

U.S. DEPARTMENT OF THE TREASURY

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Testimony of Deputy Assistant Secretary Lance Auer before the House Financial Services Financial Institutions Subcommittee on Implementing Title I of the Dodd-Frank Act: Regulating Systemically Important Nonbank Financial Institutions

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WASHINGTON - Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, thank you for the opportunity to discuss the Financial Stability Oversight Council's (the Council) rule and guidance for identifying nonbank financial companies that will be subject to enhanced prudential standards and supervision by the Federal Reserve. I serve as the Deputy Assistant Secretary for Financial Institutions at the U.S. Treasury, where I helped coordinate the work of the Council's members in developing the rule and guidance setting out the Council's process and analysis for evaluating nonbank financial companies for supervision and regulation.

In the 2007-2008 financial crisis, financial distress at certain nonbank financial companies contributed to a broad seizing up of financial markets. These nonbank financial companies were not subject to the type of regulation and consolidated supervision applied to bank holding companies, nor were there mechanisms in place to resolve the largest and most interconnected of these nonbank financial companies without causing further instability.

To address potential risks posed to U.S. financial stability by these companies, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) authorizes the Council to determine that certain nonbank financial companies will be subject to supervision by the Board of Governors of the Federal Reserve System (the Board of Governors) and to enhanced prudential standards. This authority is one of the Council's important tools to carry out its statutory duty to identify risks to financial stability and respond to emerging threats. The Council acts as a collaborative body, chaired by the Secretary of the Treasury, that brings together the expertise of the federal financial regulators, an insurance expert appointed by the President, and state regulators.

Although the Dodd-Frank Act specifically outlines the substantive considerations and procedural requirements for designating nonbank financial companies, the Council determined that a rulemaking would provide increased transparency and guidance that would be beneficial. The Council went to great lengths in its rulemaking to foster additional transparency and to obtain input from all interested parties. The Council issued an advance notice of proposed rulemaking in October 2010 and a first notice of proposed rulemaking (the First NPR) in January 2011 providing guidance on the statutory criteria and specifying the procedures that the Council will follow in assessing nonbank financial companies for designation. The Council elected to issue a second notice of proposed rulemaking (the Second NPR) in October 2011 to provide additional details regarding the framework for assessing nonbank financial companies and to offer further opportunity for public comment on the Council's proposed approach. After receiving significant input from market participants, non-profits, academics, and other members of the public, the Council's members worked in close collaboration to develop a final rule. The final rule, issued in April 2012, describes an analytic framework for designations that provides a consistent approach to determinations that incorporates both quantitative analyses and qualitative judgments.

Council members are also working closely with their international counterparts on the process for identifying global systemically important financial institutions. Treasury and U.S. regulators are active participants in the G-20 and Financial Stability Board (FSB). G-20 Leaders, at the Seoul Summit in November 2010, endorsed a policy framework developed by the FSB to address the moral hazard posed by systemically important financial institutions. Most recently, at the Cannes Summit in November 2011, G-20 Leaders requested extension of this policy framework beyond global systemically important banks to nonbanks of global systemic importance. Council members are continuing to cooperate with their international partners to ensure consistency across frameworks and the development of international standards of the highest quality. For example, the International Association of Insurance Supervisors (IAIS) is working, in cooperation with the FSB, to extend the FSB's policy framework to the insurance sector, and is developing criteria and a methodology for identifying global systemically important insurers (G-SIIs). The Federal Insurance Office (FIO) of the Treasury Department, whose director is also a member of the Council and a member of the IAIS and the IAIS Executive Committee, is pursuing an international consensus that aligns the IAIS criteria, methodology, and timing with the final rule issued by the Council. At the same time, the Council's designations under the Dodd-Frank Act are an important part of the U.S. financial reform process, and the Council will continue to move forward in implementing its framework in a timely manner.

Process for Determinations

The Council has developed a robust process for evaluating whether a nonbank financial company should be subject to Board of Governors supervision and to enhanced prudential standards. The Council will approach each determination using a consistent framework, but ultimately each designation must be made on a company-specific basis, considering the unique risks to U.S. financial stability that each nonbank financial company may pose.

The Dodd-Frank Act requires the Council to assess ten considerations when evaluating nonbank financial companies, as well as any other risk-related factors that the Council deems appropriate. The Council has grouped these ten statutory considerations into a six-category framework for its analysis. Three of these six categories seek to assess the potential impact of a company's financial distress on the broader economy: size, interconnectedness, and substitutability. The remaining three categories seek to assess the vulnerability of a nonbank financial company to financial distress: leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. An assessment of all six categories will encompass all ten of the statutory considerations.

The Council's interpretive guidance issued with its final rule explains the three-stage process that the Council generally intends to use in assessing nonbank financial companies:

Stage 1: First, the Council will apply uniform quantitative thresholds to identify those nonbank financial companies that will be subject to further evaluation.

Stage 2: The Council will analyze the nonbank financial companies identified in Stage 1 using a broad range of information available to the Council primarily through existing public and regulatory sources.

Stage 3: The Council will contact each nonbank financial company that the Council believes merits further review to collect information directly from the company that was not available in the prior stages. Each nonbank financial company that is reviewed in Stage 3 will be notified that it is under consideration and be provided an opportunity to submit written materials related to the Council's consideration of the company for a proposed determination.

If the Council approves a proposed determination, the nonbank financial company will receive a written explanation of the basis of the proposed determination. The company may then request a hearing to contest the proposed determination. After any hearing, a final determination requires a second vote of the Council.

Stage 1 Analysis

Much attention has been focused on the Stage 1 thresholds. Stage 1 is not intended to identify nonbank financial companies for a final determination. Instead, the Council developed the uniform quantitative thresholds in Stage 1 as a tool that the Council, nonbank financial companies, market participants, and other members of the public may use to assess whether a nonbank financial company will be subject to further evaluation by the Council. As noted in the final rulemaking, based on data currently available to the Council through existing public and regulatory sources, the Council has estimated that fewer than 50 nonbank financial companies meet the Stage 1 thresholds. The Council recognizes, however, that the Stage 1 thresholds may not capture all types of nonbank financial companies and all of the potential ways in which a nonbank financial company could pose a threat to financial stability. Therefore, the Council reserves the right to subject any nonbank financial company to further review if the Council believes that further analysis of the company is warranted to determine if the company could pose a threat to U.S. financial stability, regardless of whether such company meets the thresholds in Stage 1.

A nonbank financial company will be subject to further evaluation beyond Stage 1 if it has at least \$50 billion in total consolidated assets and meets or exceeds any one of the following Stage 1 thresholds:

- \$30 billion in gross notional credit default swaps outstanding for which the nonbank financial company is the reference entity;
- \$3.5 billion in derivative liabilities;
- \$20 billion of total debt outstanding;
- 15 to 1 leverage ratio, as measured by total consolidated assets to total equity; or
- 10 percent ratio of short-term debt (having a maturity of less than 12 months) to total consolidated assets.

The Stage 1 thresholds and their levels reflect the collective judgment of the Council members, in light of the statutory standards and considerations and an extensive review of applicable data and various analyses. The Council selected the Stage 1 thresholds based on their applicability to nonbank financial companies that operate in diverse financial industries and because the data underlying these thresholds for a broad range of nonbank financial companies are generally available from existing public and regulatory sources. The Council reviewed distributions of various samples of nonbank financial companies and bank holding companies to inform its judgment regarding the appropriate thresholds and their quantitative levels. The Council also considered historical testing of the thresholds to assess whether they would have captured nonbank financial companies that encountered material financial distress during the financial crisis of 2007–2008.

For U.S. nonbank financial companies, the Council intends to apply each of the Stage 1 thresholds based on the global assets, liabilities, and operations of the company and its subsidiaries. For foreign nonbank financial companies, the Council intends to calculate the Stage 1 thresholds based solely on the U.S. assets, liabilities, and operations of the foreign nonbank financial company and its subsidiaries. These thresholds add significant transparency to the designation process, beyond the statutory requirements, by helping nonbank financial companies assess whether they are likely to be subject to additional review by the Council. In addition, the Council may develop additional guidance regarding potential metrics or thresholds, as appropriate, as more data and information about firms and industries, such as asset managers, hedge funds, private equity firms, and swaps entities, become available. Any additional guidance will be released to the public.

While the Board of Governors has not issued regulations under section 170 of the Dodd-Frank Act to exempt certain types or classes of nonbank financial companies from designation, the Stage 1 thresholds provide a significant level of transparency and certainty for the public regarding the nonbank financial companies that are most likely to be subject to evaluation for designation.

Stage 2 Analysis

In the second stage of the process, the Council will conduct a comprehensive analysis of each nonbank financial company identified in Stage 1. In contrast to the application of uniform quantitative thresholds to a broad group of nonbank financial companies in Stage 1, the Council intends to evaluate the risk profile and characteristics of each individual nonbank financial company in Stage 2 based on a wide range of quantitative and qualitative industry-specific and company-specific factors. The analysis will use the six-category analytic framework described above – size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. To the extent data are available, the Council also intends in Stage 2 to consider the impact that resolving a failing nonbank financial company could have on U.S. financial stability.

In general, this analysis will be based on a broad range of information already available to the Council through existing public and regulatory sources, including information possessed by the company's primary financial regulatory agency or home country supervisor, as appropriate, and any information voluntarily submitted by the company. The Council also intends to fulfill its statutory obligation to rely whenever possible on information available through the Office of Financial Research (the "OFR"), member agencies, or the nonbank financial company's primary financial regulatory agencies before requesting the submission of information from any nonbank financial company in Stage 3.

Based on the Stage 2 analysis, the Council intends to contact those nonbank financial companies that the Council believes merit further evaluation in Stage 3.

Stage 3 Analysis

The Council will conduct a review of each nonbank financial company in Stage 3 using information collected directly from the nonbank financial company, as well as the information used in the first two stages. At the beginning of Stage 3, the Council will send a notice of consideration to each nonbank financial company that will be reviewed in Stage 3. Notified companies will be provided an opportunity to submit materials to the Council. This opportunity for the company to submit materials to contest the Council's consideration of the company for a proposed determination is an additional protection, not statutorily required, that the Council provided in its final rule.

The notice of consideration likely will also include a request that the nonbank financial company provide information that the Council deems relevant to its evaluation. This information will generally be collected by the OFR. Before requiring the submission of reports from any nonbank financial company that is regulated by a Council member agency or any other primary financial regulatory agency, the Council will coordinate with such agencies and will, whenever possible, rely on information available from the OFR or from such agencies. The

Council will also consult with appropriate foreign regulatory authorities, to the extent appropriate. Council members and their agencies and staffs will maintain the confidentiality of such information in accordance with applicable law.

In its analysis under the six-category framework, the Council will consider both quantitative and qualitative information. The Council expects that the information necessary to conduct an in-depth analysis of a particular nonbank financial company may vary significantly based on the nonbank financial company's business and activities and the information already available to the Council from existing public sources and domestic or foreign regulatory authorities. Information relevant to the Council's analysis may include confidential business information such as internal assessments, internal risk management procedures, funding details, counterparty exposure or position data, strategic plans, resolvability, potential acquisitions or dispositions, and other anticipated changes to the nonbank financial company's business or structure that could affect the threat to U.S. financial stability posed by the nonbank financial company. The Council will also consider qualitative factors that include considerations that could mitigate or aggravate the potential of the nonbank financial company to pose a threat to U.S. financial stability, such as the nonbank financial company's resolvability, the opacity of its operations, its complexity, and the extent and nature of its existing regulatory scrutiny.

The objective of the Stage 3 analysis is to assess whether a nonbank financial company meets one of the statutory standards for a determination: that is, whether the company's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to U.S. financial stability.

At the end of Stage 3, based on the results of the analyses conducted during each stage of review, the Council may, by a vote of at least two-thirds of the Council's voting members then serving, including an affirmative vote by the Chairperson of the Council, make a proposed determination regarding the company. If a proposed determination is made, the Council will provide the nonbank financial company with a written explanation of the basis of the proposed determination. The company may request a hearing to contest the proposed determination. After any hearing, in order to make a final determination, the Council must again vote by a two-thirds majority of the Council's voting members then serving, including an affirmative vote by the Chairperson. The Council will publicly announce all of its final determinations, as required by the Dodd-Frank Act. The Council is also required, by statute, annually to reevaluate currently effective determinations and rescind any determination if the Council determines that the nonbank financial company no longer meets the standards for determination.

Revisions to the Rule and Interpretive Guidance Based on Public Comment

In response to comments on the First NPR, the Council incorporated numerous additions and changes in the Second NPR. Most notably, the Council added extensive interpretive guidance that outlined the three-stage process described above, including the addition of the uniform, quantitative Stage 1 thresholds and sample metrics for each item in the six-category analytic framework. In response to requests from commenters, the Council also added definitions of the terms "threat to the financial stability of the United States" and "material financial distress" with respect to the statutory determination standards to the interpretive guidance, and added a confidentiality provision to the rule. In addition, the Second NPR included greater safeguards for nonbank financial companies under evaluation, including a requirement for a notice from the Council to companies upon completion of the Council's evidentiary record in Stage 3, and a 180-day deadline for a proposed determination after that notice is sent; and greater clarity on the process for emergency waivers or modifications of the otherwise applicable procedural requirements.

In developing the final rule and guidance, the Council made a number of additional changes in response to comments on the Second NPR. The final rule provides greater clarity on the confidentiality provisions that will apply to information submitted voluntarily by nonbank financial companies and information that is collected from regulators that are not Council members. The final rule and guidance also include additional procedural steps to benefit nonbank financial companies and aid the Council's analysis, including an intention to consult with primary financial regulatory agencies of a company's significant subsidiaries in Stage 2, when appropriate; an intention to provide at least one business day's notice to a firm before publicly announcing its designation following a final determination; and additional notice and opportunity for firms to submit information in annual reevaluations of designated companies. The final rule also provides greater clarity on a number of issues, including the definition of "company"; how the Council may consider managed funds and fund advisors; and several clarifications to the definitions, calculations, and processes for applying the Stage 1 thresholds.

Determinations

The Council will exercise its judgment as it considers both quantifiable metrics and the unique risks that a particular nonbank financial company may present to the financial system. This flexibility will allow the Council to address the diverse range of business models among nonbank financial companies. Moreover, given the dynamic nature of financial markets and the evolution of financial products and services, the Council will need the ability to take such changes into account in its determinations. Ultimately, in accordance with the Dodd-Frank Act, all designations will be based on a determination that a company's material financial distress – or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company – could pose a threat to U.S. financial stability.

Every designation decision will be firm-specific, and every firm will receive robust due process protections, including the opportunity for judicial review of any final designation. Even before the Council votes on a proposed designation, a company under consideration will have the opportunity to submit written materials to the Council addressing whether, in the company's view, it meets the standard for designation. Only after Council members have reviewed that information will they vote on a proposed designation, which requires the support of two-thirds of the Council (including the affirmative vote of the Chairperson) and after which the Council will provide the company with a written explanation of the basis of the proposed designation. If challenged, the proposed designation is subject to review through a formal hearing process and another two-thirds Council vote. The Council must report to Congress annually on all final designations and the basis for such designations.

In the wake of the 2007-2008 financial crisis, Congress included in the Dodd-Frank Act the authority for the Council to designate nonbank financial companies that could pose a threat to U.S. financial stability. The designations process described in the Council's rule and guidance is the result of over a year of dialogue with market participants, non-profits, academics, and members of the public. The resulting rule and guidance form an important part of the Council's ability to carry out its statutory duties to identify risks to financial stability and respond to such threats in order to better protect the U.S. financial system.

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