

A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act



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Part of an ongoing series

The FSOC SIFI Designation Proposal for Nonbank Financial Companies

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“A second reason why science cannot replace judgement is the behavior of financial markets.”

— Martin Feldstein¹

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or “the Act”) introduces the concept of macroprudential regulation into US law to foster and protect the financial stability of the United States. The key objective of such regulation is to ensure that any financial firm whose distress or failure could pose a risk to the financial stability of the United States is subject to federal regulation and supervision and, if necessary, to a separate federal resolution authority administered by the Federal Deposit Insurance Corporation (FDIC). These “systemically important financial institutions” (SIFIs) break down into three groups under the Act:

1. Bank holding companies (BHCs) with \$50 billion or more in total consolidated assets
2. Foreign banks with US banking operations that have \$50 billion or more in total (global) consolidated assets
3. US or foreign nonbank financial companies (NBFCs) designated as systemically important by the Financial Stability Oversight Council (FSOC or “the Council”)

¹ Chairman of the Council of Economic Advisers under President Reagan and appointed by President Obama in 2009 to be a member of the President’s Economic Recovery Advisory Board.

The first two groups know who they are, while the last group has yet to be determined. But on October 18, 2011, the FSOC published in the Federal Register a second notice of proposed rulemaking (following on from its January 26, 2011, proposed rulemaking) setting forth with some specificity the process to be employed for designation and the criteria to be used in the first stage of that process. By opening up its black box to greater transparency, the FSOC has allowed NBFCs to better assess their likelihood of being designated as a SIFI, although certainty is always at a premium when interpreting Dodd-Frank and the regulators' smoke signals.

In this *A Closer Look*, we will review which factors define an NBFC subject to possible designation, look at the fundamental elements of the three-stage determination process, and examine Stage 1 criteria designed by the FSOC for designation. More importantly, we will discuss some steps that the NBFCs likely to pass the Stage 1 quantitative filter may wish to take to prepare for the later stages, where a mix of quantitative and qualitative factors to assess "systemicness" becomes more critical.

What is an NBFC SIFI?

To be designated a SIFI, a US NBFC must be "predominantly engaged" in financial activities permissible for financial holding companies (which is a broad list of activities including lending, insurance, investment banking, asset management, and other activities). To be "predominantly engaged" in financial activities, a US NBFC must derive 85% or more of its consolidated annual gross revenues from financial activities or have 85% or more of its consolidated assets related to activities that are financial in nature. If a US NBFC owns an insured depository institution, the revenues from such subsidiary are included in the 85% amount. With respect to a foreign NBFC, only US activities are measured using the 85% of revenues or 85% of assets test to determine if they are predominantly engaged in financial activities in the United States.

The prototypical NBFC SIFI is likely to be a major financial company with a significant presence in financial markets. It may or may not already be subject to some form of federal or state regulation. Types of firms mentioned by the FSOC in the proposal include specialty lenders, insurance companies, broker-dealers, asset management companies, hedge funds, financial guarantors, futures commission merchants, savings and loan holding companies, and other financial firms. Specifically excluded by law from being considered an NBFC SIFI are:

- Farm Credit institutions
- National securities exchanges (or a parent thereof)
- Clearing agencies (or a parent thereof unless a BHC)
- Security-based swap execution facilities or swap data repositories registered with the SEC
- Any board of trade designated as a contract market (or a parent thereof)
- Derivatives clearing organizations (or a parent thereof, unless a BHC)
- Swap execution facilities or swap data repositories registered with the Commodity Futures Trading Commission

Will many NBFCs be designated as SIFIs?

In our view, relatively few NBFCs are likely to be designated initially as SIFIs. As noted above, the Council may in some cases (such as in the evaluation of hedge funds) wait until better data becomes available, while in other cases (such as in evaluating asset management companies) it is considering whether other forms of enhanced regulation may be more appropriate than regulation as a SIFI, as set forth in the Act. Also, the Stage 1 determination thresholds are intended to apply to all types of NBFCs, but the Council states that certain companies (i.e., hedge funds, private equity firms, asset management firms, and financial guarantors) may pose risks that are not well-measured by the quantitative threshold approach. The Council intends to study and assess whether additional metrics or thresholds tailored to these firms may need to be established.

In the case of insurance companies, Michael McRaith, director of the Federal Insurance Office (FIO), testified recently that the International Association of Insurance Supervisors (IAIS) has been developing a process for the designation of globally significant insurance companies, and the FIO and state regulators are participating in that process. The Council may not want to get too far ahead of that international process.

Also, practically, it will take the Council time to implement the process and procedures in a way that ensures careful consideration and analysis of complex firms. The Council acknowledges that it intends to follow a deliberate process to make a final determination, similar to the final rule issued in August that establishes the authority to designate financial market utilities (FMUs). Several months following this rulemaking, no firms have yet been designated as systemically important FMUs.

Because the stakes are high in terms of what it means to be designated a SIFI, we believe the Council will be highly selective in making its initial designations, tending to select firms that will meet the most stringent criteria. A parallel can be seen in the recent work that has been conducted globally by the Financial Stability Board (FSB) in its recommendations for designating globally systemically important banks (G-SIFIs), and in decisions to delay formal designations for nonbank firms. On November 4, 2011, the FSB announced the list of 29 G-SIFIs that will need to meet resolution-planning requirements by the end of 2012. The FSB and the Basel Committee on Banking Supervision will be working expeditiously to define the modalities to extend the framework to all SIFIs. The FSB is to report on its progress to the G20 at its next summit in June 2012. The IAIS is expected to complete its assessment methodology for identifying globally systemically important insurers in time for the June G20 meeting.

What are the major consequences to an NBFC is designated a SIFI?

If designated a SIFI, an NBFC and any subsidiary thereof will be subject to examination and supervision by the Federal Reserve Board (FRB), including regulatory reporting requirements intended to determine the NBFC's or subsidiary's financial condition and its systems for monitoring and controlling financial, operating, and other risks, as well as the extent to which the activities and operations of the company or subsidiary pose a threat to the financial stability of the United States. When the FRB assumed supervisory responsibility over savings and loan holding companies (SLHCs) on July 21, 2011, it stated that it was its intention, to the greatest extent possible taking into account the diversity of SLHCs and governing law over their operations, to assess the condition, performance, and activities of SLHCs on a consolidated basis in a manner that is consistent with the FRB's

established risk-based approach regarding BHC supervision. It is reasonable to assume that the FRB will apply a similar approach in its initial supervisory approach toward NBFC SIFIs. Even where an NBFC SIFI is (or has one or more subsidiaries that are) subject to some form of functional federal or state regulation (e.g., the SEC and state insurance regulators), the FRB's consolidated approach to supervision will likely present pronounced cultural differences to most NBFC SIFIs. To the extent acculturation is required, the burden will most likely be on the NBFC, though the FRB has authority to tailor SIFI supervision by differentiating by category or even by individual firm.

While adapting to a BHC-oriented approach to supervision will be challenge enough, the major impact of SIFI designation for an NBFC will be complying with enhanced prudential standards as well as other prudential provisions of the Act, including the Volcker Rule in some fashion. The Act requires the FRB to establish enhanced prudential standards for all SIFIs that are more stringent than standards and requirements applied to similar organizations that do not present similar risks to US financial stability. For an NBFC SIFI, the Act appears to require that this additional stringency be measured against the same type of NBFC — e.g., a SIFI insurance company would need to meet standards and requirements more stringent than those applied to an insurance company that is not a SIFI. But further clarity in this area must await the FRB's proposal pertaining to enhanced prudential standards for SIFIs, which is to be released in a single package some time before year-end.

The scope of enhanced prudential standards that will need to be determined by the FRB for SIFIs is extensive, including (i) risk-based capital requirements, (ii) leverage limits, (iii) liquidity requirements, (iv) overall risk management requirements, (v) resolution plan and credit exposure report requirements, (vi) concentration requirements, (vii) enhanced public disclosure, (viii) short-term debt limits and (ix) contingent capital requirements. In some cases, the Act directs the FRB to consider the appropriateness of some requirements for some firms (e.g., capital requirements for asset management companies), but even in the case of a poor fit, the FRB is directed to come up with standards that result in similarly stringent risk controls.

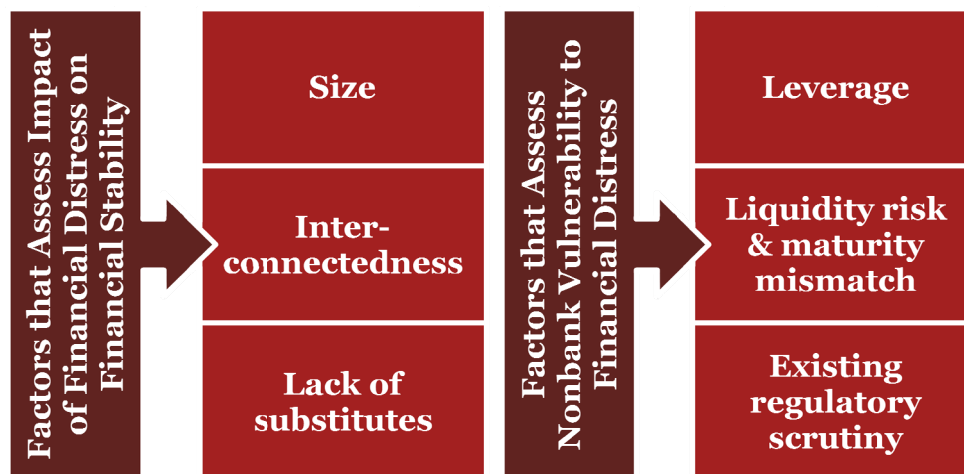
Other provisions affecting NBFC SIFIs include a requirement that publicly traded NBFC SIFIs establish a board-level risk committee. In applying the Volcker Rule to NBFC SIFIs, federal regulatory agencies are also directed to apply additional capital requirements for and additional quantitative limits with regard to proprietary trading or investments or sponsorship of hedge or private equity funds. In the recent proposed rule to implement Volcker, the SEC and CFTC indicated that until NBFCs are designated as SIFIs, it was premature for them to apply this requirement.

What are the standards for NBFC SIFI designation?

The Council may determine that an NBFC is a SIFI if 1(i) material financial distress at the NBFC could pose a threat to the financial stability of the United States, or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the NBFC could pose a threat to the financial stability of the United States. "Material financial distress" as used in the first standard would exist if the Council finds that an NBFC is in "imminent danger of insolvency or defaulting on its financial obligations" and will be assessed in the context of a period of overall stress in the financial services industry and a weak macroeconomic environment. A "threat to financial stability" as used in the second alternative standard would exist if there would be an impairment of financial

intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the real economy.

Six-category framework



To facilitate its determination, the FSOC proposed an analytical framework grouping all statutory and relevant risk factors and considerations into six categories:

1. Size
2. Interconnectedness
3. Substitutability
4. Leverage
5. Liquidity risk and maturity mismatch
6. Existing regulatory scrutiny

Factors 1, 2, and 3 seek to assess the potential impact of an NBFC's financial distress on the broader economy; factors 4, 5, and 6 assess the vulnerability of an NBFC to financial distress (see the "Six-category framework" graphic).

Incorporating these categories into the Council's analysis, the proposal outlines a three-stage approach to evaluating companies for their "systemicness" across all industry sectors. Furthermore, in an attempt to harmonize the review process, a set of standardized criteria has been proposed. Commencing with a size threshold, various other quantitative measures will be employed to filter candidates that would merit further company-specific evaluation.

Stage 1. In order to be subject to further evaluation in subsequent stages of review, an NBFC must meet a size threshold of \$50 billion in global assets (or, for foreign NBFCs, \$50 billion in US total consolidated assets) and meet at least one of the following additional thresholds:

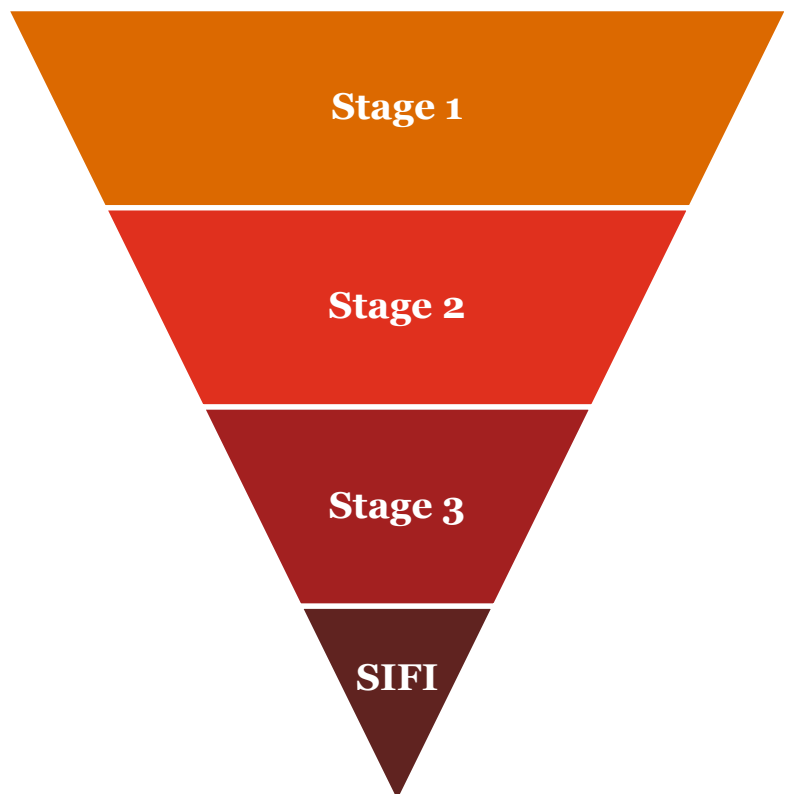
- A total of \$30 billion in gross notional credit default swaps outstanding for which the NBFC is the reference entity.
- A total of \$3.5 billion in derivative liabilities. (Derivative liabilities equals the fair value of any derivatives contracts in a negative position after taking into account the effects of

master netting agreements *and* cash collateral held with the same counterparty on a net basis, if elected.²)

- A total of \$20 billion of outstanding debt (loans borrowed and bonds issued).
- A leverage ratio of 15 to 1 or higher, as measured by total consolidated assets (excluding separate accounts) to total equity.
- A short-term debt ratio of 10% (having a remaining maturity of less than 12 months) to total consolidated assets (excluding separate accounts).

Stage 2. The NBFCs captured in the net of Stage 1 would then be analyzed and prioritized according to their risk profile and the characteristics of each individual firm. Based on publicly available data, the Council's evaluation would include a wide range of both quantitative and qualitative industry-specific and company-specific factors. The Council would also evaluate whether the resolution of the NBFC would pose a threat to US financial stability, and look at the extent to which the firm is subject to regulation.

Stage 3. At the conclusion of Stage 2, firms that the FSOC believe warrant further analysis would be placed into the Stage 3 Pool. These firms would receive a "Notice of Consideration" that they are being considered for SIFI designation and may be asked to provide additional non-public information to the Council. The Stage 3 review would be conducted in cooperation with the Office of Financial Research while also using information collected directly from the NBFC. The review would focus on whether the potential SIFI, under a stressed scenario, could pose a threat to US financial stability due to its material financial distress or as a result of the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities. An evaluation of the company's resolvability would also be conducted.



² In the Preamble to the Proposed Rule, the Council notes that less data is available to allow it to use the Stage 1 thresholds to assess hedge funds and private equity firms. Nevertheless, commencing in 2012, the SEC will require increased reporting by advisers to such funds. Using this new data, the Council may consider whether to establish an additional set of metrics or thresholds more appropriately tailored to evaluating these funds. While considering potential threats to financial stability presented by asset management companies, the FSOC would also consider whether any threats to financial stability that may exist would be better addressed via other regulatory measures.

What are the procedures governing actual designation of an NBFC?

Following the more in-depth Stage 3 analysis, if the Council (by a two-thirds vote of its members) concludes that a firm should be supervised by the FRB and be subject to prudential standards, the potential SIFI would receive a written “notice of proposed determination” with an explanation of the status basis. If the Council is unable to determine if a US NBFC poses a threat to US financial stability based on the Stage 3 analysis, the Council may request that the FRB conduct an examination of the NBFC to determine whether it should be subject to FRB supervision.

The Council would notify any NBFC in the Stage 3 Pool if, either before or after a proposed determination, that firm ceases to be considered for determination. However, any NBFC that ceases to be considered at any time in the Council’s determination process may still be considered for a proposed determination in the future, at the Council’s discretion.

An NBFC that is subject to a proposed determination would be provided the opportunity to appeal the Council’s decision and request a hearing to contest the designation. At the conclusion of the hearing (should one have been requested), the Council would determine by another vote (by two-thirds of the voting members of the Council, including the affirmative vote of the chairperson) whether to subject the NBFC to FRB supervision and prudential standards. An NBFC that has been deemed a SIFI has the right to bring an action in the US district court for an order requiring that the determination be rescinded.

What should an NBFC do to respond to the proposed rule?

Given the timing, we anticipate that the proposed rule will not be finalized until the first half of 2012, as the Council reviews the methodology and public comments. During these coming months, NBFCs should position themselves by being proactive in preparing their comments on the proposal and data. Since the re-proposed rule has incorporated the public comments made in response to the January 2011 notice of proposed rulemaking, and the Council has finalized the companion rule on FMUs, we don’t believe there will be significant changes in the final rule; however, even modest adjustments in some criteria may be important for some firms, and with respect to the appropriateness of including certain types of NBFCs, the Council’s own misgivings could be reinforced. Therefore, firms should be prepared to view the thresholds for Stage 1 inclusion broadly, and consider both the publicly available information and pertinent non-public information that may be instructive to the Council and the Office of Financial Research in evaluating the firm’s position against the two determination standards.

What can an NBFC do now to prepare for a Stage 2 inquiry?

There are several things that an NBFC can embark upon now in preparation for a Stage 2 inquiry from the Council. First, it would be prudent for an NBFC to develop a strategy for how it will interact with the agents of the Council and share information with them upon any inquiries. Most NBFCs have already designated central points of contact that report into an already existing or newly minted regulatory-focused management committee tasked with and/or designed to handle the firm’s potential interactions with the Council and associated regulators. Secondly, a principal part of the strategy and a primary task of these committees is the development of a thoroughly documented enterprise-wide profile of the organization based on the statutory framework outlined in the two notices of proposed rulemaking and the Dodd-Frank legislation (i.e., performance of a supportable and

repeatable analysis that provides for the scope and purpose of certain activities within the organization). This effort will provide meaningful perspective for all the relevant stakeholders, allowing them to view the profile of the organization through the lens of what regulators think characterizes an NBFC SIFI.

To achieve this, the committee should consider commissioning a project that identifies the full organizational structure of the enterprise and sets out to document (i) all of the firm's financial activities, (ii) the objectives of those activities, (iii) the market share of the activities, (iv) the financial profile of the entities in which all activities are executed or managed, and (v) the interconnectedness of these entities to other NBFCs, banks, and bank holding companies. Once these elements are documented, the committee should undertake an evaluation that serves to define the level and extent of potential impact or spillover to the broader economy in the event of a market stress. Questions that should be asked when evaluating the data include:

- Is the size or volume of this activity so large that, should there be an interruption, it would have an adverse effect on normal market operations, other NBFCs, banks, or bank holding companies?
- Is the NBFC such a lead player in this activity that no other NBFC could substitute for it without disrupting markets and recipients?

In addition, the evaluation should focus on any potential financial and operating vulnerability of the entities. Questions that should be asked when evaluating the data include:

- Is the entity reliant upon short-term funding?
- Does the activity and the way it is funded subject the broader NBFC to certain risks?
- Is the activity that is being undertaken subject to any outside supervisory oversight?

Remember, there were certain activities leading up to the financial crisis that were occurring inside NBFCs without supervisory oversight. These activities grew very large, involved the added complexity of interconnectedness, were funded using risky short-term debt vehicles, and overall added greatly to institutional leverage. Further, they often lacked board, senior management, and/or market transparency. This is what the Council cares about, and this is what NBFCs should focus on evaluating in preparation for Stage 2 and Stage 3.

Is an NBFC safe if it does not meet the Stage 1 criteria?

While the criteria of the proposed rule have clearly articulated the Council's primary focus, the FSOC has still retained its discretionary authority by allowing for the selection of any nonbank financial institution, regardless of how it complies with the aforementioned data thresholds. Also, the Council has substantial discretion in how it applies the criteria. For example, in applying the \$50 billion size threshold, the Council indicated that it also intends to take into account off-balance-sheet assets and liabilities and assets under management in a manner that recognizes the unique and distinct nature of these classes of institutions. In addition, the proposal emphasizes that a systemic threat is likely to be exacerbated if the NBFC is sufficiently complex, opaque, or difficult to resolve in bankruptcy, such that its resolution would disrupt key markets or have a material adverse effect on other financial firms or markets. As a result, large nonbank financial firms should be prepared for the possibility of being added to the Stage 2 Pool, even if they believe they will be filtered out in Stage 1.

Other issues

If an NBFC already owns an insured depository institution (IDI), is it more or less likely to be designated? NBFCs already subject to FRB consolidated supervision (e.g., SLHCs since July 21, 2011) may view themselves as less likely to be designated, but the Act covers BHCs above a certain size that are already subject to consolidated supervision. What matters is whether the NBFC satisfies the SIFI standards that are focused on the systemic importance of the NBFC, taking into account the significance of its IDI subsidiary. An NBFC could be designated with a small IDI subsidiary because of the importance of its other financial activities. By the same token, an NBFC with an IDI subsidiary with \$50 billion or more in assets may not be designated because the NBFC's overall footprint is fairly modest and its IDI subsidiary has only a limited degree of interconnectedness. The process is not about applying microprudential BHC regulation to NBFCs, but rather about applying macroprudential regulation for systemic reasons. That being said, the presence of a large, interconnected IDI or broker-dealer subsidiary of an NBFC could be seen as increasing the chances of designation.

Could an NBFC be designated both a SIFI and an FMU? The Preamble to the FMU regulation notes that the Council generally does not expect to apply the standards for systemic importance to a parent holding company or subsidiaries that are not themselves FMUs. Where a holding company has separately incorporated FMU subsidiaries whose operations are not significantly interconnected with the parent or non-FMU subsidiaries, the Council would expect to designate only the FMU subsidiary. Thus it is possible that an NBFC could be designated as a SIFI because of its importance apart from designated FMU subsidiaries. So, it's at least theoretically possible that an NBFC would be designated a SIFI and have a subsidiary designated an FMU.

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