

**Testimony of  
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**Before the  
United States Senate Committee on Banking, Housing and Urban Affairs**

**Hearing on  
Measuring the Systemic Importance of U.S. Bank Holding Companies**

**July 23, 2015**

Chairman Shelby, Ranking Member Brown, members of the committee and panel colleagues, I am grateful for the opportunity to talk to you today. My name is Jon Macey, and I am a professor of law at Yale Law School. I am here only in that capacity. I represent no firm, industry, organization, or party. It is a pleasure to be here. Thank you giving me the opportunity to address your Committee on the important topic of measuring systemic risk in U.S. Bank Holding Companies.

The central question for today is whether it makes sense to continue to assume that all banking companies with more than \$50 billion of assets are systemically important and therefore subject to a heightened level of prudential regulation. Currently under consideration is Senator Shelby's proposal to reduce the central reliance on a bright line test by moving the automatic threshold to \$500 billion in assets, and authorize the Federal Reserve and the Financial Stability Oversight Council to evaluate the systemic importance of banking companies below this asset size threshold.

The Shelby bill would reduce from 36 to six the number of financial institutions subject to the automatic cutoff. I support this new approach for five reasons.

First, the bill will reduce the distortive effect of the current regulatory regime, which provides incentives for mid-size banks to stop growing to avoid the SIFI designation, provides incentives for institutions above the threshold to grow at least until they approach the size of the so called “big six” financial institutions in order to be able to amortize the additional costs of regulation placed on institutions designated as systemically important.

Second, the proposal in the bill under consideration would inject a degree of intellectual rigor into the SIFI designation process that is currently lacking. Regulators would have to pay more attention to factors besides asset size. The role played by other factors, such as operational complexity, balance between the liquidity characteristics and maturity dates of assets and liabilities, off-balance sheet positions, earnings volatility, interconnectedness, and cross-country exposures would receive attention. While supporters of Dodd-Frank initially marketed the legislation as eliminating the long-standing practice of treating certain financial institutions as “too-big-to-fail,” nobody seriously asserts that financial institutions designated as SIFIS would be allowed to disappear. In my view the flawed process by which MetLife was designated as a SIFI illustrates the need to impose more intellectual rigor on the SIFI designation process. The MetLife designation process ignored basic principles of risk regulation, failed to distinguish plausible risks from implausible risks, and failed to appreciate the differences between MetLife’s business and balance sheet and the business and balance sheets of bank holding companies. Requiring regulators to rely less on the \$50 billion Maginot Line would incentivize regulators to be more analytically rigorous in the designation process.

A third reason to support this bill is that the new approach to SIFI designation reflected in the statute would make the regulatory system more fair by reducing reliance on an arbitrary line of demarcation that nobody has been able to support or defend either empirically or theoretically.

Fourth the change would reduce some of the current pathologies in bank regulation that Dodd-Frank created. The financial system is more concentrated, more interconnected and more opaque than it was before the financial crisis. Almost all of this increase occurred during the crisis as regulators encouraged big distressed financial firms to acquire other even more distressed financial firms. Bank of America acquired Countrywide and Merrill Lynch, JPMorgan acquired Washington Mutual and Bear Stearns, and Wells Fargo acquired Wachovia. Now the six largest financial institutions hold over 60% of all of the assets in the financial system and hold a near-100% market share of shadow banking sector activities.

For people who, like me, believe that the administrative state should be subject to the rule of law, Dodd Frank poses significant challenges. Never has so much rule-making authority and regulatory discretion been granted so broadly. As I previously observed in the Economist Magazine, “Laws classically provide people with rules. Dodd-Frank is not directed at people. It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies.”

The key term “systemically important financial institution” is not defined, other than with reference to the fact that financial firms that are designated as systemically important are systemically important. Since systemic failure is, by definition, catastrophic, regulators feel justified in acting aggressively to reduce the likelihood that such failure will occur.

The efforts of regulators to have money market funds and mutual funds designated as SIFIs is a prime example of the regulatory over-reaching that is not merely enabled but encouraged by Dodd-Frank. Simply by recognizing the primordial fact that the assets in these funds belongs to the investors and not to the funds themselves, so that losses in the value of the

assets held by these funds is not a loss for the entity, but rather for the investors who hold shares in the entity.

Recently we have seen bespoke regulations imposed on General Electrical Capital Corporation (GECC), as well as with the recent imposition of customized capital requirements on JPMorgan Chase, Citigroup, Bank of America and the five other largest U.S. banks that are tailored to the perceived riskiness of each of these financial institutions. My point is not that such firm-by-firm regulation is bad. My point is that such regulation is inevitable, and that it inevitably creates an uneven competitive playing field among institutions. It is only modestly comforting that these financial institutions are so complex that it is not possible to tell, *a priori* which institutions advantaged and which are disadvantaged by the Federal Reserve's new rules. We are clearly not living in a first or even second best regulatory environment as we pass the fifth anniversary of Dodd-Frank. From a policy perspective, as regulations increasingly are tailored to reflect regulators' views of banks' riskiness as measured by the formulas they themselves develop, exposure to the risk of favoritism, capture and other symptoms of a runaway regulatory state multiply exponentially.

Fifth, for those who, like me, believe that the best way to avoid having financial institutions that are too big to fail is to reduce to zero the number of institutions that are too big to fail, the proposed legislation provides positive incentives for banks to be smaller and negative incentives on banks to become larger. Like the Fed's new capital requirements for the eight largest financial institutions, the proposed statute imposes some costs on the very biggest financial institutions.

On the bright side, it is worth noting that the proposed statute would require the FSOC to provide any BHC under review for possible designation as a SIFI with (1) a "detailed

explanation” for any proposed or final designation as a SIFI, (2) opportunities to meet with FSOC members and staff, and (3) the opportunity to submit a “remedial plan” prior to final designation to avoid a SIFI designation. Further, the FSOC must reevaluate existing BHC SIFIs with assets of less than \$500 billion at the request of the Federal Reserve and at least every five years. These aspects of the legislation seem modest and uncontroversial, but in my view they are an important first step in restoring a measure of the regulatory accountability that was lost with the passage of Dodd-Frank.

Regulators have incentives to increase the list of systemically important financial institutions and to regulate those institutions expansively. These incentives are unfortunate. Regulators should be given incentives to reduce, not to expand the list of SIFIs. Unless our regulators have truly lost their way, it must be the case that reducing and indeed eliminating the number of financial institutions designated as SIFIs is a key goal of our public servants. The probability of failure of every firm in the private sector except for those that are too-big-to-fail is above zero. For financial institutions the probability of failure can change dramatically in a very short period of time. The more systemically risky firms there are in the economy, the more risky the economy will be. If the concept of systemic risk has any meaning whatsoever it must be the true that reducing systemic risk by reducing the number of firms that pose such risk is an important goal of any regulator worth her salt.