BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

December 19, 2011

Financial Stability Oversight Counsel
Attention: Mr. Lance Auer
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Second Notice of Proposed Rulemaking and Proposed Interpretive Guidance – Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (RIN 4030-AA00)

Dear Mr. Auer:

Better Markets, Inc.[1] appreciates the opportunity to respond to the above-captioned Notice of Proposed Rulemaking (the "Proposed Rule")[2] of the Financial Stability Oversight Council ("FSOC"), the purpose of which is to apply the statutory standards and considerations, and the processes and procedures that the Council intends to follow, in making determinations under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

The purpose of the provisions of the Dodd-Frank Act that gave rise to the Proposed Rule is to identify and designate nonbank financial firms that may be systemically significant. However, the Proposed Rule will fail to identify many such firms and, therefore, they will not be evaluated for designation. Additionally, the criteria proposed for designating those nonbank financial firms that are identified are so incomplete and limited that many of the firms initially identified will not be designated. Without bringing the Proposed Rule into compliance with the Dodd-Frank law, many systemically significant nonbank financial firms will continue to be largely unregulated and pose a serious threat to the financial stability of the United States.

It is beyond dispute that the "shadow banking system" played a key role in causing and amplifying the financial crisis. That system is a collection of unregulated or lightly regulated financial intermediaries that, taken together, exceed the entire regulated banking sector in size. However, the Proposed Rule will leave much of the shadow banking system unregulated, clearly contrary to the intent and purpose of the law.

Within that unregulated and non-transparent shadow banking system, unsupervised mortgage banks originated a torrent of doomed subprime mortgages. Banks, broker-dealers,

1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 The defined term Proposed Rule herein refers to the text of the explanatory discussion, proposed rule, and proposed guidance issued by the Financial Stability Oversight Council in its second notice of proposed rulemaking, 12 CFR Part 1310, Authority to Require Supervision Certain Nonbank Financial Companies. Available at http://www.treasury.gov/initiatives/fsoc/Pages/notices-of-proposed-rulemaking.aspx.

and hedge funds took highly leveraged positions in mortgage-related assets by creating conduits, structured investment vehicles, and collateralized debt obligations, or by accessing the repo market. Money market funds and other large financial institutions financed those positions by purchasing the asset-backed commercial paper issued by the special purpose vehicles, and by making repo loans. When the house price bubble burst, the ensuing run on the shadow banking system threatened to cause the collapse of the entire financial system. The run was ended and that collapse was avoided **only** through massive intervention by the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC"), and the Treasury.

When Congress addressed the failures of the financial regulatory system in the Dodd-Frank Act, it recognized the need to address the threats to the stability of the entire financial system, including importantly those created by shadow banking. However, because information about the existing shadow banking system is incomplete, and because its structure is likely to evolve in the future, the law took a flexible and pragmatic approach to determining where additional regulation is needed. It created and gave the FSOC the responsibility of identifying nonbank financial intermediaries whose material distress could threaten U.S. financial stability. FSOC was given wide latitude to choose the qualitative and quantitative factors used to determine its designations.[3]

The Proposed Rule, which describes how this designation authority is to be implemented, does not do what the law requires. It inexplicably limits the data that will be considered in the early part of the designation process, when it should use all the relevant data and analytic approaches available to come to grips with an opaque and imperfectly understood system. The Proposed Rule also sets arbitrary quantitative thresholds for designation – such as a minimum asset size of $50 billion – which are not part of the law and will exclude important shadow banking entities from consideration. It then proposes the use of contemporary and static metrics, ignoring historic information and the tendency of shadow bank behavior to vary significantly over time. And, it makes the extent of existing regulatory scrutiny a metric, when the demonstrated effectiveness or ineffectiveness of existing regulation must be the relevant consideration.

The law requires abandoning arbitrary limitations on data and the manner in which they are analyzed, removing arbitrary thresholds for designation that are not in the law, giving explicit consideration to historical data on shadow banking entities and activities, and paying attention to the effectiveness of existing regulation of these entities and activities.

SUMMARY OF COMMENTS

The Proposed Rule for designating nonbank financial firms that are capable of threatening U.S. financial stability will frustrate the letter and intent of the law, which instructs FSOC to identify unregulated or incompletely regulated entities and activities that threaten U.S. financial stability. The Proposed Rule does this by constructing a three-stage sequence of procedures that arbitrarily limit the data and analysis that will be used in the identification and designation process.

Limiting Stage 1 data sources will result in FSOC failing to identify potentially systemically significant entities that should at least be evaluated for designation

In Stage 1 of the proposed designation process, FSOC determines the universe of firms that are eligible to be designated. However, the Proposed Rule limits FSOC to the use of existing

[3] Dodd-Frank Act Section 113.

public and regulatory information. This makes it virtually certain that financial firms and elements of the "shadow banking system," which were acknowledged sources of financial instability during the crisis, but about which information is decidedly incomplete, will escape designation. This limitation is not part of the law and is inconsistent with the legal mandate to FSOC to identify and designate such firms.

By limiting designation to firms with at least $50 billion in assets, the Proposed Rule will prevent regulatory agencies from effectively reducing the risks to the financial system

The Stage 1 procedures impose an arbitrary $50 billion asset threshold for a firm to be considered for designation. This threshold (along with other Stage 1 quantitative measures) will prevent designation of shadow banking firms, such as conduits, that have demonstrated a collective ability to wreak havoc on our financial system, but which individually fall below the threshold. The asset threshold created by the Proposed Rule is not part of the Dodd-Frank law and should be eliminated.

Firms or activities that had to be rescued by the Federal Reserve, FDIC, or Treasury during the financial crisis must be considered for designation

To ensure that systemically significant nonbank financial entities are identified and designated, the law provides that FSOC use a wide range of qualitative as well as quantitative information on firms and activities that **may** threaten financial stability. At a minimum, FSOC should take the obvious step of giving thorough consideration to those nonbank entities and activities that required significant aid from the Federal Reserve, FDIC, or Treasury during the crisis. The law requires no less, given that their need for rescue is **prima facie** evidence that they can create or amplify threats to financial stability.

A desire for short run market certainty should not be an element in the identification or designation process because it is unrelated to the statutory mandate to identify and designate systemically important nonbank financial firms

The Proposed Rule notes that the Stage 1 thresholds will "....help a nonbank financial company predict whether such company will likely be subject to additional review by the Council."[4] The desire to provide this kind of certainty may explain the decision to adopt the $50 billion asset threshold, along with the other quantitative metrics. However, there is no such goal is in the statute, which mandates that regulators focus on identifying nonbank financial firms that pose threats to stability.

Static, contemporary metrics must be complemented by data on historical behavior of these metrics

In Stage 2 of the proposed designation process, both quantitative and qualitative characteristics are used to further screen firms for designation.[5] The quantitative characteristics in this list are apparently static, based on contemporary measures of their value. However, whenever quantitative metrics are adopted, they must be complemented with historical data, particularly data from the run-up to the financial crisis, as well as current values. For example, the Stage 2 metrics include some measures of liquidity risk and maturity mismatch. While this kind of mismatch is common to much of financial intermediation, the

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4 12 CFR Part 1310, op. cit., 16.
5 12 CFR Part 1310, op. cit., 65-66.

mismatch became much more severe at broker-dealers during the run-up to the financial crisis. Consideration of historical patterns is necessary if firms are to be properly evaluated for designation. Otherwise, the incomplete evaluation in the Proposed Rule will doom us to learn about historic and current values only when in the midst of the next crisis.

The existence of regulatory scrutiny is an incomplete metric for designation purposes and must include consideration of regulatory effectiveness

Another measure considered in Stage 2 is the extent of existing regulatory scrutiny. This metric omits consideration of regulatory effectiveness, which is surely a prime consideration for deciding whether additional supervision and prudential regulation is needed.

FSOC should automatically consider bank holding companies that reorganize as nonbank financial firms for designation

The anti-evasion provision of the Dodd-Frank Act gives FSOC the power to designate any nonbank financial company for supervision by the Federal Reserve if material distress related to its financial activities would pose a threat to financial stability, but it is "...organized or operates in such a manner as to evade the application of [the financial stability title of the Dodd-Frank Act]...".[6] FSOC should automatically consider firms that cease to be bank holding companies, but still engage in substantial financial activity, for designation. Because such a reorganization allows such firms to escape Federal Reserve supervision and bank capital and other requirements, there is good reason for FSOC to examine whether the reorganization creates threats to financial stability that require designation.

COMMENTS

A. Limiting Stage 1 data sources will result in FSOC failing to identify potentially systemically significant entities that must be at least be evaluated for designation

Under the Proposed Rule the FSOC will rely "solely on information available through existing public and regulatory sources" in Stage 1 of the process by which nonbank financial firms will be designated for supervision by the Federal Reserve.[7] This restriction makes it virtually certain that elements of the "shadow banking system", which are acknowledged to have played a central role in the recent financial crisis, will be excluded from the consideration for supervision by the Federal Reserve.

The shadow banking system , which has been defined as the collection of financial intermediaries that conduct bank-like financial intermediation, but which were supposed to lack access to public sector credit guarantees and access to central bank lending, remains large even after the events of the crisis. It includes entities such as "asset-backed commercial paper ("ABCP") conduits, limited-purpose finance companies, structured investment vehicles, money market mutual funds, securities lenders, and government-sponsored enterprises."[8]

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6 Dodd-Frank Act Section 113(c).

7 12 CFR Part 1310, op. cit., 62.

8 Z. Pozar et al. (2010), Shadow Banking, Federal Reserve Bank of New York Staff Report No. 458, July. Available at http://www.ny.frb.org/research/staff_reports/sr458.pdf

By one estimate, the liabilities of the shadow banking system were approximately $16 trillion in the first quarter 2010, down from a peak value of approximately $20 trillion before the crisis, but still greater than aggregate commercial bank liabilities. [9]

The run on the shadow banking system, which was a crucial element of financial crisis dynamics, was only halted by massive intervention by the Federal Reserve, FDIC, and Treasury.[10] The Federal Reserve created a large set of lending facilities, such as the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF") and Commercial Paper Funding Facility ("CPFF").[11] The FDIC insured the unsecured debt of banks and their affiliates (such as finance companies) through the Temporary Liquidity Guarantee Program ("TLGP").[12] And the Treasury created an insurance program for the liabilities of money market mutual funds.[13]

Because significant parts of the shadow banking system are unregulated or only lightly regulated, basing Stage 1 decisions only on data that are public or available to regulators will mean that these systemically significant intermediaries will almost certainly be missed. Given their role in the last crisis and their almost certain role in the next crisis, this is not consistent with the Dodd-Frank law and the Proposed Rule must be changed to include them in the identification stage of the process.

B. Stage 1 designation criteria are arbitrarily limited

The Proposed Rule allows the FSOC to designate only the very largest nonbank financial companies for supervision by the Federal Reserve. To be eligible for designation under the Proposed Rule, a company must hold at least $50 billion in assets in addition to one of the following characteristics:[14]

1. at least $30 billion in CDS written on it;
2. at least $3.5 billion in net derivative liabilities;
3. at least $20 billion in loans and bonds outstanding;
4. leverage ratio of at least 15:1; or
5. short-term debt-to-asset ratio of 10 percent.

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9 Ibid, 4-6. See also M. Singh and J. Aitken (2010). The (sizeable) Role of Rehypothecation in the Shadow Banking System, IMF Working Paper WP/10/172, and Z. Pozar and M. Singh (2011). The Nonbank-Bank Nexus and the Shadow Banking System, IMF Working Paper WP/11/289.

10 Z. Pozar et al. (2010), 2. For a Federal Reserve Bank of New York chronology of crisis events that shows when rescue efforts were implemented *see* http://www.newyorkfed.org/research/global_economy/policyresponses.html

11 Description of the Federal Reserve lending programs can be found at http://www.federalreserve.gov/monetarypolicy/bst.htm

12 Description of the FDIC guarantee program can be found at http://www.fdic.gov/regulations/resources/TLGP/index.html

13 Description of the Treasury insurance program are at http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx

14 The Proposed Rule notes that "[i]n all instances the Council reserves the right, in its discretion, to subject any nonbank financial company, irrespective of whether such company was identified in Stage 1, to further review if the Council believes that further analysis of the company is warranted to determine if the company poses a threat to U.S. financial stability." However, this does not provide for systematic consideration of firms that do not meet these thresholds. *See* 12 CFR Part 1310, op. cit., 21-22.

(1) By limiting designation to firms with $50 billion in assets, the Proposed Rule will prevent the regulatory agencies from effectively reducing the systemic risks to the financial system that are created the "shadow banking system"

(a)The Dodd-Frank Act does not require a $50 billion asset threshold, or other quantitative thresholds, for designation and FSOC should not adopt such a wooden approach to designation, particularly where such a threshold will result in systemically significant firms not being evaluated at all

It is clear that the $50 billion asset threshold is not required by the Dodd-Frank Act. Section 113 of the DFA gives FSOC broad authority to designate nonbank companies for supervision, regardless of their asset size. While Section 113 mentions asset size as **one** of the factors to be considered when determining if a nonbank entity could threaten financial stability, it is only one factor among many.

For example, the law states that FSOC should consider the "nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company."[15] Moreover, the law expressly directs FSOC to consider "any other risk related factors that the Council deems appropriate."[16] No single, wooden size threshold is contemplated in this part of the statute. Indeed, it is clear that the law was designed to ensure that all the relevant quantitative and qualitative metrics be considered and that the focus be on whether or not a firm is or might be systemically significant.

Regarding the application of post-designation prudential standards, the law states that FSOC **may** "recommend an asset threshold that is higher than $50,000,000,000 for the application of any [prudential] standard described in subsections (c) through (g)," FSOC is not required to do so.[17] In fact, the statute directs FSOC that it **may** follow Section 115(a)(2)(B) **or** Section 115(a)(2)(A) when making recommendations for enhanced prudential standards for nonbank companies. Section 115(a)(2)(A) gives FSOC wide discretion, allowing it, to "differentiate among companies that are subject to heightened standards on an individual basis by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including financial activities of their subsidiaries), size and any other risk-related factors that the Council deems appropriate." But Section 115(a)(2) is permissive, so long as the standards for designated nonbank companies serve the purpose of mitigating risk to financial stability.

It should also be noted that Section 120 gives FSOC authority to recommend more stringent regulation on financial activities "for a financial activity or practice conducted by bank holding companies or nonbank financial holding companies under their respective jurisdictions, if the Council determines that the conduct, scope, nature size, scale, concentration, or interconnections of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities." The prerequisite for these regulations is that the standards apply to federally-supervised financial and nonbank financial entities. There is no asset size threshold because an asset threshold would be inconsistent with the intent of the law.

15 *See* DFA Section 113(a)(2)(G)
16 *See* DFA Section 113(a)(2)(K)
17 *See* DFA Section 115(a)(2)(B)

Moreover, Section 121 allows FSOC and the Board of Governors of Federal Reserve to take certain actions when "...a bank holding company with consolidated assets of $50,000,000,000 or more, or a nonbank financial company supervised by the Board of Governors, poses a grave threat to the financial stability of the United States..." Under standard rules of statutory construction, this language makes clear that the Dodd-Frank Act did not intend to limit designated nonbank companies to $50 billion or more in assets and FSOC should not do so. As set forth below, such a quantitative limitation will defeat the qualitative analysis the law requires.

(b) The creation of a $50 billion asset threshold for designation will prevent needed regulation of nonbank companies that threaten financial stability

It is widely understood that the shadow banking system played an important role in creating and propagating the recent financial crisis. However, the proposed asset threshold would make it difficult to supervise and regulate entities that contributed to the crisis, as well as yet-be-created entities that engage in systemically significant activities.

Consider, for example, asset conduits. These special purpose vehicles, created by commercial and investment banks, mortgage banks, hedge funds, and others, were used to finance subprime mortgages and other forms of securitized lending. They took a variety of legal forms, but in general they issued ABCP and other short-term liabilities that were used to fund the purchase of less liquid assets of longer maturity. Some conduits had liquidity or credit guarantees provided by commercial banks, while others such as the structured investment vehicles (SIV's) had partial or no guarantees from their creators. Conduit financing was attractive because capital charges for liquidity guarantees were lower than the capital charges required for on-balance-sheet financing. The willingness of banks to engage in regulatory arbitrage, as demonstrated by their use of conduits, suggests that they will easily respond to an arbitrary asset threshold by creating entities that evade it.

These conduits were on average small when measured against the proposed $50 billion threshold. Among all conduits rated by Moody's as of January 1, 2007, the mean asset size was $4.1 billion. However, these conduits held over $1.2 trillion in assets, which meant that they were collectively a very significant part of the financial system.[18] And, they were connected directly to the core of the banking system; in the sample rated by Moody's, approximately 73.7 percent of conduits by assets were sponsored by commercial banks.[19]

When it became clear in mid-2007 that the house price bubble had burst and that subprime mortgage assets would sustain significant losses, the market for ABCP began to contract rapidly. Outstanding financial ABCP began to plummet from its peak value of $1.2 trillion in August 2007. By December it had collapsed by approximately a third to $833 billion.[20]

This run on conduits had significant effects on the financial system. Banks that had provided liquidity and credit guarantees had to make good on them and took losses. Other banks, such as Citibank, absorbed losses on SIVs they had sponsored, even though they were

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18 It should be noted that the Moody's sample omits collateralized debt obligations and may be otherwise incomplete.
19 Ibid, Table 2.
20 V. Acharya et al. (2011), 3.

not legally compelled to do so.[21] Given a lack of publicly available data, the extent of conduit-related losses is difficult to calculate. However, the run created the possibility that conduit management or guarantors would be forced into a fire sale of assets. The resulting effect on prices would have spread losses to other financial actors, leading to a downward price spiral.

This threat explains the efforts of then-Treasury Secretary Paulson to organize an SIV rescue through a private-sector "Master Liquidity Enhancement Conduit" in late 2007. This effort failed. In the end, the Federal Reserve was compelled to support the ABCP market to prevent a downward asset price spiral. It created the AMLF, CPFF and Money Market Investor Funding Facility ("MMIF") to do so, which at peak operating levels added more than $340 billion to the Federal Reserve balance sheet.[22]

As a second example, consider the events surrounding the failure of Long Term Capital Management ("LTCM") in 1998. LTCM was a hedge fund with $126 billion in assets. Through the use derivatives, repo financing, and other techniques, LTCM managed to raise its leverage ratio to 55.[23] When its investment strategy collapsed, federal financial market regulators feared a severe impact on market functioning. In its post-mortem report on the crisis, the GAO reports that:[24]

> According to Federal Reserve officials, LTCM's failure, had it occurred in the unsettled market conditions of September 1998, might have disrupted market functioning because of the size and concentration of LTCM's positions in certain markets and the related sales of other market participants. As noted previously, the firm had sizeable trading positions in various securities, exchange-traded futures, and OTC derivatives markets. Moreover, LTCM's counterparties might have faced the prospect of "unwinding" their own large LTCM-related positions in the event of that firm's default. Unwinding these positions could have been difficult: according to LTCM officials, about 20,000 transactions were outstanding between LTCM and its counterparties at the time of its near-collapse.

Had there been two or three firms, each with something less than $50 billion in assets, pursuing the LTCM strategy, it is difficult to see why their simultaneous implosion would not have posed the same threat as LTCM. Indeed, if there had been a hard threshold of $50 billion, then it is only reasonable to believe that LTCM would have organized itself in a way to ensure that its firms were each under that amount.

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21 Citigroup Inc. 2007 10-K, 163. *See* http://www.marketwatch.com/story/citigroup-to-take-49-bln-of-siv-assets-onto-balance-sheet.

22 *See* http://www.federalreserve.gov/releases/h41/20090102/.

23 M. Dungey et al. (2002). International Contagion Effects from the Russian Crisis and the LTCM Near-Collapse. International Monetary Fund Working Paper WP/02/74, 6. Available at http://useconomy.about.com/gi/o.htm?zi=1/XJ&zTi=1&sdn=useconomy&cdn=newsissues&tm=49&f=00&tt=12&bt=1&bts=1&st=11&zu=http%3A//www.imf.org/external/pubs/cat/longres.cfm%3Fsk%3D15735.0.

24 U.S. General Accounting Office (1999). Long Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk, GAO/GGD-00-3, October, 12.

(2) Firms or activities rescued by the Federal Reserve, FDIC, or Treasury during the financial crisis must be considered for designation

Many nonbank entities and activities required significant aid from the Federal Reserve, FDIC, or Treasury during the crisis. It may not be practical to describe a set of metrics that would encompass all these entities or activities given that the systemic significance of many only became obvious as the crisis unfolded. However, we now know for a fact that they were systemically significant and, therefore, they must be considered for designation because the need for rescue last time is **prima facie** evidence that they can create or amplify threats to financial stability.

For example, after the failure of Lehman Brothers caused the Reserve Primary money market fund to "break the buck", there was a run on money market funds generally. During a two-week period institutional investors reduced their holdings in prime money market funds by about $382 billion, and holdings of retail investors declined by $28 billion.[25] In the response to threat of a larger run, which would have withdrawn more funds from the commercial paper market, the Treasury money market guarantee program provided insurance for money market investors. In addition, the Federal Reserve established the AMLF and the MMIF to help the funds meet demand for redemptions. It also created the CPFF in part to replace the diminished capacity of money market funds. This suggests that money market funds in the aggregate, regardless of size, should be considered for designation. Under other circumstances, the failure of a handful of similarly situated smaller funds could provoke a run, just as the failure of Reserve Primary Fund did.

The firms and activities that caused the Federal Reserve to establish its other lending facilities – such as the Primary Dealer Credit Facility, which prevented the collapse of repo lending and prevented asset fire sales by broker-dealers and others – also must be explicitly considered for designation.[26] So should the firms and activities that needed the FDIC-administered Temporary Liquidity Guarantee Program, which provided guarantees for unsecured debt issued by banks and their affiliates.

Consideration must be given to the weaknesses identified by federally-organized financial crisis rescues, regardless of the ability of FSOC to derive a set of quantitative metrics that successfully sweeps in all the relevant firms and activities. After all, there is no better evidence of systemic significance than the fact that a firm or activity had to be bailed out during the last crisis. Any metric or process that fails to include these firms or activities simply cannot comply with the mandate of the Dodd-Frank Act.

(3) A desire for short run market certainty should not be an element in the identification or designation process because it is unrelated to the statutory mandate to identify and designate systemically important nonbank financial firms

The Proposed Rule notes that the Stage 1 thresholds will "....help a nonbank financial company predict whether such company will likely be subject to additional review by the Council."[27] The desire to provide this kind of certainty may explain the decision to adopt the $50 billion asset threshold, along with the other quantitative metrics. However, there is no

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[25] Squam Lake Group (2011). Reforming Money Market Funds, January, 2. *Available at* www.squamlakegroup.org.

[26] *See* T. Adrian et al. (2009). The Federal Reserve's Primary Dealer Credit Facility. The Federal Reserve Bank of New York Current Issues in Economics and Finance, Volume 15, Number 4, August.

[27] 12 CFR Part 1310, op. cit., 16.

such goal is in the statute, which mandates that regulators focus on identifying nonbank financial firms that pose threats to stability. The FSOC must not provide this certainty to industry at the expense of failing to identify entities that threaten financial stability.

C. Stage 2 designation criteria must require consideration of historical data and must account for regulatory effectiveness

In Stage 2 of the designation process FSOC will consider categories of metrics to determine if an entity that passed Stage 1 thresholds ought to be designated. They include:

1. interconnectedness (counterparty exposures, number of counterparties, CDS referencing the entity, etc.);
2. substitutability (ability of market to compensate for failure);
3. size;
4. leverage;
5. liquidity risk and maturity mismatch;
6. extent of existing regulatory scrutiny; and
7. the effect of resolution on overall stability.

(1) Static, contemporary metrics must be complemented by data on the historical behavior of these metrics

The quantitative characteristics in this list are apparently static, based on contemporary measures of their value. However, whenever quantitative metrics are adopted, consideration must also be given to historical data, especially in the run-up to the financial crisis, as well as current values.

For example, the Stage 2 metrics include some measures of liquidity risk and maturity mismatch. While this kind of mismatch is common to much of financial intermediation, the mismatch varies significantly over time. A study by the Federal Reserve Bank of New York notes that as repo borrowing surged in the run-up to the financial crisis, the collateral used became increasingly less liquid, with more mortgage-backed securities, corporate securities and other asset-backed securities being funded in this very short-term market.[28] Therefore, consideration of historical patterns of liquidity risk and maturity mismatch is necessary.

Stage 2 also makes leverage a metric for designation. Here, too, historical patterns are important. It has been established that investment bank/broker-dealer leverage ratios are much higher in asset price booms, when boom prices encourage additional borrowing to fund asset purchases.[29] This pattern of behavior amplifies the formation of asset price bubbles. It also increases the risk that there will be asset fire sales by the highly leveraged when the bubble bursts, especially when leverage is obtained using short-term debt.[30] Bear Stearns and Lehman are recent, canonical examples of that dynamic. Hence the historical patterns of leverage formation must be considered in the designation process.

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28 T. Adrian et al. (2009), 4.

29 T. Adrian and H. Shin (2010). Liquidity and Leverage. Journal of Financial Intermediation, Volume 19, 418-37.

30 H. Shin (2009). Securitisation and Financial Stability. The Economic Journal, Volume 119, March, 309-332.

(2) The existence of regulatory scrutiny is an incomplete metric for designation purposes and must include consideration of regulatory effectiveness

The events of the crisis show that some existing regulation is inadequate to the task of preserving financial stability. For example, while there is extensive oversight of broker-dealers by the Securities and Exchange Commission ("SEC"), this oversight did little to restrain broker-dealers from using very short to borrowing to leverage their balance sheets to ridiculous levels during the crisis. This made them vulnerable to runs, while threatening overall financial stability. As then-SEC Chairman Christopher Cox noted in 2008, Bear Stearns was comfortably in compliance with the net capital rule and other SEC regulations until just before it failed.[31]

But while Bear Stearns had liquidity of more than $20 billion on March 4, by March 13 its liquidity was down to $2 billion. As repo and other counterparties deserted them, and prime brokerage customers withdrew assets that could be used as collateral for loans, Bear Stearns lost access to the short-term borrowing on which it based its business. Lehman collapsed for similar reasons. Morgan Stanley and Goldman Sachs escaped runs and the same fate only by becoming bank holding companies and thereby gaining long-term access to Federal Reserve liquidity, and Merrill Lynch was absorbed by the Bank of America holding company, also enabled by federal support.

The more recent demise of MF Global also suggests weaknesses in the oversight of broker-dealers. According to news reports, over a billion dollars in client funds, which by law were to be held in segregated accounts, somehow vanished as the firm's credit rating was downgraded and collateral calls increased.[32] Although all the evidence is not in, one possible conclusion is that reliance on self-regulatory organizations such as the Chicago Mercantile Exchange and FINRA to implement regulations of broker-dealers is inadequate.

The existence or extent of regulation is not, in itself, sufficient criteria for identifying nonbank financial firms that ought to be designated. Instead, the actual and potential effectiveness of existing regulation must to be taken into account.

C. FSOC should automatically consider bank holding companies that reorganize as nonbank financial firms for designation

The anti-evasion provision of the Dodd-Frank Act gives FSOC the power to designate any nonbank financial company for supervision by the Federal Reserve if material distress related to its financial activities would pose a threat to financial stability, but it is "...organized or operates in such a manner as to evade the application of [the financial stability title of the DFA]...".[33] The Proposed Rule does not spell out what kind of organization or operation might warrant designation. This is somewhat understandable, given the multitude of evasive strategies that might be adopted. However, FSOC should automatically consider firms that cease to be bank holding companies, but still engage in substantial financial activity, for designation.

For example, Barclay's has terminated the bank holding company status of its U.S. subsidiary, and other bank holding companies may be considering doing so.[34] Because such a reorganization allows such firms to escape Federal Reserve supervision and bank capital and

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31 *See* the March 20, 2008 letter from Chairman Christopher Cox to the Basel on Banking Supervision, available at http://www.sec.gov/news/press/2008/2008-48.htm

32 *See* http://www.bloomberg.com/news/2011-11-25/freeh-appointed-trustee-in-mf-bankruptcy.html

33 DFA Section 113(c).

34 *See* http://online.wsj.com/article/SB10001424052748704657704576150443241518166.html

other requirements, there is good reason for FSOC to examine whether the reorganization creates threats to financial stability that require designation.

While the Barclay's U.S. holding company had assets greater than $50 billion, FSOC should also examine smaller holding companies that reorganize. A complex, opaque, and highly interconnected former bank holding company may still pose a threat to financial stability, even if it has less than $50 billion in assets.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Rule.

Sincerely,

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