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Hearing Summary

January 11, 2024

DIGITAL ASSETS PANEL EXAMINES UPDATED FSOC SIFI GUIDANCE

EXECUTIVE SUMMARY

On January 10, the House Financial Services Subcommittee on Digital Assets held a hearing entitled "Regulatory Whiplash: Examining the Impact of FSOC's Ever-Changing Designation Framework on Innovation." The hearing featured a panel of witnesses who offered perspectives and recommendations on the Financial Stability Oversight Council's (FSOC) ability to designate non-bank financial institutions as systemically important under its updated Dodd-Frank section 113 Systemically Important Financial Institution (SIFI) authority.

Republicans on the panel expressed concerns that the updated guidance would allow FSOC to circumvent the intent of congress and that designating non-bank entities as systemically important may stifle innovation. However, Subcommittee Democrats argued that the updated guidance will allow FSOC to act more quickly to emerging risks. Witnesses largely agreed that the designation of non-bank entities is a tool that should be used sparingly.

OPENING STATEMENTS

Chair French Hill (R-AR) (statement) was concerned about FSOC's revised guidance for non-bank financial company designations. He criticized the new guidance for potentially leading to abuse and unintended consequences, particularly highlighting the removal of the requirement for FSOC to conduct a cost-benefit analysis. Chair Hill argued that the FSOC's approach, including its focus on digital assets, may undermine legislative efforts by Congress. In closing, he called for careful consideration to avoid "side-stepping" congressional intent.

Ranking Member Stephen Lynch (D-MA) highlighted the origins and purpose of FSOC, emphasizing its role in preventing financial crises. He emphasized the importance of FSOC's authority to designate non-bank financial institutions as systemically important, considering factors such as leverage and off-balance sheet exposures. Ranking Member Lynch expressed concerns about potential risks in the financial system, including those associated with digital asset firms. He also stressed the need for FSOC to balance its mission of identifying emerging threats with fostering innovation and ensuring appropriate oversight.

WITNESS TESTIMONY

Mr. Paul Kupiec (testimony), of the American Enterprise Institute, criticized FSOC for "inadequately" addressing financial stability risks, particularly in its perceived failure to prevent risks associated with interest rate mismatches in the banking system. He argued that FSOC's designations have become “politicized,” and highlighted concerns about its focus on climate change as a systemic risk. Mr. Kupiec proposed changes to the voting process within FSOC and emphasized the need for comprehensive congressional legislation, rather than FSOC designations, to address regulatory uncertainty in industries such as digital assets.

Mr. Bill Hulse (testimony), of the U.S. Chamber of Commerce, highlighted concerns about FSOC’s designation of non-bank financial companies as systemically important, emphasizing the impact on the entities' business models. He expressed worry about FSOC's “de-prioritization” of an activities-based approach, the perceived lack of due process for designated companies, and the need for transparency in FSOC's annual reports. Mr. Hulse calls for congressional legislation to address regulatory uncertainty, recommending the FSOC Improvement Act (H.R. 3812) to strengthen due process and provide alternative approaches.

Mr. Ji Kim (testimony), of the Crypto Council for Innovation, underscored the importance of sound regulation to safeguard consumers and markets while fostering innovation in the global economy. He emphasized the need for FSOC to focus on risks of such magnitude that require its unique intervention, respecting the roles of state and federal regulators. Mr. Kim highlighted the positive impact of digital assets, such as stablecoins, in improving financial access, reducing costs for cross-border transactions, and promoting financial inclusion, while urging Congress to establish a comprehensive federal regulatory framework for digital assets.

Mr. Jeffrey Dinwoodie (testimony), of Swaine & Moore LLP, expressed hope that FSOC's recent decision to place non-bank SIFI designation authority on equal footing with its other powers is primarily symbolic, with non-bank SIFI designation remaining a tool of last resort. Mr. Dinwoodie also calls for FSOC to stay disciplined, resist being used for unrelated policy agendas, and focus on assessing true vulnerabilities and risks, including those arising from government actions.

Mr. Amias Gerety (testimony), of QED Investors, highlighted three points during his remarks. First, he provided historical context on the impetus of FSOC and its role in addressing weaknesses leading up to the global financial crisis. Second, he discussed the importance of FSOC's authority to supervise complex non-bank financial companies, emphasizing the balance between activities-based and entity-based approaches. Finally, he underscored the significance of FSOC's role in analyzing low probability, high severity events and its duty to prevent potential risks — especially in the context of emerging trends such as artificial intelligence (AI), digital assets, and climate change.

DISCUSSION AND QUESTIONS

Digital Assets and Stablecoins

- Chair Hill asked Mr. Hulse if FSOC attempting to “side-step” Congress would constitute an overreach by the Council. Mr. Hulse expressed concern that FSOC’s November 2023 guidance makes it easier for FSOC to do so allowing it more leeway to designate non-bank financial institutions — such as digital asset and stablecoin issuers — as systemically important.

- Chair Hill pressed Mr. Kupiec if FSOC had concerns about the interconnectedness of uninsured deposits and financial risk prior to the collapse of Silicon Valley Bank (SVB). Mr. Kupiec suggested that FSOC had not.
- Chair Hill and **Rep. John Rose (R-TN)** questioned whether FSOC's focus on digital assets as a "top priority" is misguided, given its relatively smaller size in comparison to other asset classes. Mr. Kim asserted that analysis shows that digital assets do not constitute a systemic risk, further claiming that FSOC has acknowledged this. In questioning with Rep. Rose, Mr. Kim opined that industries such as insurance pose a greater risk to financial stability.
- Arguing that FSOC is "unaccountable" to lawmakers, **Rep. Tom Emmer (R-MN)** urged his colleagues to support his legislation — the Financial Stability Oversight Council Reform Act (H.R. 1549).
- **Rep. Sean Casten (D-IL)** asked what area of financial markets lawmakers should be concerned about if stablecoins deviated from their one-to-one reserve ratio. Mr. Gerety suggested that the initial concern — when examining the reserve portfolio of stablecoins — is uninsured deposits.
- Rep. Rose prompted Mr. Kim to discuss whether the GOP-led digital asset regulatory framework legislation would benefit the digital asset industry. Mr. Kim suggested that it would be beneficial.
- **Rep. William Timmons (R-SC)** questioned whether FSOC's updated SIFI designation guidance might result in digital asset firms shifting their operations overseas. Mr. Kim claimed that it would create uncertainty for digital asset firms and likely incentivize such firms to move to more favorable jurisdictions.
- **Rep. Erin Houchin (R-IN)** inquired whether FSOC's statement — that it remains willing to act to address potential risks posed by stablecoins in the event lawmakers do not enact a regulatory framework — constitutes an "overreach" by the Council. Mr. Hulse contended that FSOC currently possesses broad authority in this regard under Dodd-Frank, as a result of its updated guidance, but emphasized that any action it would take under its current parameters would likely deviate from a "tailored approach." He further asserted that the Fed — which supervises any SIFI-designated entities — does not possess the regulatory tools to address any potential risks posed by stablecoins.
- **Rep. Mike Flood (R-NE)** pressed Mr. Hulse on why FSOC adopted a more aggressive approach with respect to digital assets between its 2022 and 2023 reports. Mr. Hulse responded that he is unaware of any market developments that would have led to the change in tone.

Artificial intelligence

- Pointing to concerns over the use of artificial intelligence (AI) in financial markets, Ranking Member Lynch wondered whether FSOC should have greater authority to investigate AI trading activities. Mr. Gerety pointed out that AI's growth is largely outside of the financial sector and welcomed the notion that AI might be able to provide retail investors with quality investment advice. Further, he suggested first starting with aligning the use of AI models in trading with regulations surrounding existing investment techniques.

- Rep. Flood inquired whether potential disparate outcomes and consumer compliant risks associated with AI will fall under the purview of FSOC. Mr. Dinwoodie argued that it is unclear how these two facets of AI fall within the FSOC's jurisdiction.

Designation Process

- **Rep. Bill Foster (D-IL)** pressed Mr. Gerety on whether FSOC will take lightly any decision to designate a non-bank financial institution as systemically important. Mr. Gerety stated that FSOC's designation authority is narrow, suggesting that the authority will be used sparingly, if at all. Rep. Foster then asked how Mr. Gerety envisions FSOC using its authorities short of designating a non-bank financial institution as systemically important. Mr. Gerety pointed to FSOC's annual report highlighting digital assets as a potential risk but not designating them as systemically important as evidence of this.
- **Rep. Warren Davidson (R-OH)** questioned why the administration omitted the inclusion of "bright line" thresholds for SIFI designation. Mr. Hulse was unaware of why this omission was made but added that bright line asset thresholds are useful in concert with other metrics.
- **Rep. Brad Sherman (D-CA)** asked what considerations should be factored in when determining whether an entity is a SIFI with respect to asset managers, such as Vanguard. Mr. Dinwoodie asserted that SIFI designation is not congruent with asset managers because the Fed has little experience supervising such entities.
- **Reps. Frank Lucas (R-OK)** and Rose asked Mr. Dinwoodie to compare FSOC's most recent guidance with its 2019 guidance on the designation process. Mr. Dinwoodie stated that the courts ruled that the SIFI designation for Met Life was "arbitrary and capricious" because the designation lacked sufficient cost-benefit analysis. Similarly, Rep. Lucas pressed Mr. Hulse to identify how the new guidance on the subject deviates from FSOC's statutory authority under the Dodd-Frank Act. Mr. Hulse asserted that the updated guidance "fails" to emphasize the vulnerability of a company to financial distress, instead focusing on the size of a company to determine its systemic risk profile.
- Rep. Lucas prompted Mr. Dinwoodie to explain what impact a SIFI designation might have on a firm and whether FSOC would have been in conversation with the firm prior to the designation. Mr. Dinwoodie suggested that the designation process takes roughly one and a half years, but did not directly answer the question.
- Rep. Lucas asked Mr. Hulse to comment on how regulations such as Basel III may drive banking activity toward the non-bank sector, thus providing bank regulators with justification to supervise non-banks. Agreeing with this sentiment, Mr. Hulse referenced a speech by Federal Deposit Insurance Corporation (FDIC) Chair Martin Gruenberg, during which he suggested imposing "bank-like" regulations on non-bank financial institutions.
- **Rep. Bryan Steil (R-WI)** prompted Mr. Hulse to detail how the changes to FSOC's SIFI determination process may ultimately result in greater financial stability risks. Mr. Hulse asserted that, by regulating non-bank financial institutions as banks and designating them as systemically important, it will reduce competition in the financial sector.
- Rep. Steil wondered whether FSOC's updated guidance would restore its ability to make designations similar to what led to the MetLife court decision. Mr. Kupiec suggested that it would.

- Rep. Timons highlighted statements from Consumer Financial Protection Bureau (CFPB) Director Rohit Chopra suggesting that the "lack" of non-banks designated as systemically important represents FSOC's ineffectiveness. Mr. Hulse opposed this characterization, arguing that the Council should resume their "activities-based" approach to SIFI designation.

Other Topics

- Rep. Davidson suggested that there are ongoing efforts from bank regulators to consolidate smaller banks to the benefit of large banks. Mr. Kupiec did not confirm this sentiment but acknowledged that there has been a decline in the number of community banks in recent years.
- **Rep. Al Green (D-TX)** pressed witnesses to explain how climate change-related natural disasters might pose a risk to financial stability. Mr. Gerety posited that the risk stems from the increased severity of such events, which he claimed has increased from our previous understanding of these events. He added that, while he does not believe climate change poses an immediate financial risk, it is an important issue to monitor, pointing to FSOC's recognition of cybersecurity as a potential stability concern several years ago as justification for his claim.