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November 5, 2010

Financial Stability Oversight Council
c/o United States Department of the Treasury
Office of Domestic Finance
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Advance Notice of Proposed Rulemaking Regarding Authority to Require
Supervision and Regulation of Certain Nonbank Financial Companies

Dear Sir or Madam:

The Independent Community Bankers of America¹ (ICBA) welcomes the opportunity to comment on the Advance Notice of Proposed Rulemaking issued by the Financial Stability Oversight Council (“Council”) regarding the authority it has to require that a nonbank financial company be supervised by the Board of Governors of the Federal Reserve System and subject to enhanced prudential standards.

The Council was established under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) for the purpose of identifying risks to the financial stability of the United States that could arise from the material financial distress or failure of a large, interconnected banking institution or a nonbank financial company. This ANPR solicits public comment on the criteria that the Council should use to designate a nonbank financial company as systemically risky; i.e. a nonbank financial company that poses a risk to the financial stability of the United States (1) just from the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the firm or (2) if it were to fail or become subject to material financial distress.

¹ The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever changing marketplace.

With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold \$1 trillion in assets, \$800 billion in deposits, and \$700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA’s website at www.icba.org.

ICBA's Position

ICBA strongly supported the creation of the Council when the Dodd-Frank Act was being considered by Congress. We strongly believe that certain large nonbank financial companies should be subject to enhanced prudential standards including higher capital, leverage, and liquidity standards, concentration limits and contingent resolution plans.

The events that led to the worst financial crisis in our nation's history certainly support our view that many companies that are a part of the "shadow banking industry" need to be subject to enhanced supervision and regulation. As Chairman Bernanke stated in his testimony before the Financial Crisis Inquiry Commission last September², the shadow banking system played a major role in the global financial crisis of 2008. One banking analyst has estimated that approximately two-thirds of all U.S. lending prior to the crisis was in the shadow banking system and one third in the traditional banking system. Despite a contraction of \$5 trillion in the wake of the financial crisis, the liabilities of the shadow banking system were roughly \$16 trillion as of the first quarter of 2010.³

The shadow banks over dependence on short-term wholesale funding including commercial paper, repurchase agreements (repos), interbank loans and contingent funding commitments made them particularly vulnerable to runs, much like commercial banks were before the establishment of FDIC deposit insurance.⁴ Money market mutual funds proved particularly vulnerable to runs and liquidity pressures after the collapse of Lehman Brothers when short-term wholesale funding markets came under severe stress and there was a flight away from purchasing any type of asset-backed commercial paper.

As Chairman Bernanke further pointed out in his testimony, shadow banks were not subject to consistent and effective regulatory oversight. Many types of shadow banks lacked meaningful prudential regulation, including various special purpose vehicles, asset-backed commercial paper vehicles, hedge funds, and nonbank mortgage-origination companies. No regulatory body restricted the leverage and liquidity policies of these entities, and few if any regulatory standards were imposed on the quality of their risk management or the prudence of their risk-taking.

Other shadow banks were subject to some oversight, but gaps in the regulatory system meant that in practice they were inadequately regulated and supervised. The holding companies of broker-dealers, for instance, were not adequately regulated by the SEC. During the financial crisis, large broker-dealer holding companies faced serious losses and funding problems creating severe instability at Bear Stearns and Lehman Brothers. AIG's insurance operations were supervised and regulated by various state and

² Chairman Ben Bernanke's testimony before the Financial Crisis Inquiry Commission dated September 2, 2010.

³ Pozsar, Z. et al. Federal Reserve Bank of New York Staff Report. "Shadow Banking", July 2010.

⁴ For instance, repo liabilities of U.S. broker dealers increased by 2-1/2 times in the four years before the crisis.

international insurance regulators but somehow, the division which housed the derivative activities and that caused most of its major losses was completely overlooked.

It is therefore important that the Council's process for determining which nonbank financial institutions should be considered systemically important should be a sufficiently broad enough inquiry to include as many large or interconnected nonbank financial firms that pose systemic risk to the financial system and the economy as possible. The list should include, but not necessarily be limited to, large investment banks, insurance companies, hedge funds, private equity funds, venture capital firms, mutual funds (particularly money market mutual funds), industrial loan companies, special purpose vehicles, and nonbank mortgage origination companies. Any company that is "predominantly engaged in financial activities" as the Dodd-Frank Act defines that term should be considered if its failure or material financial distress could cause financial instability in the United States.

Furthermore, even if a large nonbank financial firm (or one or more of its subsidiaries or affiliates) is already subject to some degree of financial regulation, it should still be considered by the Council as potentially systemically important. Money market mutual funds, for instance, were substantially regulated by the SEC but it was the failure of the Reserve Primary Fund that substantially exacerbated the financial meltdown and triggered unprecedented intervention by the Treasury Department in the form of a \$50 billion temporary guaranty program to insure money market mutual funds. The same can be said for AIG which was regulated by various state and international insurance regulators. **No large nonbank financial company should be excluded merely because it is partially or substantially regulated by a state, federal or some foreign governmental entity.** In addition to AIG, large insurance companies such as Prudential or MetLife should be considered even though they may own a bank or thrift institution. Large banking institutions over \$50 billion are considered systemically risky and will be subject to oversight by the FSOC even though they are already regulated.

The Dodd-Frank Act requires the Council to consider a long list of factors before determining whether the company should be subject to supervision by the Federal Reserve. These include (1) the extent of the leverage of the company, (2) the extent and nature of the off-balance-sheet exposures of the company, (3) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies, (4) the importance of the company as a source of credit, (5) the importance of the company as a source of credit for low-income minority or underserved communities, (6) the extent to which assets are managed rather than owned by the company, (7) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company, (8) the degree to which the company is already regulated by one or more primary financial regulatory agencies, (9) the amount and nature of the financial assets of the company, (10) the amount and types of liabilities of the company, including the degree of reliance on short-term funding, and (11) any other risk-related factors that the Council deems appropriate.

ICBA believes that the Council should take into consideration all of the factors with particular attention to items (3), (4) and (7) above. The degree to which the nonbank is

interconnected with the banking industry and the importance of the company as a source of credit are critical factors. For instance, we believe that a large lender and industrial loan corporation such as GE Capital should be considered as systemically important because of its substantial relationships with other bank holding companies and its importance as a source of credit in the United States. Despite owning both a thrift and an industrial loan corporation (ILC), GE is not subject to significant supervision by bank regulators at the holding company level. According to their most recent 10-Q, GE had financial assets of \$624 billion as of June 30, 2010. In 2007 prior to the financial crisis, GE Capital had outstanding over \$100 billion of commercial paper and during the crisis was a significant participant in the FDIC's Temporary Guaranty Liquidity Program and the Federal Reserve's Commercial Paper Funding Facility.⁵

While the traditional banking industry has access to credit and liquidity puts provided by the government in the form of deposit insurance and access to the discount window, the shadow banking industry relies on credit and liquidity puts provided by the private sector in order to mitigate the risks inherent in the credit intermediation process. These puts consist of back-up lines of credit from traditional banks, and credit guarantees such as wraps or credit default swaps provided by mortgage insurers, mono-line insurers, diversified insurance companies, credit derivative product companies and hedge funds.

An important measure of a shadow banking institution's potential to become systemically risky impact is the size of the back-up credit line maintained with a money-center bank. Since the shadow banking industry is susceptible to runs, these lines are often tapped en masse leaving the traditional banking sector highly exposed to health of shadow banking institutions. Any entity that provides the private sector credit enhancements needed for this shadow banking system to operate could become a source of systemic risk and must be closely monitored.

Some of the largest private equity firms such as the Carlyle Group, Kohlberg Kravis Roberts and The Blackstone Group should also be considered systemically risky because of their investments in banks and the scale, concentration and interconnectedness of their activities. During the financial crisis, private equity funds financed both mortgage-lending and real-estate-development companies, both directly and by purchasing equity in commercial CDOs and providing credit guarantees.

Similarly, the failure and subsequent bailout of the large hedge fund, Long-Term Capital Management in 1998 has taught us that the failure of a large hedge fund can have devastating consequences to the U.S. financial system. The hedge fund industry played a key role in the run-up to the banking crisis and as buyer and trader of collateralized-debt obligations and other complex high-risk securities. The industry provided the money to create these securities and a market for them while borrowing money from the large banks creating them. Any large hedge fund with over \$20 billion under management and any large mutual fund over \$100 billion in assets should be considered by the Council as a candidate for enhanced Federal Reserve supervision and regulation. Large money market mutual funds present systemic risk due to the nature of their business and the

⁵ See testimony of Mark Barber, Deputy Treasurer of GE Capital, before the Financial Crisis Inquiry Commission on May 6, 2010

ability of customers to destabilize the fund with withdrawals in extremely short time frame. Treasury's overnight implementation of a temporary guaranty fund for money market funds in September 2008 is clear evidence of their systemic risk status.

ICBA agrees with FDIC Chairman Sheila Bair who recently testified before the Senate Committee on Banking, Housing and Urban Affairs that the best way for the Council to proceed with its job of designating nonbank financial companies as systemically important would be to first qualify a small group of companies that are clearly subject to the Dodd-Frank Act and then work through the details necessary to identify the more nuanced cases. Hopefully, the Council can finish identifying most of the large, systemically important nonbank financial companies within two years of the date of the enactment of Dodd-Frank, or by July 21, 2012.

It is critical that the new Office of Financial Research in the Treasury Department focus on the shadow industry and compile information on the nature, scope, size, scale, concentration, interconnectedness, and mix of activities of mutual funds, hedge funds, broker-dealers, private equity funds, and industrial loan companies. In many instances, these industries and their activities are not that transparent and it will be important for the OFR to determine how interconnected many of these companies are and to identify of all their counterparties, the dollar volume of their exposures to other banking institutions particularly in the form of credit default swaps and other derivatives, and their various other interconnections. The OFR, in consultation with the Council, will need on an ongoing basis to require periodic and other reports from many of these shadow banks to continue to monitor whether they pose a potential threat to financial stability. The success of the Council will depend substantially on the amount of information that the OFR can collect on the shadow industry and its interconnections with the banking industry and the scope of their activities.

Conclusion

ICBA strongly supported the creation of the Council when the Dodd-Frank Act was being considered by Congress and we strongly believe that certain large nonbank financial companies should be subject to enhanced prudential standards including higher capital, leverage, and liquidity standards, concentration limits and contingent resolution plans. The list should include, but not necessarily be limited to, large investment banks, insurance companies, hedge funds, private equity funds, venture capital firms, mutual funds (particularly money market mutual funds), industrial loan companies, special purpose vehicles, and nonbank mortgage origination companies. If a large nonbank financial firm (or one or more of its subsidiaries or affiliates) is already subject to some sort of financial regulation, it should still be considered by the Council as potentially systemically risky.

ICBA believes that the Council should take into consideration all of the statutory factors delineated by the Dodd-Frank Act with particular attention to the degree to which the nonbank is interconnected with the banking industry and the importance of the company as a source of credit. A large lender and industrial loan corporation such as GE Capital should be considered as systemically risky because of its substantial relationships with

other bank holding companies and because it is such an important source of credit in the United States. In addition to large insurers like AIG with substantial relationships with the banking industry, large hedge funds with over \$20 billion under management and any large mutual fund over \$100 billion in assets should be considered by the Council as candidates for enhanced Federal Reserve supervision and regulation.

It is critical that the new Office of Financial Research in the Treasury Department focus on the shadow industry and compile information on the nature, scope, size, scale, concentration, interconnectedness, and mix of activities of mutual funds, hedge funds, broker-dealers, private equity funds, and industrial loan companies. Due to the lack of transparency of many of these industries, it will be important for the OFR obtain as much data about them as possible, including the dollar volume of their exposures to other banking institutions.

ICBA appreciates the opportunity to comment on the Financial Stability Oversight Council's Advance Notice of Proposed Rulemaking regarding their authority to require supervision and regulation of certain nonbank financial companies. If you have any questions about our letter, please do not hesitate to contact me at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,

/s/ Christopher Cole

Christopher Cole
Senior Vice President and Senior Regulatory Counsel