

Comment on the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies

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As a co-coordinator of the SAFER project, I am writing in support of the views and comments submitted by Americans for Financial Reform (AFR) on the provisions of the Dodd-Frank Act authorizing supervision and regulation of certain nonbank financial companies. Like AFR, we believe the establishment of clear, credible and certain guidelines for determining when and how nonbank financial companies can pose a threat to the financial stability of the United States is one of the more decisive issues for the reform effort.

In addition, I would add that these provisions present an opportunity and an obligation for regulators to take notice of the evolving structure of the US financial sector and how, in the absence of any degree of systemically oriented oversight and supervision, the fragmented framework of regulation posed a threat to financial stability. Perpetuating differences in soundness regulation - and in some cases, requiring minimal or no regulation for some sectors such as hedge funds and private equity funds - would have been acceptable if the majority of credit flows were channeled through the highly regulated banking sector. But this is no longer the case. While a continuation of the focus of regulation on banks is critical because of their role in the payments system and as the transmission belt for monetary policy, the fact that banks now account for less than a quarter of total credit flows compared to 65 percent in the 1950s indicates that the threat that credit problems may develop that can cause systemic risk is now more widely dispersed and is likely to remain so.

While securitization is responsible for much of the shrinkage in banks' share of outstanding credit market assets and for the escalation in the share of credit channeled to housing over the last decade, the shift away from a bank-based system is not new. In "The Parallel Banking System" a working paper written for the Economic Policy Institute (EPI) in 1993, my co-author, Tom Schlesinger, and I discussed one of the more important changes occurring in the system in that period: the rising importance of finance companies and their role in restructuring the US financial system.

From 1980 to 1992, for example, total finance company assets grew from about 16 percent to 26 percent of the total assets of domestically chartered banks. During that same period, banks' share of total credit dropped from 39.1 to 26.5 percent and remained at or below that level to the present. Equally important, finance companies' share of total credit to business borrowers reached two-thirds of the share held by banks in 1992. Their growth reflected significant advantages in competing with banks due to the absence of regulation. And those advantages, in turn, reflected the growing risk their unregulated operations posed for systemic soundness.

Finance companies make the same kinds of loans as banks but with virtually no regulatory costs. They are not subject to capital or reserve requirements, to limits on loans to individual borrowers as a percentage of their capital, or to limits on transactions with parent companies or affiliates. These are basic soundness regulations applicable to banks now as well as in the past. Most of the large financial companies, then and now, have direct links to commerce because they are owned by some of the largest nonfinancial companies. Those links and the absence of regulatory oversight present numerous opportunities to engage in anti-competitive practices and conflicts of interest.

As we noted in 1993, the growth in finance companies set off a surge of growth in the commercial paper market. By 1991, finance companies dominated the market and General Electric Capital Corporation (GECC) alone accounted for over 7 percent of total paper issued. This, in turn, changed the composition of assets of money market mutual funds (MMMFs) as they became major buyers of commercial paper. The symbiotic relationship between finance companies as lenders and MMMFs as suppliers of funding is what we characterized as the parallel banking system – a structural change that altered the institutional makeup of the financial system and moved a substantial share of the public’s money away from the protection that financial guarantees give bank deposits in the form of both FDIC insurance and bank access to Federal Reserve liquidity.

Meanwhile, banks had begun the practice of guaranteeing the commercial paper of nonfinancial corporations after the Penn Central default in 1971 and, in the 1980s, began to guaranty the paper of their competitors as well. Over the next decade, the immense volume of contingency liabilities rivaled the actual volume of loans on the books of the largest banks. In fact, estimates of total commitments and contingency liabilities were as high as \$5.6 *trillion* as early as 1991. With the subsequent addition of other products and entities in the late 1990s and 2000s, the off-balance sheet commitments of the largest banks reflected a virtual explosion of guarantees that were at the center of the systemic crisis and created the ripple effects that spread to other sectors.

These evolutionary developments were treated with benign neglect but their unintended consequences were anything but benign. The creation of the FSOC by the Dodd-Frank Act is intended to address the problem by providing oversight of the financial system as a whole. To do so, the Council must begin to define the actual structure of the system – not as outlined in the way law and regulation are codified, but through an assessment of how institutions actually function in credit markets. That process would not only include an assessment of the role and importance of nonbank financial institutions, but an evaluation of the regulatory framework needed to ensure the soundness of their operations in the context of the system as a whole.