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SAFE Finance Blog

Systemic Risk Council: A Letter to the U.S. Senate

10/18/2018

Jan Pieter Krahen: The tendency for loose financial regulation in the US is alarming. Europe should not follow



In the aftermath of the financial crisis, former U.S. President Barack Obama installed the Dodd-Frank Act in 2010. The goal of the legislation was to increase regulation of financial institutions and to protect consumers in case of a new crisis. Times have changed since then, with Donald Trump another President has taken over, and, as it seems, the approach to regulation has changed as well. In July 2018, the JOBS and Investor Confidence Act (JOBS Act 3.0) passed the House of Representatives. It aims to promote

economic growth and create jobs by facilitating lending for businesses. The JOBS Act 3.0, however, has its flaws. The Systemic Risk Council (SRC) criticizes the new legislation, warning that Federal Reserve and other regulators could lose vital tools to mitigate systemic risk. The SRC is a private sector, non-

partisan body of former government officials and financial and legal experts, chaired by Sir Paul Tucker. I happen to be a member as well.

In a letter (<https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2018/10/SRC-Comment-Letter-JOBS-Act-3.0-Bill.pdf>) to the U.S. Senate Committee on Banking, Housing, and Urban Affairs the SRC writes: "The SRC's strong recommendation to you and your Senate colleagues is that the sections of the JOBS Act 3.0 that deal with Living Wills and Stress tests should be dropped or amended in order to ensure that the financial regulators have the capacity to respond adequately and promptly to systemic threats."

According to the SRC, two of the 32 bills have the potential to weaken financial stability. First, the "Financial Institution Living Will Improvement Title" (Title XII) would limit the Federal Reserve (Fed) and the Federal Deposit Insurance Corporation (FDIC) to require resolution plans from bank holding companies to only once every two years. "This is too rigid", writes the SRC. Fed and FDIC could not revisit those plans and could not make off-cycle adjustments in terms of changing market environment, in the firms' material, or law. Such scheduled planning can therefore cause high economic costs.

Second, the "Alleviating Stress Test Burdens to Help Investors Title" (Title XV), on the other hand, could dilute financial stress tests as it would exempt certain market participants like broker-dealers, investment advisers, and non-bank swap dealers from the tests. But these actors may be quite important in adverse market conditions; carving them out of the stress test is therefore likely a dangerous precedent. Under Title XV, the Security and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) would be allowed to issue regulations requiring companies to conduct their own periodic analyses of their financial condition under adverse economic conditions. However, SEC and CFTS are not entitled to require the information from the companies. Moreover, the Fed would lose any legal right to be consulted or receive information of any such assessments. The Fed would be "entirely removed from the process", as the SRC writes.

In the letter, the SRC points out that the proposed changes would weaken the regime for supervising the resilience of the U.S. financial system. The choice to require firms' stress tests or not, and the used methodology would be too permissive. That "does not reflect the lessons of that failed regime", the SRC criticizes.

No reason for relaxing the stricter regulation

Especially due to sometimes fast shifts in the financial markets and the economy, the SRC does not support the efforts to soften stress test policies. At least, SEC and CFTC should be allowed to conduct or regulate stress tests to firms to the extent such tests are warranted by economic or market circumstances. The SRC also stresses that the Fed should be involved in the process. It states that "history strongly suggests that the necessary inter-agency cooperation will not occur without legislation provisions."

Further, the SRC warns that the adverse effects of the next recession on borrowers and the financial system are likely to be even more severe than the previous because the monetary arsenal is depleted and a likely constrained period for fiscal stimulus. The Congress would dilute or remove safeguards against systemic risk that are currently in place if they do not revisit those two bills.

Likewise, we can state for Europe's banks that there is no reason for relaxing the stricter regulation introduced since 2010. To the contrary, we would expect policy makers and agencies to exert great efforts to harmonize and to complete the implementation of major regulatory rules, ensuring the bail-in ability of MREL/TLAC debt capital and to resolvability of all financial institutions, large and small.

Moreover, in order to limit the violation of bail-in in crisis situations, the instrument of precautionary recapitalizations, which has been entered into the banking rulebook, are potentially the gateway to government bailouts; they urgently need to be formally restricted to full blown systemic crises, without

national discretion. This will probably require an ex-ante consent by an European institution, like the Single Resolution Board (SRB) or the European Stability Mechanism (ESM).

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