



International Centre for
Financial Regulation

Financial Stability Oversight Council
Attn: Lance Auer
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220 USA
By email via <http://www.regulations.gov> website

19 December 2011

Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies.

Dear Sirs,

Thank you for the opportunity to respond to your second notice of proposed rulemaking, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (NBFC).

The International Centre for Financial Regulation (ICFR) aims to provide a fresh perspective on the challenges of regulating global markets. As a non-partisan organisation, with the support of both industry and government, we act as a catalyst for dialogue, thought leadership and scholarship in this critical area. We also support practical training initiatives to improve understanding among practitioners and regulators. Our job is to encourage dialogue that identifies best practice across the traditional financial centres in the Americas, Europe and Asia and embraces emerging and developing economies worldwide. To this end, when the ICFR has relevant expertise or evidence of best practice that can be relevant, it submits comments on rulemaking.¹

Most respondents to this second round of consultation are likely to offer an industry or legal perspective on the finer details of the proposed rule. We would like to take a step back and look at the institutional context in which the proposed rule is set to operate. The ICFR believes the importance of the issue of the regulatory perimeter, the difficulty of predicting the locus of the next financial bubble or crisis, and the complex regulatory challenges for the authorities, industry, and wider society make these vital elements to consider, however late in the process, before the rulemaking is finalized.

The ICFR recognises that post-crisis, the placement of the regulatory perimeter and the issue of so-called “shadow intermediation” are being given an increasing amount of attention. This forms a part of the ongoing work to adopt a more system-wide perspective on the financial system, embodied in the redoubling of efforts to develop conceptually and operationally sound macro-prudential regulatory frameworks.

¹ For more on our organisation, please see www.icffr.org

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The Financial Stability Oversight Council (FSOC), in line with its mandate to identify and respond to risks and emerging threats to the financial stability of the United States, is well placed to monitor the financial system beyond banks in a manner consonant with the recommendations of the Financial Stability Board (FSB) concerning so-called “shadow” intermediation.² Furthermore, in its Annual Report, the Council demonstrates an awareness of crucial issues, such as the difficulties of constructing measures for systemic risk, the importance of going beyond the micro-prudential focus on institutions, and the importance of a forward-looking stance. The ICFR appreciates that macro-prudential supervision in general, and measurements of financial stability in particular, are works-in-progress, in need of both theoretical and empirical research.

Further, the ICFR notes that the Council is under an obligation with respect to the Dodd-Frank Act to write the rule in question, the consequences of which are not necessarily wholly within its control. Thus, it is not appropriate to criticise the Council on account of the intentions of the rule, which are externally given. However, the ICFR would emphasise the fact that, given the legal obligations upon various regulatory agencies arising from the Dodd-Frank Act, it is the responsibility of these agencies to ensure the day-to-day functionality of regulations, and to ensure proportionality in their application.

The placement of the regulatory perimeter is unsurprisingly a subject of concern for practitioners in asset management and insurance, who fear that they may become subject to rules designed with the safety of banking practices in mind, rather than their own particular activities. This is reflected in some of the responses submitted to previous rounds of FSOC consultation. However, the argument should not deter the Council from continuing to pursue an extension of its framework for considering the symptoms and risks of these institutions, and the ICFR supports the proposals whereby, at least in stage 1 of the determination process, the net is cast wide, consistent with FSB recommendations. The proposed Rule clearly contains scope enough that the peculiarities of differing business models across the financial system can be taken into consideration at stages 2 and 3 of the determination process. Since the burden on firms at stage 1 appears very limited, the Council would do well to keep its net as open as possible.

In the wake of the crisis, governments and regulators have sought to regain the initiative after regulatory failures were perceived to have contributed to the turmoil. As noted above, the FSOC’s commitment to a forward-thinking stance on financial stability is welcome. In this respect, the ICFR urges the FSOC to resist pressure to harden rules which must of necessity retain scope for flexibility and judgment. Comments in the first round sought to take issue with definitional problems and require further refinement. We would argue an opposite course equally strongly. What you want are the broadest and most generic definitions possible so that the ‘net’ can be cast wide, and then a requirement to use judgment rather than quantitative criteria as determinant factors. This permits the FSOC to adapt to the ever changing nature of financial innovation and financial risk, and address the possibility that smaller, but more poorly managed firms may present larger risks than larger, better managed firms.

² See FSB (2011), ‘Shadow Banking: Strengthening Oversight and Regulation’, 27 October, available online at http://www.financialstabilityboard.org/publications/r_111027a.pdf

The ICFR feels the issue of creative compliance, whereby firms use the narrowness of legal rules to circumvent them, to be extremely important with respect to the FSOC's proposed Rule. The Council is thus to be commended for the way in which the proposed Rule seeks to keep broad scope for judgment at all stages of determination. The FSOC must tread a fine line between providing the level of detail necessary for firms to plan for the future, and providing a level of detail which may prove constraining to regulators in the long-term, and therefore detrimental to financial stability. The specifics provided on stage 1 of the determination process represent good progress in this respect, and the clear provision for judgment on the part of the Council at all stages is to be welcomed, despite the inevitable calls from industry for a greater level of detail. It is important that the processes involved do not result in a situation in which companies can simply aim to avoid being subject to a procedural and legalistic definition, rather than the substantive end of reducing systemic risks to financial stability.

Prior to the financial crisis, discussion of "principles-based" regulation was becoming increasingly common on both sides of the Atlantic. However, in the regulatory fervour that followed, hard-learned lessons of regulation have been lost, and talk of principles-based regimes is now less common. This is an unfortunate consequence of the crisis, and one which is better reconsidered. However, principles-based regulation must be sophisticated, and this means that there needs to be a proper understanding of the purpose of regulation, as well as its limitations. The ICFR believes that the capacity for discretion comes with an obligation for disclosure, to the benefit of all market participants. The FSOC can, through its ongoing work, help to encourage better regulation through observance of this principle, and this rule appears to leave scope for this possibility.

More generally, a shift from judgement to rules, and therefore the ability to work around such rules, has been a fundamental shift that actually plays against financial stability. While it might more clearly circumscribe responsibility on the part of both the regulators and the regulated, it is widely recognised that the possibility of "gaming" the rules, such as through the manipulation of risk-weighted assets under Basel II, contributed to financial instability.

We should measure the success of attempts to extend the regulatory perimeter against two criteria: the extent to which systemic risk is reduced, and the extent to which opportunities for regulatory arbitrage are lessened.³ The sharp rise in the volume of credit-intermediation in the non-bank sector over the last 10 years is often attributed to regulatory arbitrage, as financial institutions sought to evade regulations and the costs they imposed by conducting activities through non-bank subsidiaries. Proposals seeking to bring a broader range of activity under the supervision of the Board of Governors are sure to meet similar problems, as incentives to circumvent rules are strengthened for some market participants. This will likely happen in two ways: companies seeking to evade the rules altogether, and companies seeking to comply with the procedural, but not substantive, aspects.

Regarding the particulars of the thresholds, the ICFR recognises that in the early stages it is inevitable that somewhat arbitrary lines must be drawn for practical purposes. The decision to set the stage 1 thresholds so that companies which are *either* US non-banks with \$50 billion in assets or

³ FSB (2011) p.3

non-US non-banks with \$50 billion dollars in US assets, *and* which meet one of the other five thresholds, appears to strike a suitable balance between arbitrariness and pragmatism. However, we would like to single out the threshold referring to credit default swaps (CDS) for particular criticism. It is currently not within the power of financial companies to determine the extent to which they are used as the reference entity for credit default swaps bought and sold by other investors. Indeed, the primary difference between CDS and insurance is that traders of CDS need not have any insurable interest in the reference entity whatsoever. But given that the consequence of being designated within the Council's procedure is that firms are to be subjected to potentially significantly heightened supervision, it seems inappropriate that one of the initial thresholds refers to activities entirely beyond the control of the nonbank financial companies in question. While the reasoning employed by the Council, that the failure of firms on which there are large outstanding sums of CDS contracts may be destabilising, is sound, we would suggest that this problem is better tackled by dealing with the CDS market itself, or with firms holding CDS contracts, perhaps based upon size of gross positions or concentrations of holdings exposed to highly correlated underlying assets (such as those relating to banks operating in countries experiencing sovereign debt crises). This would be more desirable than creating new obligations for firms based on activities beyond their control.

With respect to the other thresholds, the ICFR believes that the categories should capture the intended sources of risk. In particular, the use of a leverage ratio is welcome. However, whereas the increasing amount of attention paid to leverage in banking regulation is suitable, a leverage ratio of 15 to one, while suitably conservative for banks, may not be for some nonbanks. Certain consolidated nonbank entities may have highly leveraged subsidiaries, which may pose large risks to the integrity of the whole entity, but which may not be reflected in an overall leverage ratio. Given the diversity of NBFCs, and the opacity of some consolidated groups, the ICFR believes it will be difficult to capture all the risks which excessive leverage can create through a single ratio if only applied to groups as a whole. It may be warranted for the Council to make adopt two rounds of leverage assessment: a highly stringent first round, followed by a more nuanced second round, both within stage 1 of the assessment process. Furthermore, it is critical that the definition of leverage gives due care to the definition of on- and off-balance sheet, as a failure to capture risky off-balance sheet activity could render the whole exercise redundant.

We would emphasise the importance of keeping the thresholds dynamic in order to reflect possible changes in external economic conditions, and to minimise the scope for regulatory arbitrage. However, where the Council reserves the right to use other company-specific data for determination purposes, this should come with an obligation to provide robust explanations of why such data is appropriate to the individual case, and why it is *not* appropriate to be included in general in the broader framework, in order to make the process more transparent, and to prevent possible perceptions of an *ad hoc* determination process. The ICFR notes that the Council has constructed the stage 1 assessment process so that NBFCs should be able to reproduce the Council's assessments, but that the Council retains the discretion, irrespective of whether the stage 1 thresholds catch a particular NBFC, to subject that NBFC to further review. As we have emphasised, keeping a broad scope for discretion is important to make avoidance more difficult. But, we would reiterate that the capacity for discretion must come with an obligation for disclosure. In this respect, the ICFR believes that a "simplicity dividend" could work: NBFCs which are not identified by the six thresholds, but which appear so complex that the Council cannot be sure that they do not pose stability risks in the

spirit of the rule, should be included for review. This would act as an incentive for simplicity, transparency, and improved public disclosure. The measure of simplicity would most appropriately be drawn from existing and ongoing work on resolution planning, which would provide the Council with a standard of reference for making determinations extra to the quantitative thresholds, while avoiding perceptions of arbitrary determination.

As noted above, the ICFR recognises that the FSOC is under a legal obligation to write rules for the Dodd-Frank Act, and that the Act lays out the terms of prudential supervision for NBFCs determined under the proposed rule. But section 165 of the Dodd-Frank Act provides that the Board of Governors can tailor prudential requirements, and make exceptions to risk-based capital requirements for certain activities. Further, the FSOC has the capacity under section 115 of the Dodd-Frank Act to make recommendations to the Board of Governors with respect to prudential standards. We would urge the FSOC to avoid the application of inappropriate rules to particular financial activities or companies. The ICFR would make a clear distinction between the identification of potential systemic risks arising from NBFCs for the purposes of macro-prudential monitoring, and the identification of these risks for the purpose of applying extensive prudential supervision. The FSOC should use its recommendations to the Board of Governors to argue for a “ladder” approach to supervision, so that there is a scale of severity ranging from solely information gathering to wholesale application of prudential supervision as envisaged by the Dodd Frank Act. This would go some way to calming fears about excessively intrusive consequences of determination, while maintaining the spirit of the rule. Again, it would be appropriate to issue guidance on the application of such an approach.

As we have suggested, one of the biggest difficulties with respect to this proposed rule may be creative compliance: firms will try to tailor their activities specifically to avoid being caught by the determination process. The incentive to do this will only be stronger without more clarity on the specific consequences of being subject to prudential supervision by the Board of Governors. Thus, in addition to the guidance provided on the determination process itself, it is crucial that the FSOC makes it clearer to the disparate group of companies who are potentially subject to this rule what the consequences will be. Uncertainty over this will only lead to less effective implementation. It is plain that the risks posed by hedge funds and insurance firms, for instance, are very different, and that as such their supervision should be correspondingly different. The fact that their determination follows the same process under Dodd-Frank should not entail that the consequences of determination should be identical, and the FSOC should exercise its ability to make this clear.

We have made a number of references to regulatory arbitrage and creative compliance. These references are bound up with wider financial regulatory issues, and in particular the dynamism of the economic environment beyond the financial services industry. Although there is no definitive account of the regulatory cycle, there does appear to be an ebb and flow to regulation, related to crises and interest group politics. The Council will be aware that the politics of interest groups are a matter for concern for a number of people. But equally important is the capacity of the external economic environment to affect regulation beyond the narrow political world of lobbying. Over 2011 the debate about the role of the financial system in the wider economy has become more prominent, as developed economies have experienced difficulties in achieving growth, and the threat of renewed recession has risen. It is in this context that regulators are faced with the

unenviable task of placing restrictions on an industry which loses no opportunity to remind legislators that it is a core facilitator of virtually all economic activity. It is in this context that the ICFR believes a number of questions to be relevant:

- Is the FSOC confident that it has in place the mechanisms to reflect changing external conditions?
- Is the Council confident that in the face of the vagaries of partisan politics it can maintain a suitable vision of financial stability, and that it can integrate that vision into the day-to-day running of broader economic issues?
- What plans does the Council have to review its rules in light of changing conditions, and what processes are in place to ensure a proper level of accountability and consultation in the face of potential amendments?
- Given that making regulation is often an iterative process, what publications does the Council intend to make after the first round of determinations?
- What provisions are in place for eliminating aspects of the rule which are seen to be impractical or superfluous, or for providing clarity on points which prove contentious?

Such questions should be addressed in published guidance, and the proposed rule should be refined as necessary, reflecting the informed judgment of the Council.

As the Council is no doubt aware, there are widespread concerns outside the United States about potential extraterritorial consequences of rules created under the Dodd-Frank Act. Concerns have been raised recently particularly in relation to the so-called “Volcker rule,” and the ICFR expects there to be a significant pushback in responses to the current consultation against aspects of the rule that are perceived to be extraterritorial. The FSOC’s proposed rule regarding NBFCs appears sensitive to issues of extraterritoriality, but we would like to place a heavy emphasis on the importance of cross-border cooperation, and again on the importance of adapting the Council’s approach as the external environment develops. Given that one of the consequences of determination will be that NBFCs must submit resolution plans, the Council must take into account potential structural changes to financial firms which will follow from ongoing and future regulatory work in other countries. The financial system is currently in a state of flux, as structural reforms are being considered in a number of jurisdictions, such as under the Volcker rule in the US, the recommendations of the Independent Commission on Banking in the UK, and the European Commission’s recent announcement that it will investigate structural reforms in 2012. It is as yet unknown how this will impact the broader financial system in terms of the migration of intermediation between different parts of the system, but it is likely that restrictions on the banking system will lead to ever-greater increases in shadow intermediation. As ever, present rules contain the seeds of future fragilities, and where cross-border issues such as resolution are at stake the Council must be proactive in its international engagement, and translate this into the content of its rules.

In summary, the ICFR broadly welcomes the proposed rule, in intention and in content, and suggests that the Council should resist calls for excessive detail where this may restrict the ability of the FSOC to fulfil the substantive end of the rule. There are a number of issues which remain to be addressed, including the credit default swap threshold, and provisions for refinement of the rule and the

determination process as the Council continues its work. Taking a systemic perspective of the financial system and its regulation and supervision is essential, and this perspective must extend beyond the supervision of individual institutions as the Council is aware. For this to be effective, clarity of purpose is of the utmost importance and the ICFR urges the Council to continue its work in refining its frameworks for assessing financial stability, to engage with a broad array of stakeholders, and to continue to engage in the international regulatory debate. The work of maintaining financial stability would not amount to much if it were simply a case of a one-time extension of the regulatory perimeter, and there are decades of experiential evidence to demonstrate that creative compliance will provide constant challenges to the substantive aims of the Council's proposed rule. The ICFR commends the FSOC for retaining significant scope for judgment in the application of its framework for designating nonbank financial companies as subject to increased prudential supervision. Maintaining this scope for judgment along with proper clarity of purpose will be a significant challenge in the future.

Yours faithfully,



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For and on behalf of

The International Centre for Financial Regulation