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

Overview – Maximum discretion, limited transparency, no exemptions

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or the Act) reached one of its macro-prudential milestones on April 3, 2012 when the Financial Stability Oversight Council (FSOC or Council) approved the final rule and interpretive guidance it will use for determining when a "nonbank financial company" (NBFC) is systemically important to US financial stability (is a SIFI) and must be supervised by the Federal Reserve Board (FRB) under the enhanced prudential standards of Section 115 of the Act. While the final rule and guidance largely mirrored the Proposed Rule published on October 18, 2011, the Council emphasized several times that its determinations would be on a case-by-case basis guided by the statutory factors of Section 113. It rejected requests by several segments of the financial services industry to be essentially exempt from designation. Although the Council was reluctant to make any significant changes in its current Stage 1 metrics for identifying a pool of NBFCs warranting further analysis, the Council indicated a willingness to consider new metrics or thresholds in the future as better data becomes available, in particular, in the case of hedge and private equity funds and their advisers.

While there has been much speculation in the financial press and among NBFCs as to which companies may be selected in the initial round, which Secretary Geithner indicated would happen before the end of 2012, our view is that only a very small number of firms will be officially designated as SIFIs, probably in the range of 1 to 3 firms. Other large NBFCs will linger, likely without affirmative acknowledgement and for an unspecified period of time, in Stages 1 or 2—"under watch."

The Council is well aware of the market significance of these determinations and the significant burden both real and perceived that will be placed upon those that are officially designated as SIFIs. This burden will be the greatest on the first round of designees as the potential impacts—increased capital, limitation of activities and supervision by the FRB—are currently open to a wide-range of speculation and without further clarity will likely be viewed negatively in the short term by the market. Accordingly, we believe the first round of SIFIs will be very small, carefully chosen and not a big surprise to those designated. Such a process would limit any risk of overreach and industry push-back, but at the same time not let anyone off the hook, as remaining firms will assume they are in Stage 1 or 2 and could be next up—effectively creating a form of self-regulation by all potential large NBFCs to not appear systemic. As important, this approach would give the FRB, which is currently resource challenged under Dodd-Frank rule-making and implementation, some much needed breathing room to more slowly on-board the new NBFC-SIFIs and develop their supervisory game-plan for nonbanks.

So, only a few designated, but everyone else in fear of being next in line.

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The designation process – Governing standards and the regulatory framework

As more fully described in our earlier ***Closer Look on the FSOC SIFI Designation Proposal for Nonbank Financial Companies*** issued in December 2011, the Final Rule maintains the "Three stage" process to be followed by the Council in applying the Act's standards for determining whether a NBFC may pose a threat to the financial stability of the US. The process is intended to progressively narrow the pool of NBFCs for review and possible designation. Only NBFCs making it to Stage Three may be subject to a Proposed Determination.

To subject a NBFC to FRB supervision under the Act, either of two determinations must be made—(i) that material financial distress at the NBFC would pose a threat to US financial stability or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities at the NBFC could pose a threat to US financial stability. In making a determination, the Council must consider a number of statutory factors which the Council has incorporated into an analytic framework consisting of six categories—three of which (size, interconnectedness and substitutability) seek to measure the impact of a NBFC's financial distress on the broader economy, and three of which (liquidity risk, maturity mismatch and existing regulatory scrutiny) seek to assess the vulnerability of a complex NBFC to financial distress.

The stage one thresholds

Under the Final Rule, an NBFC will not be subject to further analysis beyond Stage 1 unless its total consolidated assets are $50 billion or more and it meets one of the following five thresholds.

1. **$30 billion in gross notional credit default swaps outstanding for which a NBFC is the reference entity.** This threshold will likely be the more significant driver of "interconnectedness" across the market**.** The Council intends to calculate this data through the Trade Information Warehouse, a subsidiary of the Depository Trust & Clearing Corporation. Also, in a Stage 2 analysis, the Council will consider CDS for which an NBFC parent is the reference entity. Embedded derivatives will be included in accordance with GAAP when such information is available.
2. **$3.5 billion of derivative liabilities.** Currently the rule takes into account the fair value of derivative contracts in a negative position while for companies that disclose the effects of master netting agreements and cash collateral held with the same counterparty on a net basis, the Council will take into account the effects of these arrangements in its calculation. As the current threshold captures only current exposure, the Council said that it may revisit this calculation to consider potential future exposure.
3. **$20 billion in total debt outstanding.** The final guidance defines the term "debt outstanding" broadly and regardless of maturity to include loans, bonds, repos, commercial paper, securities lending arrangements, surplus notes (for insurers) and other forms of indebtedness);
4. **15 to 1 leverage ratio of total consolidated assets (excluding separate accounts) to total equity.** Separate accounts are excluded because they are not available to claims by general creditors of an NBFC.
5. **10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months to total consolidated assets (not including separate accounts).** Total debt outstanding will be defined the same as in measuring this amount above.

Wild card authority. Because the uniform thresholds may not capture all of the potential ways a NBFC could be a threat to financial stability, the Council may, in limited cases, initially evaluate a NBFC based on other firm-specific qualitative or quantitative factors, such as substitutability or existing regulatory scrutiny.

Treatment of nonbank financial industry sectors

Several sectors of the nonbank financial services industry—insurers, asset managers, financial guaranty insurers, captive finance companies, money-market funds, and the Federal Home Loan Banks—recommended in comments that the Council exclude their respective industry from consideration due to structural or other factors that make them less likely to raise systemic concerns and that would make it inappropriate to subject them to the type of enhanced prudential standards in Section 115 of the Act which are based on a Bank Holding Company model. The Council stated that it would not provide industry-based exemptions from potential determinations but it does intend to afford such arguments due consideration in the Determination process.

Hedge fund commenters had requested clarification as to whether separate funds would be considered separately for purposes of total consolidated assets. The Final Rule remains ambiguous—the Guidance states that the FSOC "may consider the aggregate risks posed by separate funds that are managed by the same adviser, particularly if the funds' investments are identical or highly similar." Similarly, where asset managers asked for clarification as to how assets under management would be considered, the Final Rule merely states that the FSOC's "analysis will appropriately reflect the distinct nature of assets under management compared to the asset manager's own assets."

The Final Rule acknowledged that there is little data available for financial guarantors, asset management companies, private equity firms, and hedge funds. As a result, and in light of the new Form PF filing requiring financial disclosures for advisers to large hedge and private equity funds, the Council will later "consider whether to establish an additional set of metrics or thresholds tailored to evaluate hedge funds and private equity firms and their advisers." Likewise, the FSOC "may develop additional guidance regarding possible metrics and thresholds relevant to determinations regarding asset managers."

Further explanations and clarifications

- ***Accounting***. In applying the metrics, US GAAP will be utilized when available, and in its absence, statutory accounting principles (SAP), international financial reporting standards, or other such data will be used.
- ***Timing.*** The Stage 1 thresholds will be applied on the basis of the latest quarterly data if available.
- ***Foreign NBFCs.*** For purposes of evaluating Stage 1 thresholds, the FSOC will consider global assets, liabilities, and operations for US nonbank financial companies, but only US assets, liabilities, and operations for foreign nonbank financial companies.
- ***Stage 3 Notices Only.*** The FSOC rejected the requests of several commentators to provide notice to a company if it progresses to Stage 2 or does not progress to Stage 3. Similarly, the FSOC rejected the suggestion that it explain the reasons why a company will be subjected to Stage 3 review.
- ***Resolvability*****,** A NBFC's resolvability may mitigate or aggravate as the case may be the potential threat to US financial stability during the Stage 3 process.
- ***Confidentiality.*** The final rule clarifies that the confidentiality protections will apply as well to any data, information or reports that are being voluntarily submitted by a NBFC being considered for a determination.

The FRB clarifies the definition of financial activities

Shortly after the Council's adoption of its Final Rule, the FRB published a Supplemental Notice of Proposed Rulemaking that effectively expands the scope of financial activities to be included in determining whether a company is "predominantly engaged in financial activities" and thus legally eligible to be designated by the Council as a NBFC SIFI. The "predominantly engaged test" applies to both US and foreign NBFCs. To be considered as "predominantly engaged in financial activities," a NBFC must either derive 85 percent or more of its consolidated gross revenues from financial activities or have 85 percent of its consolidated assets related to financial activities.

In its Supplemental Notice, the FRB proposes to amend its earlier Proposal by clarifying that any activity referenced as financial in Section 4(k) of the Bank Holding Company Act (as applicable to Financial Holding Companies) will be considered to be a financial activity without regard to conditions imposed for prudential or other reasons that do not define the activity itself. This proposed change will have the effect of expanding the scope of financial activities for purposes of the calculation, which, in turn, could result in more companies being considered as NBFCs subject to possible designation. Based on the FRB's proposal, the companies most likely to be affected to some degree are mutual fund companies, futures commission merchants, private equity investment companies, real estate financing companies and certain thrift holding companies.

For a large NBFC, what does all this really mean?

It is important to maintain some perspective on the Council designation process amid all the speculation in the financial press and company hallways about which firms may be designated. The Council is clearly not going to use a Noah's Ark Approach—two of every type of NBFC—as some have suggested or displace State regulation of insurance. Many may appear called by the Stage 1 thresholds but few are likely to be chosen—probably in the range of 1 to 3 NBFCs initially. Why?

- The authority granted the Council in Section 115 is not intended to expand FRB jurisdiction over every large NBFC in every financial sector but rather to identify those very specific NBFCs whose financial distress or size and scope of financial activities make them truly a potential systemic concern. This is likely to be a very small number of firms which will be determined on a rigorous case-by-case basis.
- This new designation authority is part of the macro-prudential approach to regulation and supervision and will be closely watched. The Council, particularly in the beginning, will want to act unanimously and not appear to be overreaching.
- The message of the final Rule is that the Council wants to have the maximum discretion possible because there are no pre-determined answers. The uncertainty associated with the current process is, in fact, built into the Act because what makes a NBFC SIFI now may be very different from what makes a NBFC SIFI several years down the road.
- While no large NBFC gets a lifetime pass from designation, there are several other provisions of Dodd-Frank and the G20 reform agenda that are designed to reduce concentration of risks, such as the proposed single counterparty exposure limit and central clearing of derivatives that may well lessen the number of NBFCs likely to be designated in the future.
- The FRB will to some degree have to tailor enhanced prudential standards to NBFCs that are designated, as a wholesale transfer of the banking model will not be feasible. Devising that framework will have to compete with equally pressing regulatory requirements under Dodd-Frank that are already impacting agency bandwidth on reform.

What can a large NBFC do now if it is concerned about possible designation?

With a Final Rule now in place, the thresholds for Stage 1 are set and any hope of getting an industry pass is gone for now. The Final Rule does not provide for any notice to the NBFC if it is moved into Stage 2. The Council states that Stage 2 is intended to comprise the Council's initial company-specific analysis based primarily on public and regulatory sources and the Council believes that Stage 3 provides a sufficient opportunity for NBFCs to participate in the Determination Process.

Each NBFC in the Stage 3 Pool will receive a "Notice of Consideration" that the NBFC is under consideration for a Proposed Determination. The Notice will include a request that the NBFC provide information that the Council deems relevant to the Council's evaluation, and the NBFC will be provided an opportunity to submit written materials to the Council. The Official Guidance accompanying the Final Rule sets forth in some detail the types of information—including qualitative information—which the Council will be seeking.

Preparing now for how to handle and respond to such Council requests and developing and implementing a plan to address, through submissions to the Council, the key quantitative and qualitative factors discussed in the Council's Guidance would put an NBFC in the best position to influence favorably the ultimate Stage 3 analysis—should it come. Of particular note is the Council's emphasis on its intention to consider "resolvability."

While full "Living Will" requirements come after designation as a SIFI, large NBFCs, in a Stage 3 Proposed Determination, should nonetheless be in a position to support how they would deleverage risk in a crisis situation to reduce their systemic footprint.

Additional information

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