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Congress of the United States
House of Representatives
Washington, DC 20515–3219

April 8, 2011

The Honorable Timothy Geithner
Secretary
The Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, DC 20220

Dear Secretary Geithner:

On January 26, 2011, the Financial Stability Oversight Counsel ("FSOC") issued a proposed rule regarding the designation of certain nonbank financial companies for enhanced prudential regulation.[1] If enacted as currently drafted, the vagueness of FSOC's rule will increase uncertainty and regulatory distortion in the financial markets. Further, this lack of transparency regarding the standards and models for designating will render Congressional oversight impossible and administrative or judicial review meaningless.

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203)("DFA") requires FSOC to designate certain nonbank financial companies that will be regulated by the Board of Governors of the Federal Reserve. Pursuant to this requirement, the FSOC issued an Advanced Notice of Proposed Rulemaking[2] and Notice of Proposed Rulemaking[3] requesting responses to 15 specific questions and proposing a rule identifying six categories of information for identifying institutions for enhanced prudential regulation. However, the proposed rule is silent with regard to standards or models that would apply this information for designating institutions systemically important.

Regulatory Concerns

The designation of systemically important financial institutions ("SIFIs"), and the process by which FSOC makes these decisions, will have significant consequences for financial markets.

Market Distortions

Experts recognize market consequences associated with being a perceived as a SIFI. For example, the Committee on Capital Markets Regulation, a group of prominent financial services scholars, "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."[4] Studies prove that institutions considered "too-big-to-fail" have access

to funds at significantly lower costs.[5] The FSOC's designation of institutions will have significant market consequences.

Transparency

The degree of FSOC's transparency will affect these market consequences. Prior to the financial crisis, there was debate over whether banking regulation should be transparent. For example, some scholars championed "constructive ambiguity" to negate the moral hazard associated with too-big-to-fail by promoting uncertainty and, therefore, greater market discipline.[6]

However, numerous analysts of the causes and lessons of the recent financial crises support greater transparency and certainty in designating SIFIs.[7] One prominent scholar concluded, "constructive ambiguity is dead."[8] "For a number of reasons, *a policy of supervisory transparency is superior to constructive ambiguity for our purposes*...Hence, the list of SIFIs, *including categories and criteria for inclusion*, should be made public, along with a watch list of financial institutions whose SIFI status might change.[9]"

Others have argued similarly:

> Given precedents dating back to Continental Illinois in the 1980's and beyond, market participants made inferences about what government protection might be forthcoming in future instances of financial distress—that is, which institutions were likely to be viewed by authorities as "too big to fail." This lack of clarity about the safety net grew in the decades leading up to the crisis—and came about because policymakers hoped that "constructive ambiguity" would dampen the markets' expectations of bailouts, but preserve their option to intervene if necessary. Other factors contributed to the crisis, but I believe the ambiguity of safety net policy was a major driver.
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> Continued ambiguity thus would pose risks to financial stability and the economy, including the risk of new costs to taxpayers.[10]

This disclosure includes not only the criteria, but the underlying standards and models to which the criteria are applied, as well:

> An effective system of supervisory transparency entails more than simply disclosing information; it must also include producing information and disseminating it in a useful form...In the supervisory transparency regime, this means that all information used to assign institutions to an SIFI category—*including supervisory risk models and their results*—should be disclosed.[11]

Market uncertainty regarding systemically important institutions has proven to be damaging. As discussed below, financial markets, Congress, and designated entities need great transparency.

Economic Modeling of Systemic Risk

The FSOC's proposed rule identifies six categories of information used to identify nonbank financial companies for enhanced prudential regulation: size; lack of substitutes; interconnectedness; leverage; liquidity; and existing regulatory scrutiny.[12] However, the proposed rule does not identify the economic standards or models the FSOC will use to evaluate this information.

Economic research has identified a number of standards and models for analyzing systemic risk that use the categories of information identified by FSOC in the proposed rule. For example, the information can be input into models to determine the systemic risk associated with institutions' interconnectedness.[13] Alternatively, standards or models can evaluate the systemic risk associated with institutions' participation in markets.[14] Whether an institution is designated systemically important pursuant to the information collected in the FSOC's proposed rule will depend on which standard or model is used.

Public Need for More Information Regarding Designation

Market Distortion

Information regarding institutions that may be systemically important is critical to the financial markets. "Given precedents dating back to Continental Illinois in the 1980's and beyond, market participants made inferences about what government protection might be forthcoming in future instances of financial distress..."[15] Information regarding the government's treatment of institutions has a tremendous effect on decisions by depositors and creditors.[16] The key to addressing concerns regarding systemically important institutions and the moral hazard of too-big-to-fail is providing the market certainty regarding the treatment of entities.[17] To counter speculation in the markets that will distort decisions by participants, the FSOC's criteria must provide clear information regarding the standards and models for designating nonbank financial companies systemically important.

This market distortion is compounded if the FSOC's designation criteria for nonbank financial companies are used by markets to assess bank holding companies considered by government as too-big-to-fail. While DFA designates any bank holding company with greater than $50 billion in assets as a SIFI, financial markets are unlikely to consider a bank holding company too-big-to-fail simply because it exceeds the arbitrary asset threshold of $50 billion. In determining which bank holding companies are too-big-to-fail, financial markets will likely be influenced by the government's criteria for nonbank financial companies. These market assessments of bank holding companies as too-big-to-fail, and the resulting market distortions, are also mitigated by regulatory clarity in designations for nonbank financial companies.

Congressional Oversight

Congressional oversight of the FSOC's activities is critical under the separation of powers and checks-and-balances embodied in our Constitution. Ensuring compliance with legislative intent, providing for effective and efficient public programs, protecting against malfeasance in

administration, and guaranteeing access to information regarding the execution of laws are all critical functions of Congress.

The FSOC must provide greater transparency in how it designates institutions as systemically important. Only with greater transparency and more information regarding FSOC's standards and models can Congress fulfill its important, constitutional function.

Meaningless Appeal

The DFA statute and the FSOC's proposed rule provide an administrative process through which designated entities may contest their status as systemically important, as well as a right to seek judicial review of such decisions. Legislative intent and fundamental notions of fairness require that designated entities and reviewing bodies have access to information necessary to make such administrative and judicial appeals meaningful, including the standards and models for designation.

A recitation of the facts identified in the FSOC's proposed rules, without any information regarding the underlying applicable standards or models, makes a defense by a designated entity extremely difficult. While a designated entity could contest the facts, a designated entity could not argue that the facts do not satisfy the FSOC's standards or models for designation.

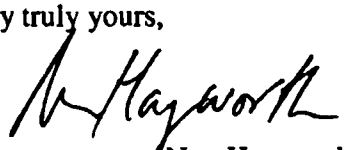
Without disclosure of the standards and modeling, an appeal, especially to a court, could not adjudicate whether the facts identified in the FSOC's proposed rule should result in an entity being designated systemically important. The lack of disclosure regarding standards and modeling renders a designated entities' right to contest, as well as any administrative or judicial review, meaningless. This meaningless appeal is contrary to legislative intent and fairness.

We look forward to your response to the concerns outlined above. *In addition to an explanation of how the FSOC is addressing our concerns*, we also request responses to the following questions:

1. Does the FSOC intend to make substantive changes to the rule as proposed to increase transparency and decrease uncertainty? Will these changes be made pursuant to an amended notice of proposed rulemaking subject to public comments?
2. Will the FSOC make publicly available notices and final determinations issued pursuant to §1310.21 or other sections of the proposed rule? While the FSOC has emphasized transparency,[18] will the FSOC issue regulations or policies requiring the confidentiality of FSOC documents as other banking regulators require for examination materials?[19] Will FSOC exercise its authority pursuant to 5 U.S.C. § 553(b)(8), or other relevant provisions, to exempt disclosure of these records from requests pursuant to the Freedom of Information Act?
3. Do you anticipate that proposed or actual designations are material and that publicly-traded companies will have to disclose to investors receipt of notices proposing designation as systemically important nonbank financial companies? What information will publicly-traded companies be required to disclose when they receive notices from the FSOC proposing designation?

4. The Federal Deposit Insurance Corporation's ("FDIC") proposed rule on resolution plans requires entities to "Take into account that such material financial distress or failure of the Covered Company may occur at a time when financial markets, or other significant companies, are also under stress and that the material financial distress of the Covered Company may be the result of a range of stresses experienced by the Covered Company..."[20] How has the FSOC's rule for designating nonbank financial companies take into account the rationale and considerations of the FDIC in determining and evaluating "when financial markets, or other significant companies, are also under stress?" Do the rules conflict? If not, how do the proposed rules complement each other?
5. The FSOC is required to disclose in its annual report to Congress "all determinations made under section 113 of title VII, *and the basis for such determinations*..."[21] What information will FSOC provide to Congress pursuant to this requirement?
6. The FSOC's proposal briefly explains that the rule is "consistent with the international approach to identifying systemically important firms that is currently under development by the Basel Committee on Bank Supervision and the Financial Stability Board."[22] How do these entities identify systemically important firms? When and how have other countries implemented these agreements? How will the FSOC monitor these developments and prevent an unlevel global playing field and regulatory arbitrage? How does the FSOC plan to share information with Congress addressing these concerns? Will information from enforcement provisions like the Financial Stability Board's Peer Review Council be made available to Congress?

Very truly yours,



Congresswoman Nan Hayworth, M.D.

Cc:

Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System
John Walsh, Acting Comptroller of the Currency
Mary Schapiro, Chairman of the Securities and Exchange Commission
Sheila Bair, Chairperson of the Federal Deposit Insurance Corporation
Gary Gensler, Chairperson of the Commodity Futures Trading Commission
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Debbie Matz, Chairman of the National Credit Union Administration Board

[1] 76 Fed. Reg. 4,555 (Jan. 26, 2011).
[2] 75 Fed. Reg. 61,653 (Oct. 6, 2010).
[3] 76 Fed. Reg. at 4,560-4,561.
[4] Committee on Capital Markets Regulation, Letter to Secretary Timothy Geithner, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," Nov. 5, 2010 (*available at* http://www.law.harvard.edu/news/2010/12/related-content/fsoc_systemic_importance-comment_letter.pdf); *See also* Peter J. Wallison, Statement Before the Senate Banking Committee on Regulating and Resolving Institutions Considered Too Big to Fail, May 2009; Gary H. Stern and Ron J. Feldman, Too Big To Fail: The Hazards of Bank Bailouts, Brookings Institution Press, 2004.
[5] Thomas Hoenig, Financial Reform: Post Crisis? at 5, Speech to Women in Housing and Finance (Feb. 23, 2011), *available at* http://www.kansascityfed.org/publicat/speeches/hoenig-DC-Women-Housing-Finance-2-23-11.pdf; Jeffrey M. Lacker, Statement Before the Oversight and Investigations Subcommittee of the Committee on Financial Services (Mar. 30, 2011), *available at* http://financialservices.house.gov/media/pdf/033011lacker.pdf.
[6] *See* Frederic C. Mishkin, Financial Consolidation: Dangers and Opportunities, National Bureau of Economic Research Working Paper 6655, July 1998.
[7] James B. Thomson, On Systemically Important Financial Institutions and Progressive Systemic Mitigation at 8-9, Federal Reserve Bank of Cleveland Policy Discussion Papers (August 2009); Robert E. Litan, Regulating Systemic Risk at 15, 21, Initiative on Business and Public Policy at Brookings, Fixing Finance Series 2009-03 (March 2009); Lacker, Statement Before the Oversight and Investigations Subcommittee of the Committee on Financial Services.
[8] Litan, Regulating Systemic Risk at 21.
[9] Thomson, On Systemically Important Financial Institutions and Progressive Systemic Mitigation at 9 (emphasis added). Thomson argues:

> First, constructive ambiguity, broadly viewed, is a competitor of the progressive systemic mitigation regime proposed in this paper. Constructive ambiguity is a supervisory policy aimed at reducing the agency problems associated with firms' systemic importance by creating uncertainty about which firms and creditors might be rescued if a firm fails. Progressive systemic mitigation is an explicit set of regulations and supervisory policies designed to reduce (if not eliminate) the advantages of being systemically important. Under its rules, the social costs of systemic importance would be internalized by the institution and its stakeholders. Second, to the extent that SIFIs would be subject to specific sets of regulatory treatments, it is unlikely that there would be much value in continuing the policy of constructive ambiguity in the proposed progressive systemic mitigation system. After all, markets will probably be able to surmise which firms are on the SIFI list by observing differences in capital structure, balance sheet entries (including footnotes), and intensity of regulatory scrutiny. Finally, the benefit of constructive ambiguity in avoiding a SIFI certification effect that might result from publishing a list of SIFI firms would only affect a small number of firms at the margin. The efficiency gains of avoiding the certification effect on these marginally systemic firms is likely to be swamped by efficiency losses associated with withholding information from the market.

[10] Lacker, Statement Before the Oversight and Investigations Subcommittee of the Committee on Financial Services.
[11] Lacker, Statement Before the Oversight and Investigations Subcommittee of the Committee on Financial Services.
[12] 76 Fed. Reg. at 4,560.
[13] Mathias Drehmann and Nikola Tarashev, Measuring the Systemic Importance of Interconnected Banks, BIS Working Paper No. 342 (March 2011).
[14] Huang X, H Zhou and H Zhu, Assessing the Systemic Risk of Heterogeneous Portfolio of Banks during the Recent Financial Crisis, BIS Working Paper No. 296 (Jan. 2010).
[15] Lacker, Statement Before the Oversight and Investigations Subcommittee of the Committee on Financial Services.
[16] Mishkin, Financial Consolidation: Dangers and Opportunities at 5.

[17] Gary Stern, President/CEO, Federal Reserve Bank of Minneapolis, Statement of Gary H. Stern, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (May 6, 2009).
[18] *See* http://www.treasury.gov/initiatives/Documents/FSOCtransparencypolicy.pdf.
[19] *See* 12 C.F.R. Part 4 (Office of the Comptroller of the Currency); 12 C.F.R. Part 261 (Board of Governors of the Federal Reserve); 12 C.F.R. Part 309 (Federal Deposit Insurance Corporation).
[20] Federal Deposit Insurance Corporation, Proposed Rule: Resolution Plans and Credit Exposure Reports Required at [---].4(a)(3)(i), *available at* http://www.fdic.gov/news/board/29Marchno4.pdf.
[21] Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. Law 111-203), § 112(a)(2)(N)(iv)(emphasis added).
[22] 76 Fed. Reg. at 4,561.