Research

Primer: FSOC's SIFI Designation Process for Nonbank Financial Companies

ANDY WINKLER | SEPTEMBER 3, 2014

The Dodd-Frank Wall Street Reform and Consumer Protection Act[1] became law in July 2010, passed to address systemic weaknesses made apparent by the financial crisis, end "too big to fail," and protect consumers from abusive practices by the financial services industry. Among its myriad provisions, Dodd-Frank created a new council of regulators, the Federal Stability Oversight Council (FSOC), tasked with identifying and addressing threats to the U.S. financial system.

Importantly, FSOC was given the power to designate financial firms whose failure would jeopardize the financial stability of the United States and label them "Systemically Important Financial Institutions" (SIFIs). Once designated, SIFIs fall under increased supervision and regulation by the Federal Reserve Board (FRB), and enter receivership under a special resolution process administered by the Federal Deposit Insurance Corporation (FDIC) in the event of their failure. This paper briefly outlines the process by which nonbank financial companies (NFCs), financial companies without bank charters, are designated as systemically important and ongoing efforts by market participants and lawmakers to inform and alter that process.

BACKGROUND ON AUTHORITY UNDER THE DODD-FRANK ACT

The Treasury Secretary, whose vote is mandatory for a SIFI designation, chairs the FSOC. The heads of eight regulators (OCC, FDIC, CFPB, FHFA, FRB, NCUA, CFTC, and SEC) and one independent member with insurance expertise also have voting rights on the FSOC. Five non-voting members also sit on the Council including the Directors of the Federal Insurance Office and Office of Financial Research (OFR), a state banking supervisor, a state insurance commissioner, and a state securities commissioner. Dodd-Frank established the OFR to conduct data analysis on behalf of FSOC and its member regulators, and thus gave it authority to collect data from companies being considered for designation.

Title I, Subtitle A, of the Dodd-Frank Act established FSOC, outlined the council's powers, and introduced factors that must be considered in the SIFI designation process of NFCs. Because banking companies with over $50 billion in assets are automatically considered SIFIs in Dodd-Frank, key issues involving SIFI designation revolve around NFCs.

Specifically, Section 113 of Dodd-Frank gives FSOC the authority by two-thirds vote (including the chairperson) to bring a NFC under increased supervision and regulation by the FRB if the Council determines that “material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.”[2] In making that determination, Dodd-Frank lists ten criteria for FSOC to consider, but also allows FSOC to consider “any other risk-related factors that the Council deems appropriate.”[3] As such, FSOC has very broad authority statutorily when evaluating companies for SIFI designation.

Because Dodd-Frank gives FSOC such expansive authority to set the specific determinants of a SIFI designation, FSOC’s operational procedures have largely been set through the regulatory rulemaking process. Table 1 outlines the actions FSOC and the Federal Reserve Board have taken to date to define their procedures, receive feedback from the public, and exercise their authority to designate NFCs and regulate them.

TABLE 1. TIMELINE OF FSOC RELATED EVENTS, RULEMAKINGS AND ACTIONS	
JULY 2010	DODD-FRANK ACT EFFECTIVE
OCTOBER 2010	1ST FSOC MEETING APNR: FSOC's AUTHORITY TO REQUIRE NFC REGULATION/SUPERVISION
JANUARY 2011	1ST NPR: FSOC's AUTHORITY TO REQUIRE NFC REGULATION/SUPERVISION
OCTOBER 2011	2nd NPR: FSOC's AUTHORITY TO REQUIRE NFC REGULATION/SUPERVISION
JANUARY 2012	NPR: ENHANCED PRUDENTIAL STANDARDS & STRESS TESTING FOR SIFIs FROM FEDERAL RESERVE
MARCH 2012	EXTENSION OF COMMENT PERIOD ON ENHANCED PRUDENTIAL STANDARDS FROM FEDERAL RESERVE
APRIL 2012	FR & IG: FSOC's AUTHORITY TO REQUIRE NFC REGULATION/SUPERVISION
MAY 2012	EFFECTIVE DATE ON FSOC FINAL RULE
OCTOBER 2012	FR: STRESS TESTING OF SIFIs BY FEDERAL RESERVE
NOVEMBER 2012	EFFECTIVE DATE ON STRESS TESTING OF SIFIs BY FEDERAL RESERVE
MAY 2013	VOTE: STAGE 3 NFCs MOVE TOWARD SIFI DESIGNATION

JULY 2013	VOTE: AIG & GE CAPITAL DESIGNATED SIFIs (9-0; ONE MEMBER RECUSED); HEARING GRANTED TO PRUDENTIAL FINANCIAL
SEPTEMBER 2013	VOTE: PRUDENTIAL FINANCIAL DESIGNATED A SIFI (7-2; NON-VOTING STATE INSURANCE REP ALSO DISSENTS)
MARCH 2014	FR: ENHANCED PRUDENTIAL STANDARDS FROM FEDERAL RESERVE
JUNE 2014	EFFECTIVE DATE ON ENHANCED PRUDENTIAL STANDARDS
AUGUST 2014	VOTE: STAGE 3 NFC MOVES TOWARD DESIGNATION (REPORTED TO BE METLIFE)
Note: Advanced Notice of Proposed Rulemaking (ANPR), Notice of Proposed Rulemaking (NPR), Final Rule (FR) & Interpretive Guidance (IG)	

SIFI DESIGNATION PROCESS

Three-Stage Evaluation

In April 2012, FSOC released a final rule and interpretive guidance on the process it uses to designate SIFIs.[4] The three-stage evaluation process it developed is intended to narrow the pool of companies potentially subject to designation by applying specific thresholds based on ten criteria included in Section 113 of Dodd-Frank. The ten criteria have been incorporated into six overarching framework categories that the FSOC considers: (1) size, (2) interconnectedness, (3) leverage, (4) substitutability, (5) liquidity risk and maturity mismatch and (6) existing regulatory scrutiny. Table 2 highlights how thresholds in these categories are applied and how scrutiny increases as a company advances through each stage.

TABLE 2. FSOC DESIGNATION PROCESS
STAGE 1: APPLY QUANTITATIVE THRESHOLDS

A NFC moves on to Stage 2 if it has: (1) $50 billion in total consolidated assets, and (2) One of the following: · $30 billion in gross notational credit default swaps outstanding for which a NFC is the reference entity; · $3.5 billion of derivative liabilities; · $20 billion in total debt outstanding; · 15 to 1 leverage ratio of total consolidated assets (excluding separate accounts) to total equity; or · 10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months of total consolidated assets (excluding separate accounts). Note: FSOC reserves the right to "evaluate any NFC based on other firm-specific qualitative or quantitative factors, irrespective of whether such company meets the thresholds."[5]
STAGE 2: QUANTITATIVE & QUALITATIVE ANALYSIS
In further detail, FSOC applies its six-category framework: · Size · Leverage · Interconnectedness · Liquidity Risk & Maturity Mismatch · Substitutability · Existing Regulatory Scrutiny The Council evaluates the risk profile and characteristics of each NFC using industry- and company-specific factors, with company information being gathered from existing regulators and public sources as well as information submitted voluntarily by companies under consideration.
STAGE 3: IN-DEPTH ANALYSIS OF COMPANY
With previously amassed information, FSOC performs an in-depth analysis of the company based on the six-category framework. Through OFR, FSOC further collects confidential data obtained from the company to incorporate into its analysis.

Process and Notification

Following initial screening and evaluation in Stages 1 and 2, a company is sent a Notice of Consideration and allowed the opportunity to submit written materials detailing its view of designation not less 30 days afterward.[6] At that time, FSOC can also request information for Stage 3 evaluation including: internal assessments, internal risk management procedures, funding details, counterparty exposure, position data, strategic plans, resolvability, potential acquisitions or dispositions and anticipated changes to the NFC's business or structure that could affect U.S. financial stability. FSOC also sends notice to the company that the evidentiary record is complete.

Following Stage 3 evaluation, FSOC votes on a proposed designation and then sends the company notification along with an explanation for the determination.[7] FSOC also notifies the existing regulators of the company and its subsidiaries. Then, the company may request an oral or written evidentiary hearing within a month after the proposed designation. If the company does not request a hearing, within 60 days FSOC must vote on final determination. Ultimately, a final determination requires two-thirds of the FSOC and the Treasury Secretary voting in the affirmative. FSOC revisits the designation annually and must vote again to rescind a designation.

IMPLICATIONS OF A SIFI DESIGNATION

Following SIFI designation, a NFC is then subject to "enhanced prudential standards" as defined by the Federal Reserve through regulatory rulemakings. FRB supervision and regulation will likely include a mix of increased capital requirements, requirement to produce a "living will" in the event that the firm fails, increased reporting, stress testing, credit exposure limits, debt-to-equity ratio requirements, and early remediation requirements. To meet new requirements, it is likely that SIFIs will be required to hire additional staff, increase data and technology infrastructure, and set aside capital. Subjecting only certain NFCs to such regulation could also have impacts on the structure of the market and economy.

In a final rule issued in March 2014 on enhanced prudential standards for bank holding companies and foreign banking organizations, the FRB decided that "following designation of a NFC for supervision by the Board, the Board intends thoroughly to assess the business model, capital structure, and risk profile of the designated company to determine how the proposed enhanced prudential standards should apply, and if appropriate, would tailor application of the standards by order or regulation."[8] This decision to assess the appropriate standards on a firm-specific basis means there is still a high degree of uncertainty around the exact regulatory burden facing designated NFCs.

CRITICISMS AND ONGOING REFORM EFFORTS

Industry participants and even lawmakers have shared their criticisms and questioned the appropriateness of the process by which NFCs are designated as SIFIs and the scope of subsequent regulation. Among these criticisms, six are often repeated:

1. ***FSOC fails to provide meaningful information on the determinants leading to designation***. Through the final rule and interpretative guidance FSOC released in April 2012, FSOC laid out the metrics used in evaluating firms for designation. Yet those metrics fundamentally lacked specificity. While many determining factors are mentioned as being part of the evaluation process, no determinant is weighted as more heavily signaling or requiring designation, making the process appear highly subjective. In addition to the undifferentiated criteria upon which FSOC structures its evaluations, FSOC is further authorized to consider "any other risk-related factors the Council deems appropriate," which broadens that authority. In sum, the current process makes it difficult for companies to assess whether they face SIFI designation and allows for broad changes in the direction of regulation when administrations change.

2. ***The SIFI designation process lacks transparency.*** According to a report issued by the GAO, "public information on FSOC's and OFR's decision making and activities is limited, which makes assessing their progress in carrying out their missions difficult."[9] Subsequently, GAO recommended a number of changes including developing a plan to improve communications with the public, a recommendation still pending

action. Furthermore, GAO is not alone in suggesting more open communication with the public and companies under consideration, the Bipartisan Policy Center and others have echoed such concerns.[10]

3. ***There is a fundamental lack of analytical rigor in the SIFI evaluation process.*** In his dissent from the FSOC's SIFI designation of Prudential, Roy Woodall, appointed by the President as the independent member of the Board with insurance expertise, noted his concerns about the analytical rigor of the designation process stating, "The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance."[11] John Huff, the non-voting member of the Council representing state insurance regulators, echoed Woodall's concerns, writing in his dissent, "The analysis contained in the basis for the final determination in large part relies on nothing more than speculation."[12] Experts have further argued that the analytical processes behind designations are generally far too opaque and likely insufficient.[13] Additionally, FSOC has stated it does not intend to "conduct cost-benefit analyses in making determinations with respect to individual nonbank financial companies," reflecting how recent designations have failed to accurately assess the implications of SIFI designations on the insurance industry.[14]

4. ***FSOC does not give NFCs the time or opportunity to more comprehensively inform the process***. A company does not have to be notified it is a SIFI target until it is entering Stage 3 of the evaluation process. Time frames to submit comments and feedback against designation are additionally tight. Throughout the process there is little opportunity for a company to take the steps necessary to avoid designation, especially when the full details of what qualifies a company for designation remains unclear (noted in critique 2).

5. ***The consequences of SIFI designation and enhanced regulation are still uncertain, at a cost.*** In his dissent from designating Prudential Financial as a SIFI, the now former FHFA Acting Director, Ed DeMarco, expressed concern at the Council's decision, understanding that the enhanced supervision by the FRB could distort "market equilibrium and competition," and acknowledging that the full effects remained largely "unknown at this point."[15] The possibility of designation comes without allowing a company to fully understand the factors leading to designation or the nature or scope of regulation that will be implemented. These regulations can end up being particularly costly; for example, AAF estimated that a young retirement saver could lose 25 percent or $108,000 of potential accumulation due to SIFI capital requirements on asset managers, one type of NFC for which traditional bank-like standards would not be appropriate.[16]

6. ***FSOC has not been forthright in addressing how SIFI designation and its implications will intermingle with the international process by which globally systemically important financial institutions are named and regulated.*** Lawmakers and industry groups have expressed concerns that the Financial Stability Board (FSB), an international forum, designation process of globally systemically important banks and insurers is superseding FSOC's designation process or being used to make FSOC designations inevitable.[17] Under Basel III, companies designated by FSB are subject to higher capital standards. It is still uncertain how the FSB process and implications coexist with those of FSOC.

Several bills being considered in Congress attempt to alter FSOC's designation process or the specifics subsequent enhanced regulation. For example:

· *H.R. 613*, the Systemic Risk Mitigation Act, would repeal requirements for enhanced supervision and prudential standards by the Federal Reserve Board of SIFI-designated companies.

· *H.R. 4060*, the Systemic Risk Designation Improvement Act of 2014, would alter the determinants of a SIFI designation that the FSOC could consider and coordinate those efforts with the Basel Committee on

Banking Supervision.

· *H.R. 4881*, passed by the House Financial Services Committee, would halt FSOC's SIFI designations of NFCs for six months.

· *H.R. 4387,* the FSOC Transparency and Accountability Act, was passed in the House Financial Services Committee to alter the reporting FSOC meetings and allow for greater scrutiny by committees of jurisdiction in Congress.

· *H.R. 5016*, the Financial Services and General Government Appropriations Act of 2014, which passed the House in July included language preventing funds from being used to designate NFCs as systemically important.

· *H.R. 5180,* the Financial Stability Oversight Council Improvement Act (Ross-Delaney Bill), is a bipartisan bill put together by members of the House Financial Services Committee to reform FSOC and OFR, add transparency and improve the processes leading to a SIFI designation.

· *S. 2270,* the Insurance Capital Standards Clarification Act of 2014, passed the Senate. It would give the Federal Reserve greater leeway in developing minimum leverage and risk-based capital requirements for NFCs designated by FSOC.

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm