COMMENT LETTER ON ADVANCE NOTICE OF PROPOSED RULEMAKING REGARDING AUTHORITY TO REQUIRE SUPERVISION AND REGULATION OF CERTAIN NONBANK FINANCIAL COMPANIES

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Americans for Financial Reform ("AFR") appreciates this opportunity to comment on the Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (the "ANPR"). AFR is a coalition of over 250 national, state and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, religious and business groups along with economists, and other experts.

A clear and credible set of criteria to limit or eliminate the "too big to fail" syndrome that led to the bailouts in the financial crisis that began in 2008 is of paramount importance to AFR and its member organizations. The designation of a firm as subject or not subject to supervision will have a direct bearing on the financial security of millions of American investors, workers, pensioners, consumers, and others represented by AFR's members. These members need confidence - reasonably justified confidence - that their life-long savings and investments are not subject again to hard-to-indentify connections and risks and consequent cascading failures.

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA") empowers the Financial Stability Oversight Council ("FSOC") to require those nonbank financial companies that could pose a threat to the financial stability of the United States ("significant") to be subject to supervision by the Board of Governors or the Federal Reserve System (the "Board of Governors") and prudential standards. Moreover, the determination that such firms are significant will also give the Board of Governors and the Federal Deposit Insurance Corporation ("FDIC") authority to approve the firm's detailed orderly liquidation plan ("Living Will").[1] Living Wills prepared and maintained,[2] supervision and, where necessary, liquidation are meant to obviate the dismal choice between a disruptive, drawn-out bankruptcy process and a taxpayer-funded bailout.

While the DFA describes broadly the types of entities that are nonbank financial companies,[3] it defers to the FSOC to select from that grouping those significant firms that deserve prudential oversight by the Board of Governors. Such nonbank financial companies might include, without limitation, investment banks, insurance companies, private equity firms, hedge funds, money market funds, mutual funds, mortgage companies, structured investment vehicles, collateralized debt obligations, and other unregulated or lightly regulated entities.

The FSOC is tasked with establishing rules and guidelines for determining what makes a nonbank financial company significant as well as how to continually monitor all nonbank financial companies. This perpetual monitoring will serve two goals. First, it will help ensure that a nonbank financial company that is or becomes significant, is brought under supervision. Second, it will help inform the FSOC if changing market practices would support updating its methodology to help identify certain companies not previously identified as significant.

We believe that the establishment of clear, credible, and certain guidelines for determining when and how nonbank financial companies pose a threat to the financial stability of the United States is one of the most significant decisions that regulators seeking to implement the DFA face and that straightforward, clear definitions and metrics regarding the framework and criteria for nonbank designations will serve the interests of regulators, firms, and the American public in certainty and predictability.

As former Federal Reserve Board Chairman Paul Volcker wrote,

> "[c]lear and concise definitions . . . and specificity in describing the permissible activities will be of prime importance for the regulators as they implement and enforce this law. Bankers and their lawyers and lobbyists will no doubt search for and discover seeming ambiguities within the language of the law. Surely, any such ambiguities need to be resolved in light of carrying out the basic intent of the law. That approach – and only that approach – provides the basis for consistent and effective regulation."[4]

In addition, we believe that the FSOC should err on the side of over-inclusion in its determinations, as omissions may delay the process of assessing systemic risk fully, thus preventing regulators from acting in a timely manner to maintain the stability of the financial system. Some firms, such as General Electric Capital Corporation,[5] certain insurance companies such as Prudential Financial, Inc. and Met Life Inc.,[6] and certain large private equity firms and hedge funds, merit obvious and immediate consideration. Other candidates for inclusion may require more deliberate examination.

Nonbank financial companies comprise the bulk of what is referred to as the "shadow banking" system. Many conduct bank-like financial activities outside the traditional commercial banking system. Many of these practices involve taking funds from savers and investors, aggregating and holding financial assets, and transferring them to borrowers. Such entities play a key role in the securities markets for structured products, commercial paper, asset-backed commercial paper, repurchase agreements, and derivatives. [7]

These markets constitute an enormous part of the financial sector and play a central role in its operations. Just prior to the failure of Lehman Brothers Holdings Inc. in September 2008, the U.S. repurchase agreements ("Repo") market was over $4.5 trillion, the asset-backed commercial paper ("ABCP") market was roughly $1.2 trillion, financial commercial paper ("CP") aggregated roughly $800 billion and nonfinancial CP roughly $220 billion.[8] The notional value of the over-the-counter derivatives market stood at roughly $600 trillion.

Furthermore, because many shadow banking entities were -- and remain -- highly leveraged and relied disproportionately on short-term funding, these market systems are extremely vulnerable to financial stress. Immediately after the Lehman failure, investors withdrew funds from shadow banking entities, forcing them to sell assets at depressed prices to raise cash, thus truly imperiling firms' solvency. The impact ricocheted across the banking system and the American economy, and is still felt by homeowners, business owners, investors, workers, pensioners, consumers, taxpayers -- practically everyone -- today.

Americans will remain vulnerable to another systemic breakdown with the attendant macroeconomic consequences that we have seen before and to taxpayer funded bailouts once again unless and until regulations are implemented and enforced that set forth strict standards limiting practices by nonbank financial institutions that continue to imperil the financial system -- risk itself must be made more risky.

We are guided in our perspective by some overriding principles and considerations. We believe that the public interest and financial stability are best served by rigorous and faithfully implemented and enforced rules that identify the basis for such designations. The details involved in defining, measuring, and limiting risk in all its forms are important, but the main concern is to convey the urgent need to fix a broken system, instill market discipline, and end the "too big to fail" era once and for all. We believe that regulatory agencies too often tend to be reluctant to implement and enforce rules that will mean certain marginal and potentially considerable losses to firms, shareholders, and creditors. Thus we argue that allowance for regulatory discretion and forbearance must be minimized.

Among the statutory designation factors we view as of the highest priority, some are easy to define and quantify: a simple assets to equity leverage ratio; amount and nature of capital and other financial assets; amount and types of liabilities (based, for example, on their maturity, volatility, or stability); and degree of reliance on short-term funding.

Some factors are more difficult to measure, such as the extent and type of off-balance-sheet exposures, embedded leverage, extent to which assets are managed rather than owned and to which ownership of assets under management is diffuse, the extent of the nonbank financial company's interconnections with other significant financial companies, and the complexity of the nonbank financial institution.

Others cannot be as easily measured and assessed by reference to a given firm's balance sheet. We regard these as the most critical -- in part because they are opaque and difficult to quantify -- and therefore most in need of clear, precise metrics and most stringent rules. Some of these are macro-systemic. For example, the degree to which a particular activity is concentrated in the hands of a small number of firms, as in the case of the credit derivatives market, or the extent to which a once-novel trading strategy or instrument becomes popular throughout the system, the reversal of which by any number of players simultaneously would cause systemic risk.

Some of these reflect interconnection: the contractual relations among firms and counterparties that comprise the greatest risk of cascading losses and failures and take many forms, such as money market/CP interconnection, proprietary trading interconnection, and, of course, shadow market interconnection. Some are off-balance sheet assets of entities that hold assets as collateral to issue debt: structured investment vehicles and ABCP.

We stress also that metrics are dynamic and require regular and frequent review. A single acquisition can radically transform a firm and the degree of risk it poses from one day to the next. Moreover transactions that are "hidden" during mid-reporting periods may not be transparent to counterparties and investors and must be subject to regulatory scrutiny. And while asset size correlates closely with potential systemic risk, the lesson of Long-Term Capital Management is that a firm modest in equity but highly-leveraged and interconnected can cause a chain reaction of systemically destabilizing losses disproportionate to its own balance sheet.

Accordingly, we recommend below that the FSOC base its determinations of the systemic significance of nonbank financial institutions on two principal *per se* tests: size and market concentrations of firms and products and interconnection between and among such institutions.

Finally, we note that in a global financial marketplace, foreign firms can pose systemic risk to the U.S. as easily as American firms can, so, to the extent feasible, foreign nonbanks should be subject to systemic scrutiny and appropriate U.S. and international regulatory responses should be taken.

In addition to the foregoing, with respect to specific questions presented, we add the following:

1. What metrics should the Council use to measure the factors it is required to consider when making determinations under Section 113 of DFA?

a. How should quantitative and qualitative considerations be incorporated into the determination process?

As described in more detail in response to question 4, we believe that the FSOC should employ two bright line *per se* tests that would result in automatic designation of a nonbank financial company as significant. For example, an entity with assets above a certain level should be *per se* significant. This would be pursuant to a "too big to fail" test. The other principal *per se* test would be participation above a certain level as a buyer or seller in the repo or other short-term funding markets or contractual interconnections placing financial obligations on firms. These would comprise "too interconnected to fail" elements.

There should also be designations based upon a combination of these two tests. For example, if a nonbank financial company falls marginally below the threshold that would result in a *per se* designation, it should still be deemed significant. That is, if a company is marginally below the *per se* size test, and also marginally below the *per se* interconnected test, the FSOC should bring the company under the designation. Similarly, the FSOC can use the other indicia set forth in the DFA to establish supplementary rules and rules for which a combination of factors would contribute to a decision to designate.

Moreover, given that the FSOC will be developing these metrics prior to the establishment and operation of the Office of Financial Research (the "OFR"), the FSOC should re-examine institutions in light of these basic indicia of systemic risk -- size/concentration, reliance on short-term funding markets and interconnectedness – as soon as practicable and again when more information is gathered and analyzed by the OFR.

b. Are there some factors that should be weighted more heavily by the Council than other factors in the designation process?

Our view is that the systemic factors, principally concentration, interconnectedness, and reliance upon short-term funding, including as a participant in the repo markets, should be given at least equal weight with those considered with reference to individual firms. A firm should not be allowed to argue that the strength of its financial condition exempts it from designation when its very strength is accompanied by interconnectedness or reflects outsized systemic influence with a potential for anticompetitive or unforeseen negative systemic consequences.

2. What types of nonbank financial companies should the Council review for designation under DFA? Should the analytical framework, considerations, and measures used by the Council vary across industries? Across time? If so, how?

Entities that are part of the shadow banking system should be the main focus of FSOC review. This would include, without limitation, investment banks, insurance companies, private equity firms, hedge funds, money market funds, mutual funds, mortgage companies, structured investment vehicles, collateralized debt obligations, other unregulated or lightly regulated entities, and any other entities that would be investment companies under the 1940 Act but for an exemption. We believe that the FSOC should also be careful to look past what name a firm, entity or vehicle is given as a matter of regulation or industry practice. The FSOC should also be cognizant of "legal innovation" such as new financial vehicles/entities that have the effect of circumventing oversight yet which could pose significant risk.

3. Since foreign nonbank companies can be designated, what role should international considerations play in designating companies? Are there unique considerations for foreign nonbank companies that should be taken into account.

As noted above, we believe that in a global financial marketplace, foreign firms can pose systemic risk to the U.S. as easily as American firms can, so, to the extent feasible, foreign nonbanks should be subject to systemic scrutiny and appropriate U.S. and multilateral international regulatory responses taken.

4. Are there simple metrics that the Council should use to determine whether nonbank financial companies should even be considered for designation?

As noted in response to question 1, there are some metrics that are simple and others more complex. FSOC might use a series of diagnostic tests. Some results should require *per se* designation of a firm as significant. Others would require such treatment only in combination -- analogous to a patient seeking medical treatment where some symptoms and test results demand automatic treatment whereas others would require medical oversight or intervention only if in combination.

Some of these tests should be status-based and others conduct based. In terms of status-based determinations, there should be size tests appropriate to the type of entity. Another status test should be a systemically important role, such as a large custodian. In terms of conduct-based determinations, there should be tests related to participation in a certain high risk market or trading strategy. Other conduct-based tests might include trading volume and frequency,

For example, for a size test, all non-bank financial firms like hedge funds and private equity funds that are subject to little if any supervision, with assets of $1 billion or greater should be *per se* significant. And, this should reflect the consolidation of all such assets under management by the same investment adviser or affiliate.

5. How should the Council measure and assess the scope, size, and scale of nonbank financial companies?

a. Should a risk-adjusted measure of a company's assets be used? If so, what methodology or methodologies should be used?

We believe that often simple ratios, such as an assets to tangible-common-equity leverage ratio is a more reliable indicator of indebtedness than some of the purported risk-adjusted measures that invite gamesmanship and helped to magnify risks, bearing in mind that asset quality is also important.

b. Section 113 of DFA requires the Council to consider the extent and nature of the off balance-sheet exposures of a company. Given this requirement, what should be considered an off-balance sheet exposure and how should they be assessed? How should off-balance sheet exposures be measured (e.g., notional values, mark-to-market values, future potential exposures)? What measures of comparison are appropriate?

The FSOC should consider the scope of such off-balance sheet exposures in relation to capital. Including off-balance sheet exposure is essential as we have learned that firms can suddenly be required to consolidate what seemed like off balance sheet liabilities.

c. How should the Council take managed assets into consideration in making designations?

How should the term, "managed assets" be defined? Should the type of asset management activity (e.g., hedge fund, private equity fund, mutual fund) being conducted influence the assessment under this criterion? How should terms, conditions, triggers, and other contractual arrangements that require the nonbank financial firm either to fund or to satisfy an obligation in connection with managed assets be considered?

Assets under management should be considered so as to encourage the safety of the financial system. A series of funds managed by the same or affiliated investment advisers should not escape supervision simply because the trusts or entities in which the asses are collected are individually below a particular threshold. The amount of contingent liabilities, including counterparty risk and exposure, should be considered as a factor to encourage including a nonbank financial company within the significant designation.

d. During the financial crisis, some firms provided financial support to investment vehicles sponsored or managed by their firm despite having no legal obligation to do so. How should the Council take account of such implicit support?

Implicit support should be strongly considered by the FSOC in determining whether to designate for prudential regulation. The credit market itself often looks at credit risk to the sponsor of an investment vehicle and not just credit risk to the vehicle. Thus, the FSOC should also consider this a factor for concentration, interconnectedness and size.

Two examples from the crisis highlight how a firm's implicit support of investment vehicles can result in explicit taxpayer bailouts and/or contribute to a global financial crisis. State Street Bank bought securities for nearly $2.5 billion from one of its ailing funds, (but then the bank relied on TARP and several other taxpayer-backed programs to stay afloat during the crisis.)[9] Bear Stearns bailed out two of its funds for over $3 billion despite having only about $35 million invested in them. Ultimately, the firm collapsed. Firms that indicate that they will "bail out" investment vehicles should be evaluated accordingly and included in the determinations around size and interconnectedness.

In addition, regulators must be vigilant against a major potential loophole: the definition of "nonbank financial company" would allow a company that is just 15 percent non-financial or commercial to escape supervision, no matter how systemically significant it may be. Affiliates and subsidiaries should be evaluated independently of a parent or holding company when the Council assesses their systemic risk. A key example of this type of mixed commercial and financial firm is the bailed-out shadow bank GE Capital.[10] It was the single largest issuer of commercial paper in the United States before the crisis, with $620 billion in assets at the end of 2007. GE Capital received more than $50 billion in bailouts, and was the second-largest beneficiary of the FDIC debt guarantee program even though it held only a relatively small amount of deposits. The legislation was crafted to ensure that the Federal Reserve could have oversight over GE Capital without regulating General Electric, the manufacturer parent company. However, regulators must consider that commercial firms are increasingly creating finance subsidiaries in order to benefit from the upside of riskier trading operations; the crisis showed that it is difficult for parent companies to both benefit from profits in good times and insulate themselves from risk in bad times. Since shared balance sheets make it easy for mixed commercial-financial firms to use accounting maneuvers, regulators should pay particular attention to this risk and use both the authority to impose intermediate financial holding companies and the anti-evasion provisions liberally.

6. How should the Council measure and assess the nature, concentration, and mix of activities of a nonbank financial firm?

a. Section 113 of DFA requires the Council to consider the importance of the company as a source of credit for households, businesses, and State and local governments, and as a source of liquidity for the United States financial system. Given this requirement, are there measures of market concentration that can be used to inform the application of this criterion? How should these markets be defined? What other measures might be used to assess a nonbank financial firm's importance under this criterion?

Among other measures, the FSOC might use shares of total credit market to measure the above from the Flow of Funds tables.

b. Section 113 of DFA requires the Council to consider the importance of the company as a source of credit for low-income, minority, and underserved communities. Given this requirement, are there measures of market concentration that can be used to inform the application of this criterion? How should these markets be defined? What other measures might be used to assess a nonbank financial firm's importance under this criterion?

The FSOC should use existing data on communities and expand as necessary and, again, assess the individual institution's share of total credit extended to meet these needs.

7. How should the Council measure and assess the interconnectedness of a nonbank financial firm?

a. What measures of exposure should be considered (e.g., counterparty credit exposures, operational linkages, potential future exposures under derivative contracts, concentration in revenues, direct and contingent liquidity or credit lines, crossholding of debt and equity)? What role should models of interconnectedness (e.g., correlation of returns or equity values across firms, stress tests) play in the Council's determinations?

b. Should the Council give special consideration to the relationships (including exposures and dependencies) between a nonbank financial company and other important financial firms or markets? If so, what metrics and thresholds should be used to identify what financial firms or markets should be considered significant for these purposes? What metrics and thresholds should be used in assessing the importance of a nonbank financial company's relationships with these other firms and markets?

In general, the same criteria limiting credit exposure as a share of capital should apply to an affiliate of a nonbank company and to its transactions with an unrelated financial institution as applies to national banks under Sections 609-611 of DFA. Similarly, the company's dependence for funding on its affiliates or unrelated financial institutions should be assessed to avoid concentrations.

8. How should the Council measure and assess the leverage of a nonbank financial firm? How should measures of leverage address liabilities, off-balance sheet exposures, and nonfinancial business lines? Should standards for leverage differ by types of financial activities or by industry? Should acceptable leverage standards recognize differences in regulation? Are there existing standards (e.g., the Basel III leverage ratio) for measuring leverage that could be used in assessing the leverage of nonbank financial companies?

Obviously, there are differences in the composition of balance sheets and in regulation among different types of nonbank financial institutions. But to meet systemic concerns, the FSOC must develop standards for leverage in relation to capital for these institutions including off-balance sheet exposures.

9. How should the Council measure and assess the amount and types of liabilities, including the degree of reliance on short-term funding of a nonbank financial firm?

a. What factors should the Council consider in developing thresholds for identifying excessive reliance on short-term funding?

b. How should funding concentrations be measured?

c. Do some nonbank financial companies have funding sources that are contractually short-term but stable in practice (similar to "stable deposits" at banks)?

d. Should the assessment link the maturity structure of the liabilities to the maturity structure and quality of the assets of nonbank financial companies?

In general, we believe assessments of the vulnerability of all financial institutions to funding sources should take into account the maturity structure of their liabilities to the maturity structure and quality of their assets.

10. How should the Council take into account the fact that a nonbank financial firm (or one or more of its subsidiaries or affiliates) is already subject to financial regulation in the Council's decision to designate a firm? Are there particular aspects of prudential regulation that should be considered as particularly important (e.g., capital regulation, liquidity requirements, consolidated supervision)? Should the Council take into account whether the existing regulation of the company comports with relevant national or international standards?

We believe that the particular aspects or regulation cited here – capital regulation, liquidity requirements and consolidated supervision – are of critical importance in preventing systemic threats from nonbank companies. This argues for over-inclusion in determinations, since most nonbank firms would not otherwise be subject to capital, leverage, or other prudential regulations in the ordinary course. We also note that regulatory arbitrage contributed to the crisis and compliance with then-existing national and international standards led to a global financial meltdown. Compliance with the law is necessary but not sufficient. A key role of the FSOC is to identify activities that pose systemic economic risk and take steps to curtail this risk to prevent another crisis.

11. Should the degree of public disclosures and transparency be a factor in the assessment? Should asset valuation methodologies (e.g., level 2 and level 3 assets) and risk management practices be factored into the assessment?

We agree that disclosure and transparency should be factors in the assessment. In particular, required disclosure of transactions that might not otherwise be observable by counterparties and investors including intraday transactions and also mid-reporting period transactions should be implemented.

12. During the financial crisis, the U.S. Government instituted a variety of programs that served to strengthen the resiliency of the financial system. Nonbank financial companies participated in several of these programs. How should the Council consider the Government's extension of financial assistance to nonbank financial companies in designating companies?

Nonbank financial institutions that received government support during the crisis should automatically be regulated under Section 113 from the outset. So long as these institutions continue to pursue the same business model in which they engaged before the crisis, the FSOC should be very reluctant to discontinue overseeing them. Going forward, the FSOC must evaluate the financial condition of any participating or assisted institution absent U.S. Government support to determine whether it is appropriate to discontinue Section 113 oversight.

13. Please provide examples of best practices used by your organization or in your industry in evaluating and considering various types of risks that could be systemic in nature.

a. How do you approach analyzing and quantifying interdependencies with other organizations?

b. When and if important counterparties or linkages are identified, how do you evaluate and quantify the risks that a firm is exposed to?

c. What other types of information would be effective in helping to identify and avoid excessive risk concentrations that could ultimately lead to systemic instability?

It's important to identify concentrations in types of assets and types of transactions. While addressed above in the assumption that certain nonbank companies are critical for lending to consumers, small businesses and for mortgages, etc., the financial crisis revealed that large concentrations of assets by large companies was seriously destabilizing. There is a need to assess size in relation to concentrations. Small consumer or mortgage lenders may pose no systemic threat but large ones do.

14. Should the Council define "material financial distress" or "financial stability"? If so, what factors should the Council consider in developing those definitions?

In response to this question, we refer the FSOC to the information set out above.

15. What other risk-related considerations should the Council take into account when establishing a framework for designating nonbank financial companies?

In response to this question, we refer the FSOC to the information set out above.

Thank you again for this opportunity to comment on this ANPR. If you have the further questions, please contact Craig Mehall, Policy Council, Public Citizen at (202) 454-5151 or Heather McGhee, Director of the Washington Office of Demos at (202) 559-1543 ext. 105, Co-chairs of the AFR Systemic Risk and Resolution Authority Taskforce.

1. See Section 165(d)(3) of the DFA.

2. Section 165(d)(1) describes this as "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure."

3. See Section 102(a)(4) and 102(a)(6) of the DFA.

4. Letter to The Honorable Timothy Geithner from Paul Volcker, Office of Paul Volcker re Public Input on Study Regarding Implementation of the Volcker Rule, October 29, 2010, Document ID: FSOC-2010-0002-0045, available at http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480b7d87e.

5. Ian Katz, "Non-Bank Companies Poised for Fed Scrutiny on Systemic Risk," *Bloomberg News*, October 7, 2010 ("A large number of hedge funds, private equity firms, and derivatives clearinghouses could also be considered. GE Capital, General Electric's financial arm, has said it expects to be included.")

6. Victoria McGrane and Damian Paletta, "Regulators Begin Process of Labeling the 'Systemically Important,'" *Wall Street Journal*, August 20, 2010. "In financial-industry circles, some speculate that U.S. insurance giant Prudential Financial Inc. could get the designation. On paper, Prudential is similar in size and type of activities to MetLife Inc., another big insurance company."

7. A July 2010 report from the Federal Reserve Bank of New York, "Shadow Banking" defined shadow banks as "intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees."

8. Financial Crisis Inquiry Commission, *Shadow Banking and the Financial Crisis*, Preliminary Staff Report, May 4, 2010, p. 4.

9. Raj Date, "Test Case on the Charles; State Street and the Volcker Rule," June 12, 2010; Cambridge Winter.

10. See Section 102(a)(6) and Jia Lynn Yang, "Financial Reform Amendment Protects Manufacturers from Risk Evaluation," *Washington Post*, May 20, 2010.