June 18, 2012

Systemic Risk Council

A Call to Action

The Systemic Risk Council (SRC or Council) is a private sector, non-partisan body of former government officials and financial and legal experts committed to addressing regulatory and structural issues relating to systemic risk in the United States. It has been formed to provide a strong, independent voice for reforms that are necessary to protect the public from financial instability. Our goal is a system in which we can all have confidence.

Our overriding concern stems from the lack of progress made by the members of the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR) to address several critical issues as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), enacted in 2010. That concern increases each day that the implementation of systemic risk reform languishes. A sense of complacency has made reforms for effective oversight seem less urgent despite escalating problems elsewhere in the global financial system. In many ways, the financial system faces larger potential challenges today than it did in the run-up to the 2008 crisis, given the troubled state of the European Union and uncertainties at home related to fiscal and monetary policy.

It is essential that the FSOC show leadership in coordinating the rule-writing process to promote the development of cohesive, consistent regulations and provide clear and transparent explanations of the reforms in a way that is understandable to the general public. We have created this Council to assist in that effort.

SRC Priorities

To that end, the SRC initially will focus on the following issues, which we believe require priority attention by the FSOC and its members:

- **Act immediately to propose and finalize rules that will substantially strengthen both the quality and amount of capital that must be held by the nation's largest financial institutions.**

- **Expedite determination and designation of all systemically important nonbank financial institutions (SIFIs) and rules for capital requirements, resolution planning, examination and data collection to avoid a repeat of the 2008 financial crisis where risk-taking in the "shadow sector" caused widespread damage to the financial system.**

- **Activate a fully functioning OFR data collection and analytics system, including the integration of data collected by individual FSOC agencies and secure Senate confirmation of a director for the OFR.**

- **Expedite analysis and resolution of the challenges in applying the Volcker Rule with the goal of simplifying the regulation, while maintaining appropriate market making and risk management activity.**

- **Complete consistent rule-makings for greater oversight and transparency in the OTC derivatives market, including centralized clearing of and use of execution facilities for standardized contracts, robust margining and capital requirements, position limits, and other measures necessary to address harmful speculation and systemic contagion, including the credit derivatives markets.**

- **Focus on the need for international coordination of prudential and functional regulators, including the sharing of data, to ensure that global policymakers are aware of growing threats to financial stability.**

These priorities will evolve as circumstances change. The SRC stands ready to monitor and communicate with the regulators, and call public attention to the implementation, or lack thereof, of these and other essential financial reforms.

FSOC Progress under the Dodd-Frank Act

The FSOC was chosen by Congressional leaders as the appropriate response to proper systemic risk oversight after months of debate and political haggling. Once implemented, the FSOC and its counterparts would answer questions about how to prevent future disruptions to the financial markets of the scale experienced worldwide during 2008-09. To that end, it was charged with three primary responsibilities:

- Significantly improve capabilities to identify and address risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services sector;

- Promote market discipline by disabusing both the financial services industry and the investing public of the notion of "too-big-to-fail"; and

- Effectively monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States.

Despite the importance of this mandate, the FSOC has been slow to act in a number of ways. Created in part to design systems, processes and infrastructure to detect and prevent repeats of the world market turmoil in 2008, the FSOC has done little to develop, much less implement, appropriate data gathering and other monitoring safeguards to both recognize and address in a timely manner underlying vulnerabilities in the U.S. financial markets system.

Since mid-2010, the FSOC's lack of progress has been disappointing:

- Only seven of the FSOC's 10 voting members are confirmed agency heads;
- No nonbanks have been designated as SIFIs;
- The FSOC has done little to coordinate, prioritize, and lead Dodd-Frank reforms to address systemic risk;
- The FSOC has not sufficiently coordinated with regulators outside the United States regarding what it has accomplished;
- The potential for severe systemic disruptions remains high; and
- The problem of dealing with an even larger pool of potentially too-big-too-fail institutions has not been addressed by the FSOC.

We recognize the enormity of creating an entity such as the FSOC. The task of effectively monitoring and mitigating systemic risk is both vast and procedurally complex. Yet, there are enormous consequences for failing to do so. In addition, known risks to the system – excess leverage, opaque and volatile derivatives markets, and use of the government safety net to support speculative, high-risk activities – have yet to be addressed even as new risks emerge on the horizon.

Both the timeliness and substance of what has been produced have beset this effort since the FSOC's inception. This immediately raises questions about the level of planning, resource allocation and regulatory commitment by FSOC leadership and its commitment to a rigorous and technically proficient systemic risk mitigation function. In the absence of FSOC leadership, Dodd-Frank rulemakings have been accomplished through protracted inter-agency bargaining and heavy industry lobbying, leading to a confusing array of overly complex and unfinished rules implementation. Many, such as higher capital adequacy standards, have only recently been proposed and do not yet include internationally agreed-upon surcharges for the largest financial institutions. Rules to address liquidity have not been proposed, even as large US financial institutions remain reliant on short-term funding.

Duty to Recommend Prudential Measures

Perhaps the most glaring shortcoming is the FSOC's failure to designate any nonbank financial institutions as systemically important, as this alone lies at the heart of its mandate.

In its first Annual Report to Congress released in June 2011, the FSOC noted "perceptions that institutions are 'too big to fail' can increase uncertainty in periods of market turmoil and reinforce destabilizing reactions within the financial system. These destabilizing reactions and their consequences for the economy are at the core of the concept of systemic risk." Though the FSOC has issued the final rule permitting it to designate "nonbank financial companies" as systemically important, it is unclear when the first round of designations will occur.

Without the implementation of this primary systemic-designation process, the FSOC continues to fail to fulfill its duties to recommend prudential measures in important respects. As charged by Dodd-Frank, the FSOC has the responsibility for making recommendations to the Federal Reserve concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital resolutions plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large interconnected bank holding companies that are supervised by the Federal Reserve.

To date, the Federal Reserve has proposed certain prudential standards, but only the regulations relating to resolution planning have become final and effective. Rules to implement international agreements to raise capital requirements have been delayed and only partially proposed. Derivatives markets remain opaque and highly volatile. Rules to prevent the government safety net from being used for risky proprietary trading remain mired in complexity and inter-agency disagreements. Rules to ensure that bank holding companies serve as a source of strength for FDIC-insured banks have not yet been proposed.

The FSOC bears responsibility to assure that high-quality, cohesive rules are effectively coordinated among its member agencies and proposed and finalized in a timely way. Moreover, the FSOC bears direct responsibility for the identification and designation of systemically significant institutions. Yet, no heightened prudential measures have been applied to nonbank SIFI candidates simply because the FSOC has not yet identified any.

The FSOC also is to make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets. Given that the FSOC has not fully identified financial institutions outside the traditional banking sector as systemically important, progress in both of these above areas has been severely lacking. In addition, it is impossible to engage in resolution planning for such entities if they are not identified. This puts the economy at risk for disruptions (or more taxpayer bailouts) should one of them fail.

The slow pace at which issues central to systemic risk detection and mitigation are being addressed delays economic recovery to the extent that financial institutions are hesitant to make commitments until they believe they understand the new rules that will be applied. In addition, the continued vulnerability to our financial markets as a consequence, is alarming.

Duty to Monitor and Identify Threats

As part of its oversight duties, the FSOC is supposed to monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States. This includes the need to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress and make recommendations in such areas that will enhance the integrity, safety, competitiveness and stability of the US financial markets.

In its 2011 Annual Report, the FSOC acknowledges this responsibility and discusses several areas that present "ongoing challenges to financial stability." Yet, no formal action has been taken to address these threats and the relationship of the FSOC to the commitments made by the Group of Twenty in Washington and the newly-organized international Financial Stability Board remains unclear.

Duty to Develop and Use the OFR

To provide direct support to the FSOC, Congress created the OFR and instilled in it vital responsibilities for systemic data collection and analysis. The OFR was specifically given responsibility for, among other things, collecting information from agencies represented by the FSOC members, other federal and state regulatory agencies, the Federal Insurance Office and potentially from bank holding companies and nonbank financial companies, all in order to help assess risks to the US financial system. Moreover, in collecting and analyzing such matters, it was to be a primary link in coordinating systemic risk mitigation efforts globally.

To date, the work of the OFR has been limited. Though the President has nominated Richard Berner to head the OFR, the nomination has not been confirmed by the Senate. The OFR has announced its intentions to create an advisory committee to provide advice, recommendations, and analysis and information to the OFR, but no such committee has been created as of yet.

Perhaps most concerning, the OFR has failed to establish and activate a robust data collection process. As noted by many systemic risk experts, that process includes the ability to collect, analyze and model vast amounts of information about financial markets and participants. Currently done to different degrees by individual FSOC member organizations, the level of collaboration, sharing and collective analysis of such information is largely absent and not proficient. That capability is critical to providing the FSOC with timely and relevant systemic monitoring information needed for a properly functioning systemic oversight regime.

Though it has begun to provide analytical and data-related services to the FSOC, the OFR has yet to announce that it has established secure computing environments for data storage and sharing. They are far behind on sophisticated techniques of data analysis needs, as well. These include taking inventory of the financial data held by the FSOC member agencies and establishing a proper system to both access and process such data using proper analytics and systemic risk metrics. Presently, we are far removed from creating the comprehensive and operational data collection system that both Congress had intended and this Council envisions.

The Time for Leadership

The time for action by the FSOC has long passed. We urge creation and public disclosure of a new plan for prompt initiation and completion of appropriate systemic risk steps as prioritized and outlined above. This Council strongly urges the FSOC to exercise leadership and act promptly to fulfill its Congressional mandate under Dodd-Frank to monitor, identify, and address in a forward looking way systemic risks to the US financial system. Further delay in addressing these risks prolongs the recovery and uncertainty for US financial markets while leaving them vulnerable to new and potentially more disastrous systemic disruptions.

Respectfully submitted,

The Systemic Risk Council

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The text of this document was sent today to the following:

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