

# COMMITTEE ON CAPITAL MARKETS REGULATION

*SUBMITTED VIA WWW.REGULATIONS.GOV*

November 5, 2010

Hon. Timothy F. Geithner  
Chairman, Financial Stability Oversight Council  
United States Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653 (Docket No. FSOC-2010-0001)

Dear Chairman Geithner:

The Committee on Capital Markets Regulation appreciates the opportunity to comment on the Financial Stability Oversight Council's (FSOC or Council) advance notice regarding its authority to require supervision and regulation of certain financial companies under § 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>1</sup>

Since 2005, the Committee on Capital Markets Regulation (Committee) has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled, *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains 57 recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.<sup>2</sup> Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.<sup>3</sup>

The Dodd-Frank Act allows the Council to determine that a nonbank financial company, if met with financial distress, "could pose a threat to the financial stability of the United States" and therefore must be supervised by the Board of Governors of the Federal Reserve System.<sup>4</sup>

<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter Dodd-Frank Act), Pub. L. No. 111-203, § 113(a)(1); Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653 (Oct. 6, 2010).

<sup>2</sup> COMM. ON CAPITAL MKTS. REG., *THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM* (May 2009), <http://www.capmktreg.org/research.html>.

<sup>3</sup> *See, e.g.*, Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, and Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Fin. Serv. Comm. (Mar. 4, 2010) (proposing a comprehensive approach to reducing systemic risk from over-the-counter derivatives).

<sup>4</sup> Dodd-Frank § 113(a)(1).

The Act specifies several characteristics the Council should use in making its determination, including the size of the firm.

The Committee has consistently been opposed to singling out certain firms for enhanced supervision and regulation because that will increase moral hazard, introduce competitive distortions into the marketplace, and artificially lower the cost of funds borne by institutions that are branded as systemically important. More fundamentally, there is simply no principled way to single out particular firms—we really cannot tell which firms are systemically important *a priori*. The best course of action for the Council would be to avoid making any such designations at all. If, however, the Council is determined to designate firms for enhanced supervision by the Federal Reserve, then the best way to do so—or, perhaps better stated, the least harmful way to do so—is on the basis of a single, objective factor: total assets.

### **Individual Determinations**

The Dodd-Frank Act lists the following measures as relevant for making these determinations:

1. leverage;
2. off-balance-sheet exposures;
3. relationships to other systemically important companies;
4. importance as a source of household credit;
5. importance as a source of credit for low-income, minority, or underserved communities;
6. whether assets are managed or owned;
7. nature, scope, size, scale, concentration, interconnectedness, and mix of activities;
8. degree of existing regulation;
9. amount and types of assets;
10. amount and types of liabilities; and
11. “any other risk-related factors.”<sup>5</sup>

This assortment of criteria suffers from many problems. Many of the terms are so ambiguous as to provide no guidance. Others, such as source of credit for underserved communities, have no bearing on the problem of systemic risk and financial stability of the country. Overall the criteria leave too much discretion to the Council, which in turn will make the Council susceptible to legal challenges at its every turn. Let us expand on this.

First, making an individual determination of systemic risk based on subjective and uncertain criteria will increase moral hazard and create uncertainties in the marketplace and among investors. Inevitably, therefore, the markets will be impacted adversely. In its letter dated

<sup>5</sup> Dodd-Frank Act § 113(a)(2).

June 14, 2010,<sup>6</sup> and on several prior occasions,<sup>7</sup> the Committee noted its opposition to labeling financial institutions as systemically important, which has the same effect as the designation required by § 113. Once an institution is labeled systemically important, it is more likely to be bailed out. Creditors, therefore, will be deterred from adequately policing their risks and the firm's cost of funds will be lower than their undesignated competitors, distorting competition and the allocation of funds in the capital markets.

Second, the designation of a firm based on a set of vague standards will inevitably lead to a legal challenge based on the criteria the Council used. The cry will be why me and not them or why them and not me. The Dodd-Frank Act expressly provides for notice, opportunity for an agency hearing, and judicial review. A firm that is designated using ambiguous and indefensible criteria will undoubtedly challenge its designation, triggering a process that will be costly and time consuming for the company and the Council alike.

### **Asset Thresholds**

If the Council is to designate any nonbank firms at all, then the Committee believes there can be no subjectivity in the designation. And the only practical alternative is for the Council to consider assigning nonbank financial institutions to Federal Reserve supervision based on asset thresholds. This is not to say assets are a proxy for riskiness, but no other meaningful standard makes sense. This approach would avoid the moral hazard and market uncertainties associated with using a subjective and unpredictable set of criteria. It is less harmful to use the single, objective, predictable measurement of asset size because it will cause no stigma or signal to be attached to the firm. We emphasize that we are against the designation process and this approach should only be used as a last resort.

Nonbank financial institutions encompass a diverse array of entities including insurance companies, hedge funds, and private equity firms, among others, which differ significantly from banks and from one another in terms of their core business activity, asset risks, capital structure, and "interconnectedness" generally. As a result, not all industries need to be supervised by the Federal Reserve; if the industry is not systemically important, in the sense that the failure of no business in the industry could pose risks to the financial system, then the Council should designate no firms in that industry. In addition, clearly not all industries should be supervised in the same way. The Federal Reserve should take into account the significant differences between banks and various kinds of nonbanks in designing its regulations. Truly, this is one area in which one size does *not* fit all.

<sup>6</sup> Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Member, H. Comm. on Fin. Servs. (June 14, 2010).

<sup>7</sup> See Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs (May 4, 2010) (addressing the formulation of key legislative provisions of the Dodd-Frank Act); Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Housing & Urban Affairs and Blanche Lincoln, Chairman, Saxby Chambliss, Ranking Member, S. Comm. on Agriculture, Nutrition & Forestry (Apr. 26, 2010).

Asset thresholds, if used, should be set low enough to include all systemically important firms, and the Council should err on the side of being over-inclusive not only out of caution but also to reduce the branding associated with the designation. That practice is consistent with the statutory threshold of \$50 billion for banks; it is obvious not all 36 banks of that size are systemically important. To illustrate the principle, Table 1 shows the number of firms in a variety of industries that exceed an asset threshold of \$20 billion. This threshold is merely meant to be illustrative; we are not proposing it. Indeed, it would be entirely appropriate to choose different asset thresholds for different industries based on an overall assessment of risks in these industries. In addition, making determinations adds the complication of some firms appearing in multiple industries.<sup>8</sup>

*Table 1: Fixed Asset Threshold of \$20 Billion<sup>9</sup>*

<b>Category</b>	<b>Asset Threshold</b>	<b>Number of Firms</b>
Bank holding company (set by statute)	\$50 billion	36
Insurance Holding Companies	\$20 billion	61
Hedge Fund Managers	\$20 billion	10
Private Equity Firms	\$20 billion	18
Mutual Fund Families	\$20 billion	51
Money Market Fund Families	\$20 billion	17
Real Estate Investment Trusts	\$20 billion	6
Consumer Finance Companies	\$20 billion	19
Retirement Fund Sponsors	\$20 billion	55

## Uncertainty of Regulatory Plan

In the complex regulatory system created by the Dodd-Frank Act, one agency makes the determination but a different agency becomes the regulator. Identifying systemically important institutions is already extremely difficult, but it is even more difficult at the beginning because the Council must make a determination before the Federal Reserve even develops a supervisory plan. It will be difficult for the Council to designate firms for a solution when the solution itself is uncertain and undetermined. For example, the Council may be willing to set a lower threshold

<sup>8</sup> The asset thresholds also do not capture off-balance sheet assets, but those are less important after the new consolidation requirement in FASB Interpretation No. 46, *Consolidation of Variable Interest Entities-an Interpretation of ARB No. 51*.

<sup>9</sup> For data supporting Tables 1, see Nat'l Info. Center, U.S. Fed. Res. Sys., *Top 50 Bank Holding Companies*, <http://www.ffiec.gov/nicpubweb/nicweb/NicHome.aspx> (bank holding companies); *Mergent Online*, <http://www.mergentonline.com> (insurance holding companies); Absolute Return + Alpha, *Billion Dollar Club* (Mar. 2010) (hedge fund managers); Private Equity Growth Capital Council (private equity firms); Morningstar, Inc., *Fund Family Data Pages*, <http://quicktake.morningstar.com/FundFamily/fundfamilylist.asp?Country=USA&Symbol=10491> (mutual fund families); iMoneyNet, 20 MONEY MARKET INSIGHT No. 9 (Sept. 2009) (money market fund families); CapitalIQ, *Company Screening* (real estate investment trusts and consumer finance companies); Pensions & Investments, 38 THE LARGEST RETIREMENT FUNDS, No. 3, 13–25 (retirement fund sponsors).

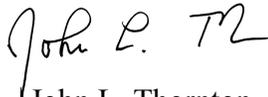
for hedge funds if the Fed will simply monitor and require reporting compared to if the Fed plans to impose leverage limitations on all firms under its supervision. The Dodd-Frank Act does not require the Council to make determinations immediately. The Committee, therefore, recommends at least delaying any determination of which nonbank financial institutions should be subject to Federal Reserve jurisdiction until the Federal Reserve has adequately articulated its plan for regulation and supervision of non-bank designated firms, on an industry-by-industry basis.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

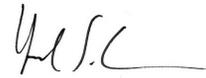
Respectfully submitted,



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