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If You're Big and Move Money, Watch Out

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Unless Congress acts, the feds will say that all large financial firms pose a 'systemic' risk and need bank-like regulation.

Article first appeared in April 13, 2014 print of the Wall Street Journal, reprinted here with permission of the author

Since the financial crisis in 2008, central bankers and bank regulators world-wide have repeatedly called for controls on "shadow banking." Federal Reserve officials, including former Chairman Ben Bernanke, have been among the most outspoken. But if bank regulators get their way, much of the U.S. financial system will lose its capacity for risk-taking as well as its dynamism, innovativeness and flexibility. And the U.S. economy would not be any safer.

Bank regulators have been cagey about exactly what firms they consider to be engaged in shadow banking. But in recent months (as outlined below), the targets have become clear. Shadow banking consists of all participants in the capital markets and the securities business that are not already covered by the prudential supervision of risk-taking and capital requirements that characterize bank regulation.

The stakes are high. The capital markets and the securities industry are far and away the principal sources of credit for American business. According to the Fed's flow-of-funds data, in the past 25 years the capital markets' financing of businesses—as well as state and local governments—has grown more than three times faster than bank lending. By 2013, the capital markets' outstanding loans to these borrowers were approximately $10 trillion while those of banks were less than $4 trillion, and the gap continues to widen.

Over the years, because of better communications technology, it has become easier for borrowers to disseminate their financial information directly to investors and other funding sources. For firms that registered securities with the Securities and Exchange Commission, and thus had access to the capital markets, it was far more efficient to sell bonds, notes and commercial paper through a broker or underwriter than to negotiate a loan from a bank.

The 2008 financial crisis, however, offered regulators a once-in-a-lifetime opportunity to expand their reach. The government's narrative about the financial crisis, accepted by the media, claimed that any large financial institution could pose a danger to the financial system if it fails. The implication: Every large financial institution requires bank-like prudential regulation to prevent failure. Chief among these financial institutions were the illicit-sounding "shadow banks," which were (not coincidentally) out-competing the regulated banking system.

The principal moving party in this effort has been the Financial Stability Board (FSB)—an international group of central bankers, finance ministers and financial regulators. In 2008, shortly after the financial crisis, the G-20 (the heads of government of the 20 major economies) met in Washington and charged the FSB with responsibility for developing plans to prevent another crisis.

The FSB has since moved aggressively, with the concurrence of the U.S. Treasury and the Federal Reserve (who are members, along with the Securities and Exchange Commission), to designate large financial firms as "systemically important financial institutions." SIFIs are institutions that, supposedly, could cause a breakdown in the financial system if they fail. Thus far the FSB has designated 39 banks and nine insurance firms.

The FSB is now turning its sights on the securities business, reporting in September 2013 that it is "reviewing how to extend the SIFI Framework to global systemically important nonbank non-insurance (NBNI) financial institutions." This category of firms, said the FSB, "includes securities broker dealers, finance companies, asset managers and investment funds, including hedge funds."

When companies are designated as systemically important, the FSB assumes that their home-country supervisors will place them under much stricter regulation. In the U.S., this will be done by the Financial Stability Oversight Council, a body created by the Dodd-Frank Act and made up primarily of the heads of the federal financial regulators. The council, led by Secretary of the Treasury Jack Lew, has the authority to designate U.S. firms as systemically important. When it does, they are turned over to the Fed for the bank-like regulation that Dodd-Frank requires.

Last July the FSB designated three insurance companies—AIG, Prudential PRU.LN -0.64% and MetLife MET -0.88% —as systemically important. The Financial Stability Oversight Council then promptly designated AIG and Prudential as systemically important and is investigating MetLife for this purpose.

Before the FSB had suggested publicly, in January 2014, that asset managers with $100 billion under management should be considered for designation as systemically important, the Financial Stability Oversight Council had already asked the Office of Financial Research, another Treasury agency set up by Dodd-Frank, for a report on whether asset managers might cause a systemic breakdown of the U.S. financial system. The agency, following Treasury policy, said yes.

In its September 2013 report, the Office of Financial Research argued that "a certain combination of fund- and firm-level activities within a large, complex firm . . . could pose, amplify, or transmit a threat to the financial system." The agency seemed not to understand that, unlike a bank, the losses of a managed fund fall on its investors and do not threaten creditors or create systemic risk.

The FSB and the Financial Stability Oversight Council are clearly working in tandem. The council follows the FSB's lead, although Congress probably expected that the council would make independent and fact-based judgments about which firms should be considered systemically important.

This leaves the most important financial sources in the U.S. economy exposed to stringent and unnecessary bank-like regulation. If nothing is done by Congress, and soon, we can expect that—after the FSB's decisions about securities firms, asset managers, finance companies, hedge funds and the like—these institutions will disappear into the welcoming arms of the Fed.