BETTER MARKETS

June 6, 2017

The Honorable Steven Mnuchin
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20500

Dear Secretary Mnuchin:

Better Markets[1] appreciated the opportunity to participate in the Department of the Treasury's (Department's) recent roundtable discussion regarding the President's Executive Order on "Core Principles for Regulating the U.S. Financial System." We wish to follow up on some of the issues raised during that discussion with some additional information, contained in this letter and in the documents included herewith, which also relate to other reviews currently being undertaken by the Department.

The False Choice Between Financial Protection Rules and Economic Growth

Contrary to the oft-repeated claims, it is simply not the case that financial protection rules and economic growth are mutually exclusive. In fact, durable, sustainable economic growth requires effective financial protection rules that ensure a balanced, competitive financial sector working in support of the real economy and the American Dream of homes, jobs, savings, education, a secure retirement and a rising standard of living.

America's financial system is today much better capitalized and much less leveraged, with lower risk, than it was before the 2008 financial crisis, while still lending and supporting the productive economy and economic growth. Notably, this has happened despite the worst financial and economic shock the country has experienced since the 1930s. This has been amply demonstrated. For example:

- The FDIC reported that the financial sector is seeing record profits, the rate of loan growth for the industry remains above the growth rate of GDP, and loan balances for community banks are up an astonishing 7.7 percent year-over-year.[2]

- Federal Reserve Board Chair Janet Yellen testified before the Senate Banking Committee that commercial and industrial lending has surged in recent years, along with industry profits:

> There's much more capital in the banking system. U.S. banks are generally considered quite strong, relative to their [international] counterparts. They built up capital quickly, partly as a result of our insistence that they do so, following the financial crisis….They're gaining market share and they remain quite profitable.[3]

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies— including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] https://www.fdic.gov/bank/analytical/qbp/2017mar/qbp.pdf

[3] http://www.cnbc.com/2017/02/14/janet-yellen-banks-are-lending-and-quite-profitable.html

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- Former Federal Reserve Board Chair Paul Volcker, in April 2017, gave remarks to the Bretton Woods Committee that are worth quoting at length:

> [C]laims that Dodd-Frank and other regulatory approaches have somehow gravely damaged the effective functioning of American financial markets, the commercial banking system, and prospects for economic growth simply do not comport with the mass of the evidence before us. Here we are in 2017 with a near fully employed economy, close to stable prices, bank profits at a new record, and the return on banking assets again exceeding one percent. Loans at both large and small banks are at new highs, double the pre-crisis years. In fact, loan growth has again been exceeding growth in nominal GDP.[4]

These statements and data, coming seven years after the Dodd-Frank financial reform law was passed, provide real-time, real-life evidence that financial protection rules have not damaged the banks or the economy; rather, they have created the conditions for sustained economic growth and prosperity.

The financial protection rules put in place in the aftermath of the 2008 crisis are doing exactly what they were meant to do: strengthen and maintain the stability of the financial system which enables lending, growth and profitability. We know this because while U.S. banks are flourishing, European banks are not. According to the European Banking Authority, "The EU banking sector continues to struggle with high levels of non-performing loans (NPLs), low profitability and efforts to restore confidence, notwithstanding the steady strengthening of the capital base."[5]

What accounts for the difference? The U.S. took comprehensive action to stabilize the financial system, as explained by National Economic Council Chairman Gary Cohn, who spoke to Bloomberg TV in 2016 when he was serving as President of Goldman Sachs:

> Almost all US banks took our medicine [recapitalizing, restructuring and implementing financial reform rules] early. We went out and raised capital really early in the process and then we went out and raised capital a second time….We really built our balance sheet up. We really de-leveraged ourselves. We really built enormous excess liquidity….And we made ourselves as financially secure as we could. We're subject to enormously robust stress tests here in the United States, and I give the Fed enormous credit for what they've done in stress testing the major banks here in the United States. [It's t]o the point where no one should question the viability of the big U.S. banks. I think some of the European banks have been slow to getting themselves recapitalized and getting their financial balance sheet in the best place it can be.[6]

Mr. Cohn's emphasis on the importance of increased capital has been definitively established by recent robust data-driven academic work establishing that better capitalized banks have higher rates of lending and a lower cost of capital throughout the business cycle. In particular, Morris Goldstein's new book, *Banking's Final Exam: Stress Testing and Bank-Capital Reform* (a copy of which is included with this letter), undertakes a rigorous review of all the data and analysis, demonstrating that 14% to 18% capital levels for the 8 U.S. G-SIBs (and a sliding scale for smaller banks) would be appropriate with negligible impact on lending. The understated summary of the analysis is worth considering in full:

> At the heart of the banking industry's opposition to much higher capital requirements is the assertion that higher bank capital requirements will depress bank lending and thereby reduce

[4] https://www.volckeralliance.org/sites/default/files/attachments/Paul%20Volcker_Bretton%20Woods%20Speech_19Apr2017.Pdf
[5] https://www.eba.europa.eu/documents/10180/1315397/EBA+Risk+Assessment+Report_December+2016.pdf
[6] https://www.bloomberg.com/news/articles/2016-02-09/u-s-banks-safer-than-europeans-due-to-early-medicine-cohn-says

> output and employment in the economy. This assertion is increasingly at odds with the empirical evidence – as well as with the appraisals of senior bank supervisors.…Better capitalized banks lend more, not less, than weakly capitalized ones. One recent impressive study, which looked at 105 large banks from advanced economies over the 1994-2012 period, finds that after holding other factors constant, a 1%-point increase in the equity to total assets ratio (i.e., the leverage ratio) is associated with a 0.6% increase in total lending growth. With this empirical finding, a key pillar of the case against much higher capital requirements is taken away.[7]

Thus, the evidence proves that increasing levels of capital has little if any effect on increased lending costs and, therefore, lending and economic growth. However, even if capital requirements were not raised to a more appropriate level, they certainly shouldn't be reduced and cannot be without making the financial system more fragile and, therefore, the likelihood of crashes and bailouts more likely.

It cannot be denied that US banks and financial institutions are much stronger and more stable today as a direct result of financial protection rules, including but not limited to capital. Moreover, those financial firms are in a much better position to support the real economy and the evidence proves that they are doing so, with lending increasing at twice the rate of economic growth. Thus, while seeking to promote economic growth and jobs is a laudable goal and social imperative, subpar performance is not related to lending, bank profitability or financial protection rules.

Put differently, the problem with subpar economic and job growth is not a credit supply problem. It is a demand problem due to a lack of creditworthy borrowers and consumers creating demand. That is directly due to the broad and deep economic costs that the 2008 financial crash inflicted on tens of millions of Americans families, many of whom are still suffering today from un- and underemployment, wage stagnation, underwater or nonexistent home equity, decimated savings, among so many other costs.

The Continuing Costs of the 2008 Financial Crisis

As detailed in the enclosed Report by Better Markets, the cost of the financial crisis so far stands at a staggering $20 trillion dollars in lost gross domestic product, which includes everything from destroyed household wealth, foreclosures, and un- and under-employment, to government bailouts, emergency spending measures, and other actions necessary to prevent a second Great Depression.[8]

Several independent analyses support this estimate. The Federal Reserve Bank of Dallas issued a report in which they "conservatively estimate the loss of national output as a result of the financial crisis and its aftermath at between $6 trillion and $14 trillion."[9] The independent U.S. Government Accountability Office also undertook a number of studies released in February 2013 that "suggest losses associated with the recent crisis could range from a few trillion dollars to over $10 trillion."[10] The staggering size of this very real cost, imposed on every single American and still being paid for today, must be uppermost in the minds of regulators as they assess the benefits of financial protection rules, and weigh the claims by industry that a particular rule is too difficult to comply with.

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[7] Goldstein, Morris. *Banking's Final Exam: Stress Testing and Bank-Capital Reform*, Peterson Institute for International Economics, 2017; citing Gambacorta and Shin, *Why Bank Capital Matters for Monetary Policy,* Working Paper 558. Basel: Bank for International Settlements; see also Admati and Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About it*, Princeton University Press, 2013; and Admati and Hellwig *The Parade of Bankers' New Clothes Continues: 31 Flawed Claims Debunked,* Revised December 2015.

[8] https://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf

[9] Assessing the Costs and Consequences of the 2007–09 Financial Crisis and Its Aftermath

[10] Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act

Cost-Benefit Analysis: A Trojan Horse

As regulators weigh the value of financial protection rules to help prevent another catastrophic crash, many are demanding that every rule first be subject to exhaustive quantitative cost-benefit analysis. Not only is this an impossible standard for financial regulatory agencies to meet, as detailed in the Report included herewith, but it also focuses the attention of regulators on the wrong question: what are the possible costs to a small handful of gigantic financial firms, as opposed to what are the real, often intangible, benefits of regulation to the American people.[11]

The 2008 financial crash was the worst since the Great Crash of 1929 and it caused the worst economy since the Great Depression of the 1930s, pushed un- and under-employment (the U6 rate) to a peak of 17.5%, pushed 15 million homeowners into foreclosure, liquidated trillions of dollars in retirement savings, and caused untold wealth destruction and human suffering. Congress responded with emergency measures to stop the crisis, and comprehensive reforms to ensure it would never happen again.

By necessity, these reforms imposed some costs on Wall Street, either through increased compliance costs or foregone profits as some of the biggest, most dangerous banks were prohibited from engaging in a limited number of high-risk practices that had been very profitable for them (if also very costly for their trading partners and, ultimately, the U.S. taxpayer). Congress determined that the vast public benefit of avoiding cataclysmic crashes and a second Great Depression far exceeded the costs to the financial industry.

In fact, there's a good argument that all the financial reform rules do not add any incremental costs to the US, but just affect the timing of when those costs are incurred and who pays them. For example, a dangerous, fragile financial system with few regulatory costs will lead to periodic financial crashes, including some that will be historically catastrophic like 1929 and 2008. Under such a system, the pre-crash regulatory costs are low, but the post-crash bailout and economic damage costs are extremely high and concentrated. Moreover, the public at large pays all the costs in cleaning up after a crash. An alternative system would be a better regulated financial system that isn't dangerous or fragile and, therefore, does not periodically crash or crash very severely. Under such a system, the pre-crash regulatory costs are higher (and spread out over time and distributed among the users and beneficiaries of the financial system and its products) and the post-crash costs are minimized because the downturns are much less frequent and much less severe. One could even argue that the costs of the second system with much greater regulation is, in fact, much less costly than the first, certainly in terms of human suffering if not in actual dollars.

This raises the issue of an inherent bias in a quantitative cost benefit analysis which accounts for actual dollars very well, like those spent by financial firms on compliance, but fails to fully or properly account for the many intangible benefits like preventing human suffering and reducing the likelihood of a second Great Depression or another Great Recession. Costs are simply always easier to identify and quantify than benefits; while financial firms can easily point out a cost incurred purportedly due to a given rule, the benefit of that same rule is often diffuse and identifiable only in the aggregate. The multi-trillion dollar estimates developed in the Better Markets Report and the others cited above provide some guidance, yet even they do not fully account for all the damage done from inadequate regulation and the resulting crises.

Moreover, a quantitative cost benefit analysis has another bias that is misleading and incomplete: It is typically applied on a rule-by-rule basis, whereas the financial reform law was intended and designed to be a comprehensive, inter-related structure that, together, reduced the risk in and to the financial system. Thus, each rule can only be evaluated holistically. No single rule or group of rules in isolation can be determined to stop another

[11] https://www.bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf

crash, but all of them together can prevent another $20 trillion loss. Thus, the Dodd-Frank law and the rules adopted pursuant to it have to be evaluated in terms of the law's overriding goals: to prevent another financial crash and economic calamity, with all the human wreckage and economic devastation it would bring.

That isn't to say that economic costs should be ignored and they are not. For example, the SEC is required to "consider" whether its rules will promote efficiency, competition, and capital formation. Similarly, the CFTC is required to "consider" the costs and benefits of its rules, along with a number of other factors. In each case, Congress intended the agency to be sensitive to the economic impact of its rules, but it deliberately chose not to require these and other financial regulators to try to slavishly catalogue, quantify, and balance costs and benefits. The resulting regulatory approach achieves the best of all worlds: It's an analysis that enables the consideration of those costs as well as the larger purposes and benefits from the law, while not being biased toward costs and against benefits and without paralyzing an agency with the duty to conduct impossible cost-benefit analyses.

FSOC is the Only Formal Mechanism the U.S. Government has to Identify and Regulate Systemically Significant Nonbanks, i.e., the Shadow Banking System

The Financial Stability Oversight Council (FSOC) was created to (1) be an early warning system to help detect and prevent future financial and economic calamities like those of 2008-2009; (2) identify and ensure the regulation of systemically significant nonbanks; and (3) to prevent the reoccurrence of a two-tier regulatory system where banks were highly regulated and nonbanks were lightly regulated if at all, which invited regulatory arbitrage and risk migration from the regulated arena to the unregulated arena. We would like to emphasize three key points about FSOC:

1. Congress created the FSOC in response to the catastrophic failure of unregulated systemic threats from nonbanks like American Insurance Group (AIG), and FSOC's success is vital to strengthening the financial system and economy while reducing future nonbank systemic threats.

2. FSOC's implementation of Section 113 of the Dodd-Frank Act shows that it is using its power deliberatively and judiciously. Moreover, the significant changes it has made over time demonstrate it is responding appropriately to constructive input from stakeholders.

3. Recent calls to change FSOC would impair or cripple its ability to protect American families, workers, and taxpayers from another financial crash arising from systemically significant nonbanks and the shadow banking system.

We expand on those points below.

<u>Congress created FSOC to address systemic threats from wherever they might arise</u>: On the eve of the 2008 financial crisis, financial regulators were focused on their specific segment of the industry; no one regulator was responsible for detecting, addressing, or preventing unseen, unknown, and unexpected risks and threats regardless of where they arose or who had jurisdiction over them. Some nonbank financial companies thereby grew to pose a risk to the entire financial system without being perceived as risky and without being appropriately regulated.

The best such example was AIG. In 2008, AIG was the world's largest insurance company. However, a division of AIG also accumulated hundreds of billions of dollars of liabilities by selling credit default swaps. This caused AIG to become deeply entwined throughout the entire financial system. When the mortgage-backed and other securities AIG was "insuring" failed, the company lacked the capital necessary to fulfill its obligations. The result: The federal government was forced to provide an unlimited bailout of AIG (ultimately amounting to about

$185 billion), assume AIG's obligations, bailout the firm's many counterparties - including many foreign banks - and even enable the payment of $218 million in bonuses to some AIG executives who were involved in the company's reckless risk-taking in the first place.

AIG's failure and subsequent bailout happened because no regulator was responsible for overseeing the systemic risk posed by the firm or, for that matter, by any nonbank. As Michael Barr, of the University of Michigan Law School, explained in testimony before the House Financial Services Committee:

> One of the major problems in the lead up to the financial crisis was that there was not a single, uniform system of supervision and capital rules for major financial institutions. The federal financial regulatory system that existed prior to the Dodd-Frank Act largely developed in the context of the banking system of the 1930s. Major financial firms were regulated according to their formal labels – as banks, thrifts, investment banks, insurance companies, and the like – rather than according to what they actually did. An entity that called itself a "bank," for example, faced tougher regulation, more stringent capital requirements, and more robust supervision than one that called itself an "investment bank." Risk migrated to the less well-regulated parts of the system, and leverage grew to dangerous levels.[12]

Consequently, in the aftermath of the crisis, it was widely agreed that the best way to fill this regulatory gap was to create a single regulator with responsibility for overseeing systemic risk across the entire financial system. Stakeholders from government and the financial industry testified in support of this proposal, including representatives of the Financial Services Forum,[13] the Investment Company Institute,[14] the American Bankers Association,[15] and the Securities Industry and Financial Markets Association.[16]

Congress created FSOC as an essential part of the post-crash reforms, and tasked it with the mission of identifying and responding to risks to the financial stability of the United States. Moreover, it sought to end the two-tied regulatory system of highly regulated banks and unregulated nonbanks, which invited regulatory arbitrage and risk migration.

<u>FSOC is implementing Section 113 of the Dodd-Frank Act judiciously:</u> Under Section 113 of the Dodd-Frank Act, FSOC has the authority to designate a nonbank financial company for enhanced prudential regulation by the Federal Reserve if certain conditions are met. Congress necessarily gave FSOC broad discretion in the exercise of this authority, since the agency must confront the inherently difficult and predictive task of identifying potential risks to the stability of the U.S. financial system. Nevertheless, FSOC has exercised its designation authority sparingly and deliberatively. In the seven years since it was created, FSOC has designated just four nonbank financial firms for enhanced supervision (and one of those firms - GE Capital - has since been de-designated because it voluntarily took steps to reduce the risks that it posed.).

In each instance, FSOC acted prudently, designating the firm only after conducting an extraordinarily thorough analysis and concluding that each one satisfied the applicable statutory standards. Given this track record, the FSOC can hardly be accused of acting hastily or over-broadly. Frankly, four designations in seven years is far fewer than what could have been done given the number of nonbank financial companies that failed, received bailouts, or posed systemic risk during the financial crisis just a few short years ago.[17] Clearly FSOC is acting deliberatively and carefully when considering and making designation determinations.

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12 Testimony at House Financial Services Committee (April 26, 2017)
13 Testimony at House Financial services Committee (July 17, 2009).
14 Testimony at Senate Banking Committee hearing (July 23, 2009).
15 Testimony at House Financial Services Committee (July 17, 2009).
16 Testimony at House Financial Services Committee (Mar. 17, 2009).
17 *See* U.S. Gov't Accountability Office, Rep. No. GAO-11-696, *Federal Reserve System: Opportunities Exist to Strengthen Policies and*

Proposals to change FSOC would cripple its ability to protect American taxpayers from another financial crash: recent legislative proposals to overhaul FSOC's operations would prevent the Council from carrying out its mission, and would leave our financial system and economy much more vulnerable to another crisis.

For example, provisions in H.R. 10, the Financial CHOICE Act, pending in the House of Representatives, would retroactively repeal FSOC's previous designations of certain nonbank financial firms as systemically important, prohibit FSOC from making any such designations in the future, strip FSOC of its ability to prohibit or otherwise limit Wall Street firms from engaging in risky activities, tie up the Council's budget and operations with Congressional interference, and even mandate how the Council should conduct its internal votes. This would leave the country at the mercy of systemically significant nonbanks. It would mandate the recreation of the two-tiered regulatory system and it would all but guarantee risk migration from banks to the a newly revitalized unregulated shadow banking system. Future surprises like AIG would be assured and taxpayers would again pay the price.[18]

The key decisions made by FSOC already require supermajorities of the country's most senior financial experts. These decisions are complex and involve judgments over which reasonable minds might disagree. But to instead require each regulatory agency to vote to determine how each agency head should vote during FSOC proceedings would paralyze FSOC and politicize the decision-making process, leading to unnecessary delays and, inevitably, weaker actions, if any are taken at all. FSOC was meant to break down the myopic jurisdictional silos that blinded individual agencies from risk and mindlessly prevented cooperation. Recreating the pre-crash dysfunction would be a grave disservice to the American people and trigger a fresh wave of risk build-up in the financial system unseen, until bailouts are required.

As detailed in a recent Policy Brief issued by the Peterson Institute for International Economics,[19] it is important to note that designation authority was designed to be a forward-looking warning system to prevent nonbank systemic risks that might trigger the next crisis. For that reason, FSOC needs flexibility, discretion, and independence to identify new and emerging risks and keep abreast with market developments and financial innovations. These proposals would add unnecessary layers of bureaucracy to FSOC and create risky delays that would undermine its mission.

Ensuring Fair Dealing Among Derivatives Dealers

Unregulated and non-transparent derivatives trading was a key cause of the 2008 financial crisis and a primary means by which risk was spread throughout the global financial system. The Dodd-Frank Act overhauled the oversight of the derivatives markets, providing for registration of market participants, transparent trading on designated platforms, public reporting of trades, and centralized clearing to mitigate the systemic posed by counterparty failures. While many of these reforms have been adopted, a small cadre of derivatives dealers still dominate the markets and have prevented many reforms from being fully and properly implemented as intended (as detailed in the attached Policy Brief). [20]

Dodd-Frank included the blueprint for essential improvements in the oversight of our derivatives markets; completing that would not only bring more small- and mid-tier financial firms into the derivatives market, it would also have the not-incidental benefit of drastically reducing risk to the financial system. That is why it is important that federal regulators, led by the CFTC or FSOC if the CFTC fails to act, take swift action to ensure that the biggest

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Processes for Managing Emergency Assistance (July 2011); ProPublica, *Bailout Recipients*, *available at* https://projects.propublica.org/bailout/list/simple.

[18] Kelleher testimony at Senate Banking Committee (March 25, 2015)

[19] https://piie.com/publications/policy-briefs/financial-stability-oversight-council-essential-role-evolving-us

[20] https://www.bettermarkets.com/keywords/stopping-wall-street%E2%80%99s-derivatives-dealers-club

derivatives dealers do not succeed in their ongoing efforts to kill, weaken, or delay essential reforms in the derivatives marketplace.

Key among the Dodd-Frank derivatives reforms was the creation of swap execution facilities (SEFs), exchange-like trading venues where most, if not all, swap trading would be executed. Properly enacted, SEFs will bring transparency, oversight, a level playing field, and competition to the swaps markets. That promise has yet to be realized, because the largest participants in the market have carved out loopholes in the rules under which they have essentially replicated the pre-crash derivatives markets. As a result, seven years after the passage of Dodd-Frank, most of the handful of large dealers who have always dominated the derivatives markets continue to do so. In fact, currently five of the largest Wall Street banks together control almost 95% of all derivatives trading in the U.S. That simply would never happen in a competitive, properly regulated free markets.

The Repeal of Glass-Steagall Enabled the Supersizing of the Biggest Banks, which Contributed Significantly to the 2008 Crash

As detailed in the Fact Sheet included with this letter, after the Great Crash of 1929 and the Great Depression of the 1930s, several laws were passed to create different layers of different types of protections between the highest risk financial activities on Wall Street and the hardworking American families on Main Street. These protections were regulatory, supervisory, and structural.

The Glass-Steagall Act was the key structural protection: It prohibited the same bank from engaging in both lower-risk traditional commercial banking (using FDIC-insured and Fed-backed savings accounts to make mortgage and business loans) and higher-risk trading, insurance and investment banking operations. For more than 60 years, the Glass-Steagall Act kept those activities separate and, during that time, the U.S. created the largest middle class and had the highest rate of economic growth in its history while the financial system thrived and avoided catastrophic crashes.

Because Glass-Steagall prohibited banks from engaging in both commercial and residential banking and investment banking, securities trading, and insurance at the same time, it prevented Wall Street's highest-risk activities from endangering the bank that engaged in socially useful traditional banking. As University of Chicago economist Luigi Zingales explains: "While Glass-Steagall may not be the most efficient form of regulation, it worked for more than sixty years . . . The beauty of Glass-Steagall, after all, was its simplicity: banks should not gamble with government-insured money."

However, following the repeal of Glass-Steagall, large financial institutions were able to acquire other financial institutions thus combining lower-risk traditional banking with higher-risk Wall Street trading, securities, and insurance activities. These mergers and acquisitions created gigantic, sprawling, interconnected, and highly leveraged global financial institutions that threatened taxpayers and risked massive bailouts if they ever failed. That was because, if the uninsured investment banking activities of a megabank got into trouble and threatened to take down the FDIC-insured part of the bank, then the government would inevitably have to save both parts of the firm to save the insured part.

In addition to adding interconnectedness and complexity from combining so many different financial institutions, these consolidations resulted supersizing a handful of banks This resulted in the top 6 banks increasing their assets from about 20% of GDP in 1997 to more than 60% of GDP in 2008.

It is important to note that a new law substantively the same as the original Glass Steagall Act could, if implemented incorrectly, increase the likelihood of future crashes. For example, it could re-create the dangerous two-tiered system of regulation that caused the unregulated shadow banking system to expand dramatically. That is to say, if a Glass Steagall-like law were passed, then both types of systemically significant financial institutions would have to be similarly regulated to ensure that risk does not again migrate from a highly-regulated banking system to a lightly regulated shadow banking system. (This is another reason why FSOC's mission is so vital.) In addition, systemic risk could increase if a Glass Steagall-like law were passed but other critical financial protection rules on capital, liquidity, resolution plans, stress tests, and other reforms were simultaneously weakened or eliminated.[21]

We do not believe Glass-Steagall is a panacea to preventing all future banking crises. There are no magic bullets or simple answers to the massive threat posed by too-big-to-fail firms and activities. But as far-sighted legislators and policy makers saw after the Great Crash of 1929, what a safe, sound, durable, non-threatening, and socially-useful financial system needs are multiple layers of protection of different types between Wall Street and Main Street. Restoring the separation between commercial and investment banking is one of the most sensible layers of protection because it takes away the taxpayer subsidy of insured deposits while at the same time forcing the biggest banks to absorb their own costs and, therefore, become less dangerous to taxpayers and the economy.

Reinstating Glass-Steagall is not the only solution and it won't solve too-big-to-fail by itself. It can, however, be an important part of a strategy to reduce the risk on Wall Street while increasing protections for Main Street.

Ensuring Investment Advisers Put their Clients' Best Interests First

<u>The SEC has neither the legal authority nor the institutional capacity to write a fiduciary duty rule for advice about retirement accounts. Congress clearly and deliberately assigned that responsibility to the Department of Labor ("DOL").</u> Opponents of the DOL's new fiduciary duty rule have long argued that the SEC, not the DOL, should set the standards applicable to all financial advisers, even those who serve retirement accounts that were created not under the securities laws but under the labor laws and the tax code. Their argument is legally and factually wrong on multiple levels.

Legally, the SEC has no authority to write rules implementing the Employee Retirement Income Security Act ("ERISA"), nor does it have any authority over investment advice relating to the many non-securities investments found in retirement accounts. Moreover, as a matter of institutional commitment, the SEC has proven itself incapable of effectively regulating the advisory activities of the brokers over which it does have jurisdiction—notwithstanding an explicit authorization from Congress in the Dodd-Frank Act to strengthen that oversight and notwithstanding the strong recommendation of the SEC's own staff in a 2011 report that the fiduciary duty should be extended to broker advisers. In reality, this entire line of argument is simply a distraction created to defeat the DOL's fiduciary duty rule, with no prospect of an adequate substitute ever being issued by the SEC.

<u>The SEC has no authority to write the rules necessary to implement ERISA.</u> The SEC has no legal authority to issue or update any rules implementing ERISA. Congress mandated that the DOL, not the SEC, discharge that responsibility, and it did so intentionally, fully aware of the vast regulatory framework it had already created governing securities transactions.

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[21] Another unacceptable risk would arise if Goldman Sachs and Morgan Stanley were allowed to convert from bank holding companies to non-bank holding companies, i.e., engaged solely in the securities, trading, and insurance business. These two investment banks were lightly regulated pre-crash because they were supposed to be outside the federal safety net, but they were nonetheless allowed to convert virtually overnight to bank holding companies to obtain access to the safety net and bailouts. Access to the safety net is supposed to be conditioned on rigorous regulation for the protection of taxpayers, but that wasn't the case with Goldman Sachs and Morgan Stanley. That turned the so-called implicit federal backstop into an explicit bailout for firms that were not regulated for the protection of taxpayers. While some might argue this was necessary emergency action for the greater good, there can be no such argument for allowing these two banks to get bailed out and returned to their prior status as if nothing ever happened. That would be the ultimate example of privatizing gains and socializing losses.

Congress passed the Investment Advisers Act in 1940 to establish a regulatory regime governing those who give investment advice about securities. Thirty-four years later, in 1974, fully aware of the regime it had created for SEC-registered investment advisers, Congress determined that a separate regulatory framework, including higher standards of loyalty and care, was necessary to ensure that Americans' retirement assets were adequately protected from fraud, abuse, and conflicts of interest. Fueling this initiative was a recognition that retirement assets play a unique and critical role in determining the quality of life for all Americans once they leave the workforce. In addition, Congress understood the need to create special protections for retirement savings in light of their privileged tax status. ERISA was the result, and the DOL has been expressly required by Congress to administer it. Congress clearly intended the SEC and DOL to oversee distinct sets of rules designed for distinct purposes.

As former SEC Chair Mary Jo White acknowledged when testifying before the Senate Financial Services and General Government Appropriations Subcommittee in 2015, the DOL and SEC "are separate agencies with separate statutory mandates," and the DOL fiduciary duty rule relates to its "important" mandate under ERISA.[22]

<u>The SEC has no jurisdiction over advice pertaining to any investment that is not a security.</u> Furthermore, the SEC lacks any authority to regulate advice about investments that are not securities. Yet, retirement accounts routinely include a variety of non-securities investments, including insurance products, real estate investments, and even commodities. Unlike the SEC, the DOL has broad authority over all of these assets, as well as any other "moneys" or "property" of a retirement plan.[23]

Thus, the SEC could not possibly promulgate a rule that protects retirement savers from any conflicts of interest or other abuses arising from the sale of many financial products commonly found in retirement accounts. These are facts not subject to legitimate dispute.

<u>Section 913 of the Dodd-Frank Act confirms the separate and important role Congress intended for the DOL.</u> Section 913 of the Dodd-Frank Act only reinforces this conclusion. In Section 913, Congress granted the SEC explicit authority to raise the standards of conduct applicable to broker-dealers who give advice about securities investments. Again in recognition of the two separate roles of the DOL and the SEC, Congress declined in Section 913 to subordinate or alter the DOL's authority over advisers to retirement savers, or to link it in any way to the SEC's oversight of securities transactions, broker-dealers, or investment advisers.

<u>The Harkin Amendment highlights the need for DOL's independent jurisdiction over all retirement investments, especially those that are not securities.</u> The so-called Harkin Amendment in the Dodd-Frank Act highlights the importance of DOL's separate authority to regulate advice about all retirement investments, including those that are not categorized as securities. *See* DFA Sec. 989J.

In that amendment, Congress yielded to pressure from the insurance industry and prohibited the SEC from regulating fixed indexed annuities ("FIAs") as securities, categorizing them instead as insurance products. FIAs are among the most often recommended investments for retirees, and they are aggressively sold by insurance agents seeking the exceptionally high commissions they generate. Yet FIAs are also among the most complex products on the market, and they have often been the subject of abusive sales practices. Fortunately, Congress's decision to limit the SEC's authority over these products did not limit in any way the DOL's ability to protect retirement savers from the powerful conflicts of interest that motivate financial advisers to promote them.

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22 U.S. Senate Committee on Appropriations, FSGG Subcommittee Hearing: FY16 Budget Requests for the SEC and CFTC (May 5, 2015), *available at* http://www.appropriations.senate.gov/webcast/fsgg-subcommitteehearing-fy16-budget-requests-sec-cftc

23 29 U.S.C. § 1002.

The SEC has been unable to effectively regulate the advisory activities of broker-dealers. As a practical matter, subordinating the DOL mandate to protect retirement savers to the SEC means that retirement savers will never have adequate protection from their advisers' conflicts of interest. The SEC has demonstrated a steadfast unwillingness to ensure that financial advisers in the securities realm abide by a fiduciary duty.

First, for decades, the SEC has allowed broker-dealers to invoke a limited exemption from the fiduciary duty found in the IAA, even though brokers flout the conditions of the exemption every day. Thanks to the SEC's sustained regulatory failure over the years, it is now a de facto rule of law that financial advisers employed by broker-dealers may hold themselves out as trusted advisers, and perform the same advisory services as registered "investment advisers," without complying with any version of the fiduciary, or best interest, standard.

Second, the SEC has refused to exercise the explicit authority that Congress granted it in Section 913 of the Dodd-Frank Act to impose a uniform fiduciary duty upon all advisers, thus leveling the playing field between broker-dealer advisers and registered investment advisers while protecting savers and investors of all types. This, despite the fact that the staff of the SEC conducted a study of the issue, as required by Section 913 of the Dodd-Frank Act, and **recommended** that the SEC undertake just such a rulemaking initiative. Thus, for the foreseeable future, the SEC cannot be expected to take any action that would adequately protect retirement savers from the conflicts of interest among too many financial advisers. The DOL rule is indispensable, and the SEC cannot and will not offer an effective substitute.

Improving the Living Will Process

The "living wills" that are required of the country's largest banks are the first line of defense in protecting the American people from the catastrophic failure of one of these firms. Put simply, living wills merely require the country's largest banks to be resolvable in bankruptcy like every other business in the United States. But after years of effort, too many of these financial institutions continue to threaten the financial stability of the United States and are not believed to be resolvable in bankruptcy.

Better Markets has commended the regulators for insisting that these banks produce credible living wills and for working to ensure that these institutions can, if necessary, be wound down in bankruptcy without requiring a bailout or crashing the economy. Better Markets has also commended them for making more detailed information available to the public regarding these banks' living wills and the regulators' assessment of them.

Nevertheless, the living will process must be improved for the credibility of the resolution plans to be recognized in the marketplace and for market discipline to be restored. As set forth in the Policy Brief included with this letter, Better Markets has suggested several ways to accomplish these goals, including making the process more transparent and involving creditors to a greater extent. These measures should make these plans more credible to market participants and the public as well as regulators.[24]

$50 billion SIFI Bank Threshold Applies to Just 37 Banks

Dodd-Frank subjects banks with assets exceeding $50 billion to enhanced scrutiny and supervision by federal regulators. However, the law also expressly gives the Federal Reserve Board, in conjunction with other banking regulators, the authority and discretion to tailor its oversight of these banks to their specific risk profiles, to ensure that a $50 billion bank is not treated the same as a $250 billion bank or a $2 trillion bank.

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[24] https://www.bettermarkets.com/sites/default/files/Breathing%20Life%20Into%20Living%20Wills_0.pdf

Currently, just 37 banks are above the $50 billion threshold; put another way, the $50 billion threshold excludes more than 99% of all banks in the United States from enhanced review by the Fed.

Contrary to claims by some in the industry that legislative changes to the Dodd-Frank Act are necessary to provide the Fed with flexibility to tailor its financial regulations for banks of different sizes and risk profiles, current law already provides the Fed with ample authority and flexibility to do exactly that. As detailed in the enclosed Better Markets fact sheet, the Fed has made use of this authority.[25] Indeed, it is the regular practice of the Fed to tailor its standards to appropriately match the risk profile and activities of different banks, as opposed to the one-size-fits-all approach that industry claims.

The burden should be on those who call for increased flexibility by the Fed and other regulators to demonstrate which specific statutory requirements lack flexibility or regulatory discretion or are causing damage to the U.S. economy, and why such requirements cannot be addressed through the Fed's existing practices and existing statutory authorities.

One change that should be made, however, is to index the $50 billion threshold. Whether it's to industry average in asset growth, GDP or some other benchmark, the idea was always for the threshold to only capture the largest banks and indexing would achieve that goal over time.

Conclusion

It must be remembered that the 2008 financial crash and the economic crisis it caused did more damage to lending, growth, and jobs than any regulation passed to prevent that from happening again did: In September 2008, there was no market liquidity or lending or capital formation, there was no economic growth or job creation, there was only chaos and panic followed by bailouts and economic wreckage for the American people.

It is an obvious point, but one worth repeating: Nothing is more harmful to economic growth than a financial crash like that in 2008-2009. Protecting our gains, and preventing another crash, must be our top priority. And that means avoiding the kind of behavior that helped cause the crash in the first place. As the economic, financial, and banking data prove, this is not only entirely compatible with economic growth, but necessary if we are to have both.

Sincerely,

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[25] https://www.bettermarkets.com/resources/fact-sheet-50-billion-threshold-and-feds-sifi-designation-0

Enclosures:

Report on Cost of the Crisis
Report on Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC
Policy Brief: Stopping Wall Street's Derivatives Dealers Club
Fact Sheet: Glass-Steagall
Policy Brief: Breathing Life into Living Wills
Testimony: Dennis Kelleher before Senate Banking Committee, March 25, 2015
Banking's Final Exam: Stress Testing and Bank-Capital Reform
Fact Sheet: The $50 Billion Threshold and Fed's SIFI Designation

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