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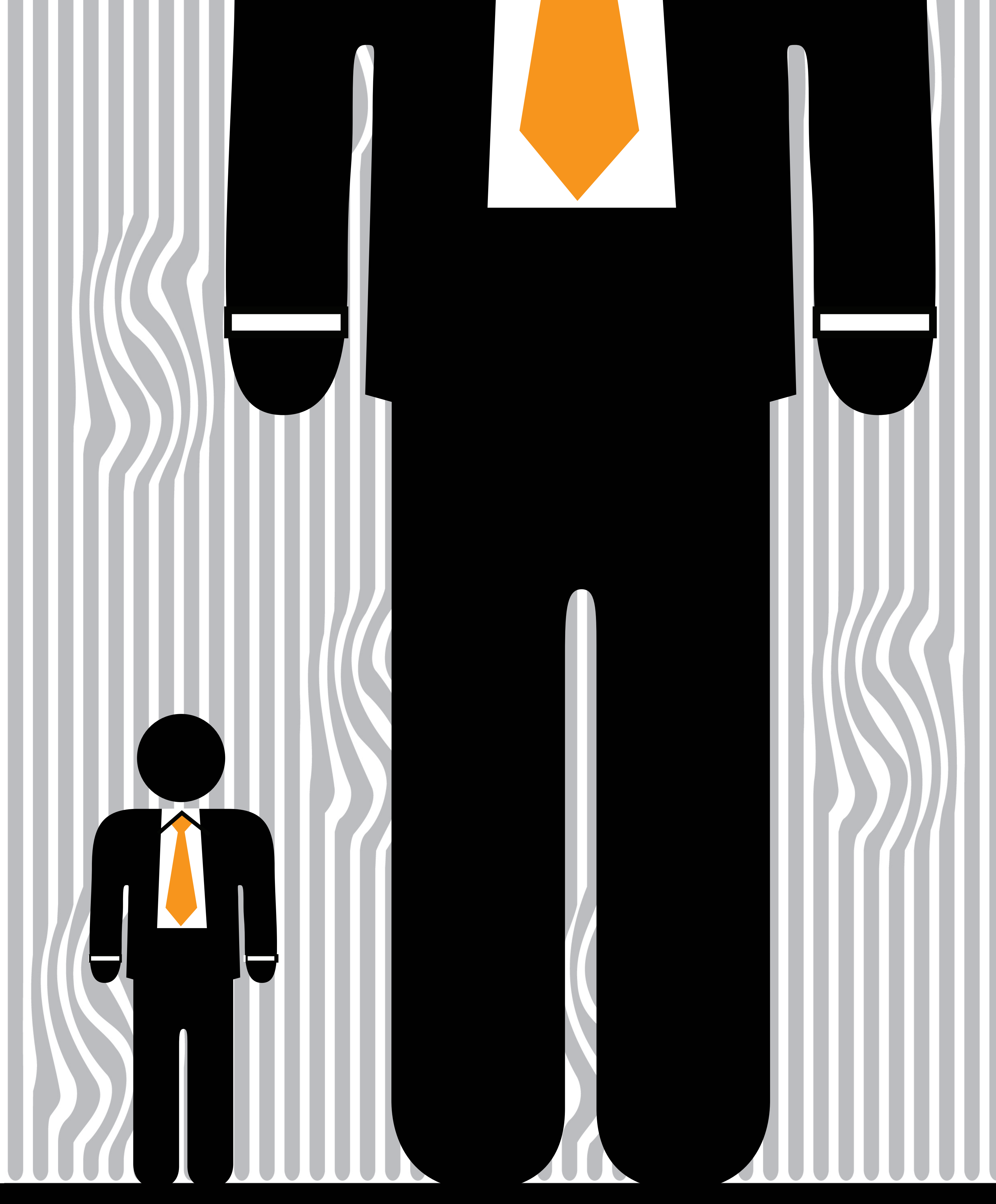
HOW BIG IS TOO BIG?

An explanation of what qualifies as a systemically important financial institution and the new rules those businesses will have to adhere to. By Jeffrey Schlinsog and Thomas Sullivan



During the financial crisis, a host of financial institutions contributed to and were impacted by the accompanying severe economic distress, including certain nonbank financial institutions. These nonbank financial companies (NBFCs) were not subject to the type of prudential regulation and supervision applied to U.S. banking organizations, nor were effective resolution mechanisms in place to address potential systemic risks at the largest and most interconnected financial firms.

In response, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or the act). This act introduced the concept of macroprudential regulation to foster and protect the financial stability of the United States. A key objective of Dodd-Frank is to subject systemically important financial institutions (SIFIs) to enhanced prudential standards to limit any impact their distress may have on financial stability. Congress determined that any bank holding company with $50 billion or more in assets would be a SIFI, as would any foreign bank with U.S. banking operations that have worldwide assets of $50 billion or more. In the case of NBFCs, which include insurance companies, Congress left the question of which NBFCs should be designated as SIFIs to the Financial Stability Oversight Council (FSOC or the council). After much deliberation, on April 3, 2012, the FSOC approved the final rule and interpretive guidance it will use for determining when an NBFC is deemed systemically important to U.S. financial stability.

The council emphasized that its determinations would be on a case-by-case basis. Requests by several segments of the financial services industry (including insurance) to essentially exempt their segment from designation were rejected. On May 16, 2012, Congress conducted a hearing on the final rules and heard several concerns expressed by the insurance industry and its regulators over the possible designation of insurance companies. Chief among these are that insurers are not systemically important and are not suited to be regulated under a banking model.

DEFINITION OF FINANCIAL ACTIVITIES

Under Dodd-Frank, an NBFC is defined to be a company that is "predominantly engaged in financial activities," which means 85 percent or more of its activities in insurance and annuity related businesses as well as credit, real estate, asset management, securities underwriting and merchant banking.

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TREATMENT OF NONBANK FINANCIAL INDUSTRY SECTORS

In addition to insurers, several other sectors of the nonbank financial services industry (including asset managers, captive finance companies, money-market funds and the Federal Home Loan Banks) requested that the council exclude their respective industry from consideration, due to structural or other factors that make them less likely to raise systemic concerns. In the opinions of these NBFCs, it would be inappropriate to subject them to the type of enhanced prudential standards that are based on a bank holding company model. Nevertheless, the council stated that it would not provide industry-based exemptions from potential determinations, yet it does intend to afford such arguments due consideration in the determination process.

In certain comments received, clarification had been requested by hedge funds as to whether separate funds would be considered separately for purposes of total consolidated assets. The final rule remained ambiguous, as 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 DESIGNATION PROCESS

For the designation process, the final rule describes a "three stage" process that will be followed by the council for determining whether an NBFC may pose a threat to the financial stability of the United States. 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 designate an NBFC as a SIFI under the act, either of two determinations must be made—(i) that material financial distress at the NBFC would pose a threat to U.S. financial stability, or (ii) the nature, scope, size, scale, concentration, interconnectedness or mix of the activities at the NBFC could pose a threat to U.S. financial stability. In making a determination, the council must consider a number of statutory factors that 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 an 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 1 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 (CDS) outstanding for which an 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. 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. This means a surplus-to-assets ratio under 6.67 percent.

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 the amount above.

WILD CARD AUTHORITY

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

Although there is no notice provision for Stage 2, 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 guidance accompanying the final rule sets forth in some detail the types of information—including qualitative information—which the council will be seeking.

FURTHER EXPLANATIONS AND CLARIFICATIONS

In the final rule, in response to other comments received, the FSOC provided further

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What Is FSOC?

UNDER THE DODD-FRANK ACT, the Financial Stability Oversight Council (FSOC) was established to help provide comprehensive monitoring to ensure the stability of the United States financial system. The council is charged with identifying threats to the financial stability of the United States, promoting market discipline and responding to emerging risks. Comprised of 10 voting members and five nonvoting members, the council consists of federal financial regulators, state regulators and an insurance expert as appointed by the president.

explanation and clarification on various items including:

- **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 U.S. nonbank financial companies, but only U.S. 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.** An NBFC's resolvability may mitigate or aggravate, as the case may be, the potential threat to U.S. 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 an NBFC being considered for a determination.

FOR A LARGE NBFC, WHAT DOES ALL THIS REALLY MEAN?

The implications of being determined a SIFI place significant burdens, both real and perceived, upon those NBFCs officially designated. The burden will most likely be greatest on the first round of designees as the potential impacts 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. Enhanced prudential standards for SIFIs (whether a bank holding company or NBFC) include higher capital and augmented liquidity requirements. SIFIs will also be subject to enhanced oversight, including the mandatory submission of resolution plans and prudential regulations and supervision by the Federal Reserve in selected areas such as increased levels of capital and liquidity.

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).

While no large NBFC gets a lifetime pass from designation, there are several other provisions of the act and the Group of 20 (G-20) 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 Federal Reserve 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.

At the same time, the FSOC may also take into consideration the International Association of Insurance Supervisors (IAIS) efforts, as they are currently developing their own process for designation of Globally Significant Important Insurers (G-SIIs). The IAIS (an organization of international insurance regulators), has been deputized to recommend G-SIIs, which will ultimately be determined by G-20 members. A data call was commissioned by the IAIS during 2011, where U.S. insurers submitted data confidentially for review. In the IAIS' review of the data collected, the need to establish common metrics and trigger criteria was revealed. After several months of deliberations to develop its criteria, on May 31, 2012, the IAIS' rule was proposed for a 60-day comment period (which ended on July 31, 2012). After the criteria is set, a second data call will be issued, which is expected to occur during 4Q2012, with G-SII determinations and recommendations expected to occur during early 2013. The IAIS feels its approach is consistent and aligned with the FSOC, which may lead the FSOC to wait until the final recommendations are made by the IAIS to ensure international consistency—a key objective of the G-20 process. In its proposed rule, the IAIS devoted discussion toward the deference shown to the jurisdictional regulator, and the need to share information amongst regulatory agencies.

In its proposed rule, the IAIS recognized how the traditional insurance business model has several unique features that are not typically found in banking, and therefore, in their view, less risky than banking. However, here in the United States, the FSOC made no such delineation for specific industries in establishing the systemic risk criteria. Such unique features identified by the IAIS as compared to banking include the technique of pooling insurance risk, a liability-driven investment approach, cash outflows that occur over an extended period of time, and a high degree of substitutability.

The proposed measures for the IAIS criteria include both quantitative and qualitative components, consisting of an 18-point system divided into five categories covering size, global activity, interconnectedness, substitutability, nontraditional and non-insurance activities. The criteria of the IAIS and proposed weighting factors to those criteria are also distinctive from the FSOC, advocating that size alone should not be a determining factor. In fact, the IAIS opines that size in traditionally regulated insurance is actually a favorable characteristic since "in an insurance context size is a prerequisite for effective pooling and diversification of risks," and thus assign a 5 to 10 percent weighting factor to size criteria. On the other hand, the IAIS assigns the most significant weight to two of its other criteria, those being 1) "Non-Traditional and Non-Insurance Activities" (40 to 50 percent), and 2) "Interconnectedness" (30 to 40 percent). Unlike the FSOC approach, the IAIS methodology adds the criteria of international activity and type of activities an insurer engages in, recognizing the unique features of insurance, such as the long horizon of insurance liabilities, the concept of pooling of risks, insurable interest, and cash claims patterns.

IN CONCLUSION

The adoption of final rules for designating SIFIs is one more milestone in the slow but steady implementation of Dodd-Frank. The process has been deliberate, reflecting the complexity of the issues, the vast amount of comments received from industry and interested parties, and resource constraints at the Federal Reserve.

In the next three to five years, insurance industry participants will fall into one of three camps. First, there may be a handful, or less, that are designated as SIFIs and made subject to Federal Reserve oversight. As some are already finding, they will have to build out significant infrastructure to comply with this additional enhanced supervision.

Next, there will be a group of 30 or so companies that meet the NBFC threshold of more than $50 billion in total assets, but are not deemed to be SIFIs. These companies will linger in an under watch status for an unspecified period of time, effectively creating a form of self-regulation of all potential NBFC-SIFIs to avoid being deemed systemic. These companies may operate with an eye toward not piercing the Stage 1 thresholds. While they are not subject to Federal Reserve supervision, they may begin to develop capabilities to satisfy those enhanced standards to the extent it makes good business sense.

The balance of the industry will not be directly impacted by Dodd-Frank except as it may impact centralized clearing of derivatives or limitations placed on counterparties. To date there is no indication that the NAIC will incorporate Federal Reserve enhanced supervision standards that so far are grounded on bank holding company oversight. Rather, the NAIC is clearly committed to its statutory insurance regulatory regime and is currently enhancing it under the Solvency Modernization Initiative. This system has proven to be effective in regulating insurance company solvency and is likely to persist for the foreseeable future. A

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