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On "Regulatory Whiplash: Examining the Impact of FSOC's Ever-changing Designation Framework on Innovation."

FSOC Designations and Financial System Stability

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FSOC Designations and Financial System Stability
by Paul H Kupiec[1]

Chairman Hill, Ranking Member Lynch, and distinguished members of the Subcommittee, thank you for convening today's hearing, "Regulatory Whiplash: Examining the Impact of FSOC's Ever-changing Designation Framework on Innovation." and thank you for inviting me to testify.

My name is Paul Kupiec. I am an economist and senior fellow at the American Enterprise Institute, but this testimony represents my personal views. In my nearly 40 years as a professional economist, including nearly a decade at both the Federal Reserve Board and the FDIC, and as a former Chairman of the Basel Committee on Bank Supervision's Research Task Force, my research has been focused on the financial services industry, and more specifically on risk measurement, banking and financial stability issues. It is an honor for me to be able to testify before the subcommittee today.

A short summary of my testimony finding and recommendations follow.

- In theory, the Financial Stability Oversight Council (FSOC) was created to enhance the federal financial regulatory agencies' ability to maintain financial stability by discharging their responsibilities to monitor financial institutions to ensure that they comply with applicable safety and soundness regulations.
- In practice, the FSOC has failed to identify and ensure that FSOC members proactively take steps to mitigate risks associated with products, processes, and institutions that subsequently triggered financial instability.
    - The FSOC failed to identify FTX as a systemic risk in a Digital Asset report it released just a month prior to the FTX failure.
    - The FSOC and its bank regulatory agency members failed to identify the risk associated with legally permitted banking services that attracted large uninsured deposits from crypto-businesses that banks invested in long-maturity assets thereby creating interest rate risk and ultimately large losses and bank failures when the Fed increased interest rates.
        - If more banks had provided the services in question to crypto business, the concentration of uninsured deposits in the two banks in question and the risks associated with them would have been reduced.
    - The FSOC and its bank regulatory agency members failed to identify and proactively take steps to mitigate the risk caused by maturity mismatches, and massive unrealized interest rate losses in several banks which lead to depositor runs and bank failures.
- Instead of a performing as a body that objectively identifies financial stability risks and promotes transparent improvements in financial safety and soundness supervision and regulation, the FSOC's activities have become highly politicized.
    - The FSOC has revised the standards and procedures that govern the discharge of its Section 112 and 113 powers each time the political party in power changes.

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[1] Senior Fellow, American Enterprise Institute. The opinions in this testimony are mine alone and do not represent the opinions of the American Enterprise Institute.

        - The FSOC's 2023 revisions to its definition of "financial instability" and the standards and procedures it uses are designed to make it easier for the FSOC to make Section 113 designations.
    - The FSOC favors the use of opaque Federal Reserve Board stress tests to measure and regulate risks it identifies instead of recommending transparent and publically verifiable risk measures.
    - No FSOC annual report prior to 2021 mentioned climate change as a systemic risk threatening financial stability nor is there any evidence that climate change has historically been an important factor causing bank failures.
        - The FSOC's recommendation to impose climate change regulations on banks and other financial institutions was not the result of objective data analysis, but was the execution of a political plan to discourage investments in fossil fuel related activities hatched well before the current administration was elected.
        - It seems unlikely that climate change would remain an FSOC priority should the party in power change.
- The policy uncertainty created by the politicization of the FSOC discourages private sector investment and financial services innovation.
- There is a need for crypto-related regulations. However, these regulations should be determined by Congressional legislation. Crypto business innovation will be stifled without the regulatory clarity and scope that can only be provided through legislation.
    - FSOC Section 113 designations focus on a single nonbank entity and apply the Board of Governors enhanced bank holding company regulations which may not be appropriate for a nonbank financial firm engaged in crypto-related activities.
- If Congress is not willing to revisit the Dodd-Frank Act and repeal the FSOC's Section 113 powers, it should at least alter the FSOC's voting rules to require that the FSOC's issuance of reports and Section 113 designations be approved by the Secretary of the Treasury, 2/3 of FSOC voting members, and the appropriate Committee ranking member in both the House and the Senate of the party ***not*** in control of the executive branch.

Introduction

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act which created the Financial Stability Oversight Council (FSOC) and empowered it to designate non-bank financial institutions as systemically important entities and subject them to Federal Reserve Board supervision, Dodd-Frank stress tests, and any new enhanced prudential standards the Federal Reserve Board may promulgate to regulate the minimum capital, subordinated debt and other activities of the largest systemically important bank holding companies. Moreover, under Section 112 powers, the FSOC has authority to recommend enhanced regulations to existing regulators when the FSOC determines specific market-wide financial products or practices may be a source of financial instability. However, the FSOC's recommendations for enhanced regulations in such cases are nonbinding.[2] The FSOC calls this process an "activities based approach" for mitigating the risk of financial instability.[3]

If one harbored hope that the creation of the FSOC would enhance the ability of so-called "independent" federal financial regulatory agencies to discharge financial safety and soundness regulations unfettered by political influence and bias, the decision to delegate financial regulatory

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[2] https://crsreports.congress.gov/product/pdf/R/R47026 p.8.

[3] https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf pp. 74-79.

authority to the FSOC has been a disappointment. In cases where the FSOC has anticipated risks that could potentially destabilize the financial system, FSOC member agencies failed to adequately monitor and mitigate these risks even when the agencies were fully empowered to do so. FSOC members' supervisory inattention to systemic threats identified by the FSOC resulted in contagious bank runs that required a systemic risk exception to quell the crisis—an outcome antithetic to FSOC's responsibility to "[eliminate] expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure."[4] Indeed the Secretary of the Treasury implied that the federal government might expand the emergency deposit insurance blanket guarantee if such action was needed.

FSOC Section 113 nonbank designations are politicized. The FSOC has revised its Section 113 policies and procedures with every change of political party holding executive branch power. The FSOC consolidates executive branch control over the activities of the so-called "independent" federal financial regulatory agencies. The current administration has used the FSOC to create a systemic risk narrative that promotes new regulations of dubious merit to support the administration's climate-change political agenda.

The FSOC's recent revision of the standards and procedures it will use to discharge its Dodd-Frank Section 113 designation powers overturn many of the revisions in operating procedures adopted in the FSOC's 2019 revised guidance. The 2019 revisions were made to address shortcomings in the FSOC's 2012 guidance that were identified in *MetLife, Inc. v. Financial Stability Oversight Council, 177 F. Supp. 3d 219 (D.D.C. 2016).*

Specifically, the current administration's FSOC has concluded that, in reaching a decision to designate an entity, the FSOC no longer must quantify the probability that the entity will experience material financial distress nor does the FSOC have to conduct a rigorous cost-benefit analysis that shows that designation benefits exceed the costs imposed on the designee and other impacted parties. The FSOC's 2023 revision argues that a favorable cost-benefit analysis and an assessment of the likelihood a designee may experience material financial distress are not explicit requirements in the Section 113 legislative language. These changes, if they go unchallenged or are upheld by the courts, will make it much easier for the FSOC to designate nonbank entities.

Notwithstanding the reasoning in the FSOC's November 2023 guidance, the failure of the FSOC to establish that MetLife, Inc faced a substantial probability of material financial distress was an important factor contributing to the court's decision to overturn MetLife's designation. Moreover, the court also found that the Supreme Court's findings in *Michigan v. Environmental Protection Agency* require a favorable cost-benefit balance as a prerequisite for an FSOC designation.

Each of these revisions to the standards and processes that guide FSOC designations reflect the preferences of a new administration and not fundamental advancements in the art of systemic risk identification. The FSOC's short history illustrates the transient political nature of FSOC designations. Such regulatory uncertainty discourages financial sector innovation and private sector investment.[5]

[4] 12 U.S. Code § 5322(a)(1)(B)

[5] See, for example https://www.nber.org/papers/w21633

Background

Section 111 of the Dodd-Frank Wall Street Reform and Consumer Protection Act established the FSOC. The FSOC is chaired by the Secretary of the Treasury and includes all of the federal financial regulatory agencies as voting members.[6]

Under Section 112 of the Dodd-Frank Act, the FSOC's responsibilities are: to identify 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 marketplace; to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and to respond to emerging threats to the stability of the United States financial system.[7]

Section 113 of the Dodd-Frank Act empowers the FSOC with the ability to designate non-bank financial institutions for supervision by the Board of Governors of the Federal Reserve and require designated entities to comply with the enhanced prudential standards promulgated under authority of Section 165 of the Dodd-Frank Act if the FSOC determines that the material financial distress of the entity, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the entity could pose a threat to the financial stability of the United States.[8]

In 2012, the FSOC published guidance outlining the standards and procedures that would govern the FSOC's exercise of its Section 113 powers. In 2014, the FSOC designated MetLife, Inc arguing that,[9]

> MetLife, Inc. (MetLife) is a significant participant in the U.S. economy and in financial markets, is interconnected to other financial firms through its insurance products and capital markets activities, and for the other reasons described below, material financial distress at MetLife could lead to an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy. Based on the Council's evaluation of all the facts of record in light of the factors that the Council is statutorily required to consider, the Council has made a final determination that material financial distress at MetLife could pose a threat to U.S. financial stability and that MetLife will be supervised by the Board of Governors and be subject to enhanced prudential standards. The Council's final determination does not constitute a conclusion that MetLife is experiencing, or is likely to experience, material financial distress.

MetLife challenged Its FSOC designation and, in 2016, a district court ruled in MetLife's favor. The court found that the procedures the FSOC used to designate MetLife were arbitrary and capricious.[10] The

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[6] FSOC voting member include: The Secretary of the Treasury and chairpersons/directors of: The Board of Governors of the Federal Reserve System; The Comptroller of the Currency; The Bureau of Consumer Financial Protection; The Securities and Exchange Commission; The Federal Deposit Insurance Corporation; The Commodity Futures Trading Commission; The Federal Housing Finance Agency; The National Credit Union Administration; an insurance expert nominated by the president and confirmed by the Senate.

[7] As paraphrased from US Treasury https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf p.2.

[8] https://www.ecfr.gov/current/title-12/chapter-XIII/part-1310

[9] https://home.treasury.gov/system/files/261/MetLife,%20Inc..pdf

[10] MetLife, Inc. v. Fin. Stability Oversight Council, 177 F. Supp. 3d 219 (D.D.C. 2016)

court found the FSOC's analysis of MetLife to be inconsistent with the FSOC's stated standards and procedures for a Section 113 designation in part because the FSOC did not assess the probability that MetLife, Inc might become materially financially distressed. Moreover, the court found that the FSOC's failure to take into account the cost to MetLife of a Section 113 designation was itself cause to overturn MetLife's designation since the Supreme Court case, *Michigan v. Environmental Protection Agency*, established that an administrative agency must consider cost when deciding whether to regulate an entity.[11]

In 2019, the FSOC adopted new standards and procedures for exercising its Section 113 designation power. If the FSOC identified issues or activities that had the potential to destabilize the financial system, it would first attempt to attenuate the risk through an "activities based approach" where it worked with state or federal regulators raise awareness of the FSOCs concerns and recommend new industry-wide regulations or modifications to industry processes or procedures that would diminish the potential that the products or activities identified could create financial instability. Under the 2019 revised guidance, a Section 113 designation of a nonbank financial institution would only be considered in cases where an activities based approach was judged to be ineffective in controlling the identified systemic risk. In reacting to the MetLife decision, the revised guidance also included the requirement that a Section 113 designation pass a rigorous cost-benefit test.

In November 2023, the FSOC issued a new set of standards and procedures for use in designating nonbank financial entities using its Section 113 powers. The revised guidance no longer prioritizes the industry-wide activities based approach adopted in the 2019 guidance.[12] The new standard rescinds the FSOC's prior commitment to ensure that activities-based interventions or a Section 113 designation pass a rigorous cost-benefit analysis. The new guidance also would permit a Section 113 designation without an FSOC assessment of the probability that the designated company could experience material financial distress. The new guidance would also apply to FSOC assessments of payment, clearing and settlement activities as well as the activities of financial market utilities.

By oversight or design, the Dodd-Frank Act never defines systemic risk notwithstanding the 39 times the term appears in the 849-page legislation. Similarly, the FSOC's 2012 Final Rule and Interpretive Guidance also fails to define the term "risk to financial stability." The FSOC's 2019 revised guidance addresses this oversight. It defines "risk to financial stability" as meaning "the threat of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict ***severe*** damage on the broader economy.[13]

The FSOC's November 2023 revised guidance lowers the threshold of economic impairment needed to designate a financial product, practice or non-bank financial institution as a "financial stability risk",

> Financial stability can be defined as the financial system being resilient to events or conditions that could impair its ability to support economic activity, such as by intermediating financial transactions, facilitating payments, allocating resources, and managing risks. Events or

[11] https://scholarship.law.unc.edu/cgi/viewcontent.cgi?article=1438&context=ncbi p. 264-265.

[12]

[13] Emphasis added to original passage.

conditions that could substantially impair such ability would constitute a threat to financial stability.[14]

From its beginning, the FSOC issued guidance explaining how it would evaluate the eleven statutory characteristics the FSOC is to consider when making Section 113 designations.[15] The FSOC's 2012 designation framework focused on a non-bank entity's size, interconnectedness, available substitutes, leverage, maturity mismatch, liquidity, and designee's regulatory environment. The FSOC's 2019 revised analytic framework was designed to determine whether a designee's financial distress would be transmitted to other financial firms through on- and off-balance sheet exposures, opacity-driven contagion, asset fire sales, the impairment of a critical service or function, organizational complexity that makes liquidation outcomes unnecessarily costly and uncertain, and the extent to which any of these risks are attenuated by current regulation. In 2023, the FSOC again revised its analytic framework to focus on designee risks created by: leverage, liquidity, maturity mismatches, operational risks, interconnections with other financial firms, opacity and complexity of the organization and operations, risk management deficiencies, and the extent an entity operations and activities could destabilize markets through various transmission channels.

The multiple revisions in the Section 112 and 113 standards and procedures that guide the FSOC decision illustrate the fact that there is no unique scientifically supported framework for the identifying entities, products or practices that generate financial systemic risk. Each of the revisions of FSOCs standards and processes reflects the preferences of a new administration and not fundamental advancements in the ***art*** of systemic risk identification. The FSOC's short history illustrates the transient nature of FSOC recommendations and designations. Such regulatory uncertainty discourages financial sector innovation and private sector investment.

How Successful is the FSOC at Systemic Risk Designation, Identification and Mitigation?

The FSOC has a mixed record when it comes to its prognostications regarding which nonbank entities, financial products or practices have the potential to destabilize the financial system. Despite all of the FSOC's analytic resources, it could not convince a court that MetLife, Inc posed a systemic risk to the

[14] Federal Register/Vol. 88, No. 218/Tuesday, November 14, 2023/Notices https://home.treasury.gov/system/files/261/Analytic-Framework-for-Financial%20Stability-Risk-Identification-Assessment-and-Response.pdf p. 78032

[15] Section 113 b(2) specifies the issues the FSOC must consider in making a Section 113 designation. They are: "(A) the extent of the leverage of the company; (B) the extent and nature of the United States related off-balance-sheet exposures of the company; (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (D) the importance of the company as a source of credit for United States households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (E) the importance of the company as a source of credit for low-income, minority, or underserved communities in the United States, and the impact that the failure of such company would have on the availability of credit in such communities; (F) the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse; (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (H) the extent to which the company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority; (I) the amount and nature of the United States financial assets of the company; (J) the amount and nature of the liabilities of the company used to fund activities and operations in the United States, including the degree of reliance on short- term funding; and (K) any other risk-related factors that the Council deems appropriate.+

financial system. And in the years since MetLife's designation was rescinded by the courts, to the best of my knowledge, MetLife's activities have not had a destabilizing impact on the financial sector.

In September 2013, the FSOC used its Section 113 powers to designate Prudential Financial, Inc. The FSOC's designation of Prudential seemed to turn primarily on the fact that Prudential was the largest life insurance company in America. The FSOC's analysis and designation justification for Prudential was similar to the arguments the FSOC subsequently used to designate MetLife in December 2014. Unlike MetLife, Prudential Financial choose not to litigate its designation.

Similar to MetLife designation, the FSOC did not assess the likelihood that Prudential Financial, Inc could become materially financially distressed, nor did it perform a cost-benefit analysis of the Prudential designation. In 2016, Prudential requested that the FSOC delay its designation review until the courts decided the MetLife case so it could use a favorable court decision in Prudential's upcoming annual designation review.[16] The district court ruling in favor of MetLife set a precedent that arguably forced the FSOC to rescind Prudential's designation. The FSOC subsequently rescinded Prudential Financial, Inc's designation in October 2018.

In explaining its decision to remove Prudential's designation, the FSOC tried save face by arguing that it did so because Prudential had somehow become less of a systemic financial risk notwithstanding the fact that in its 2018 decision statement, the FSOC writes:[17]

- Prudential's aggregate capital markets exposures do not appear to have changed significantly.
- Prudential is the largest life insurance organization in the United States, and its material financial distress could pose challenges to market participants, counterparties, and regulators.
- Prudential's gross notional amount of derivatives and derivatives liabilities have increased…
- Prudential's legal structure remains complex, with hundreds of legal entities.
- Prudential and its subsidiaries continue to exhibit a significant amount of operational and financial interconnectedness and inter-dependencies.
- Prudential's market share in its key businesses has been stable since the Council's final determination regarding Prudential.

The FSOC does mention a reduction in Prudential Financial, Inc's overall leverage, alleged improvements in its liquidity management practices and enhanced cooperation among Prudential's state insurance regulators as factors that contributed to its decision. These changes notwithstanding, it is clear that the overriding reason for rescinding Prudential Financial, Inc's designation is that the FSOC's original designation analysis—in which insurance policy holders were assumed to cancel their policies and withdraw funds like depositors in a classic bank run—was completely discredited by the MetLife decision.

[16] On November 17, 2016, Prudential sent a letter to the Council requesting that the Council either wait until after the U.S. Court of Appeals for the District of Columbia Circuit issued a ruling in MetLife, Inc. v. Financial Stability Oversight Council5 before making a determination with respect to the Prudential reevaluation or, in the alternative, toll the period in which Prudential could challenge the Council's determination in its annual reevaluation of Prudential in court until 30 days after the circuit court's ruling. See, https://home.treasury.gov/system/files/261/Prudential%20Financial%20Inc%20Rescission.pdf

[17] Ibid. pp. 5-7.

The FSOC has a slightly better track record when it comes to identifying products, practices and risk factors that have the potential to destabilize the financial system. However, it has a very disappointing record when it comes to encouraging FSOC members to use their powers and resources to proactively mitigate the likelihood these risks cause a systemic financial disturbance.

On October 3, 2022, the FSOC issued, "Report on Digital Asset Financial Stability Risks and Regulation". In the report, the FSOC concluded,[18]

> Crypto-asset activities could pose risks to the stability of the U.S. financial system if their interconnections with the traditional financial system or their overall scale were to grow without adherence to or being paired with appropriate regulation, including enforcement of the existing regulatory structure. … Although interconnections with the traditional financial system are currently relatively limited, they could potentially increase rapidly.

Section 4.2.2 of the FSOC's report, "Regulation of Banks', Credit Unions' and Trust Companies' Interactions with Crypto-Assets," contains a lengthy discussion of the steps federal banking regulators had taken to monitor depository institutions exposures to crypto-asset businesses. However, the report does not specifically mention banks' provision of proprietary blockchain-based dollar trading systems used by crypto-asset businesses as a risk to be monitored.[19]

It is worth mentioning that, while FTX was not incorporated in the United States, the FSOC still had the authority to consider designating FTX as systemically important nonbank financial firm and subject it to enhanced Federal Reserve Board supervision [12 U.S. Code § 5323(b)(1)]. Yet the FSOC's digital asset report does not mention any financial systemic risk concerns it may have had with FTX or its operations and the report gave no indication that the FSOC was considering FTX for Section 113 designation.

In its (December) 2022 annual report, the FSOC writes,

> The Council has identified five vulnerabilities associated with market and credit risk: Commercial Real Estate, Residential Real Estate, Nonfinancial Corporate Credit, Short-term Wholesale Funding Markets, and Digital Assets.

It is notable that the FSOC's annual report does *not* highlight what was (and is) the largest systemic risk facing the financial sector—unrealized interest rate losses on long maturity fixed income investments.[20] With regard to banks specifically, the FSOC annual report *recommends* that,

> [B]anking supervisors continue to ensure that banks maintain adequate capital and liquidity, sound interest rate risk management practices, and well-developed operational resiliency plans. The Council encourages banks and supervisors to focus their monitoring efforts on the impact of

[18] https://home.treasury.gov/system/files/261/Fact-Sheet-Report-on-Digital-Asset-Financial-Stability-Risks-and-Regulation.pdf

[19] Indeed, the report (p. 80) cites an OCC interpretive letter on National Bank activities related to crypto-assets that states that, as long as a National Bank complies will all associated regulations and operates in a safe and sound manner, it was permissible to provide banking services that facilitate customers "crypto" and "fiat" exchange transactions.

[20] According to estimates I construct using publicly available bank regulatory data, unrealized interest rate driven losses are nearly $1.3 trillion. Many banks are undercapitalized when their regulatory capital measures are adjusted to these reflect market-value losses.

> interest rate risk on bank capital, including the impact of unrealized losses on their securities portfolios.[21]

But of course, events would shortly reveal the banking supervisors were ***not*** ensuring that banks maintained adequate capital and liquidity, sound interest rate risk management practices, and well-developed operational resiliency plans.

In March 2023, just a few short months after the FSOC issued these reports, factors identified by the FSOC did destabilize financial markets. Unfortunately, FSOC members had not headed the call for supervisory vigilance broadcast in the FSOC's 2022 annual report. Interlinkages between banks and crypto-asset firms, maturity mismatches and heretofore unrealized interest rate losses lead to a banking sector crisis that required the Secretary of the Treasury to approve a systemic risk exception that provided new emergency federal government guarantees and financial support to banks to prevent the banking crisis from spreading.

Silvergate Bank and Signature Bank both attracted low-cost uninsured deposit funding by providing a valuable service for crypto businesses. Cryptocurrencies and tokens exchanged on public blockchains typically clear and settle in minutes. If the crypto trade involves a corresponding exchange of dollars, and if the dollar leg of the trade is consummated using a normal Automated Clearing House banking transaction, it would typically clear and settle overnight.

The difference in timing between the settlement of a crypto token trade and the settlement of a dollar leg of the trade through normal banking channels creates a delivery versus payment timing problem. If a party is selling crypto tokens in exchange for dollars, unless the seller receives the dollars before entering the crypto trade in the blockchain, they are at risk that the counterparty receives the crypto tokens but defaults on the promised dollar payment. A counterparty who sends dollars in advance faces a risk that once the dollars are received, crypto tokens are never sent.

Silvergate and Signature Banks each developed their own private blockchains that allowed their proprietary blockchain members to send dollar balances to other blockchain members in real time 24/7/365 without the bank's intervention. These services allowed crypto firms to transact the dollar side of crypto token trades in real time. The dollar leg of crypto transactions could be settled within a time interval that approximated transactions settlement on the crypto token blockchain significantly reducing the settlement risk associated with crypto token trades. To use these services, firms were required to maintain large uncompensated deposit balances with these banks.

Many U.S. based firms with businesses involving crypto trading used these two banks' dollar blockchain exchange services and kept large uninsured deposits balances at these banks to facilitate their crypto business. If ***more*** banks would have provided this valuable service, Silvergate and Signature banks would likely not have attracted such large concentrations of uninsured crypto-business deposits. Instead the deposits would have been spread among banks offering competing services if more banks had entered the business. Moreover, even in these two banks, the crypto business deposits would ***not*** have been a factor in these banks' failure if the banks had been required by their regulators to invest the deposits in discount window eligible short-term liquid assets and required to have the processes and procedures in place to give the banks ready access to the Federal Reserve discount window.

[21] https://home.treasury.gov/system/files/261/FSOC2022AnnualReport.pdf p.38.

Because of the maturity mismatches between their deposits and investments, Silvergate Bank and Signature Bank were both imperiled by their interconnections with crypto-asset businesses. The withdrawals of large balances of uninsured deposits following the failure of FTX and other crypto businesses ultimately caused the failure of Signature Bank and the voluntary liquidation of Silvergate Bank. Because these banks had invested crypto business deposits in longer maturity assets, and these assets had experienced substantial reductions in market value as a consequence of Federal Reserve interest rate increases, the banks were forced to realize large interest rate driven losses when they liquidated held-to-maturity assets to meet depositor withdrawal demands.[22]

Notwithstanding the FSOC's report warning that digital asset interlinkages with traditional financial institutions could be a source of systemic risk, the Federal Reserve and FDIC fell short on their efforts to supervise banks that had significant business relationships with the digital asset industry. They did not use their prompt corrective action powers to mitigate the risks generated by the banks' investment decisions and the digital business relationships of Silvergate and Signature Banks. Bank regulators had the authority to restrict these banks' ability to grow using large uninsured deposits and/or require that the banks invest these deposit proceeds in short maturity liquid assets, but regulators did not exercise these authorities.

In March of 2023, at the same time Silvergate and Signature Banks were experiencing large deposit withdrawals, many depositors that held large uninsured balances at other banks with very large unrealized interest rate related losses on their held-to-maturity security and loan portfolios simultaneously came to recognize the risk they faced holding uninsured deposit balances in banks that were likely technically insolvent on a market value basis. This realization sparked simultaneous massive depositor runs Silicon Valley Bank (SVB) and First Republic Bank in addition to the runs experienced by Signature and Silvergate banks.

To keep depositor panic from spreading, the Secretary of the Treasury, Federal Reserve Board and the FDIC voted to approve a systemic risk exception that extended a blanket federal deposit insurance guarantee to all deposit balances regardless of size in Signature and SVB and provided Treasury funds to backstop a new Federal Reserve emergency lending facility (the Bank Term Funding Program) to allow banks to borrow 100 percent of the par value of the securities pledged to the Fed even though the market value of these securities could be substantially less than 100 percent of their par value.[23] To date, because of the blanket deposit guarantee, SVB is the most expensive bank resolution in FDIC history.[24]

[22]

[23] See Kupiec (2023) https://onlinelibrary.wiley.com/doi/10.1111/jacf.12571 and https://www.aei.org/articles/the-underlying-causes-of-the-bank-panic-of-2023/ for a more detailed account of the banking crisis of 2023.

[24] Further details are provided in https://www.aei.org/op-eds/thanks-to-regulators-svb-will-be-the-most-costly-bank-failure-in-history/

The FSOC and the Politicization of Financial Safety and Soundness Regulation

The discussion in this section deals with an issue outside the purview of this subcommittee, but it is relevant to my testimony because of the additional evidence it provides regarding the politicization of the FSOC.

A computer search for the words "climate change" in every FSOC annual report from 2011 through 2020 turns up **exactly 0** occurrences. According to the FSOC's annual reports, climate change was not a financial sector systemic risk prior to 2021. What changed between the end of 2020 and 2021?

While 2020 did have an active hurricane season,[25] according to Swiss Re Institute,[26] tornadoes and wildfires were the largest source of global insurer losses. Moreover, none of the natural disasters that caused insurer losses caused systemic disruptions in US the financial system. There were no systemic financial market disruptions from notable bond market defaults or corporate bankruptcies linked to natural disasters. Nor were there any climate-change disasters that caused GSIB bank or regional bank failures, or even one community bank failure.

In 2020, 3 small banks failed. None of these failures can be even remotely linked to "climate change". First City Bank of Fort Walton Beach Florida was closed for "prolonged earnings problems and "voluminous poor quality assets" that eroded the bank's capital levels."[27] The FDIC closed The First State Bank of Barboursville West Virginia because "[t]he bank's high level of problem assets and management's inability to resolve them ultimately eroded earnings and depleted the bank's capital."[28] Finally, Almena State Bank of Kansas failed "because of a Board that did not provide adequate corporate governance or management oversight. The Board's performance and management were considered to be critically deficient."[29]

The only thing that changed between 2020 and 2021 is that the Biden administration, which had campaigned on the promise to replace fossil fuels with renewable energy, took control of the FSOC and the FSOC's voting member "independent" financial regulatory agencies.[30] While the FSOC's October 2021 "Report on Climate-Related Financial Risk" was ostensibly a studiously-researched FSOC response to Section 3 of the Biden administration's May 20, 2021 Executive Order on Climate-Related Financial Risk, the FSOC's response to President Biden's executive order was formulated before the 2020 election.

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[25] https://data.bts.gov/stories/s/2020-Atlantic-Hurricane-Season/smay-dskr/

[26] https://www.swissre.com/media/press-release/nr-20201215-sigma-full-year-2020-preliminary-natcat-loss-estimates.html

[27] https://www.fdicoig.gov/sites/default/files/reports/2022-08/FBR-21-002.pdf

[28] https://www.fdicoig.gov/sites/default/files/reports/2022-08/FBR-21-001-Final.pdf

[29] https://www.fdicoig.gov/sites/default/files/reports/2022-08/FBR-21-003.pdf

[30] I have not been able to find any information on how FSOC members voted when the FSOC approved its climate change systemic risk report in late October 2021. Of the FSOC voting members not appointed by the Biden administration, Federal Reserve Vice Chairman for Supervision Quarrels term expired in early October 2021. President Biden did not nominate Federal Reserve Board Chairman Powell for a second term until late November 2021, after the FSOC designated climate change as a systemic risk in late October. FDIC Chair McWilliams resigned in December 2021. It is notable that, among the independent agencies, the FDIC was the only agency mentioned in the Treasury documents that did not form an internal climate-change working group before the FSOC report was issued. https://home.treasury.gov/system/files/136/FACT-SHEET-The-Financial-Stability-Oversight-Councils-Response-to-Climate-Related-Financial-Risk.pdf page 4.

In a 2020 article published in the *Cornell Journal of Law and Public Policy,* Graham Steele, then Director of the Corporations and Society research initiative at Stanford Graduate School of Business, described a detailed plan to use federal financial regulatory agency powers to implement a new national industrial policy without the need for Congressional legislation. The plan was to use the powers of the financial regulatory agencies to restrict the flow of credit and capital to firms and activities that produce greenhouse gas emissions.

The plan proposed to use the FSOC to declare climate change as a systemic risk. This would in turn require FSOC members to use their regulatory powers to impose new regulations to mitigate the alleged climate-change systemic risk threatening the financial system.
The scheme proposed to impose climate-change regulations in the form of heightened capital requirements for bank loans to greenhouse gas (GHG) intensive firms and activities. These higher capital requirements will be justified by claiming that climate-change factors elevate the future credit risk profile of targeted borrowers.

According to Mr. Steele's plan, to limit GHGs, regulators would also increase minimum collateral haircuts and margin requirements on capital market transactions and place new regulatory caps on the total amount of GHGs that can be emitted by the firms whose securities are held by mutual funds, pension funds, public investment companies, and insurance companies. These caps could require divestitures. These new heightened regulatory restrictions would be applied to counterparties from specific targeted industries.

To quote Mr. Steele,

> [C]apital rules can be updated to increase risk weights on the basis of climate risk to reflect the potential for capital intensive losses based on financial climate risks. Risk weights could be increased for loans and investments in climate change-driving assets, as well as credit exposures to sectors that are vulnerable to the effects of climate change. These risk weights would apply, at a minimum, to all financing of the industries that encompass the 100 producers that, as of 2017, accounted for 71 percent of global industrial greenhouse gas emissions, as well as agribusinesses operating in areas that are sensitive to deforestation, to better reflect the true costs and risks from the climate impacts of these investments.

President Biden nominated Mr. Steele to serve as Assistant Secretary of the Treasury for Financial Institutions and he was confirmed by the Senate. Time has revealed that the plan Mr. Steele outlined in a 2020 law review article—long before the FSOC supposedly researched the potentially destabilizing effects of climate change on the financial system—is the actual blueprint for implementing an important component of the Biden administration's net-zero policies using the FSOC and the powers of the "independent" financial regulatory agencies.

The FSOC report on climate-change risk argues that the companies emitting GHGs are the ultimate source of systemic risk. But these companies are predominately nonfinancial in nature and consequently not subject to the provisions of the Dodd-Frank Act. Congress never granted the executive branch or independent financial regulatory agencies the power to regulate nonfinancial firms. The systemic risk provisions of the Dodd-Frank Act apply to federally regulated banks, financial institutions, and to nonbank financial institutions designated to be "systemically important" by the FSOC. The latter must be nonbank companies ''predominantly engaged in financial activities.''

The FSOC circumvents this issue by arguing that the FSOC has not designated the emission-intensive firms as systemic, but instead has determined that these firms carry heightened credit risk as a consequence of so-called "climate-change transitional risk." Transition risk is a hypothetical credit-risk multiplier the FSOC links to a nonfinancial firm's GHG emissions.

Transitional risk is the conjectural risk that a firm's revenues or costs could be negatively impacted by future government policies or regulations, or because of diminished demand as a consequence of changing consumer preferences. The ambiguous concept of transitional risk is wholly conjectural and not based on specific historical experiences. The FSOC's concept of hypothetical transition risk could be applied to any firm to justify any political goal.

In order to regulate something, it must first be measures The plan to use the SEC to collect greenhouse gas emissions data by requiring all public companies to disclose their emissions in their mandatory periodic SEC filings. Using these data, the financial regulatory agencies will invoke Dodd-Frank powers to craft new bank capital requirement surcharges to discourage emission-intensive loans, design investment fund rules to cap the emissions of the securities mutual funds may hold, and take other regulatory actions to forestall investments in emission-intensive activities—all in the guise of mitigating financial system systemic risk.

Adding climate-change scenarios to Dodd-Frank mandated stress tests is the regulatory approach the FSOC proposes to use to measure the credit risk associated with hypothetical climate-change transition risk. In these stress test exercises, regulators require banks to estimate the credit related losses that they might accrue in the distant future should climate change somehow catalyze the modern day equivalent of the old testament plagues unleashed on the Egyptians that in turn trigger government policies or demand changes that limit GHG-intensive industries ability to continue operations.

The Fed—an institution that, time and again, has proven that it cannot forecast the inflation rate or GDP growth over the next three months let alone years into the future—decides what level of individual bank losses are "accurate" in these hypothetical climate apocalypse scenarios. The Fed is also the judge of whether the bank will have sufficient capital in the future to absorb these fictional losses.

As a practical matter, banks cannot take issue with the Fed's imaginary catastrophic scenario assumptions, nor can they dispute the accuracy of the Fed's bank-specific loss estimates because the stress test exercise will be repeated periodically, and in the next round, the Fed will still be the bank's regulator.

The use of newly-coined risk, climate-change transitional risk, to impose extra-legal regulatory sanctions on specific industries and activities mirrors a previous administration's abuse of financial regulatory powers. In the illegal "Operation Choke Point," the Obama administration's DOJ teamed up with the FDIC under chairman Gruenberg to pressure banks to cease doing business with, among other industries, gun shops, payday lenders, and legal purveyors of fireworks and pornography. The justification was that such businesses had a high probability of being involved in money laundering and other fraudulent activities. Authorities argued that when these activities are discovered, a bank will suffer damage to its reputation which could negatively impact it business, as well as invite regulatory sanctions for violating anti-money laundering regulations.

When the legality of Operation Choke Point was questioned by Congress, the DOJ abandoned the operation. A group of payday lenders subsequently sued the FDIC arguing that the FDIC illegally used regulatory guidance regarding reputation risk "as the fulcrum for a campaign of backroom regulatory pressure seeking to coerce banks to terminate longstanding, mutually beneficial relationships, with all payday lenders." A DC federal court denied the FDIC's motion to dismiss the suit and plaintiffs won a settlement in which the FDIC admitted that "certain employees acted in a manner inconsistent with FDIC policies with respect to payday lenders…"

Like the abuse of the ill-defined concept of "reputational risk", the FSOC's plan to use Dodd-Frank stress authority and "climate-change transitional risk" to penalize emission-intensive activities using the powers of the independent financial regulatory agencies is an abuse of power facilitated by poorly drafted legislation and independent federal agencies that are only weakly accountable to Congress. Congress should reassert its authority and limit the FSOC's ability to use its "systemic risk" powers to advance a political agenda.

Recommendations

The crypto industry needs certainty regarding the safety and soundness and consumer protection regulations that apply in order to innovate and grow. FSOC designations do not provide such certainty, nor can they address the scope of issues that need clarification The needed safety and soundness and consumer protection regulations can only be addressed through comprehensive Congressional legislation.

The FSOC record on identifying and mitigating financial systemic risks does not justify extending its powers to regulation of the crypto industry. The FSOC has demonstrated time and again that its recommendations reflect the political objectives of the executive branch instead of non-political objective risk assessments. The FSOC's powers to make binding regulatory decisions should be reduced either by removing its Section 113 designation powers or by changing the voting process needed to approve FSOC reports and designations so that the appropriate Committee ranking member in both the House and the Senate of the party not in control of the executive branch has veto power over the FSOC report or designation.