

FSOC Proposal Further Clarifies Which Nonbank Financial Companies Could Be Designated “Systemically Important Financial Institutions”

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In response to criticism and pressure from financial industry participants and members of Congress, the Financial Stability Oversight Council (FSOC), on October 11, provided a more detailed proposal for designating nonbank financial firms as “systemically important financial institutions.” This follows an advance notice of proposed rulemaking on October 6, 2010, and a first “notice of proposed rulemaking” on January 26, 2011, that was widely perceived as too vague.¹

The FSOC’s latest proposal contains a second notice of proposed rulemaking (the Proposed Rule) as well as proposed interpretative guidance (the Proposed Guidance) designed “to provide (i) additional details regarding the framework the [FSOC] intends to use in the process of assessing whether a nonbank financial company could pose a threat to U.S. financial stability and (ii) further opportunity for public comment on the [FSOC’s] proposed approach to the Determination Process.” The Proposed Rule and particularly the Proposed Guidance do provide greater clarity on the analyses and processes the FSOC will use in examining nonbank financial companies to determine whether they are “systemically important” and therefore subject to prudential standards under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) and supervision by the Board of Governors of the Federal Reserve System (Federal Reserve).

The FSOC indicated that it intends to follow a three-stage process “of increasingly in-depth evaluation” in making a determination that a nonbank financial company could pose a threat to the financial stability of the United States. This level of detail was absent in prior FSOC proposals, and several public comment letters submitted in response to those proposals highlighted the need for a more transparent process based on detailed criteria. The FSOC’s three-stage analytical process will include both quantitative and qualitative criteria, described in more detail below.

A specific concern raised by members of the insurance industry with respect to the FSOC’s prior proposals was the absence of sufficient insurance industry input and representation among the FSOC members. In the interim, the Director of the Federal Insurance Office and an “Independent Insurance Expert” have been added as members of the FSOC, joining the state insurance regulatory representative. However, it is unclear the extent to which input was solicited from those newly appointed members.

¹ These earlier releases were discussed in several previous Sutherland Legal Alerts, see “[The Financial Stability Oversight Council Holds Inaugural Meeting: Proposed Rulemakings on Nonbank Financial Companies and the Volcker Rule Will Impact Insurers](#)” (October 13, 2010); “[The Financial Stability Oversight Council Takes Action: New Insight into Determination of Which Insurers May be Subject to Enhanced Oversight](#)” (February 18, 2011); “[FSOC Proposed Rulemaking on Fed Supervision of Nonbank Financial Companies: Critics Submit Comments and Ask Who is Speaking on Behalf of the Insurance Industry](#)” (March 7, 2011); and “[FSOC Proposed Rulemaking on Fed Supervision of Nonbank Financial Companies: Congress Questions Transparency](#)” (May 23, 2011). These Legal Alerts are available at www.regulatoryreformtaskforce.com.

A. Identifying Companies That Could Pose a “Threat to the Financial Stability of the United States”

Under Section 113 of the Dodd-Frank Act, the FSOC is charged with identifying nonbank financial companies that could pose a threat to the financial stability of the United States. The Proposed Guidance states that the FSOC would find a threat to the financial system exists “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 broader economy.” The Proposed Guidance explains that the FSOC considers several “channels” through which the negative effects of a nonbank financial company’s activities or financial distress can be transmitted to other financial firms and markets. These channels are categorized as “exposure,” “asset liquidation” and “critical function or service.”

“*Exposure*” refers to the risk that the company’s creditors, counterparties, investors or other market participants could also become materially impaired due to their exposure to the company, and thus in the aggregate pose a threat to U.S. financial stability. In analyzing exposure, the FSOC will consider metrics including its total consolidated assets, derivative liabilities, loans and bonds outstanding, leverage ratios and credit default swaps referencing the company’s debt.

“*Asset liquidation*” refers to the risk that a nonbank financial company holds assets that if liquidated quickly would significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings due to falling asset prices.

“*Critical function or service*” refers to the risk to the market if a nonbank financial company is no longer able or willing to provide a critical function or service that is relied upon by market participants.

B. Determining That a Nonbank Financial Company Could Pose a Threat to the Financial Stability of the United States

A nonbank financial company will be placed under supervision by the Federal Reserve and subject to the Dodd-Frank Act’s prudential standards if the FSOC determines that such company could pose a threat to the financial stability of the United States because the company is in material financial distress (First Determination Standard) or because of the particular nature and extent of the company’s activities (Second Determination Standard).

First Determination Standard: Material Financial Distress. The Proposed Guidance states that “material financial distress” will exist when a nonbank financial company is in imminent danger of insolvency or defaulting on its financial obligations. For purposes of considering whether a company could pose a threat to the U.S. financial system, the FSOC will assess the impact of material financial distress in scenarios of “overall stress in the financial services industry and in a weak macroeconomic environment,” when the impact would be greatest.

Second Determination Standard: Nature, Scope, Size, Scale, Concentration, Interconnectedness, or Mix of Activities. According to the Proposed Guidance, this standard will be met if the FSOC finds that “the nature of a nonbank financial company’s business practices, conduct or operations could pose a threat to U.S. financial stability, regardless of whether the company is experiencing financial distress.” The Proposed Guidance notes that there will likely be considerable overlap in applying the two standards “because, in many cases, a nonbank financial company that could pose a threat to U.S. financial stability because of the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities could also pose a threat to U.S. financial stability if it were to experience material financial distress.”

C. The FSOC's Framework for Evaluating the Factors Enumerated in the Act

The Act requires that the FSOC's determination whether to place a company under supervision by the Federal Reserve should include consideration of 11 factors enumerated in Section 113 of the Act, in addition to "any other risk-related factors that the Council deems appropriate." Similar to prior FSOC proposals, the Proposed Guidance distills the stated considerations into six conceptual categories and explains in considerable detail, especially as compared to prior FSOC proposals, how each category relates to the various statutory factors. Each category is explained at some length in the Proposed Guidance, along with a discussion of the kinds of metrics that the FSOC would review. There is also a chart included that illustrates how the six categories relate to the 11 statutory factors. The six categories are:

Interconnectedness. "Interconnectedness captures the direct or indirect linkages" that may transmit the effects of "a nonbank financial company's material financial distress or activities." "Interconnectedness depends not only on the number of counterparties that a nonbank financial company has, but also on the importance of that nonbank financial company to its counterparties and the extent to which the counterparties are interconnected with other financial firms, the financial system and the broader economy." Reinsurance networks are among the kinds of interconnections specifically identified in the Proposed Guidance.

Substitutability. "Substitutability captures the extent to which other firms could provide similar financial services in a timely manner at a similar price and quantity if a nonbank financial company withdraws from a particular market. Substitutability also captures situations in which a nonbank financial company is the primary or dominant provider of services in a market that the Council determines to be essential to U.S. financial stability." Matters to be considered would include market share; the ability of competitors to fill the gap; the cost to customers of substituting other providers; and the degree and length of any expected market disruption. The FSOC will also examine substitutability with respect to global nonbank financial companies in the event of the material financial distress of a foreign parent company.

Size. "Size captures the amount of financial services or financial intermediation that a nonbank financial company provides. Size also may affect the extent to which the effects of a nonbank financial company's financial distress are transmitted to other firms and to the financial system." The Proposed Guidance also notes that the FSOC will take into account off-balance sheet exposures where the company has a risk of loss and the nature and significance of assets under management.

Leverage. "Leverage captures a company's exposure or risk in relation to its equity capital." Leverage amplifies a company's risk of financial distress by raising the "likelihood that a company will suffer losses exceeding its capital" and its "dependence on its creditors willingness and ability to fund its balance sheet." Leverage can also amplify the effects on other companies by increasing the amount of exposure that other companies have to the distressed company and by increasing the size of any asset liquidation the distressed company may be forced to undertake.

Liquidity Risk and Maturity Mismatch. Liquidity risk generally refers to the risk that a company may not have sufficient uncommitted liquid assets to satisfy its short-term needs. Liquidity risk can arise from maturity mismatches. A maturity mismatch is the difference between the maturities of a company's assets and liabilities. "A maturity mismatch affects a company's ability to survive a period of stress that may limit its access to funding and [its ability] to withstand shocks in the yield curve." The Proposed Guidance lists several relevant metrics, such as what percentage of a nonbank financial company's

balance sheet is composed of hard-to-value and potentially illiquid securities, and liquid asset ratios which indicate a company's ability to repay its short-term debt.

Existing Regulatory Scrutiny. The Proposed Guidance advises that the FSOC will take into account the extent to which nonbank financial companies are already subject to regulation. This will include consideration of the “current regulatory bodies’ ability to impose detailed and timely regulatory reporting obligations, capital or liquidity requirements, enforcement actions, and resolutions.” For insurance companies, it will include “an assessment of the number of primary financial regulatory agencies and the number of ‘lead state’ regulators.”

The following chart illustrates how the FSOC believes its six analytical categories relate to the 11 required statutory factors:

Statutory Considerations	Category or Categories in Which This Consideration Would be Addressed
(A) The extent of the leverage of the company	Leverage
(B) The extent and nature of the off-balance sheet exposures of the company	Size; Interconnectedness
(C) The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies	Interconnectedness
(D) The importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system	Size; Lack of Substitutes
(E) The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities	Lack of Substitutes
(F) The extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse	Size; Interconnectedness; Lack of Substitutes
(G) The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company	Size; Interconnectedness; Lack of Substitutes
(H) The degree to which the company is already regulated by one or more primary financial regulatory agencies	Existing Regulatory Scrutiny
(I) The amount and nature of the financial assets of the company	Size; Interconnectedness
(J) The amount and types of the liabilities of the company, including the degree of reliance on short-term funding	Liquidity Risk and Maturity Mismatch; Size; Interconnectedness
(K) Any other risk-related factors that the FSOC deems appropriate	Appropriate category or categories based on the nature of the additional risk-related factor

D. Stages in the FSOC's Proposed Evaluation Process

The three-stage process “of increasingly in-depth evaluation” is described below.

Stage 1. Stage 1 is designed to identify, based on publicly available information through existing regulatory sources, those nonbank financial companies that are the most likely to require further analysis. The FSOC proposes that these should be companies that have at least \$50 billion in total consolidated assets and meet or exceed any one of the following thresholds:

- \$30 billion in gross notional credit default swaps outstanding that reference the nonbank financial company's debt obligations;
- \$3.5 billion of derivative exposure liability to third parties;
- \$20 billion of outstanding loans borrowed and bonds issued;
- 15-to-1 leverage as measured by total consolidated assets (excluding separate accounts) to total equity; and
- 10% ratio of short-term debt (maturity of less than 12 months) to total consolidated assets.

In addition, as a fail-safe device for situations where these simple thresholds may not capture a potentially significant company, the FSOC reserves the right to evaluate nonbank financial companies on other “firm-specific qualitative or quantitative factors, such as substitutability and existing regulatory scrutiny.” The companies identified in Stage 1 (the Stage 2 Pool) would be further assessed in Stage 2. As proposed, it initially appears few nonbank financial companies are likely to meet these criteria.

Stage 2. The FSOC would perform a more “robust” analysis of nonbank financial companies in the Stage 2 Pool. The Stage 2 analysis would be based on information already available to the FSOC from publicly available and regulatory sources, plus information “obtained from the company voluntarily.” Further, the Stage 2 analysis would involve a vast array of quantitative and qualitative industry and company-specific factors relating to the six analytical categories described above. Based on the Stage 2 analysis, the FSOC would contact those nonbank financial companies that it believes could merit a “systemically important” designation (the Stage 3 Pool).

Stage 3. The FSOC, working with the Office of Financial Research, will conduct a detailed review of each member of the Stage 3 Pool using the information collected or provided from the prior stages and additional information collected directly from the nonbank financial company being analyzed. The examination during Stage 3 will be much deeper and specifically targeted, and may include an examination of confidential business information such as internal company assessments, internal risk management procedures, strategic plans, proposed acquisitions and dispositions, and so forth.

Companies Identified by FSOC for a Proposed Determination. Following the Stage 3 analysis, the Stage 3 Pool members will be considered for a Proposed Determination. After this review, the FSOC may, by a vote of two-thirds of its members (including an affirmative vote of the Secretary of the U.S. Treasury acting in his capacity as the FSOC Chairperson (Chairperson)), make a Proposed Determination with respect to a nonbank financial company. A nonbank financial company named in a Proposed Determination would be notified by the FSOC and provided an explanation of the FSOC's rationale.

Avenues for Review of Determinations. A nonbank financial company that is subject to a Proposed Determination may request a hearing in accordance with Section 113(e) of the Dodd-Frank Act. The FSOC will (after a hearing, if a hearing is requested), determine by a vote of two-thirds (including the affirmative vote of the Chairperson) whether the company will be subject to the Dodd-Frank Act's prudential standards and supervision by the Federal Reserve. The FSOC will provide the nonbank financial company with written notice of the final determination and an accompanying explanation of the basis for the decision. A nonbank financial company that is subject to a final determination may seek judicial review in U.S. district court in an action to have the determination rescinded. In addition, under the Dodd-Frank Act, the FSOC is required to reevaluate the designation at least annually.

E. Next Steps: A Call for Comments

The Proposed Rule and accompanying Proposed Guidance provide substantial additional clarity about the process for determining those nonbank financial companies that may be subject to more stringent supervision. The FSOC has asked that additional comments be submitted within 60 days following publication in the Federal Register. Because many of the comments submitted under the earlier releases seem to have been seriously considered by the FSOC in revising and reissuing the Proposed Rule, we anticipate that additional commentary will be helpful to the FSOC in providing even greater clarity in the next iteration.



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