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Statement of the Shadow Financial Regulatory Committee

The Monumental Task Assigned to the Fed

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The Dodd-Frank Wall Street Reform and Consumer Protection Act established a Financial Stability Oversight Council to identify "systemically important nonbank financial companies" that could potentially pose a threat to US financial stability. Such companies would thereby become subject to "enhanced" regulation and "more stringent" prudential standards (than would otherwise be applicable), imposed by the Federal Reserve Board. No finding of a colourable threat at present is required.

The discretionary powers over these companies given to the Fed under certain conditions are extensive and sweeping. It is required to set higher risk-based capital, leverage and liquidity requirements. It is to prescribe risk management practices, preparation of failure plans, concentration limits, and credit exposure reporting and limits. It can set short-term funding limits, contingent capital requirements, public disclosure rules, and any additional prudential standards it deems appropriate.

The Fed must adapt the required standards to a company's predominant line of business, and can differentiate among companies and their subsidiaries based on their size, capital structure (taking into account off-balance sheet activities), riskiness, complexity, financial activities and any other risk-related factors it deems appropriate.

If a company's mandated resolution (failure) plan, including changes in business operations and corporate structure, is ultimately found deficient, the Fed (with FDIC) may impose further restrictions on growth, activities or operations. As a last resort, the company may be required to divest assets or activities deemed unacceptable.

It would be hard to imagine an authority much more unbounded in scope and unlimited by objective criteria. The companies in question are, by definition, large and complicated; it has even been suggested in some recent cases that their own full-time management did not really comprehend their possible exposures. To expect that the Fed will be better than all those managements in identifying risks, let alone those that pose a systemic threat to the functioning of financial markets or the real economy, is an unreasonable assignment. The Fed currently has neither the personnel nor the expertise to achieve such tasks, and to try to do so it must amass a large staff of versatile experts in diverse lines of business, becoming in effect the world's largest management consulting firm. Except that this firm is expected to give orders, not merely advice.

The problem in the future, as in the recent past, is not the lack of regulatory authority but the achievement of regulatory performance. If the past is any guide to the future, there is no reason to expect that unforeseen events will not cause unanticipated failures. But one can anticipate that the Fed will impose severe regulatory restrictions that are likely to pose a large regulatory drag on economic growth.