Public Interest Comment on
The Board of Governors of the Federal Reserve System’s
Proposed Rule:
Concentration Limits on Large Financial Companies
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The George Washington University Regulatory Studies Center
Retrospective Review Comment Project

The George Washington University Regulatory Studies Center strives to improve regulatory policy through research, education, and outreach. As part of its mission, the Center conducts careful and independent analyses to assess rulemaking proposals from the perspective of the public interest. This comment on The Board of Governors of the Federal Reserve System’s (‘Board’) proposed rule implementing section 622 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (‘Dodd-Frank Act’) and enforcing consolidation limits on large financial companies does not represent the views of any particular affected party or special interest, but is designed to evaluate whether the Board’s proposal incorporates plans for retrospective review, pursuant to Executive Orders 13563 and 13579.

1 This comment reflects the views of the author, and does not represent an official position of the GW Regulatory Studies Center or the George Washington University. The Center’s policy on research integrity is available at http://regulatorystudies.columbian.gwu.edu/policy-research-integrity.

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Introduction

Section 622 of the Dodd-Frank Act creates a financial sector concentration limit and requires the Financial Stability Oversight Council (‘Council’) to issue a study about how the limit will affect “financial stability, moral hazard in the financial system, the efficiency and competitiveness of US financial firms and financial markets, and the cost and availability of credit and other financial services to households and businesses in the United States.” Following the Council’s review, the Board’s proposed rule implements section 622 with slight modifications that adjust the measurement of liabilities and address the “failing bank exception,” which would allow consolidation with a bank in default or close to default even if it is in excess of the limit.

While the Council predicts that the standards would have a positive effect on financial stability, it predicts no effect on moral hazard and no effect on the cost and availability of credit and financial services. The Council also points out that, while it expects an overall positive impact on competition, the consolidation limit could allow for a disproportionate advantage for foreign firms as they would have fewer assets held in the United States. It might be possible that a foreign firm could make an acquisition that a U.S. company could not because of the limit.³

Section 622 of the Dodd-Frank Act requires the Board to issue regulations that “reflect any recommendations made by the Council.”⁴ Under the Board’s proposed rule, “a financial company is prohibited from consummating a covered acquisition if the ratio of the resulting financial company’s liabilities to the aggregate consolidated liabilities of all financial companies exceeds 10 percent.” Under the proposal, the firm’s liabilities are measured as total risk-weighted assets and the aggregate financial sector liabilities are measured as the average of the entire financial sector’s liabilities of the preceding two years. To ensure fair treatment of all affected companies, the Board must “establish the methodology for calculating the liabilities of an insurance company or other nonbank financial company.” The proposed rule would allow nonbank financial companies to use their own applicable accounting standards.⁵

As a part of its ongoing Retrospective Review Comment Project, the Regulatory Studies Center examines significant proposed regulations to assess whether agencies propose retrospective review as a part of their regulations, and submits comments to provide suggestions on how best to incorporate plans for retrospective review into their proposals. To facilitate meaningful retrospective review after the promulgation of a final rule, multiple government guidelines instruct agencies to incorporate retrospective review plans into their proposals during the rulemaking process.

³ 79 FR 27802
⁴ 79 FR 27802
⁵ 79 FR 27804
Incorporating Retrospective Review into NPRMs

Through a series of Executive Orders, President Obama has encouraged federal regulatory agencies to review existing regulations “that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned.” On January 18, 2011, President Obama signed Executive Order 13563, Improving Regulation and Regulatory Review, which reaffirmed the regulatory principles and structures outlined in EO 12866. In addition to the regulatory philosophy laid out in EO 12866, EO 13563 instructs agencies to consider how best to promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned. Such retrospective analyses, including supporting data, should be released online whenever possible.6

This ex-post review makes it possible for the government and the public to measure whether a particular rule has had its intended effect. In his implementing memo on retrospective review, former Administrator of the Office of Information and Regulatory Affairs, Cass Sunstein, stated the importance of designing regulations to facilitate their evaluation:

With its emphasis on “periodic review of existing significant regulations,” Executive Order 13563 recognizes the importance of maintaining a consistent culture of retrospective review and analysis throughout the executive branch. To promote that culture, future regulations should be designed and written in ways that facilitate evaluation of their consequences and thus promote retrospective analyses and measurement of “actual results.” To the extent permitted by law, agencies should therefore give careful consideration to how best to promote empirical testing of the effects of rules both in advance and retrospectively.7

This emphasis is repeated in Sunstein’s June 14, 2011 memo, “Final Plans for Retrospective Analysis of Existing Rules.” In its 2013 Report to Congress on the Benefits and Costs of Federal Regulations, the Office of Management and Budget (OMB) states that such retrospective analysis can serve as an important corrective mechanism to the flaws of ex ante analyses. According to that report, the result of systematic retrospective review of regulations:


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should be a greatly improved understanding of the accuracy of prospective analyses, as well as corrections to rules as a result of ex post evaluations. A large priority is the development of methods (perhaps including not merely before-and-after accounts but also randomized trials, to the extent feasible and consistent with law) to obtain a clear sense of the effects of rules. In addition, and importantly, *rules should be written and designed, in advance, so as to facilitate retrospective analysis of their effects.*

While Executive Orders generally apply only to the executive branch, President Obama has made it clear that independent agencies should adhere to the same retrospective review principles as executive branch agencies. In his subsequent Executive Order 13579, President Obama recommended that independent regulatory agencies, no less than the executive branch, should promote the goals of EO 13563:

> To facilitate the periodic review of existing significant regulations, independent regulatory agencies should consider how best to promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned.

The Board does not reference EO 13579 in its proposed rule. However, in line with the requirements of EO 13579, OMB’s implementation memo, and OMB’s 2013 Report to Congress, it is clear that the Board should incorporate specific plans for retrospective review and ex post evaluation into the text of its final rule.

**Retrospective Review Requirements**

To evaluate whether the Board’s proposal was “designed and written in ways that facilitate evaluation of [its] consequences,” we measure it against five criteria:

- Did the Board clearly identify the problem that its proposed rule is intended to solve?
- Did the Board provide clear, measurable metrics that reviewers can use to evaluate whether the regulation achieves its policy goals?
- Did the Board commit to collecting information to assess whether its measurable metrics are being reached?
- Did the Board provide a clear timeframe for the accomplishment of its stated metrics and the collection of information to support its findings?

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8 [2013 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities](May 2014)
Did the Board write its proposal to allow measurement of both outputs and outcomes to enable review of whether the standards directly result in the outcomes that the Board intends?

**Identifying the Problem**

The first of the “Principles of Regulation” outlined by President Clinton in EO 12866 makes it clear that, as a first step, agencies must be able to identify the problem that justifies government action through regulation:

Each agency shall identify the problem that it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action) as well as assess the significance of that problem.

This step is crucial to the formulation of any policy. Without knowledge of the problem that the agency is trying to address, the public cannot assess whether the policy or regulation at hand has had the intended effect, which is key in retrospectively evaluating regulation. Further, EO 12866 states:

Each agency shall examine whether existing regulations (or other law) have created, or contributed to, the problem that a new regulation is intended to correct and whether those regulations (or other law) should be modified to achieve the intended goal of regulation more effectively.

The Board does not explicitly state the problem it intends to solve in its proposed rule. However, the rule’s statutory authority does at least reference the problem that the Board is attempting to address. The rule would implement section 622 of the Dodd-Frank Act which was intended, among other purposes, to promote domestic financial stability “by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices.”

While the proposed rule does not expressly state how it will serve any of these purposes, it does indicate that the “concentration limit would have a positive impact on U.S. financial stability by reducing the systemic risks created by increased financial sector concentration arising from covered acquisitions involving the largest U.S. financial companies.”

Since the 2008 financial crisis, addressing systemic risk and financial stability have been pressing concerns for financial regulators. But the proposed rule does not indicate the “failures of private markets or public institutions that warrant new agency action,” nor does it discuss the

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9 H. R. 4173
10 79 FR 27802
The possibility that “existing regulations (or other law) have created, or contributed to, the problem that a new regulation is intended to correct.” As stated above in EO 12866, the Board needs to examine the possibility that some of the problems of the financial crisis could be attributed to previous regulatory failures. The Board does not make it clear why this is a problem that requires agency action and does not reference any attempt to modify existing regulations and laws that could have contributed to creating the problems this rule attempts to solve.

**Measurement Criteria**

In order to measure the success of this rule following implementation, it is necessary for the Board to define what constitutes a “success.” However, the subjective standard for success used by the Board in this proposed rule makes review difficult. The Board does not include any mention of retrospective review, and the proposed rule does not include a single measure for evaluating the “positive impact” on financial stability. Additionally, it fails to give measures that would evaluate the reduction in “systemic risk.”

The Board does not specify how the proposed rule will have a “positive impact” or how “positive impact” is defined. The vague problem identification and the lack of defined goals show that the rule was not “written and designed, in advance, so as to facilitate retrospective analysis of [its] effects.” This oversight will make retrospective review difficult, and prevents effective measurement of the rule’s success. The Board should identify more specific outcomes expected from the rule. Without defined goals, developing metrics is difficult and retrospective review is hindered.

While review is not included, the Board is proposing to create a new reporting form, the Financial Company Report of Consolidated Liabilities (FR Y-17), that would keep the consolidation limit current by requiring financial companies to report their liabilities every year. Since the limit is based on the average financial sector liabilities, this requirement would keep the limit flexible and adaptable to changes in the financial market. This suggests that flexibility is a desired outcome and that the Board is concerned with maintaining a relevant liability standard for the financial market.

But the proposed rule does not offer a measurement to ensure that the rule accomplishes these goals. The Board needs to offer metrics, such as checking that the FR Y-17 is effectively measuring liabilities and that liabilities are being accurately reported. However, the FR Y-17 is still a weak measure of success. The information is only reported once a year and the limit is based on previous years’ data. While it allows for reporting liabilities in the financial market, the Board does not indicate how it will use the information to measure the flexibility of the liability standard.

11 79 FR 2810
Unintended Consequences

The Board should also establish metrics to evaluate potential unintended consequences from the rule. As required by the Regulatory Flexibility Act, the Board has published an initial regulatory flexibility analysis concerning the economic impact on small entities and will publish a final analysis after the public comment period is over. Although the Board does not mention metrics for how to review the rule’s impact on small entities, the Board should commit to developing such metrics and to measuring the rule’s effects at regular intervals.

In its initial analysis of the rule, the Council mentioned a concern that

…the statutory concentration limit could allow a large foreign-based firm with a small U.S. presence to purchase a U.S. target but prevent an equally-sized U.S.-based firm from making the same acquisition because the statute would count on the U.S. assets of a foreign acquirer, but would count the global assets of a U.S. acquirer, when determining compliance with the concentration limit.\(^{12}\)

The proposed rule does not include any metrics for reviewing possible distorted foreign competition nor mention the need for such a review. The Board should consider metrics to measure unintended consequences, including this one, and should commit to measuring these metrics after implementation. Further, the Board should be open to revisiting its standards if these consequences circumvent the Board’s goals of domestic financial stability.

Information Collection

OMB’s Paperwork Reduction Act regulations require agencies to “ensure that each collection of information …informs and provides reasonable notice to the potential persons to whom the collection of information is addressed of … an estimate, to the extent practicable, of the average burden of the collection (together with a request that the public direct to the agency any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden).”\(^{13}\)

Consistent with the requirements of the Paperwork Reduction Act, the Board should commit to collecting the information needed to measure the rule’s success.

In addition to the FR Y-17 form mentioned above, the proposed rule would require financial companies to give prior notification of covered acquisitions if the acquisition would cause the company to surpass eight percent of the total financial sector liabilities, or to increase their liabilities by more than $2 billion, if the company did not otherwise need to report or obtain

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\(^{12}\) 79 FR 27802

\(^{13}\) 5 CFR Part 1320.8(b)(3)(iii)

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approval from the Board for the acquisition.\textsuperscript{14} This information could help the Board measure how flexible the rule is by collecting information on the total liabilities more often, which would keep the limit more current. By collecting liability information at the time of acquisition, the Board can maintain a current liability standard in between FR Y-17 reporting requirements. The information would indicate if the limit is accurately reflecting changes in the financial market.

The Board estimates that the total annual burden per firm to complete the FR Y-17 will be 40 hours, and that other reporting requirements in the regulation will involve another 30 hours. To comply with the PRA, the Board should include a plan for collecting information from financial companies to see if their estimate is correct and to help measure the rule’s success. Measuring the compliance burden could help measure the “positive impact” of the rule by indicating if the costs of reporting are outweighing the benefits received.

**Timeframe**

The text of the proposed rule does not include a timeframe for retrospective review. In the final rule, the Board should identify a timeframe for review, indicating how soon after implementation it will begin to measure the progress of its stated metrics.

**Measure Linkages**

In the final rule, the Board should not only identify a set of metrics, but make clear how the measures it identifies address the problems that the rule intends to solve.

As the Board commits to measuring the effects of this rule, it should also be aware of mediating factors that may have contributed to or undermined the stated metrics absent the rule. For example, financial stability could be adversely affected by a foreign financial crisis or inflation or positively affected by economic growth in the United States or changing regulations from other agencies. Determining linkages between the rule and the measured outcomes is necessary to ensure that the policy itself resulted in the desired outcomes, rather than other factors beyond the Board’s control.

**Recommendations**

Before issuing the final rule, the Board should consider possible measures for examining the rule’s success. First it needs to identify the problem it is trying to solve, addressing the possibility that the problem was caused by a public policy failure and not a market failure. The Board should then create a set of metrics to evaluate the rule’s success. Specific outcomes and timelines could be identified that would allow for more specific metrics. The Board should

\textsuperscript{14} 79 FR 27811
monitor for possible unintended consequences and design a review method to evaluate their impact. The Board should commit to collecting information to test its estimated time and cost burdens and measure the rule’s effectiveness through the reporting requirements.

As it stands, the proposed rule does not comply with the retrospective review requirements in Executive Orders 13563 and 13579.