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November 5, 2010

By *Electronic Delivery* via [www.regulations.gov](http://www.regulations.gov)

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

**RE: Advance Notice of Proposed Rulemaking Regarding Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, Docket Number FSOC-2010-0001<sup>1</sup>**

Dear Mr. Secretary:

In the attached comment, we respond to the October 6, 2010, Financial Stability Oversight Council's (FSOC) "Advance Notice of Proposed Rulemaking Regarding Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies."

The Pew Charitable Trusts is an independent nonprofit organization founded in 1948. Pew applies a rigorous, analytical approach to improve public policy, inform the public and stimulate civic life.

The Pew Financial Reform Project, formed in response to the 2008 financial crisis, brings a nonpartisan, fact-based approach to helping reform and modernize the financial sector. Over the past 18 months, the Project has commissioned scholarly papers, supported a bipartisan task force and in other ways facilitated debate on key aspects of reform. We worked to pass the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. We are now committed to contributing to the process of legislative implementation.

As always, we are available to discuss this comment or any other aspect of our work at any time. Thank you for reviewing our comment.

Sincerely,

Charles Taylor  
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<sup>1</sup> Advance Notice of Proposed Rulemaking Regarding Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653 (Oct. 6, 2010) (to be codified at 12 C.F.R. ch. XIII), <http://www.gpo.gov/fdsys/pkg/FR-2010-10-06/pdf/2010-25321.pdf>.

The Pew Financial Reform Project

Comment in response to

**Financial Stability Oversight Council: Advanced Notice of Proposed Rulemaking  
Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial  
Companies**

**(Docket Number FSOC-2010-0001)**

(Section 113 of DFA)

Submitted through [www.regulations.gov](http://www.regulations.gov)

One of the main ways that the Dodd-Frank Act addresses systemic risk is to require heightened supervision and regulation of systemically important financial institutions (SIFIs). SIFIs are bank and nonbank financial firms that by virtue of such things as their size, complexity, and interconnectedness with the rest of the financial system could pose a threat to the stability of the financial system and the U.S. economy were they to weaken and fail. For banks, the Act specifies a precise qualification threshold that includes many non-SIFIs as well as SIFIs: any bank holding company with over \$50 billion in assets is subject to this heightened supervision and regulation regime. For nonbanks, the Act requires the Financial Stability Oversight Council (Council) to decide which institutions to designate. For this purpose, the Act directs the Council to take several factors into account, but otherwise is largely silent on how these decisions are to be made.

The problem for the Council is a difficult one. Even though it is expected that only a handful of nonbank institutions will be designated initially, they need to establish a decision framework that is as defensible as possible because the consequences of designation are likely to be significant not only for the institutions concerned, but also their employees, shareholders, suppliers, and competitors. Any framework will have to strike a compromise between theoretical purity and practicality: it has to be simple enough to be tractable and understandable but comprehensive and rigorous enough to take into account the many issues that properly bear upon the decision to designate.

The Council has yet to agree on a general framework for designation as well as the numerous details that will have to be addressed before any such framework can be implemented. The ANPR asks fifteen questions about how the Council should design a framework and implement it. This comment letter puts forward one possible framework for the Council to consider and,

with that framework in mind, offers comments on some of the specific questions raised in the ANPR.

In determining the structure of the framework described here, the Pew Financial Reform Project has tried to balance several factors. Systemic significance is not a black or white issue. Designation is about drawing a line somewhere on a continuum where in reality there are many shades of grey. The framework described here aims to quantify as much of this continuum as possible with the goal of making designation as objective, transparent, rigorous, defensible, and fair as possible. At the same time the framework leaves room for necessary qualitative adjustments at different points.

This framework is meant to be meaningful for all types of financial firms, including banks and bank holding companies, to allow the Council to achieve as much comparability, comprehensiveness, and fairness as possible in its designation decisions.

The Pew Financial Reform Project hopes that this comment is useful to the Council in establishing its approach to designation.

### **Part I: General Comment: A Framework**

The basic idea put forth here is to develop a numerical measure for systemic significance built up from measures of several factors, including those described in the Act. Then this measure can be used to designate any nonbank financial firm if its systemic significance exceeds a numerical threshold that is set by the Council.

Starting from the viewpoint that systemic events are characterized by contagion, the systemic significance of a candidate firm is made up of two major elements: how fragile the firm could become, especially in any future period of financial fragility; and how vulnerable the rest of the system could become to its potential failure. If the firm is fundamentally sound in all circumstances, it is not particularly systemically significant, even if the rest of the system is very dependent on it. Equally, if the system is robust in that it would be largely unaffected by a firm's failure, then that firm is not systemically significant, even if it is very fragile. Both some level of possible firm fragility and system vulnerability are needed for a firm to be systemically significant.

While this fact means that it is impossible to assess systemic significance of a candidate firm without somehow assessing the vulnerability of the system to it, there are methods for estimating systemic vulnerability. One candidate approach discussed here would be to add together the exposures of the major firms connected to the candidate firm, using their individual estimates of firm fragility as weights. This will yield a number measured in dollars, which can be scaled with respect to GDP. Because designation requires collecting information on a larger set of firms than

is ultimately designated, a set of “heightened reporting financial firms” has to be defined and information on their fragility has to be collected anyway to implement the Dodd-Frank Act.

The Act implicitly requires that a third basic element be taken into account: the direct impact a firm’s failure might have on funding for government (federal, state and local) and on the most vulnerable individuals in our society. It is accommodated here as an adjustment to the estimate of systemic significance derived from the first two basic elements.

So this framework involves eight steps:

1. Heightened Reporting Firms: define a set of heightened reporting financial firms;
2. Factors: identify a set of factors that can affect systemic significance (including those specified in the Act); develop measures for each of them either directly if possible or using a scoring scheme of some kind if not; and then divide them into factors that affect firm fragility; factors that affect exposure between firms; and factors that affect the direct impact a firm’s failure might have on the economy;
3. Fragility: estimate the fragility of every heightened reporting financial firm;
4. Exposure: estimate the dollar exposure of every heightened reporting financial firm to every other heightened reporting financial firm;
5. System Vulnerability: thinking of each heightened reporting financial firm in turn as a candidate for designation, create a single measure of the system’s vulnerability to the candidate firm by adding up the measures of exposure of all of the other heightened reporting financial firms to the candidate firm, weighted by their fragility estimates;<sup>2</sup>
6. Preliminary Estimate of Systemic Significance: multiply this measure of systemic vulnerability by the candidate firm’s measure of fragility and divide by GDP to create a preliminary measure of systemic significance;
7. Direct Impact Adjustment: adjust this to reflect the direct impact that the firm’s failure may have on key sectors and the most vulnerable in our society to create a final measure of systemic significance; and
8. Threshold: set a universal threshold so that institutions of all types with more than that particular level of systemic significance are designated.

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<sup>2</sup> The proposed measures of individual fragility can be thought of as proxies for probabilities of failure, conditional upon there being a state of material financial distress in the United States. Thus, system exposure is similar to the expected loss to the system, if the candidate firm fails, in such a system state, and the measure of systemic significance proposed here is similar to the expected loss to the system attributable to this firm in a period of material financial distress, normalized by division by GDP.

**Step 1: Heightened Reporting Firms** Define thresholds specified in terms of total assets for firms of different kinds and share of markets or activities for each kind of asset the firm might holds or activities in which it might engages. Consideration should be given to varying the threshold downward for any asset class that shows possible incipient signs of a bubble -- to reflect risk to the system. As a general matter, the total and the class-specific components of the threshold should be set at a low enough level to ensure with reasonable confidence that all financial firms are subject to heightened reporting requirements. At the same time, they should be set no lower than necessary to avoid burdening nonbank financial firms with unwarranted additional reporting costs since firms above the thresholds will have to report all of the information necessary to complete each of the steps below.

**Step 2: Factors** Table 1 lists in the first column six factors that affect individual firm financial fragility, six factors that affect systemic exposure and three that affect direct impact. The second column describes possible measures. The third column refers to ten factors from A – J listed in the Dodd Frank Act and referenced in the ANPR.

**Table 1: Factors and Measures in Designating SIFIs**

<b>Factor</b>	<b>Measures</b>	<b>DFA</b>
<u>Factors in Individual Firm Fragility</u>		
Leverage (L)	Free assets/capital, assets/capital where assets includes off-balance sheet assets and capital is measured as Tangible Common Equity	A
Liability & short term funding (LM)	Index of liquidity mismatch	J
Concentration/Diversification (D)	Index based on number of business lines that contribute more than 10 % of revenues, number of global regions which contribute more than 20% of revenues and portfolio diversity	G
Risk management quality (RM)	Index based on supervisory score	
Complexity (CO)	Index based on the number of affiliates, countries of operation, products, and strategies	
Off-balance sheet exposures	[Captured in leverage and maturity mismatch calculations]	B

### Factors Affecting System Vulnerability

Credit exposure of other firms (CE)	Credit exposure report estimates (\$)	G
Liquidity risk to the rest of the system (LR)	Estimated exposure that each heightened reporting firm has to the candidate firm due to its dependence on the candidate firm for major services like prime brokerage, custodianship and clearing and settlement (\$)	
Ownership exposure of other firms (PE)	The size of equity investments in a candidate firm by other financial firms (\$)	
Fire-sale costs (FS)	Estimated effect of fire sale during a failure on asset values in financial markets on each heightened reporting firm (\$)	
Contestability	[Captured in fire-sale cost estimates]	G
Interconnectedness	[Captured in the other measures that contribute to system vulnerability]	C, G

### Factors Affecting the Direct Economic Impact

Credit to the vulnerable (CV)	Index of lending to low income, minority and underserved communities nationally compared to estimated annual income of these communities	E, G
Credit and liquidity source (CLS)	Index of lending to households, businesses, state and local governments as a percent of GDP	D, G
Asset Management (AM)	Index of diffusion of ownership amongst households	F, G

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Note: indices are pure numbers. All of them will be non-negative. Most should be normalized to vary between 0 and 1 or a sub-interval, depending on how much influence the Council wishes to give that particular factor on the final systemic significance measure.

Step 3: Fragility This will depend on measures of leverage (L) and liquidity mismatch (LM), concentration/diversification (D), risk management quality (RM) and institutional complexity (CO). Provided each of these considerations is captured with a measure that is normalized to vary from 0 to 1, so fragility (F) for a heightened reporting firm can be calculated as a product that will itself vary between 0 and 1.

The factors that are most difficult to measure in a comparable way for nonbanks are leverage and liquidity mismatch. One way to modify the usual concept of bank leverage to make it more universal would be to measure it against “free” assets that would be available for conversion into cash or collateral that could be used for any purpose in the event of the material financial distress of an institution. Assets under management, for example, are not “free” in this sense. Nor is short term financing. Mortgage servicing rights and insurance policy premium flows are net of expected payments. If only free assets are included in leverage and liquidity mismatch measures, then these measures are comparable across institution types.<sup>3</sup>

$$F = L * LM * D * RM * CO \quad (1)$$

Scoring for diversification of business strategies, risk management quality and all of the complexity measures should allow for some element of judgment in how they are applied.

F is a pure number, since every estimate on the right hand side of (1) is a pure number.

Step 4: Exposure This step creates an estimate of the exposure of every other heightened reporting financial firm ( $E_{HR}$ ) to the firm that is a candidate for designation. This is made up of credit exposure ( $CE_{HR}$ ), liquidity exposure ( $LR_{HR}$ ), portfolio exposure ( $PE_{HR}$ ) and fire-sale risk exposure ( $FS_{HR}$ ) estimates for each of these firms..

Under the Act, firms subject to heightened prudential standards – SIFIs, plus non-SIFI bank holding companies with over \$50 billion in assets -- must report their credit exposures. Firms subject to heightened reporting requirements should do so too. All these firms should identify their major counterparties, including in particular other financial firms with heightened reporting requirements. This will create a set of estimates of  $CE_{HR}$ .

$LR_{HR}$  depends on the share (and contestability) of the candidate firm in major financial activities (like custodianship, prime brokerage, clearing and settlement) and markets important to other heightened reporting firms.  $PE_{HR}$  captures the effect of equity investments in the candidate firm by other heightened reporting firms and can be measured by the estimated share of its equity owned by each of these firms. And  $FS_{HR}$  depends on the share of the candidate firm in specific asset classes and their price elasticity and vulnerability to a sudden fire sale by the candidate firm in the event that it becomes financially fragile.

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<sup>3</sup> Using a multiplicative formula reflects an implicit assumption that the factors on the right hand side of (1) are likely to be close enough to being independent of one another for this to be a reasonable approximation. Future research may make it possible to improve on this estimate by accounting for correlations of vulnerability in times of material financial distress. Equally, further thought on how different sources of vulnerability are related may make it possible to improve on the use of a sum to combine the dollar amounts on the right hand side of (2).

$$E_{HR} = CE_{HR} + LR_{HR} + PE_{HR} + FS_{HR} \quad (2)$$

All four of these components of  $E_{HR}$  are relatively precise measures. Since all four are measured in dollars,  $E$  is also.

Step 5: System Vulnerability So the preliminary estimate of the vulnerability ( $SV_C$ ) of the system and the economy to a candidate firm is given by:

$$SV_C = \Sigma(E_{HR} * F_{HR}) \quad (3)$$

where HR runs through all heightened reporting firms except the candidate firm.  $SV_C$  is measured in dollars.

Step 6: Preliminary Estimate of Systemic Significance The preliminary estimate of systemic significance of the candidate firm ( $SS_{PC}$ ) is then:

$$SS_{PC} = F_C * SV_C / GDP \quad (4)$$

$SS_{PC}$  is a pure number.

Clearly, this becomes a better measure as more firms are subject to heightened reporting.

Step 7: Direct Impact Adjustment The direct impact that the candidate firm's failure might have on key sectors and the most vulnerable in our society (DI) can be estimated as a scaling factor as a product of indices that reflect lending to low income, minority and underserved communities nationally compared to estimated annual income of these communities (CV); lending to households, businesses, state and local governments as a percent of GDP (CLS); and the diffusion of ownership amongst households (AM). Because the nature of this adjustment is to increase the systemic significance of a firm if it is a particularly important source of credit to these parts of the economy it would be intuitively appealing to design each of these indices so that DI would be larger than 1.

$$DI = CV * CLS * AM \quad (5)$$

Then the systemic significance of the candidate firm can be estimated as

$$SS_C = SS_{PC} * DI_C \quad (6)$$

Step 8: Threshold The last step is to compare this measure with a universal threshold that the Council should determine, so that if systemic significance ( $SS_C$ ) exceeds  $T$ , then it leads to designation:

$$SS_C > T \rightarrow \text{leads to designation.} \quad (7)$$

Of course, the question is, how should  $T$  be determined? One way is to use a prior view about which banks are systemically significant and which are not, and look for an  $SS_C$  value that creates a clean threshold between them. Other more theoretically sound ways might be developed over time, as knowledge of the stability properties of the financial system improves.

## **Part II: Specific Comments on Questions**

**Question 1. What metrics should the Council use to measure the factors it is required to consider when making determinations under Section 113 of DFA? 1a. How should quantitative and qualitative considerations be incorporated into the determination process? 1b. Are there some factors that should be weighted more heavily by the Council than other factors in the designation process?**

Table 1 in the above framework addresses question 1.

The framework as a whole lays out a method for addressing Question 1a.

It is important that qualitative adjustments not change the values they adjust too much. They should be limited to, say, add 10%, subtract 10% or leave the quantitative estimate unchanged. Qualitative adjustments should also be subject to an overall limit, such as plus or minus 20%, in their aggregate effect. Any more than this and it would be reasonable to question the validity of the underlying approach.

All of the indices in Table 1 reflected directly in firm fragility would seem to be of a similar level of importance and should, therefore vary over a range of similar size. The factors affecting system vulnerability are all calculated in absolute dollar amounts and, while they could be weighted, the rationale for any difference in weights is hard to see.

Otherwise, the relative importance of the different factors is reflected in the way each is taken into account in the framework.

**Question 2. What types of nonbank financial companies should the Council review for designation under DFA? Should the analytical framework, considerations, and measures used by the Council vary across industries? Across time? If so, how?**

The Council should look at all nonbank financial firms impartially, regardless of type. While noting that a common language for terms like capital and “free” assets will take time to establish, every effort should be made to use a common analytical framework like the one described in the general comment above.

Measures of systemic significance must be forward-looking, representing an assessment of fragility and systemic vulnerability in a future period of systemic distress. Therefore, measures of systemic significance should change during the business cycle only to the extent that the experiences of the cycle influence expectations about the probable nature of firm fragility and of system vulnerability in a future period of financial distress. In general, during a “normal” cycle, there would be no particular reason to change these measures. Of course, it is likely that occasional revisions in methodology will be warranted as methods and data improve and the financial system changes its structure. The timing of such changes, however, is not likely to be related fundamentally to the business cycle.

**Question 4. Are there simple metrics that the Council should use to determine whether nonbank financial companies should even be considered for designation?**

Firms subject to heightened reporting requirements should not be considered for designation until their systemic significance is close to the threshold, as measured by its level or rate of change.

**Question 14: Should the Council define “material financial distress” or “financial stability?” If so, what factors should the Council consider in developing those definitions?**

The Council should define both of these terms – although neither is especially important for designation. Here are two proposals:

- Material financial distress: A firm is materially distressed when it is close to failure – i.e., becoming either insolvent or illiquid -- as measured by the absolute level or rate of decline of either its capital or liquidity in relation to its needs. A market is materially distressed when it is close to failure – i.e., becoming illiquid -- as measured by a sharp decline in volumes and a rise in spreads and volatility in relation to its customary condition.

- Financially stable: The United States is “financially stable” when the risk of any firm or market failing and contributing to a systemic collapse is acceptably low.
  - A “systemic collapse” is when the linked failure of more than one financial firm or market causes a significant shock to GDP.
  - “Contributing” to a systemic collapse means triggering a significant cascade of failure of other financial firms or markets or acting as a major transmission mechanism for such a cascade.
  - A risk can only be “acceptably low” if in the absence of exceptional official intervention the chances of a significant shock to GDP are very low.
  - “Exceptional official intervention” includes an exceptional Fed intervention or an FDIC resolution involving cost to the industry or the taxpayer.

The factors used to gauge systemic significance do not belong in the definition of these terms, although they may well be relevant to measuring degrees of distress and financial stability.

A related term it would be useful to define is “financial fragility” as the term applies to the system as a whole. One possible definition is:

- Financial fragility: The financial system is fragile if it is unstable but not in collapse. When the system is fragile, correlations increase and firms face more risk than normal in relation to their capital and liquidity.

The Council should consider defining four other terms that are important for designation. These are (with possible definitions):

- SIFI: A “SIFI” is a financial firm whose failure would be likely to cause or contribute to a systemic collapse if the system is fragile, unless there is exceptional official intervention.
- Systemic Significance: An institution’s systemic significance is the likelihood it could contribute to a systemic collapse through its material financial distress or failure.
- Designation Threshold: a threshold of systemic significance above which a firm is designated a SIFI.
- Heightened Reporting Threshold: a threshold defined in terms of asset and activities set at a level that is low enough to ensure with reasonable confidence that all potential SIFIs are subject to a regime of reporting sufficient information to allow the Council to make informed judgments about designation.

**Question 10. How should the Council take into account the fact that a nonbank financial firm (or one or more of its subsidiaries or affiliates) is already subject to financial regulation in the Council’s decision to designate a firm? Are there particular aspects of prudential regulation that should be considered as particularly important (e.g., capital regulation, liquidity requirements, consolidated supervision)? Should the Council take into account whether the existing regulation of the company comports with relevant national or international standards?**

**And**

**Question 15: What other risk-related considerations should the Council take into account when establishing a framework for designating nonbank financial companies?**

In answer to Question 15, aside from the factors (A through I, as listed in the beginning of the ANPR) that Dodd Frank Act directs the Council to consider, there are two others:

- Contestability: The risk that aggregate customer switching costs for a financial firm or market are high enough to destabilize the financial system.
- Designation Costs: The “cliff” or jump in private net costs associated with designation.

For any firm that is a candidate for designation, the second factor is a function of the cost difference near the designation boundary between the Federal Reserve’s heightened regulatory regime and its current regulatory regime and the effect of designation on creditor expectations of protection in the event of failure. This is the key way in which to take into account the regulatory regime of a nonbank financial firm before designation.