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Résumé de l'article

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New legislation is required should Congress decide to assess the Federal Reserves' monetary policy performance using the Government Accountability Office (GAO). The Federal Banking Agency Audit Act of 1978 restricts the GAO from evaluating Federal Reserve activities related to the Fed's monetary policy functions.

No new legislation is required to use the GAO to assess many other Federal Reserve activities and process including the expanded regulatory powers granted to the Federal Reserve and the Board of Governors by the Dodd-Frank Act.

Many Federal Reserve regulatory initiatives related to their Dodd-Frank expanded powers merit closer Congressional oversight. In this testimony, I will limit my discussion to three areas that have especially important ramifications for the safety and vitality of the entire U.S. financial system: The Congress should exercise closer oversight over the Federal Reserve's ongoing interactions with international standard-setting bodies like the Financial Stability Board, the International Association of Insurance Supervisors, and the Basel Committee on Banking Supervision.

Congresses should instruct the GAO to assess the costs, benefits, and processes associated with the recurring Board of Governors stress tests mandated by Section 165 of the Dodd-Frank Act. These stress tests are very resource-intensive, both for banks and for the banking regulators, and there is little evidence that they are a cost effective and objective means for regulating individual financial institutions.

Congress should assess potential conflicts that may be developing between the Federal Reserve's Dodd-Frank expanded powers over the domestic insurance industry and state insurance regulations. There are indications that new Federal Reserve examination and capital policies for insurers affiliated with a depository institution may be generating serious conflicts with existing state insurance supervision and regulation, contrary to the intent of the Dodd-Frank Act.

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FEDERAL RESERVE ACCOUNTABILITY AND REFORM

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March 4, 2015[1]

SUMMARY

The Federal Reserve was created by and enjoys duties and powers delimited by laws passed by Congress. Congress retains the legal right and social responsibility to amend the Federal Reserve Act and related legislation when such amendments are judged to be in the national interest. To exercise this duty, the Congress must have the right to assess the performance of existing Federal Reserve powers and responsibilities.

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Congress should assess potential conflicts that may be developing between the Federal Reserve's Dodd-Frank expanded powers over the domestic insurance industry and state insurance regulations. There are indications that new Federal Reserve examination and capital policies for insurers affiliated with a depository institution may be generating serious conflicts with existing state insurance supervision and regulation, contrary to the intent of the Dodd-Frank Act.

Federal Reserve independence and calls to "audit the Fed"

The Federal Reserve was created by and enjoys duties and powers delimited by laws passed by Congress. Congress retains the legal right and social responsibility to amend the Federal Reserve Act and related legislation when such amendments are judged to be in the national interest. To exercise this duty, the Congress must have the right to assess the performance of existing Federal Reserve powers and responsibilities.

The Federal Reserve (Fed) was created by Congress in 1913 with limited responsibilities. These included: the establishment of regional Federal Reserve banks; the provision of an elastic currency; the rediscounting of commercial paper; and, the supervision of Federal Reserve member banks. Over the years Congress amended the Federal Reserve Act to liberalize constraints on Fed operations, establish a Federal Reserve Open Market Committee, change the Fed's governance structure, require periodic reports by the Fed Chairman to Congress, and assign the Fed specific monetary policy goals.

For most of the Fed's history, its battle for independence has been a struggle to formulate monetary policy without interference from the executive branch. Before the Fed won its independence from the

US Treasury in the early 1950s, many administrations had run the Federal Reserve as if it were a captive finance arm of the US Treasury.

Today the battle for Federal Reserve independence is a struggle to maintain minimal Congressional oversight over some of its operational areas, and a fight to maintain the legal luxury to carefully manage the

Fed's operational transparency. The current struggle is probably less about safeguarding monetary policy from being high-jacked by parochial Congressional interests, but more about safeguarding unique Federal Reserve privacy privileges derived from its monetary policy functions.

Critics of "audit the Fed" proposals argue that the modern Federal Reserve is already transparent regarding its monetary policy deliberations and operations. True, the Fed now releases minutes and transcripts from its FOMC meetings with modest delays, and it has websites that document the details of its balance sheet and securities holdings. The Dodd-Frank Act pushed the Fed to disclose details about borrowers using the Feds emergency credit facilities[2] and, beginning in in 2012, the Fed was required to release detailed data on discount window borrowing[3] and open market transactions[4] with a two year lag.

While the Fed has responded to public and Congressional pressures and become much more transparent in its disclosures in recent years, disclosure is not the same thing as oversight. Oversight involves independent evaluation of process and performance[5]. The Federal Banking Agency Audit Act of 1978 gives the GAO audit authority over the Federal Reserve, but prohibited it from auditing[6]:

- Transactions with or for foreign central banks, governments, or non-private international financing organizations
- Deliberations or actions concerning monetary policy
- Federal Open Market Committee transactions
- Discussions and communications between Federal Reserve members, officers or employees associated with the prior three areas.

Given the uncertainties associated with the long-run economic impacts of the Fed's post-crisis monetary policy, some in Congress favor an expanded role for the GAO that includes the power to make an independent assessment of the Fed's monetary policy. For example, among other legislative features, S.264 (the Federal Reserve Transparency Act of 2015) would remove all restrictions on the GAO's ability to audit the Federal Reserve. An alternative proposal, H.R. 5018 (the Federal Reserve Accountability and Transparency Act of 2014) would remove all GAO audit restrictions but also require the Fed to provide the Congress with detailed information regarding its monetary policy decision rule.

Congress created the Federal Reserve and Congress retains the power to evaluate Federal Reserve performance and amend the Federal Reserve Act. In this context, the "audit the Fed" debate is about whether Congress should deputize the GAO to evaluate Fed performance, not whether the Congress has the power to do so. Whatever the outcome of the "audit the Fed" debate, ideally Federal Reserve oversight should be designed to allow Congress to ask and receive answers to its questions and criticisms, including about the Fed's monetary policy, but still shield the Fed from undue pressure to alter monetary policy to satisfy short-run political interests.

The modern Federal Reserve does far more than monetary policy, and the Fed's non-monetary policy duties also raise important accountability concerns. The Dodd-Frank Act (the Act) granted the Federal Reserve extensive new powers to formulate supervision, regulation, and bankruptcy reorganization standards for large financial institutions, and yet the Act itself includes no explicit congressional control over these expanded Federal Reserve powers. Indeed recent speeches by Federal Reserve officials argue that these new Fed "macroprudential powers" are an essential complement to monetary policy, especially in the current zero interest rate environment.

Using its expanded regulatory powers, the Federal Reserve has the ability to shape the growth and development of the entire US financial system. Unless the Congress exercises heightened oversight and control over the Federal Reserve's use of these expanded regulatory powers, Congress will delegate decisions that determine the future vitality of US financial markets to unelected Federal Reserve officials who are at best only weakly accountable to the public[7].

In the remainder of my testimony, I will focus on the need for expanded congressional oversight over the Fed's Dodd-Frank regulatory powers and related operations. Current legal authorities appear adequate and do not appear to restrict the GAO's ability to audit the Federal Reserve's regulatory activities, including audits on the Federal Reserve's use of its expanded regulatory powers[8]. In the remainder of my testimony I will highlight three areas where I think Congress should step up its oversight of the Federal Reserve's enhanced supervision and regulation operations.

THE FEDERAL RESERVE'S RELATIONSHIP TO INTERNATIONAL STANDARD SETTING BODIES

The Congress should exercise closer oversight over the Federal Reserve's ongoing interactions with international standard-setting bodies like the Financial Stability Board, the International Association of Insurance Supervisors, and the Basel Committee on Banking Supervision.

A recent GAO report[9] examined the relationship between Financial Stability Oversight Council (FSOC) designations of nonbank financial firms for enhanced supervision and regulation by the Federal Reserve Board and prior designations of the same firms (as global systemically important institutions) by the Financial Stability Board (FSB). Since the Treasury and Federal Reserve are both members of the FSB designation group, this coincidence raised concern that the FSOC designation decisions were actually made during FSB deliberations, well before the FSOC completed its designation analysis.

The GAO reported that Treasury and Federal Reserve officials it interviewed argued that FSB designations imposed no constraint on the FSOC's subsequent designations, but were just "another factor" taken into account in the FSOC deliberations. The GAO report also includes commentary and footnotes that suggest that GAO investigators had a difficult time believing these claims. The GAO noted that FSB documents report that national authorities are consulted before the FSB designates individual institutions.

A recent letter to G20 Ministers and Central Bank Governors dated February 4, 2015[10], raises new issues regarding the Federal Reserve's participation in FSB work streams including work streams that make FSB designations. In the letter, FSB chairman (and governor of the Bank of England) Mark Carney, makes clear to FSB members that the decisions of the FSB are directives, which all FSB members are expected to carry out. In this letter, Carney states specifically that FSB members – including the Federal Reserve – have agreed to "Full, consistent and prompt implementation of agreed reforms."

FSB chairman Carney's letter notes that "FSB peer reviews" will cover "implementation of the G20 policy framework." Carney reinforces the point mentioning that the FSB's will use its oversight as a means for achieving its objectives: "The FSB will support the determined efforts of its members through enhanced monitoring of implementation and its effects across all jurisdictions. We will regularly report our key findings to the G20."

The Federal Reserve apparently has agreed that its financial regulatory policies and institution designations will be guided by FSB directives that it has agreed to implement. Moreover, the Fed appears to have agreed to have its policy implementation overseen by a body dominated by European bureaucrats and chaired by the governor of the Bank of England. While the U.S. Treasury was clearly aware of these developments by virtue of their own FSB membership and participation, it does not appear that the US Congress received prior consultation before the Federal Reserve made these commitments.

Recent experience raises legitimate concerns that the Federal Reserve and the Treasury have been deciding on FSOC designations well before the FSOC finalizes its analysis. Given the unbalanced nature of FSOC member resources, pressure from the Treasury and the Federal Reserve Board on other FSOC members would likely be more than adequate to ensure a specific institution's designation. The November 14 GAO report documents that Federal Reserve has by far the largest staff allocated to the FSOC designations process and it is unlikely that few if any of the other FSOC members without a direct regulatory interest would challenge the Federal Reserve Board staff on its designation conclusions[11]. Indeed Federal Reserve influence on FSOC designations goes beyond the Board of Governors as there are reports that Federal Reserve Bank of New York staff has also been heavily involved and influential in the FSOC designation process[12].

The recent FSOC decision regarding Metlife's designation for heightened prudential standards and supervision by the Federal Reserve Board highlights the overwhelming influence that the Federal Reserve Board and Treasury can have on the FSOC designation process, especially when the FSOC's members have no direct interest in the nonbank industry under consideration. Dissenting from the FSOC's Metlife designation was the council's independent member having insurance expertise and the Council's state insurance commissioner representative[13]. Moreover, the state insurance commissioners from five states – California, Connecticut, Delaware, New York and North Carolina – independently wrote to FSOC Chairman Lew to protest the Metlife designation.

The Metlife dissent opinion written by the FSOC's independent member with insurance expertise was particularly informative about the relationship between FSB designation and subsequent FSOC decisions. It is worth quoting at length:

On July 18, 2013, the Financial Stability Board (FSB), an international organization within the umbrella of the Group of Twenty (G-20), primarily comprising the world's finance ministers and central bankers, including the U.S. Department of the Treasury (Treasury) and the Board of Governors, announced that it had identified MetLife as a global systemically important financial institution (G-SIFI). G-SIFIs are declared by the FSB to be "institutions of such size, market importance, *and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries." Thus, MetLife was declared by the FSB as a threat not to just the U.S. financial system, but to the entire global financial system.*

The FSB's announcement of the identification of MetLife and eight other insurers as G-SIFIs stated that its action had been taken "in collaboration with the standard-setters and national authorities;" and, that as G-SIFIs, these organizations would be subject to policy measures including immediate enhanced group-wide supervision, as well as to recovery and resolution planning requirements. It is clear to me that the consent and agreement by some of the Council's members at the FSB to identify MetLife a G-SIFI, along with their commitment to use their best efforts to regulate said companies accordingly, sent a strong signal early-on of a predisposition as to the status of MetLife in the U.S –ahead of the Council's own decision by all of its members.

Despite subsequent assertions by some of the Council's members that the FSB and Council processes are separate and distinct, they are in my mind very much interconnected and not dissimilar. It would seem to follow that FSB members who consent to the FSB's identification of G-SIFIs also commit to impose consolidated supervision, yet-to-be agreed-to capital standards, resolution planning, and other heightened prudential measures on those G-SIFIs that are domiciled in their jurisdictions.

These pointed remarks from FSOC members make it apparent that that the Congress must exercise closer oversight over the Federal Reserve's participation in FSB work streams. The Congress could exercise additional oversight using GAO audits, hearings, or through other legislation. For example, H.R. 5018 would require the Fed to notify congressional committees with jurisdiction and the general public 90 days prior to its intention to enter into or complete negotiations with international committees or standard setting bodies.

Regardless of the method the Congress selects, it needs to improve oversight of Federal Reserve's involvement in FSB initiatives, especially those regarding the capital regulation of insurance firms including any work streams on capital surcharges for insurance firms designated as global systemically important institutions as well as Federal Reserve involvement in FSB work streams focused on the designation of systemically important non-bank non-insurance (aka shadow bank) institutions and the enhanced regulation of "shadow banking" activities[14].

When Federal Reserve officials refer to shadow banking, they are referring to activities that primarily associated with the asset management industry. In January 2014, the FSB issued a consultative document discussing a designation process for non-bank non-insurer systemically important firms[15]. Firms fitting the FSB's consultative document profile are large asset management institutions. In November 2014, the FSB committed to issue policy recommendations that will establish regulatory minimum "haircuts" for securities financing transactions (securities lending and repurchase agreements) among shadow banks. Mirroring these developments, senior Federal Reserve officials used recent speeches to telegraph the Federal Reserve's intention to impose market-wide minimum haircuts on securities lending and repurchase transactions. Federal Reserve officials have also identified high-yield short-maturity by mutual fund investments as a shadow banking activity that should be discouraged as a potential source systemic risk.

The FSB is also in the process of recommending changes in insurance regulation. In October 2013, the FSB directed the International Association of Insurance Supervisors to develop a comprehensive supervisory and regulatory framework, including a risk-based global insurance capital standard for internationally active insurers as well as basic capital requirements (BCR) and higher loss absorbency (HLA) requirements for global systemically important insurance institutions. The Federal Reserve is an important member of this FSB insurance work stream and many observers believe that the Federal Reserve will eventually try to impose the FSB's insurance regulatory capital standards on state-regulated domestic US insurers. The potential conflict with FSB insurance capital initiatives and U.S. insurance company capital requirements will be discussed in a subsequent section of my testimony.

If recent history is a guide, the policies the Federal Reserve develops in these and any other FSB work streams will form the basis of the policies the Federal Reserve subsequently attempts to impose as domestic regulations. It is important for Congress to step up its oversight of the Federal Reserve's involvement in FSB activities so it can make a timely evaluation of regulatory developments. Once FSB work streams conclude, it becomes more difficult for Congress to intervene and alter policies.

Congress should assess the merits of Dodd-Frank Section 165 stress tests

Congresses should instruct the GAO to assess the costs, benefits, and processes associated with the recurring Board of Governors stress tests mandated by Section 165 of the Dodd-Frank Act. These stress tests are very resource-intensive, both for banks and for the banking regulators, and there is little evidence that they are a cost-effective and objective means for regulating individual financial institutions.

Section 165 of the Dodd-Frank Act directs the Board of Governors to establish heighted prudential standards that apply to bank holding companies with consolidated assets in excess of $50 billion and non-bank financial firms designated by the FSOC. Included in Section 165 is the requirement that these institutions participate in an annual stress test exercise supervised by the Federal Reserve Board. The Federal Reserve is required to publish the results of these annual stress tests. In addition, financial institutions with $10 billion in consolidated assets and a primary Federal regulator must conduct annual stress tests similar to the Board of Governors stress test and report the results to their primary Federal regulator.

Congress should consider an extensive audit of the Dodd-Frank mandate for recurring Federal Reserve Board stress tests. The audit should include an independent assessment of the Federal Reserve Board's stress test models and methodology including an assessment of the predictive accuracy (i.e. assess the confidence bounds) of the Federal Reserve's methodology. Assessments should evaluate the consistency with which the Federal Reserve Board applies its quantitative and qualitative stress test assessments both across institutions within a year and Fed's consistency across time. Independent assessors should identify weaknesses in the methodology and evaluate the Federal Reserve Board's internal approach for identifying and managing stress test methodology weaknesses. The examination should include the remediation process that occurs when a bank disputes the Fed's findings. Assessors should have confidential discussions with the financial institutions that have participated in these stress test exercises and report on these institution's concerns with the Fed's processes. The audit should evaluate the costs and benefits of using this methodology as a primary input in supervision and regulation of individual institutions.

The Board of Governors stress tests mandated by Dodd-Frank Act are expensive both for the banks and bank regulatory agency resources that could be deployed in other productive supervisory activities. These stress tests have dubious predictive power for identifying hidden financial system imbalances or for identifying risks in specific financial institutions that would otherwise remain undetected. The quantitative outcome of these stress tests is arbitrary and completely under the control of the Federal Reserve Board because the stress tests estimates involve an overwhelming amount of judgment on the part of the stress tester. Consequently stress test results cannot be replicated by different independent stress testers. Since banks cannot accurately anticipate the Fed's stress test results even when they know the macroeconomic stress scenarios, this mandatory process interjects a huge and unproductive source of uncertainty in the bank planning process.

Board of Governor stress tests are a particularly problematic form of enhanced prudential supervision because there is no objectively correct answer in a Board of Governor's stress test. Participants are required to produce specific numerical answers to questions that have no single correct answer, knowing that the Board of Governors has wide discretion to decide the "correct" answer at will by changing modeling assumptions. Moreover, institutions have no mechanism to challenge the Board of Governors on the accuracy of Board's preferred correct answer[16].

Many have questioned the value of macroeconomic scenario stress tests for identifying and mitigating financial sector excesses[17], and yet the Federal Reserve System spends an enormous amount of resources and requires covered institutions to spend significant sums on the activity. Already, Fed stress tests have missed the "London Whale" at JPM Chase and a multibillion dollar hole in Bank of America's balance sheet. Fannie Mae and Freddie Mac both passed government-designed macroeconomic stress right up to the time they failed in September 2008. Before the financial crisis, many countries produced financial stability reports that included bank stress tests and none anticipated the crisis. And there are many additional examples where similar tests failed to identify subsequent problems.

A stress-test based approach for setting bank capital has two gigantic measurement problems. First, the macroeconomic scenario must actually anticipate the next financial crisis. And secondly, regulators must be able to translate the macroeconomic crisis scenario into accurate predictions about actual bank profits and losses.

Few regulators possess the prescience necessary to accomplish this first step. In 2006, the subprime crisis was less than 2 years away, but the Federal Reserve did not see it coming. The New York Fed's staff was publishing papers that dismissed the idea of a housing bubble and the Federal Reserve Chairman's speeches argued – worst case – there may be some "froth" in local housing markets. Even as the subprime bubble burst, the new Fed Chairman publicly opined that the economy would suffer only minor fallout.

Even if a stress scenario correctly anticipates a coming crisis, the crisis must be translated into individual bank profits and losses. However, bank profits and losses are not very tightly linked with changes in macroeconomic indicators. Quarter-to-quarter bank profits do not closely follow quarterly changes in GDP, inflation, unemployment, or any other macroeconomic indication. The best macroeconomic stress test models explain maybe 25 percent of the quarterly variation in individual bank profits and losses, meaning that more than 75 percent of the variation in bank profit and losses cannot be predicted using GDP, unemployment, or other business cycle indicators.

Because of these measurement issues, bank loss predictions from macroeconomic stress tests have very little objective accuracy. Even using the best models, there remains a great deal of uncertainty surrounding how each bank may actually perform in the next crisis, presuming the stress scenario anticipates the crisis.

These issues make macroeconomic stress testing more of an art than a science and a tool that is inappropriate for the supervision on an individual institution. There are just too many places to make mistakes. There is no formula or procedure that will lead to a single set of stress test bank loss estimates that can be independently calculated by different stress test modelers. Thus, it is not surprising that the Board of Governors and the US banks rarely agree on stress test results.

Less widely appreciated is that these coordinated macroeconomic stress tests encourage a "group think" approach to risk management that may actually increase the probability of a financial crisis[18]. Stress test crisis scenarios have to be specific so that banks and regulators can model the same event. Moreover, the Board of Governors imposes some uniformity in loss rates across all designated banks by using its own stress test estimates. The Board of Governors is very much like a coach or a central planner that tries to ensure some coherence in each designated firms estimates and capital plans. Perhaps unintentionally, by requiring all firms to approach the stress test problem in the same way as the Board of Governors, the process encourages all large institutions to think and operate the same way.

A final weakness concern is that the stress test process requires the Board of Governors to be intimately involved in modeling the operations and exposures of each large banking institution. The process requires the Federal Reserve Board to use its own judgment to set each large bank holding company's "stress tested" capital plan. These regulations have become so intrusive that the regulator virtually runs the bank. In such a situation, it becomes difficult for the regulator to admit a mistake and allow an institution to fail.

Congress should examine conflicts between Federal Reserve and state insurance regulation

Congress should assess potential conflicts that may be developing between the Federal Reserve's Dodd-Frank expanded powers over the domestic insurance industry and state insurance regulations. There are indications that new Federal Reserve examination and capital policies for insurers affiliated with a depository institution may be generating serious conflicts with existing state insurance supervision and regulation, contrary to the intent of the Dodd-Frank Act.

The new regulatory powers granted by the Dodd-Frank Act to the Federal Reserve could lead to substantial changes in insurance regulation. Since the McCarran-Ferguson Act of 1945, insurance regulation has been conducted by the states and their insurance commissions. The Dodd-Frank Act created a new Federal Insurance Office within the US Treasury, but the Act purposely limited the new office's responsibilities to monitoring and advisory duties; it does not have national supervisory responsibility.

Notwithstanding the fact that the Dodd-Frank Act intentionally avoided the creation of a national insurance regulator, many in the insurance industry believe that the Federal Reserve is using its new Dodd-Frank powers to become the de facto national insurance supervisor. Moreover, the industry is concerned that these developments could lead to wholesale revisions in the supervision and capital regulations that apply to state insurers and result in the imposition of bank-style capital regulation on the insurance industry.

Section 312 of the Dodd-Frank Act transferred regulatory authority and rulemaking over thrift holding companies and insurance holding companies that owned depository institutions from the Office of Thrift Supervision to the Federal Reserve. Section 604 of the Act authorizes the Federal Reserve to conduct examinations of the non-bank subsidiaries and affiliates of these holding companies even if these institutions have a functional regulator.

Section 604 empowers the Federal Reserve to examine insurance companies whereas, prior to the Dodd-Frank Act, bank regulators were prohibited from examining these state regulated entities. Since acquiring its new powers, the Federal Reserve has launched an extensive examinations program for insurance companies owned by thrift and insurance holding companies. These examination often are conducted using newly-hired Federal Reserve examiners with little or no insurance experience, even though these insurers being examined are already fully regulated and supervised by state insurance commissioners[1920].

These Federal Reserve insurance examinations are causing considerable concern for insurers. Industry sources suggest that the Federal Reserve examiners are less than fully conversant with state insurance regulations and they frequently find that insurer subsidiaries or affiliates are undercapitalized if their capital levels do not agree with bank capital standards, even when these insurers are well-capitalized according to long-standing state insurance regulations. Representatives of the insurance industry are worried that, unless Congress intervenes, these Federal Reserve insurance examinations and associated holding company regulatory capital restrictions will eventually lead to the imposition of bank regulatory capital standards on the entire insurance industry.

Section 606 of the Dodd Frank Act allows the Federal Reserve to apply its bank holding company “source of strength doctrine” to the insurance and thrift holding companies it now regulates. Industry sources suggest that the Fed’s erroneous examiner opinions alleging weak capital positions at insurance subsidiaries and affiliates have lead the Fed to conclude that the consolidated capital positons of some holding companies must increase. Again, in the opinion of the insurance industry experts familiar with the specific details of these cases, these mandated capital increases are not addressing true holding company capital weaknesses. Instead they are the result of longstanding and appropriate differences between the capital regulations for insurers (set by the states), and consolidated capital standards for banks (set by the US bank regulatory agencies in consultation with the Basel Committee on Bank Supervision).

Industry representatives suggest that the Federal Reserve's approach for assessing the capital position of thrift and insurance holding companies could lead to new insurance industry constraints on dividend payments or other transactions that return capital to shareholders. The Fed can apply its holding company capital rules even in cases where the holding company is comprised predominately of insurance related activities and includes a subsidiary depository institution that holds only a tiny fraction of the holding companies' assets[21]. Recent congressional testimony by Federal Reserve Board Senior Advisor Thomas Sullivan did not allay industry concerns when he reported, "Our principal supervisory objectives for insurance holding companies are protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions…"[22]

With the Fed's acquisition of thrift and insurance holding company supervision and the three large FSOC-designated insurance companies now subject to enhanced supervision and regulation by the Federal Reserve Board, the Federal Reserve is now the consolidated supervisor of companies that hold about one-third of the asset in U.S. insurance industry[23].

Reflecting these new insurance powers, the Federal Reserve has joined the International Association of Insurance Supervisors–the international standard setting body for insurance regulation. The Federal Reserve is now a member of the IAIS work stream that is developing global standards for the supervision and regulation internationally active insurers, including regulatory capital standards for insurance groups[24]. This work is part of the overall G20 financial stability initiative coordinated by the FSB. The Federal Reserve is also a member of the IAIS group that is responsible for identifying global systemically important insurers and designing the enhanced regulatory and supervisory framework that will apply to these institutions.

The Federal Reserve is a member of the IAIS work stream charged with developing group-wide capital standards for insurance groups. These consolidated capital requirements are similar to the consolidated capital requirements for bank holding companies. For some years, Europe has been developing new insurance capital standards called Solvency II. Solvency II standards are in many respects similar to the Basel capital standards for banks and bank holding companies. In fact, Solvency II is often called "Basel for insurers." The similarity between bank and insurance capital requirements in Europe is no accident because European insurance activities are often conducted as part of a universal banking organization. Because the IAIS membership is dominated by European insurance supervisors, many believe that, in the end, any new IAIS group-wide standard will strongly resemble Solvency II.

In contrast to Europe, the U.S. does not have a consolidated capital standard for insurers. Historically, the U.S. approach to insurer capitalization has served the industry well. It has not resulted in any systemic weaknesses and it likely works to contain contagion risk because it limits interdependencies among insurance companies. US capital standards are set for individual state insurance entities that are incorporated and fully capitalized within a single state. They are licensed, regulated and if need be, liquidated at by the state insurance regulator. Consolidated group capital has not been an important issue in the US because each state chartered insurance entity must be fully capitalized and cannot rely on capital support from a larger insurance group.

The extent of Federal Reserve involvement in insurance regulation and the potential for the Fed to impose significant changes on insurance supervision and regulation was unlikely to have been anticipated by Congress. The Federal Reserve is now poised to become the *de facto* national insurance regulator that Congress declined to create in the Dodd-Frank Act. The Fed is empowered to exam firms that hold one-third of insurance industry assets even though these firms are examined by state insurance regulators. The Fed is now also the most influential US regulatory member charged with designing new capital and supervisory processes in the IAIS/FSB work stream. The Fed is already showing a preference to impose bank capital regulations on insurance holding companies and there is industry concern that the Fed may agree to Solvency II bank-like capital regulations in its IAIS insurance capital work stream.

NOTES

1. This text was written as a testimony before the U.S. Senate Committee on Banking, Housing and Urban development. Paul H. Kupiec is a resident scholar at the American Enterprise Institute and this testimony represents his personal views. Dr. Kupiec has prior experience working on banking and financial policy issues at the Federal Reserve Board, the IMF and as Director of the FDIC Center of Financial Research where he served as chairman of the Research Task Force of the Basel Committee on Banking Supervision.
2. http://www.federalreserve.gov/newsevents/reform_transaction.htm
3. http://www.federalreserve.gov/newsevents/reform_discount_window.htm
4. http://www.newyorkfed.org/markets/OMO_transaction_data.html
5. This discussion borrows from Marc Labonte, "Federal Reserve: Oversight and Disclosure," Congressional Research Service, September 19, 2014.

6. 31 U.S. Code Sec. 714. The GAO normally has a number of separate Federal Reserve audits underway in any single year. The Federal Reserve System also has an Office of Inspector General (OIG) that is responsible for detecting and preventing fraud, waste and abuse. The Fed's OIG also issues semiannual reports to Congress.

7. The Federal Reserve chairman and vice-chairman face Senate confirmation every 4 years. Federal Reserve governors are confirmed by the Senate, but limited to a 14-year term unless they are initially filling a partial term of departing governor. Regional Federal Reserve bank presidents are not confirmed by the Senate.

8. If however, there are legal impediments for GAO audits, simple amendments to the Dodd-Frank Act, like extending Section 122 powers to other sections of the Act, could explicitly provide the needed powers.

9. Report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, "Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process," GAO, November 2014.

10. http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf

11. No other agency has a staff as large, technically sophisticated, or as academically credentialed as the Federal Reserve. For example, the Federal Reserve Board has more than 350 economists on its home webpage, http://www.federalreserve.gov/econresdata/theeconomists.htm and virtually all of them have PhDs. This does not include Federal Reserve economists at the Reserve Banks. For example, the New York Fed alone lists 71 PhD economists on its website. In contrast, on their respective websites, the CFTC lists 10 economists, the FDIC lists 19 economists, FHFA lists 15 PhD equivalent economists, and the newly "economist fortified" SEC lists roughly 70 economists.

12. See the letter dated July 9, 2014, from Representative Garrett to William Dudley expressing concerns and additional information about the New Your Fed's extensive involvement on the FSOC designation process.

13. http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf

14. http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf

15. http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf?page_moved=1

16. I am adapting Kevin Dowd's analogy in, "Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve," CATO Policy Analysis No. 754, September 3, 2014.

17. For some examples, see: C. Borio, M. Drehmann, and K. Tsatsaronis, "Stress-testing macro stress testing: Does it live up to expectaions?" Bank for International Settlements, November 2011; or, Til Schuermann, "The Fed's Stress Tests Add Risk to the Financial System," Wall Street Journal, March 19, 2013; or, L. Guerrieri and M.. Welch, "Can Macro Variables Used in Stress Testing Forecast the Performance of Banks?" Federal Reserve Board Finance and Economics Discussion Series 2012-49.

18. Til Schuermann, op. cit. makes this argument.

19. Testimony of Thomas Sullivan of the Board of Governors before the House Subcommittee on Housing and Insurance, November 18, 2014.

20. For official Federal Reserve guidance on these examinations, see http://www.federalreserve.gov/bankinforeg/srletters/sr1111a2.pdf

21. For a detailed discussion of the issues that concern the industry see, Letter to regulatory agencies on behalf of Nationwide Mutual Company regarding 'Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, http://www.federalreserve.gov/SECRS/2012/December/20121206/R-1442/R-1442_101712_109102_441597364672_1.pdf

23. See Thomas Sullivan's testimony.

24. Ibid.