizing dealers in securities, central counterparties that clear securities and repos, asset management vehicles, and disclosure requirements for securities of all kinds, including asset-backed securities. The CFTC is responsible for regulating and supervizing swap execution facilities, derivatives-clearing organizations, designated contract markets, swap data repositories, swap dealers, futures commission merchants, commodity pool operations, and more. Between them, therefore, they cover many of the markets and structures through which shocks to the system are propagated, and are the first line of defence in distinguishing healthy 'market-based finance' from unhealthy forms of 'shadow banking'. Neither has an overt statutory objective for the stability of the financial system.[9]

[9] In the case of the SEC, stability can be inferred as a statutory purpose from the SEC's key governing legislation. The preamble to the 1934 Act motivates the need for the agency very broadly, including the risk of sudden and unreasonable fluctuations in the prices of securities causing alternately unreasonable expansion and unreasonable contraction of the volume of credit supplied to the economy. That captures a

Correcting that should be a priority in any legislative reforms. At the very least, it is hard to see how the Financial Stability Oversight Council can be a long-term success when the agencies (as opposed to the individuals) around its table do not all have an unambiguous mandate from Congress to prioritise the resilience of the system. More basically, if these market regulators had a legal duty to address system resilience, there would be more public debate about the prerequisites for resilient markets and, so, the likelihood of systemic vulnerabilities would in time be reduced.

Securitization constraints and banking's capital adequacy

In practice, giving the market regulators a statutory stability objective would mean, for example, that when authorizing securities for public listing and/or trading, the SEC would need to attend to whether the cumulative issuance of risky securities signaled material risks to the system as a whole. It is salutary that documentation for the ABS and CDO securitizations at the center of 2007's liquidity crunch had crossed the desk of, and been authorized by, the SEC or its foreign counterparts. No doubt that is partly because SEC commissioners and staff did not see that they could contribute to maintaining stability through this function. The SRC recommends that the Financial Stability Oversight Council (FSOC) discuss the role that the SEC could play in this area.

By contrast, the UST Reports do not touch on the contribution that listing authorities could make to resilient securitization markets. Instead, they recommend a series of regulatory relaxations for securitisation structures and practices. We cover two here.

Minimum retention requirements

First, UST recommends regulators should reverse course on requiring banks and other intermediaries to hold a minimum percentage of securitisations that they sponsor/originate.

Given the pathologies of US securitisation markets prior to the 2007 phase of the crisis, this would be quite a step backwards toward systemic vulnerability. One of the lessons was that intermediaries had incentives to exaggerate the quality of the underlying portfolios, to amplify leverage through a securitisation's structure, and to obscure its riskiness through complexity. The SRC does not see much reason to believe that those incentives have been blunted, especially in exuberant markets, and for that reason opposes UST's proposals in this area.

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good deal of modern thinking about why financial stability matters, but it is not fleshed out in the body of the legislation.

Were US regulators to go ahead and pursue the course advocated by the UST, the SRC believes that the effect on the resilience of the system as a whole would need to be addressed by a corresponding increase in headline capital requirements for banks, dealers and possibly others, irrespective of whether they were directly involved in securitisations. That would not be easy to calibrate given regulatory arbitrage.

Treating some securitizations as highly liquid assets

Second, UST recommends that some 'high-quality' securitized obligations be classed by bank regulators as high-quality liquid assets (HQLA) for purposes of the Liquidity Coverage Ratio and Net Stable Funding Ratio.

The SRC opposes this. This is partly because we doubt the ability of regulators to ensure that supposedly 'high quality' securitizations could be sold in liquid markets in stressed conditions. Whatever criteria were drawn up, individual banks and bankers would have incentives to stretch them to the very limit, leaving the system as a whole much less liquid than signaled by regulatory liquidity measures. While it makes sense for high-quality securities, including asset-backed securities (ABS), to be eligible as collateral in the Federal Reserve's Discount Window Facility, it does not make sense to declare that ABS markets are highly liquid only a few years after a financial crisis caused partly by illusory liquidity in ABS markets.

Margining for uncleared derivatives: the constraint imposed by resolvability

One notable area where the post-crisis reforms do address market vulnerabilities concerns derivatives; specifically, the requirements that certain standardised derivatives be centrally cleared and that uncleared derivatives be subject to minimum margin requirements. At base, this amounts to putting a cap on the leverage available for certain transactions: leverage being the inverse of the initial margin (or excess collateral) that must be maintained.

The UST Report recommends that this be relaxed for intra-group transactions.[10] This is too sweeping, because it misses a vital point. At base, the proposal appeals to an old doctrine, partly driving the 1980s' shift to consolidated supervision of banking groups, that a group can be a source of strength for its component operating subsidiaries. What that doctrine missed --- and the reason it has been partly undone --- is that it is individual legal entities (operating subsidiaries) that fail and go into bankruptcy or special resolution.

[10] Capital Markets Report at 128.

Regulatory arrangements for intra-group exposures should depend in part on the details of the plans for resolving a group and its component subsidies.

This is particularly important where the plan is for Multiple Point of Entry (MPE) resolution, with separate resolution of distinct subgroups (known in the authorities new jargon as 'resolution entities').[11] The efficacy of that strategy depends on there not being financial (and operational) exposures and dependencies among different subgroups, as otherwise they could not be separated cleanly by a resolution process. For such groups, contrary to the UST Report, there should be intra-group margining of uncleared derivatives (and other transactions) amongst entities that are part of subgroups designated to be resolved separately.

More broadly, the SRC remains of the view that widely applicable margining requirements are important to maintaining the resilience of uncleared markets and, thus, of the financial system as a whole. While that increases private costs when all is good, it helps to ensure that markets remain open and market services remain available during more trying times.

FMU access to the Fed

Under Dodd Frank, the Federal Reserve may, under certain conditions, provide liquidity assistance to financial-market utilities (FMUs) designated as systemically significant by the FSOC. In its latest reports, the UST recommends that systemically significant providers of infrastructure services, such as CCPs, should also be able to hold surplus liquidity with the Federal Reserve. The SRC basically agrees.

In Europe, this is already possible in a number of jurisdictions. In France, clearing houses are formally designated as banks. In the UK, clearing houses are not banks but, as a matter of policy, can hold funds with the Bank of England.[12] These steps reflect a judgment that, under stressed conditions, CCPs should be able to hold their core resources for absorbing losses in the lowest risk, most liquid asset: central bank money. They underscore the importance of exacting supervision, including stress-testing, of CCPs.

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[11] Financial Stability Board, *Overview of the post-consultation revisions to the TLAC Principles and Term Sheet* (November 9, 2015), *available at* http://www.fsb.org/wp-content/uploads/TLAC-public-report-on-post-consultation-changes-for-publication-final1.pdf.

[12] Bank for International Settlements, *Payment, Clearing and Settlement Systems in France* (2012), *available at* https://www.bis.org/cpmi/publ/d105_fr.pdf; Bank for International Settlements, *Payment, Clearing and Settlement Systems in the United Kingdom* (2012), *available at* https://www.bis.org/cpmi/publ/d105_uk.pdf.

Market maker of last resort

While the 2007-09 crisis prompted Congress to introduce new constraints on the Fed's role as lender of last resort (LOLR), there has been much less debate in the US about whether the Fed should ever help directly to maintain liquidity in important markets.

LOLR assistance to individual banks and dealers would not avoid market closure where dealers withdrew because they feared or observed others withdrawing. Such market-maker runs away from markets might occur where worries developed about the underlying instruments or the dealer's own capacity to manage inventory risk. Where the underlying markets were basically sound, this would entail social costs that should, in principle, be avoidable.

In such circumstances, one possibility would be for the central bank temporarily to act as a *market maker of last resort* (MMLR), reducing the risks of sound dealers withdrawing as their peers became constrained. Various foreign central banks have been discussing this.

Plainly there are risks in such operations, which would need to be subject to carefully designed constraints. Most obviously, a particular market should really matter to the economy before the Fed acts to keep it open, and other solutions should be considered first. But the SRC recommends that as part of filling out a regulatory policy designed to ensure markets are resilient, US policy makers should consider the pros and cons of enabling the Fed to act as a MMLR and, therefore, also what regulatory and supervisory measures are necessary to mitigate the associated moral hazard risks and costs.

Summary and Conclusions

In summary, the SRC thinks that the UST Reports contribute to debates about how to strike a balance between economic growth, efficiency and investor protection but do not give enough attention to the importance of resilience in capital markets, asset management and insurance.

That being so, we are recommending that:

- The UST and Congress give the SEC and the CFTC an explicit statutory objective for financial stability framed in terms of the resilience of the system;
- The FSOC articulate criteria for identifying systemically significant markets;
- Barriers to entry be reduced in any significant markets characterized by highly concentrated suppliers, so far as that is consistent with maintaining resilient intermediaries;

- While analysis should focus on activities and markets, the possibility that some non-bank intermediaries, service-providers or vehicles might also be systemic should not be ruled out. For that reason, the Dodd Frank provisions enabling stress testing of investment vehicles should not be repealed;
- The authorities should be vigilant in ensuring that every type of financial intermediary and service provider can be resolved in an orderly way without the provision of core services being badly damaged, and without fiscal solvency support;
- Regulatory authorities determine how significant markets could be reopened swiftly after a cyber-freeze and the role of analogue back-ups in such contingency plans;
- The SEC should not abandon its plans to introduce quantified constraints on funds' liquidity risks;
- Constraints on securitization markets should not be relaxed (or only if headline equity requirements for banking institutions are increased to compensate, and so maintain the same degree of overall system resilience);
- Securitizations should not be treated as high-quality liquidity by bank regulators and supervisors.
- As part of actively using margining policy to reduce systemic risk through counterparty credit exposures, regulators should continue to impose initial margin requirements on uncleared derivatives (and other) transactions between members of a group that are part of distinct resolution subgroups;
- FMUs be given access to deposit/reserves accounts at the Federal Reserve; and
- Policymakers determine how the Federal Reserve could act as an appropriately constrained MMLR.

Our list will not remotely exhaust the issues relevant to maintaining resilient markets. So, finally, the SRC urges the UST and the other US authorities to initiate substantive debate on market resilience as a central part of their re-reform program.

Yours sincerely,

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
www.systemicriskcouncil.org