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July 8, 2014

Mr. Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue
Washington, D.C 20551

Re: Regulation XX; Docket No R-1489
RIN 7100 AE-18
Proposed Regulation XX – Concentration Limits on Large Financial Companies

Dear Mr. Frierson:

Enough is enough. The Board of Governors of the Federal Reserve System (the "Board") and the other federal bank regulatory agencies need to return to focusing on what they know and do most effectively, regulating banking entities to preserve the safety and soundness of the financial system. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") includes provisions that represent important changes to the regulatory system and are intended to address the causes of the financial crisis, including provisions designed to address the risks associated with financial institutions that are "too big to fail." Section 622 of the Dodd-Frank Act is one of the primary provisions aimed at curbing excessive growth in financial institutions that could lead to an institution becoming "too big to fail."

Enacted in response to the financial crisis, the Dodd-Frank Act was prepared quickly and without the benefit of the extensive scrubbing that is necessary to avoid technical glitches in the complex area of financial institution legislation. As is typical in financial services legislation, the statute provided the skeletal framework for new regulatory regimes, leaving to the regulators, such as the Financial Stability Oversight Council (the "FSOC") and the Board, through agency rulemaking, the role of bringing the new regimes to life. Unfortunately, as explained below, proposed Regulation XX, which implements Section 622, demonstrates what can go wrong when regulators perpetuate glitches in an underlying statute. This result appears to be avoidable given the discretion granted to FSOC and the Board to craft a regulation that most "effectively implement[s]" Section 622.[1]

Going forward, the financial system would benefit most if the Board, and the other bank and financial regulatory agencies, use the expertise and discretion they have to avoid rigidly following statutory language, such as the one size fits all language in Section 622 that conflates the activities and risks of banking institutions with those of nonbank financial institutions and nonfinancial institutions. The health and stability of financial markets depends on more tailored and more targeted regulation and supervision by regulators in the best position to regulate a particular industry or activity.

The Board's proposed Regulation XX falls short of this goal. The proposed regulation inappropriately and arbitrarily subjects categories of nonbank companies to a concentration limit and financial reporting regime that is designed to apply to banks and bank-like institutions. In doing so, the rule frustrates the purposes of Section 622 by inflating the amount of aggregate financial company liabilities and creates a regulatory reporting regime with no meaningful purpose. Further, the reporting regime and the inflation of the aggregate financial liabilities occur in a way that is almost haphazard. Although the Board's unilateral discretion to address this issue may be limited by the statute, the Board can suggest recommendations to FSOC, and FSOC can in turn make recommendations to the Board and grant the Board the requisite authority to implement a more narrowly tailored rule.

I. The Statutory Text and its Consequences

a. A Literal Interpretation

We recognize that the Board is constrained by express statutory language. Section 622 of the Dodd-Frank Act, from which Regulation XX springs, provides that a financial company may not merge, consolidate, acquire or otherwise acquire control of another company if the post-transaction consolidated liabilities of the acquirer would exceed ten percent of the aggregate consolidated liabilities of all financial companies.[2] The same section also defines a "financial company" to include a company that controls an insured depository institution.[3] As the Board knows well, the companies that control insured depository institutions are not limited to bank holding companies, thrift holding companies and foreign banking organizations but include

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[1] 12 USC §1852(e)(1)(B).
[2] 12 USC §1852(b).
[3] 12 USC §1852(a)(2)(D).

commercial companies that own industrial loan companies and companies that own trust companies that do not engage in a banking business.

Accordingly, Section 622 casts a long shadow over companies and liabilities that are unrelated to traditional banking activities or, in some cases, financial activities. The statute's definition of a financial company includes commercial, industrial and asset management institutions, among other types of institutions, without consideration of whether, and to what extent, these companies are involved in financial intermediation. While Section 622 is intended to promote financial stability, reduce moral hazard and increase the efficiency and competitiveness of financial markets by curbing the creation and growth of "too big to fail" institutions, it is unclear how these goals are furthered by creating an excessively expansive, and somewhat haphazard, category of "financial companies" and subjecting those companies to restrictions and reporting requirements that are designed to apply to banks and bank-like institutions. Including companies that are not engaged in banking and bank-like activities under the umbrella of Section 622, creates a real risk of diverting focus away from the activities that create risks to the financial system and diluting the public policy objectives underlying the provision. The Board should look to the purposes of Section 622 and work to implement a more targeted and meaningful approach.

b. Risk-Based Capital v. GAAP

Under Section 622, FSOC completed a study and recommendations report that analyzed the probable effects of the concentration limit and provided modifications that FSOC determined would more effectively implement Section 622. The FSOC report specifies that many companies that own insured depository institutions "are not currently subject to, and are not legally required to become subject to, risk-based capital rules."[4] Section 622 generally defines "liabilities", for purposes of the concentration limit, as a company's risk-weighted assets less its regulatory capital. As such, FSOC needed to create a different method for calculating the liabilities of those companies that own insured depository institutions but are not subject to risk-based capital requirements.

As a solution, FSOC recommended using total GAAP liabilities to measure the liabilities of those companies that own an insured depository institution and are not treated as bank

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[4] Financial Stability Oversight Council, Study & Recommendations Regarding Concentration Limits on Large Financial Companies, 15 available at http://www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf).

holding companies or savings and loan holding companies. The FSOC report explicitly states that "many of these firms are predominantly nonfinancial."[5] One would think that such a statement would lead to further analysis regarding the appropriateness of imposing the concentration limit and financial reporting requirements of Section 622 on predominantly nonfinancial firms. Further, one would also think such a statement would lead to an analysis of whether those nonfinancial liabilities are relevant for the purposes of establishing the concentration limits for firms that are financial firms.[6] The need to use a separate means of measuring a company's liabilities might serve as a useful indicator that such a company is fundamentally different from the others being measured.

There is a reason that some institutions are subject to risk-based capital requirements while others are not. Capital acts as a shock absorber against losses on the asset side of a balance sheet, which in turn protects creditors on the liabilities side of a balance sheet. In a bank, these protected creditors are depositors, who have historically been prone to withdraw deposits en masse during times of financial distress. Banks may be unable to meet simultaneous depositor redemption requests because, at any given time, a bank only holds a fraction of its overall deposit liability in cash or liquid investments. Banks accept short-term demand deposits and in turn issue longer-term, illiquid loans. Since bank deposits are, up to a certain limit, guaranteed by the Federal Deposit Insurance Corporation (the "FDIC") and the FDIC is ultimately backed by the U.S. Department of Treasury, the U.S. taxpayer may ultimately bear the burden of a run on banks. In addition, a distressed bank will be less able or completely unable to issue new loans. If this happens on a large enough scale, a primary source of credit in the U.S. economy could be diminished or dry up, leading to an increased risk of overall financial instability and a loss of confidence that could ripple throughout financial markets and, in the extreme, compel governmental intervention.

In contrast, the nature of other firms that are swept up in the definition of "financial company", including nonbank financial firms, and their role in the economy is different from that of banks and accordingly these firms require a varied and measured regulatory response.[7] The risks inherent in these firms are often not of the type that can be addressed through risk-based capital requirements or FDIC insurance. In addition, many of these other firms do not pose the same risks to the stability of financial markets as those of a failing bank. While the

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[5] *Id.*

[6] This is not to suggest that Section 622 is good policy.

[7] Not surprisingly, nonbank financial firms are often already subject to their own regulatory regimes that have emerged in response to the particular risks posed by those firms.

failure of any large commercial company may result in losses and near-term market dislocations, it is far less likely to present the risks of contagion and panic that the financial crisis reaffirmed can flow from troubled financial institutions. Moreover, the statutory language that includes a company that controls an insured depository institution sweeps up these controlling companies regardless of the ratio between the insured deposits and the total liabilities of the controlling company.

As a result of these differences, serious thought should be given as to whether companies that own insured depository institutions, but are not subject to risk-based capital requirements and do not engage in bank-like activities, should be included in the definition of a "financial company" for purposes of Regulation XX. However, there is no such discussion or consideration included in the FSOC report or in proposed Regulation XX.

c. Inflated "Denominator"

Regardless of whether applying the proposed concentration limit to nonbank financial companies is good policy, if it goes into effect, it should, at the very least, be representative of the threshold of liabilities that poses a risk to the stability of financial markets. As it stands currently, the proposed rule would include liabilities, such as commercial paper, of commercial and industrial companies that own industrial loan companies that are irrelevant to the health of the financial system, in the calculation of the consolidated liabilities of all financial companies. Proposed Regulation XX also would include, broker-dealers' customer free credit balances, certain managed fund assets and funds borrowed to manufacture automobiles as liabilities. As a result, the proposed rule will inflate the "denominator" overall liabilities number in the concentration limit equation. it is incongruous to include these types of companies and their liabilities in the calculation of the aggregate consolidated liabilities of all financial companies. While those who believe in competitive markets may consider an over-inclusive approach innocuous, those who are concerned about "too big to fail" institutions should realize that an over-inclusive approach could result in an under-appreciation of the risk of any potential acquisition by a true financial company. This cannot be what Congress intended in prescribing the limits in Section 622 and empowering FSOC and the Board to use their expertise to adjust these limits consistent with overall policy objectives.

As a result of the sprawling definition of a financial company in Section 622, companies in a particular industry that happen to own an insured depository institution, such as an industrial loan company or an insured trust company, will have their liabilities counted as part of the consolidated liabilities of all financial companies, while other companies in the same industry and with the same business model but that do not own an insured depository institution will not have their liabilities counted. Why should one retailer or technology company be included while another is excluded? If there is no fundamental difference between the risks posed by two companies and one is covered by Regulation XX and the other is not, then the regulation seems arbitrary in its scope. Similarly, some of the companies that are deemed to be financial companies for purposes of the concentration limit may own insured depository institutions that are so small that the inclusion of the total GAAP liabilities of these companies seems almost whimsical. To the extent an insured depository institution represents a tether by which a nonbank company is somehow tied to "too big to fail" risk, the insured depository institution should at least contain a sufficient level of liabilities to pose an actual risk and to justify the inclusion of the parent company's total liabilities in the overall financial company liabilities calculation. Consequently, if the final rule does preserve the current definition of a financial company, FSOC and the Board should consider excluding companies that own insured depository institutions with *de minimis* liabilities or that do not accept insured deposits from the public. Such a limitation would help mitigate the random consequences of the rule by ensuring that a parent company that would not otherwise be deemed a financial company will not be considered a financial company by virtue of owning an insured depository institution that has insignificant insured public deposits.

II. Process and FSOC Shadow Rulemaking

Rather than taking the statutory language and implementing a flawed rule that preserves a glitch in the statutory definition of a "financial company", FSOC could have recommended to narrow this definition in an effort to avoid frustrating the provision's "too big to fail" policy objective. Indeed, the statutory language appears to grant FSOC precisely this type of broad authority.[8] Most notably, Section 622(e) allows FSOC to "make recommendations regarding any modifications to the concentration limit that [FSOC] determines would more effectively implement this section."[9] The Board is empowered to draft a regulation that implements Section 622 in accordance with the recommendations of FSOC.[10] Neither FSOC in its study nor the Board in proposed Regulation XX took advantage of this flexibility. Moreover, FSOC, in issuing its original report, engaged in a form of shadow rule-making and legislating. That shadow rule-making should benefit from the Board's comment process. The language of the

[8] See 12 USC §1852(d), (e).
[9] 12 USC §1852(e)(1)(B).
[10] 12 USC §1852(d).

statute is broad enough to support the view that FSOC's recommendations could address the over breadth in the statue.

Although its own discretion may be limited by Section 622, the Board can take the result of the comment process and convey to FSOC the flaws in proposed Regulation XX identified above as well as other issues identified in the comment process. The Board can present a case to FSOC for correcting the problems with the statue by FSOC making appropriate recommendations. The inclusion of the liabilities of companies that own insured depository institutions but do not engage in bank-like activities only serves to water down the protective effects of the concentration limit and create a commingling of companies that pose different types of risk and do not belong in the same bucket. It would be unfortunate if the Board were to take the position that its hands are effectively tied in correcting this glitch, because it has the ability and, indeed, the responsibility to convey any concerns to FSOC.

III. Conclusion

The activities and risks of banks and bank-like institutions differ greatly from nonbank financial institutions. Accordingly, the regulation of these diverse categories of institutions should be tailored differently. Proposed Regulation XX casts too wide of a net, without sufficient concern for capturing the types of companies that create the "too big to fail" risk targeted by Congress in adopting Section 622 and that the rule is intended to mitigate. The Board should work with FSOC to amend proposed Regulation XX so that companies that do not participate in bank-like activities are not included under the umbrella of the rule. This would lead to a more honest calculation of the aggregate consolidated liabilities of all financial companies and a more faithful implementation of Congress' intent to curb "too big to fail" financial institutions through the concentration limit in Section 622.

If you have any questions on this comment, please contact me at 202-778-1614.

Sincerely,

Oliver I. Ireland