Testimony of

Hal S. Scott

Professor and Director, Program on International

Financial Systems, Harvard Law School

Before the

Subcommittee on Oversight and Investigations

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Mr. Scott. Thank you, Chairman Duffy, Ranking Member Green, and members of the subcommittee, for permitting me to testify before you today. I am testifying in my own capacity and do not purport to represent the views of any organizations with which I am affiliated, although some of my testimony is consistent with the publicly stated views of the Committee on Capital Markets Regulation, which I direct.

I want to focus on three points in my testimony today. First, FSOC is an inadequate substitute for real reform of the regulatory structure, which is itself badly needed. Second, FSOC's principal role to designate non-banks as systemically important financial institutions (SIFIs) is ill-advised. And third, the non-bank SIFI designation process should be revised to provide the public and the potential designee with adequate transparency, including a cost-benefit analysis.

The U.S. financial regulatory structure is highly fragmented and ineffective, as multiple agencies have responsibilities for the same or closely related entities and markets. Following the 2008 crisis, other leading financial centers, including the United Kingdom and the European Union, reorganized and consolidated their regulatory structure. The United States did not.

The FSOC authority to coordinate this fragmented regulatory structure is severely limited.

First, while FSOC has the authority to mediate disagreements between its members, this requires an affirmative vote of two thirds of the members of FSOC. Even if FSOC is able to make recommendations about what to do about problems, it has no mechanism for enforcing them.

Second, a simple majority of FSOC members can recommend that another agency, one of its members, issue a specific rulemaking if FSOC determines that such a rulemaking is necessary to mitigate risk to the financial system. However, FSOC does not have the authority to require agencies to actually implement these rulings.

So its ability to coordinate this fragmented regulatory structure is highly limited.

Let me turn to SIFIs.

One key point is that there is no evidence for the principle underlying SIFI designations: that large financial institutions are so interconnected to each other that the bankruptcy of one will directly cause the bankruptcy of others.

In the 2008 financial crisis, no large financial firms failed as a direct result of their exposures to Lehman Brothers. And analyses show that direct losses due to the failure of AIG would also not have caused the bankruptcy of its large counterparties. They limited their risk at AIG, as prudent counterparties do.

Instead, in 2008 systemic risk existed due to contagion, which is an indiscriminate run by short-term creditors across the entire financial system. Thus, designating certain large non-banks as systemically important and then subjecting these institutions to more stringent regulation does not meaningfully reduce systemic risk.

It also potentially increases moral hazard and could introduce competitive distortions into the marketplace if these designees enjoy reduced funding cost, a subject of some debate.

Finally, the non-bank SIFI designation process is also in need of reform. Currently, the general public and potential future designees, or ones that have been, in fact, designated, receive inadequate information regarding the basis for FSOC's determination.

FSOC does not conduct a cost-benefit analysis when making a non-bank SIFI designation, and the potential designee does not receive an opportunity to present its position to FSOC until FSOC is nearly complete with its process. Furthermore, FSOC does not provide the designee with the opportunity to review the record upon which its decision is based.

These inadequacies in the process should be corrected by the FSOC. And if FSOC does not do so, then Congress should revise the Dodd-Frank Act so that FSOC is statutorily obligated to provide such transparency.

Thank you, and I look forward to your questions.

Chairman Duffy. Thank you, Professor Scott.