FACT SHEET

A Stronger Regulatory Framework for Shadow Banks

By Gregg Gelzinis July 18, 2019

For more detail, see also, "Strengthening the Regulation and Oversight of Shadow Banks" by Gregg Gelzinis

One of the many painful lessons of the 2007–2008 financial crisis was that devastating risks to financial stability can develop outside of the traditional banking system. Shadow banks, such as investment bank Lehman Brothers and insurance company American International Group, lacked adequate supervision and faced insufficient regulatory standards relative to the risk they posed to the broader financial system.[1] Risky financial activities went unchecked, and no regulatory body had a mandate to address the buildup of risk across the entire financial system.

The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Financial Stability Oversight Council (referred to in this fact sheet as "FSOC" or "council") to address some of the shortcomings in systemic risk oversight.[2] Dodd-Frank gave the council tools to meet this mission, including the authority to designate risky shadow banks as systemically important. Once designated, a shadow bank is subjected to strong federal supervision and enhanced regulation. The Obama administration used the FSOC's mandate and authorities to improve the resiliency of the financial system. In stark contrast, the Trump administration has rejected the council's mission, undermined its tools, and eroded its institutional capabilities. Treasury Secretary Steven Mnuchin's tenure as FSOC chairman has demonstrated vulnerabilities in the council's design and authorities.[3]

At its core, the council's inherent weaknesses stem from a misplaced faith that competent regulators with a desire to meet the FSOC's statutory goals will always be in place. It is far too easy to erode the council from within, and there is a substantial embedded bias against forceful use of the FSOC's tools. The current framework also fails to contemplate the risk posed by conservative judges who are committed to defanging regulatory authorities in favor of business interests. This proposal is designed to reorient the shadow banking regulatory framework toward precaution and the public interest. The costs of regulating too few firms and activities outweigh the costs of regulating too many. The catastrophic economic and social harms caused by a financial crisis justify a vigorous approach to financial regulation. Policymakers should be more concerned with protecting the real economy from shadow banking risks than protecting shadow banks from prudent regulation.

The following policy recommendations would limit the chances that shadow banks and their activities cause or exacerbate the next crisis.

Enhancing the shadow bank designation authority

As of now, it is exceedingly difficult to designate a shadow bank as systemically important but easy to undo a designation. This bias against strong regulation of shadow banks works against the FSOC's mission to protect the real economy by mitigating risks to financial stability. This policy recommendation seeks to flip the presumption against strong shadow bank supervision and regulation.

- Shadow banks that meet certain size thresholds—and at least one additional quantitative risk metric—would be automatically designated as systemically important.[4] These firms would be subject to enhanced oversight and regulatory safeguards.
- The council would have the authority to de-designate firms on an individual basis if material distress at the firm and the nature, scope, size, scale, concentration, interconnectedness, and/or mix of the activities at the firm would not threaten financial stability in a period of broader stress in the financial system. The public, however, would be granted legal standing to contest such de-designations.
- The council would be required to review de-designations at least biennially, with the chair having the authority to call a vote sooner. If the council does not garner the necessary votes to uphold the rescission, the designation would snap back in place.
- The council would retain its current authority to affirmatively designate firms that do not meet the new threshold for automatic designation.

Granting the FSOC authority over systemically risky activities

The FSOC's current ability to research and evaluate systemically risky activities—and its authority to issue nonbinding recommendations—is insufficient. Providing the council with direct rule-making authority to regulate systemically risky activities across the financial system would help it better fulfill its mission to mitigate threats to financial stability in all forms.

- The council would have direct rule-making authority to regulate systemically risky activities across the financial sector.
- The council would be required to first issue a nonbinding recommendation to the primary regulator of such activity, if one exists. If the primary regulator does not act within a set period of time, the FSOC may directly promulgate rules.

- If the primary regulator does act within the established timeframe, the FSOC would have the authority to block the rule if it did not sufficiently conform to the council's nonbinding recommendation. The council would then have the authority to directly promulgate a rule in accordance with the initial nonbinding recommendation.
- The FSOC would also have the authority to promulgate rules mandated by Congress if the agency or agencies responsible for such rule-makings missed the deadlines included in statute.
- The primary regulator would supervise implementation of and ongoing compliance with the council's rule-making. If no primary regulator exists, the FSOC would determine which regulator will fulfill that role.

Improving the FSOC's institutional capabilities

The FSOC's independent source of funding is an important element of its institutional design, but that funding structure and associated discretion can be used as a weapon when the chair and FSOC members do not value the institution. This policy recommendation would set minimum budget and staffing floors at the FSOC and the Office of Financial Research (OFR). It would also enhance the OFR's independence and data-collecting authorities.

- The FSOC and the OFR would have minimum staffing and budget floors, above which the FSOC chair and OFR director would have discretion.
- The staff floors would be set at 75 FSOC staff and 300 OFR staff, and the corresponding budgetary floors would be $18 million and $150 million. These floors would represent roughly a doubling of the council's budget and a 50 percent increase in the OFR's budget relative to Obama-era levels.
- The OFR would no longer have to consult with the treasury secretary in setting the agency's budget and would be given clear and unfettered authority to gather, organize, and analyze data and information collected by the individual members of the council.

Increasing the FSOC's transparency and accountability

The FSOC, when used to its full potential, is a powerful institution. Accordingly, its transparency policies should meet a high bar. This policy recommendation would improve the council's transparency and accountability to both Congress and the broader public.

- The council would be required to release transcripts of its meetings on a five-year time delay and release meeting minutes three weeks after each meeting.
- The council would be required to hold a public meeting and a press conference at least once per quarter.
- All voting members of the council would have to testify together in Congress annually.
- Upon testifying in Congress, each member agency would be required to submit a signed statement either affirming that the individual member agency is taking all reasonable steps to ensure financial stability and mitigate systemic risk or detailing additional steps that the agency should take to do so.[5]

Conclusion

The Trump administration and conservative judges have exposed significant vulnerabilities in the current regulatory regime for the shadow banking sector. These policy recommendations would address these vulnerabilities and limit the chances that shadow banks and their activities trigger or exacerbate another financial crisis.

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Endnotes

1 Tim Geithner, "Treasury Secretary Tim Geithner Written Testimony before the House Financial Services Committee," U.S. Department of the Treasury, Press release, April 20, 2010, available at https://www.treasury.gov/press-center/press-releases/Pages/tg645.aspx; Robert L. McDonald and Anna Paulson, "AIG in Hindsight" (Cambridge, MA: National Bureau of Economic Research, 2015), available at https://www.nber.org/papers/w21108.

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 203, 111th Cong., 2nd sess. (July 21, 2010), available at https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

3 Gregg Gelzinis, "Re: FSOC interpretive guidance on nonbank financial company determinations," Center for American Progress, May 13, 2019, available at https://www.regulations.gov/document?D=FSOC-2019-0001-0017.

4 The size thresholds would be set at $50 billion in consolidated balance sheet assets for nonbank institutions (e.g., finance companies, insurance companies, asset management entities/investment advisers), $50 billion in net assets for registered investment funds (e.g., mutual funds, closed investment funds), and $400 billion in gross notional exposure for private funds (e.g., private equity, hedge funds). The additional six metrics include $30 billion in gross notional credit default swaps; $3.5 billion of derivatives liabilities; $20 billion in total debt outstanding; a 15-1 leverage ratio; a 10 percent short-term debt ratio; or $1 trillion in assets under management.

5 All agencies that are voting members of the council would have a financial stability mandate added to their statutory mission, if not currently included.