

# ***FS Regulatory Brief***

## **Nonbank SIFIs: FSOC proposes initial designations – more names to follow**

June 2013

### ***Overview***

On June 3, 2013, the Financial Stability Oversight Council (the Council) met in a closed session and voted<sup>1</sup> to provide written notice to three major US nonbank financial companies (NFCs) of the Council's proposal to deem them as systemically important. If the Council makes this proposed determination final, and we fully expect it will, the NFCs would be subject to supervision by the Federal Reserve Board (FRB) and to prudential standards under the Dodd-Frank Act. American International Group, Prudential Financial and GE Capital immediately disclosed that they were the NFCs which received a proposed determination from the Council.

In our view, the most noteworthy takeaways here center on the proposed designation of Prudential Financial – a large global insurance company that did not receive any governmental assistance during the financial crisis.

The insurance industry, state insurance regulators and many politicians have lobbied hard expressing their view that insurance firms: are very different from banks (in terms of their business, liquidity profile and interconnectedness); do not pose systemic risk to the economy; are already subject to strict regulation at the state level; and that size should not be a primary criterion for designation. But the federal banking regulators, led by the FRB, disagreed despite the political pressures and an improving economic situation. As importantly, the Council did not feel the need to wait for the International Association of Insurance

Supervisors (IAIS) to complete their process to designate Globally Systemic Important Insurers (GSIIIs), which once again proves that, like politics, all regulation is local.

So the key takeaways as we see it: the federal banking regulators are truly calling the shots; banking is not the only financial services industry that is interconnected and systemic; and, most importantly, size really does matter. As a result, we believe at least one more insurance firm will be proposed for designation by early 2014, and the odds of the asset management industry suffering the same fate as insurance (with a few large asset managers being proposed for designation) have gone from 50-50 to a very strong likelihood. The only open question is how quickly this will occur.

In our April 2012 *FS Regulatory Brief* on this topic, we described the final rules for designating NFCs as systemically important and shared our prediction – which proved to be accurate – that initial determinations would be issued for a relatively small number of institutions (“probably in the range of 2 to 3 firms”).<sup>2</sup> This *FS Regulatory Brief* builds on that brief by providing (a) the regulatory backdrop that got us to this point, (b) the next steps the NFCs proposed for designation may take, (c) the prudential standards that will apply if the Council makes a final determination that they are systemically important, (d) the areas of greatest challenge for these firms in the near-term, and (e) our view as to what the Council's action portends for future NFCs.

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<sup>1</sup> Any proposed or final determination by the Council requires a vote of at least two-thirds of the Council's voting members, including an affirmative vote by the Secretary of the Treasury – the Chairperson of the Council.

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<sup>2</sup> See PwC's *FS Regulatory Brief: The FSOC finalizes rules and guidance for designating nonbank financial companies as SIFIs – Expect very few on tap, but many on watch.*

## ***Regulatory background***

In order to subject these NFCs to FRB supervision and prudential standards under Dodd-Frank, either of two final determinations will have to be made by the Council: (i) material financial distress at the nonbank financial company would pose a threat to US financial stability, or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities at the nonbank financial company could pose a threat to US financial stability. In making this determination, the Council must consider a number of statutory factors which the Council has incorporated into a framework consisting of six categories. Three of these categories (size, interconnectedness and substitutability) seek to measure the impact of a nonbank financial company's financial distress on the broader economy, while the other three (liquidity risk, maturity mismatch and existing regulatory scrutiny) attempt to assess the vulnerability of a complex nonbank financial company to financial distress.

The process leading up to these initial proposed determinations has been a lengthy one, and has not been without controversy over the extension of "bank-centric" regulation and supervision to large NFCs. The Council first proposed an advance notice of proposed rulemaking for making determinations with respect to NFCs in October 2010. This was followed by a first notice of proposed rulemaking in January 2011, which was then followed by a second notice of proposed rulemaking in October 2011. Ultimately, a final rule was published on April 11, 2012 with an effective date of May 11, 2012.

Former Treasury Secretary Geithner's oft-stated intention to make the initial NFC determinations by the end of 2012 was in fact not realized. It was thus with little doubt a sense of relief for Treasury Secretary Lew when he stated on June 3rd that "[t]oday, the Council took another important step forward by exercising one of its principal authorities to protect taxpayers, reduce risk in the financial system and promote financial stability."

NFC designation has also been caught up in the politics of the broader too-big-to-fail

debate. For example, Congressman Jeb Hensarling, Chairman of the House Financial Services Committee, said in a statement shortly after the Council's vote that that the Council's action amounted to labelling the firms as "too big to fail." In his words, "[d]esignating any company as 'too big to fail' is bad policy and even worse economics. It causes erosion of market discipline. It also becomes a self-fulfilling prophecy by giving these firms market advantages over their competitors, helping to make them even bigger and riskier than they otherwise would be."

## ***What are the NFCs' next possible steps?***

When a proposed determination is made, the Council provides the NFC with a written explanation of the basis of the proposed determination. The company may within 30 days after receiving the notice request in writing an opportunity for a nonpublic, written or oral evidentiary hearing to contest the proposed determination. The Council then will fix a time for a hearing not later than 30 days after receipt of the request (but oral testimony and argument are permitted only at the sole discretion of the Council). Within 60 days after the hearing, the Council must determine whether to make a final determination and, if one is made, provide a statement of the basis of the decision of the Council and publicly announce its determination. In order to make a final determination, the Council must again vote by a two-thirds majority, including an affirmative vote by the Chairperson.

If the NFC does not make a timely request for a hearing, the Council will within 10 days of the date when a hearing could have been requested (or after the Council receives notice from the NFC that it is not requesting a hearing), determine whether to make a final determination that the NFC is systemically important. If so determined, the Council must provide the basis of its decision and publicly announce the decision. In order to make this final determination, the Council must again vote by a two-thirds majority, including an affirmative vote by the Chairperson.

## ***Which prudential standards apply to NFCs deemed systemically important?***

Dodd-Frank requires the FRB to apply enhanced prudential standards (EPS) under sections 165 and section 166. The prudential standards encompass requirements dealing with capital and liquidity (i.e., Basel III), single counterparty exposure limits (SCCL), liquidity risk management, enterprise risk management, stress-testing, debt to equity limits, and resolution planning. Under the FRB's proposed rule implementing these requirements,<sup>3</sup> the FRB would apply the same set of enhanced prudential standards to covered companies that are NFCs as those applied to bank holding companies. However, the FRB also conveys that an NFC may be able to obtain "tailor[ed]" treatment with respect to EPS's quantitative requirements (i.e., capital, liquidity and SCCL), stating that "[f]ollowing designation of a nonbank financial company by the Council, the FRB would thoroughly assess the business model, capital structure, and risk profile of the designated company ... [and] may, by order or regulation, tailor the application of the enhanced standards to designated nonbank financial companies on an individual basis or by category."<sup>4</sup>

In the proposed EPS rule, the FRB further notes that this authority to tailor application of the quantitative requirements will be particularly important in applying the enhanced standards to "specific nonbank financial companies" designated by the Council that are organized and operated differently from banking organizations. In particular, the FRB notes that the types of business models, capital structures, and risk profiles of companies that would be subject to designation by the Council could vary significantly. While the FRB's proposal was largely developed with large, complex bank holding companies in mind, the FRB takes the view that "some of the standards nonetheless provide sufficient flexibility to be readily implemented by covered companies that are

not bank holding companies."<sup>5</sup> It is on this topic amongst others that a number of NFCs and trade group organizations have provided comments to and have met with the FRB to discuss further the need for more tailoring of requirements to different types of NFCs. In the case of insurance, there has even been legislation recently introduced in Congress (H.R. 2140) that would exempt insurance companies from having to comply with bank holding company risk-based and leverage capital standards.

The outstanding question facing these firms is: To what extent will the FRB be willing to tailor application of the EPS's quantitative requirements for designated NFCs, and will such tailored proposals be subject to a further notice and comment procedure?

It is our view that the current Basel III proposal for US implementation of capital standards will be finalized as soon as this month. This rule may provide some clarity with respect to regulators' treatment of insurance related activities. More importantly, we expect the EPS to be finalized by year-end, which will provide a more fulsome picture of the tailoring approach taken by the FRB.

## ***The near-term challenges for firms receiving proposed designations from the Council***

While uncertainties over how the quantitative requirements will be determined and applied to NFCs may be the most critical regulatory issue for most NFCs going forward, implementing changes to existing processes, systems and methodologies relative to the breadth of the proposed EPS will be a heavy lift for all of the firms now. In particular, designated firms will face core challenges to meet regulatory expectations for the following key processes (regardless of the ultimate quantitative requirements):

<sup>3</sup> See 77 *Federal Register* 594 (January 5, 2012).

<sup>4</sup> *Id.* at 597.

<sup>5</sup> *Id.*

- **Resolution Plan under Dodd-Frank's section 165(d) and Recovery Plan:** As evidenced by the ongoing efforts of the largest bank holding companies and the ever increasing requirements placed on them, the initial resolution plan for designated NFCs would be required on July 1, 2014 (assuming final designation by October 2013);<sup>6</sup> however, this date can be changed based upon joint agreement between the FRB and FDIC. Regardless of the due date, meeting regulatory expectations will be challenging as firms look to corral the required information under the rule (i.e., defining material entities, critical operations and core business lines, and mapping their interconnections), and they may have to address the evolving regulatory expectations with respect to international exposures as laid out in the guidance released by regulators in April 2013.

Additionally, while not required by statute, the FRB under its supervisory powers has required all globally systemically important banks to prepare global recovery plans with a timeline for initial submission of approximately six months. We expect this requirement would become applicable to designated NFCs as well.

- **Capital Plan and Stress Testing under Dodd-Frank's section 165:** Aside from the Basel III capital definitions and quantitative requirements which, as noted above, have drawn a great deal of public and private questions on their appropriateness for NFCs, designated firms will be expected to file capital plans subject to approval by the FRB. These firms will also need to conduct company-run stress tests on a semi-annual basis with the first DFAST (Dodd Frank Act Stress Testing) reporting required in July 2014 to the FRB. This obligation will be followed by the capital plan submission and DFAST

submission due to the FRB in January of 2015. The required effort here cannot be underestimated as firms look to conform internal processes to meet supervisory expectations and to ensure documentation governing existing processes is available for review by regulators.

- **Enhanced Liquidity Risk Management, Broader Risk Management Standards and Early Remediation under Dodd-Frank's sections 165 and 166:** Designated firms will have until January 2015, assuming a rule in this area is finalized by year-end 2013, to conform to these requirements. With US proposals on quantitative liquidity measures such as the Liquidity Coverage Ratio and the Net Stable Funding Ratio waiting in the wings, operational processes required under the rule related to the liquidity risk management framework, contingency funding plans and stress testing across numerous time horizons will call for likely changes to existing exposure capture, monitoring and reporting practices. The other elements noted will also require varying degrees of process change, depending on how the firm is currently structured from an organizational perspective.

The confluence of the timing of these requirements will place sizable strains on available resources within firms, as we have observed with the larger bank holding companies dealing with CCAR stress testing, resolution planning and the yet to be released CLAR (Comprehensive Liquidity Analysis and Review). Through our ongoing work with a number of clients across these dimensions, effective planning/prioritization and project management is not optional and must cover all corners of the consolidated organization.

In addition to ensuring adherence to regulatory requirements and supervisory expectations, firms need to establish clear communication lines with FRB staff and senior officials to ensure their understanding of the firm's inherent risks and control framework. While some aspects of the firm or its risks may be known to the FRB, active dialogue with the regulators is critical to

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<sup>6</sup> Under the rule governing resolution plans, an NFC that becomes a covered company must submit its plan no later than the July 1<sup>st</sup> following the date of designation, as long as the NFC is designated 270 days before the plan is due.

ensure understanding of evolving expectations and ongoing developments within the firm. As we have seen with new bank holding companies, the FRB will look to understand the key risks of the firm through “discovery reviews” as they develop risk assessments during the first year of supervision. The discovery reviews are used by regulators to better understand key aspects of the firm’s control framework such as the governance framework, internal audit and risk management in addition to the key business lines of the firm. Once completed, the risk assessments are used to inform the FRB’s supervisory plan and target examinations that would be conducted in the second year. These processes and the FRB’s broader supervisory framework are embedded within the FRB’s Supervisory Letters 12-7 (Consolidated Supervision Framework for Large Financial Institutions) and 08-9 (Consolidated Supervision of Bank Holding Companies and Combined US Operations of Foreign Banking Organizations).

### ***What does the Council’s action mean for other NFCs?***

As discussed in the beginning of this brief, it is significant that Prudential was proposed for designation, which informs our belief that additional NFCs will be proposed for designation in the future – not just another insurance firm, but asset managers as well.

Treasury Under Secretary Mary Miller stated earlier this year at a Senate Banking Committee hearing that the Council was studying the systemic implications of the industry and may create additional criteria for designating asset managers. That said, we believe certain key regulators already view the industry and certain asset managers as systemically important, but they need the study to support a credible process to make the designation.

However, we do not believe designation is imminent. A new rule may be needed to establish the designation process for asset managers, and it took over two years to reach the current proposed NFC designations. We can only surmise that nothing will happen with respect to asset managers until 2015.

The Council’s action also indicates that, again, the US is willing to be a first mover in defining new regulatory regimes. As with resolution planning, derivatives regulation and the proposed Volcker Rule, the US did not wait for international efforts before proceeding. In this case, the IAIS has been working towards a global recommendation of insurance NFCs for designation, which has been expected to occur this summer. Perhaps this move by the Council suggests IAIS is not as close to completion as believed. It certainly suggests the Council will not wait for international cooperation indefinitely, and will likely make future designations irrespective of international consensus.

In the mean time, NFCs that were not proposed for designation will anxiously await public announcement by the Council of the final designations (subject to the hearing timeline discussed earlier) and the release of information indicating which factors were emphasized in making these proposed determinations. Disclosure of these factors will hint at which NFCs may next be proposed for designation, and will dampen the inevitable finger pointing between market participants (that has already begun) as to which other entities should be brought into the systemically important web and which should not.



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## Additional information

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