

REPORT TO THE PRESIDENT OF THE UNITED STATES
Pursuant to the Presidential Memorandum Issued April 21, 2017

Financial Stability Oversight Council Designations

NOVEMBER 17, 2017



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1 Executive Summary

1.1 Introduction

On April 21, 2017, the President issued a Presidential Memorandum (the Presidential Memorandum) directing the Secretary of the Treasury to conduct a thorough review of the determination and designation processes of the Financial Stability Oversight Council (the Council) under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and to report to the President. This report has been prepared by the U.S. Department of the Treasury, under the direction of Secretary Steven T. Mnuchin, in response to the Presidential Memorandum.

In preparing this report, Treasury consulted extensively with a wide range of stakeholders, including nonbank financial companies, financial market utilities, trade groups, academics, public interest organizations, consumer advocates, federal and state regulators, and others. Treasury also reviewed the Council's previous written analyses and research from public and private sources.

Treasury incorporated the perspectives from these stakeholders in evaluating how the Council has conducted its determination and designation processes and in developing recommendations. A list of organizations and individuals who provided input to Treasury in connection with the preparation of this report is set forth as Appendix A.

In accordance with the Presidential Memorandum, this report evaluates and provides recommendations regarding two separate processes of the Council: (1) the Council's process for making determinations that nonbank financial companies shall be supervised by the Board of Governors of the Federal Reserve System (the Federal Reserve) and subject to enhanced prudential standards, and (2) the Council's process for designating financial market utilities (FMUs) as systemically important. Section 2 of this report addresses nonbank financial companies, and section 3 addresses FMUs.

The Council's determinations and designations have serious implications for affected entities, the industries in which they operate, and the U.S. economy. Therefore, it is important to ensure that the Council's processes promote market discipline, address risks to U.S. financial stability as appropriate, and are transparent to firms and the public. The review of each process was organized around three broad issues:

- The effects and efficacy of the Council's processes;
- The rigor of the Council's analyses; and
- The Council's engagement and transparency with firms, regulators, and the public.

1.2 Scope of the Presidential Memorandum

The Presidential Memorandum directs the Secretary of the Treasury to conduct a thorough review of the Council's processes for making determinations regarding nonbank financial companies under section 113 of the Dodd-Frank Act and designations of FMUs under section 804 of the Dodd-Frank Act. The Presidential Memorandum directs the Secretary to consider the following, along with any other considerations the Secretary deems appropriate:

- (a) whether these processes are sufficiently transparent;
- (b) whether these processes provide entities with adequate due process;
- (c) whether these processes give market participants the expectation that the federal government will shield supervised or designated entities from bankruptcy;
- (d) whether evaluation of a nonbank financial company's vulnerability to material financial distress should assess the likelihood of such distress;
- (e) whether any determination as to whether a nonbank financial company's material financial distress could threaten the financial stability of the United States should include specific, quantifiable projections of the damage that could be caused to the United States economy, including a specific quantification of estimated losses that would be likely if the company is not subjected to supervision under section 113 of the Dodd-Frank Act;
- (f) whether these processes adequately consider the costs of any determination or designation on the regulated entity;
- (g) whether entities subject to a Council determination under section 113 or designation under section 804 of the Dodd-Frank Act are provided a meaningful opportunity to have their determinations or designations reevaluated in a timely and appropriately transparent manner; and
- (h) whether, prior to being subject to a Council determination under section 113 or designation under section 804 of the Dodd-Frank Act, the entity should be provided with information on how to reduce perceived risk, so as to avoid being subject to such determination or designation.

In addition, section 2 of the Presidential Memorandum directs the Secretary of the Treasury to evaluate and report whether the activities of the Council related to the determination and designation processes are consistent with Executive Order 13772 of February 3, 2017 (Core Principles for Regulating the United States Financial System) (the Executive Order). The Executive Order states that it shall be the policy of the Administration to regulate the U.S. financial system in a manner consistent with the core principles set forth therein.

The core principles are:

- (a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
- (b) prevent taxpayer-funded bailouts;
- (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;

- (d) enable American companies to be competitive with foreign firms in domestic and foreign markets;
- (e) advance American interests in international financial regulatory negotiations and meetings;
- (f) make regulation efficient, effective, and appropriately tailored; and
- (g) restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.

The Presidential Memorandum also directs the Secretary of the Treasury, to the extent consistent with law, not to vote for any non-emergency proposed determinations or any non-emergency proposed designations until submission of this report.

1.3 The Council and Its Authorities

Overview of the Council

In response to the financial crisis of 2007 to 2009, the Dodd-Frank Act established the Council to bring together the financial regulatory community to identify and respond to emerging threats to financial stability. The statutory purposes of the Council are:

- (a) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
- (b) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the government will shield them from losses in the event of failure; and
- (c) to respond to emerging threats to the stability of the U.S. financial system.¹

The Council, chaired by the Secretary of the Treasury, consists of 10 voting members and five nonvoting members.² The voting members are:

- the Secretary of the Treasury;
- the Chairman of the Federal Reserve;
- the Comptroller of the Currency;
- the Director of the Bureau of Consumer Financial Protection;
- the Chairman of the Securities and Exchange Commission (SEC);
- the Chairperson of the Federal Deposit Insurance Corporation (FDIC);
- the Chairperson of the Commodity Futures Trading Commission (CFTC);
- the Director of the Federal Housing Finance Agency;
- the Chairman of the National Credit Union Administration Board; and

¹ Dodd-Frank Act section 112(a)(1), 12 U.S.C. § 5322(a)(1).

² Dodd-Frank Act section 111(b), 12 U.S.C. § 5321(b).

- an independent member with insurance expertise who is appointed by the President and confirmed by the Senate.

The nonvoting members, who serve in an advisory capacity, are:

- the Director of the Office of Financial Research;
- the Director of the Federal Insurance Office;
- a state insurance commissioner designated by the state insurance commissioners;
- a state banking supervisor designated by the state banking supervisors; and
- a state securities commissioner (or officer performing like functions) designated by the state securities commissioners.³

Key Authorities of the Council

The Dodd-Frank Act provides the Council with numerous authorities and tools to carry out its duties. Pursuant to section 113 of the Dodd-Frank Act, if the Council determines that a nonbank financial company’s material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of a nonbank financial company, could pose a threat to the financial stability of the United States, the Council may determine that the company shall be subject to supervision by the Federal Reserve and enhanced prudential standards.⁴ Section 804 of the Dodd-Frank Act authorizes the Council to designate certain FMUs and financial activities as “systemically important,” and thus subject the designated FMUs, or financial institutions engaged in the designated financial activities, to certain risk management standards, among other things.⁵

In addition to its designation authorities,⁶ the Council has the authority to make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice conducted by bank holding companies or nonbank financial companies under the jurisdiction of such agencies if the Council determines that such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, U.S. financial markets, or low-income, minority, or underserved communities.⁷ The Council may also make recommendations to the Federal Reserve concerning the establishment and refinement of enhanced prudential standards applicable to nonbank financial companies supervised by the Federal Reserve pursuant to a Council designation under section 113 of the Dodd-Frank Act.⁸ Further, the Council can approve of an action by the Federal Reserve to

³ Dodd-Frank Act section 111(b), 12 U.S.C. § 5321(b).

⁴ Dodd-Frank Act sections 113(a)(1), (b)(1), 12 U.S.C. §§ 5323(a)(1), (b)(1).

⁵ Dodd-Frank Act section 804(a)(1), 12 U.S.C. § 5463(a)(1).

⁶ The Dodd-Frank Act uses the term “determination” with respect to nonbank financial companies in section 113 and generally uses the term “designation” with respect to FMUs and financial activities in section 804. For ease of reference, this report uses these terms interchangeably.

⁷ Dodd-Frank Act section 120, 12 U.S.C. § 5330.

⁸ Dodd-Frank Act section 115, 12 U.S.C. § 5325.

impose restrictions on certain bank holding companies or nonbank financial companies to mitigate a grave threat to U.S. financial stability.⁹

1.4 Policy Goals for the Council's Processes

In conducting this review and developing recommendations regarding the Council's designation processes, Treasury identified five goals that the Council's processes should be designed to achieve:

- Leverage the expertise of primary financial regulatory agencies;
- Promote market discipline;
- Maintain a level playing field among firms;
- Appropriately tailor regulations to minimize burdens; and
- Ensure the Council's designation analyses are rigorous, clear, and transparent.

Each of these goals is described below.

Leverage the Expertise of Primary Financial Regulatory Agencies

Nonbank financial companies are supervised and regulated by a myriad of regulators. In many cases, a nonbank financial company's primary financial regulator is represented on the Council. The Council's designation processes should leverage the insight of a company's primary regulator, because of its expertise and knowledge regarding the company and the markets in which the company operates. The primary regulator has an existing relationship with the company and can efficiently and effectively address potential risks.

Promote Market Discipline

One of the Council's three statutory purposes is to promote market discipline. The Dodd-Frank Act gives the Council the mission of "eliminating expectations on the part of shareholders, creditors, and counterparties of [large, interconnected bank holding companies or nonbank financial companies] that the Government will shield them from losses in the event of failure."¹⁰ Designation by the Council, therefore, should not imply that the government will rescue the designated firm in the event of failure. A market expectation of such a rescue could cause inefficient investment decisions and increased risk-taking. Nor should government discipline be substituted for the market discipline of investors, counterparties, and clients as a result of the designation process.

⁹ Dodd-Frank Act section 121, 12 U.S.C. § 5331.

¹⁰ Dodd-Frank Act section 112(a)(1)(B), 12 U.S.C. § 5322(a)(1)(B).

Maintain a Level Playing Field Among Firms

Firms engaged in the same activity should be treated uniformly based on how the activity may contribute to risk. Failure to do so could distort free markets. Further, the Council's designation processes should promote the domestic and global competitiveness of U.S. financial institutions.

The Council's designations result in increased regulatory costs for firms, which may be passed on to customers in the form of increased prices. Higher prices could lead customers to switch to more competitively priced products offered by less-regulated companies, causing a migration of activities outside the regulatory perimeter that could eliminate the financial stability benefit that the Council's action is intended to achieve. At the same time, a company subject to a Council designation should not receive a financial advantage from any perception that the government may rescue the company in the event of its failure. Such a perception could give the company an unfair competitive advantage in funding markets.

Appropriately Tailor Regulations to Minimize Burdens

Regulatory requirements can impose substantial costs on companies that are likely to be passed on to consumers in some combination of higher costs and a reduction in the availability of products and services, or to shareholders in the form of reduced returns on their investment. Any supervision or enhanced prudential standards imposed on a company should be appropriately tailored for the risks the company may pose, to avoid unnecessary burdens.

Ensure the Council's Designation Analyses Are Rigorous, Clear, and Transparent

The Council's designations have serious implications for affected entities, the industries in which they operate, and the U.S. economy. Public accountability and due process can only be assured if the Council's analyses are rigorous and its processes are transparent. This includes clear statements from the Council about its application of legal standards and the risks it has identified. Firms should understand the Council's processes and firms' activities or attributes that might lead to a designation. In addition, the Council should ensure that it provides the public with sufficient information to understand the Council's concerns regarding risks to financial stability, while protecting sensitive, confidential information submitted by companies and regulators to the Council.

1.5 Summary of Recommendations for Nonbank Financial Company Designations

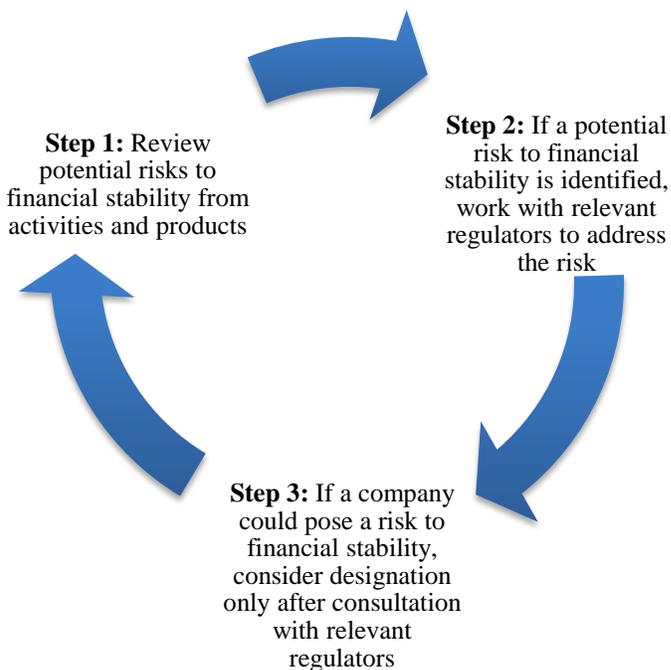
During Treasury's review of the Council's process for nonbank financial company designations, stakeholders raised a number of significant criticisms. Many of the concerns focus on the Council's transparency, as well as the analytical process it applies in making decisions about particular firms. Designations have serious implications for affected entities, the industries in which they operate, and the economy at large. But it is difficult to predict with precision the impact that the failure of any nonbank financial company will have on financial stability. The appropriateness of the nonbank financial company designations tool as a mechanism for mitigating potential risks to U.S. financial stability should therefore be considered. The

challenges associated with assessing systemic risk and designation underscore the need for the Council to make every effort for its analyses to be rigorous, clear, and comprehensible to firms and to the public, and to be undertaken only when the expected benefits to financial stability exceed the costs imposed on the designated firm.

Following is a summary of the recommendations in this report.

Prioritizing an Activities-Based or Industry-Wide Approach to Potential Risks Posed by Nonbank Financial Companies

The Council’s authority to designate nonbank financial companies is a blunt instrument for addressing potential risks to financial stability. Treasury recommends that the Council prioritize its efforts to address risks to financial stability through a process that emphasizes an activities-based or industry-wide approach. Specifically, Treasury recommends that the Council implement a three-step process for assessing and addressing potential risks to financial stability:



Increasing the Analytic Rigor of Determination Analyses

Treasury makes the following specific recommendations regarding the Council’s analyses of the risks to U.S. financial stability that a nonbank financial company could pose under this company-specific designation approach:

- The Council should revise its interpretive guidance to provide for assessment of the likelihood of a firm’s material financial distress, in order to assess the extent to which a designation would promote U.S. financial stability. Further, an evaluation of the factors

that may lead to a firm’s failure—and factors that mitigate those risks—will provide the Council with additional insights relevant to its analyses.

- The Council should revise its interpretive guidance to provide that it will designate a nonbank financial company only if the expected benefits to financial stability outweigh the costs that designation would impose. Agency regulatory action is appropriate only if it does more good than harm, and there can be no confidence in this regard unless the Council seeks to weigh the costs and benefits of its actions.
- The Council’s analyses of the “exposure transmission channel” should take into account factors that would reduce the losses a nonbank financial company’s counterparties and other market participants would experience in the event of the company’s material financial distress. The extent to which exposures are mitigated in a manner that reduces the risks posed by the company is a relevant factor in assessing the potential effects of a company’s material financial distress.
- The Council’s analyses of the “asset liquidation transmission channel” should quantitatively evaluate and specifically explain the means by which a company’s asset fire sale could disrupt trading or funding markets or cause significant losses or funding problems for other companies with similar holdings. Historical examples can give insight into the financial stability risks associated with nonbank financial companies relying on short-term funding and the behavior of a company’s counterparties and customers.

Treasury has also identified two other reforms that would enhance the Council’s processes:

- The Council should consider amending the consolidated assets threshold it applies to nonbank financial companies in Stage 1 of its process. In Stage 1, the Council evaluates nonbank financial companies by applying six uniform quantitative thresholds that are broadly applicable across the financial sector to a large group of nonbank financial companies. The current Stage 1 threshold for consolidated assets is \$50 billion. The Council should consider amending this threshold to more appropriately tailor it to the risk that an institution could pose to financial stability.
- The Council should combine Stages 1 and 2 of its nonbank financial company determinations process. This would clarify the Council’s process and make it more consistent with the process the Council uses in its FMU framework.

Improving Engagement and Transparency in the Determinations Process

Treasury is making recommendations for reforms to the Council’s engagement with nonbank financial companies under review for potential designation and their regulators, and to the Council’s transparency to the public.

- *Engagement with nonbank financial companies under review.* Treasury recommends that the Council enhance its communication with nonbank financial companies under review for a potential determination. Specifically, staff on the Council’s analytical team should explain to the company the specific risks that have been identified in the preliminary analysis. If a company is aware of the potential risks the Council has identified during its preliminary review, the company can take action to mitigate those risks prior to a Council designation. Company actions that reduce their risks help achieve the Council’s goal of addressing potential threats to U.S. financial stability.
- *Engagement with primary regulators.* Treasury recommends that the Council undertake greater engagement with a nonbank financial company’s primary financial regulator during the Council’s evaluation of the company for a potential determination. The primary regulator can provide the Council with unique insights into the company and its operations, activities, and risks. Additionally, a primary regulator may be able to take action to mitigate risks identified by the Council prior to a Council determination.
- *Public transparency.* Treasury recommends that the Council publicly release the explanation of the Council’s basis for any future nonbank financial company determinations and rescissions of determinations, redacting as necessary to protect confidential information from the company or its regulators. This approach will provide the public with the greatest possible understanding of the Council’s reasons for its actions.

Providing a Clear “Off-Ramp” for Designated Nonbank Financial Companies

Treasury recommends the Council provide a clear “off-ramp” to designated nonbank financial companies for achieving a rescission of their designations. First, the Council should articulate to a designated nonbank financial company the key risks that led to the designation, including clear guidance regarding the factors that were most important in the Council’s determination. Second, the Council should adopt a more robust and transparent process for its annual reevaluations. Such a process should make clear how companies can engage with the Council and its representatives, and what information companies should submit during a reevaluation. The process should also enable engagement with a company regarding the substance of the Council’s analysis and changes to the company’s risk profile over time. Finally, the Council should develop a process to enable a designated company to discuss potential changes it could make to address the risks it could pose to financial stability, and to receive feedback regarding whether those changes may address the Council’s concerns. Such a process may incentivize designated companies to address the key factors that led to the determination—and would therefore help the Council achieve its goal of reducing risks to U.S. financial stability.

1.6 Summary of Recommendations for FMU Designations

As fully described in Treasury’s report issued under the Executive Order regarding capital markets (the Treasury Capital Markets Report),¹¹ FMUs perform clearing, settlement, and transmission services that are critical to the U.S. financial system, particularly in light of market reforms required by Title VII of the Dodd-Frank Act. The Council’s authority to designate FMUs under the Dodd-Frank Act is separate from its authority to designate nonbank financial companies. The Council’s FMU designation authority applies a different standard for Council action, takes into account different factors, and covers different types of firms than the Council’s nonbank financial company designation authority.

FMUs are vital to the functioning of the financial system and are addressed in detail in the Treasury Capital Markets Report. That report suggests that by virtue of the scale of their activities, market reliance, and lack of competitive alternatives to services provided, the FMUs inherently present systemic risk upon their potential failure. This report describes the Council’s authorities and practices relating to FMU designations and makes a number of recommendations for enhancements. In particular, Treasury recommends retaining the designation process for FMUs, adding important enhancements to improve the analytical rigor, engagement, and transparency of the process, and ensuring that the designation process is individualized and appropriately tailored. In addition, Treasury recommends that key issues related to FMU operation, designation, and resolution, such as Federal Reserve account access and potential access to Federal Reserve emergency facilities, be studied further.

Resilience, Recovery, and Resolution

The Federal Reserve, the CFTC, and the SEC have taken steps intended to enhance the resilience of designated FMUs and their ability to recover from stress events. Treasury recommends that the agencies continue to coordinate the supervision of designated FMUs and continue to work collaboratively to develop effective resolution strategies focused on ensuring the continuity of the critical services provided by these entities.

Considering the Costs and Benefits of Designations

Treasury recommends that the Council consider incorporating cost-benefit analyses into its evaluations of FMUs for potential designation. Designated FMUs are subject to additional regulatory and supervisory requirements imposed by the Federal Reserve, the SEC, and the CFTC. Designations therefore impose real costs on firms, including the costs of maintaining risk-management standards required by the relevant supervisory agency and compliance costs associated with additional supervision. Benefits include potentially enhancing U.S. financial stability and forcing FMUs to internalize the costs of the risks they pose to financial stability.

¹¹ U.S. Department of the Treasury, “A Financial System That Creates Economic Opportunities: Capital Markets” (October 2017), p. 151, available at <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>.

The designated firms also benefit from the safety associated with depositing client margin in Federal Reserve Bank accounts.

Enhancing Engagement Between the Council and FMUs Under Review

Treasury recommends that the Council enhance communication with FMUs during Stage 2 of its process. Once an FMU is under review in Stage 2, the Council should notify the company and communicate specific areas of focus identified by Council staff during the preliminary analysis. The firm should have an opportunity to respond to staff analysis with an explanation of its views on staff's considerations.

Enhancing Engagement Between the Council and FMUs' Primary Regulators

Treasury recommends that the expertise of the primary financial regulatory agencies be leveraged to inform any consideration of whether to designate an FMU, and also to inform strategies for regulating and supervising designated FMUs. The Council should engage with the primary regulators of FMUs to enhance the resilience of FMUs, with a focus on identifying and monitoring potential threats to financial stability that could be related to or mitigated through FMUs' activities.

Enhancing the Council's Public Transparency Regarding FMU Designations

Treasury recommends that the Council publicly release the explanation of the Council's basis for any future FMU designations, redacting as necessary to protect confidential information from the company or its regulators.

1.7 Refocusing the Council's Processes in Alignment with the Core Principles

As noted above, the Executive Order sets forth core principles for regulating the U.S. financial system. The recommendations outlined in this report would refocus the Council's designation processes with the core principles:

- Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth, by reducing regulatory burdens on financial institutions that could lead to higher costs and less choice for clients and consumers of financial services.
- Prevent taxpayer-funded bailouts, by avoiding moral hazard, using the most effective means to address risks to financial stability, and creating expectations that nonbank financial company liabilities will not be guaranteed by the government.
- Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry, by taking into account the costs and benefits of designation and factors relating to a firm's likelihood of material financial distress.

- Enable American companies to be competitive with foreign firms in domestic and foreign markets, by promoting a level playing field among all financial institutions operating in a particular market or conducting particular activities.
- Advance American interests in international financial regulatory negotiations and meetings, by ensuring that the Council's processes advance U.S. interests before international organizations.
- Make regulation efficient, effective, and appropriately tailored, by promoting the tailoring of regulation to address the specific risks posed by large, complex nonbank financial companies and FMUs.
- Restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework, by increasing the transparency of the Council's processes.

2 Nonbank Financial Company Determinations

2.1 Background Regarding Nonbank Financial Company Designations

In the financial crisis of 2007 to 2009, financial distress at certain nonbank financial companies contributed to a broad seizing up of financial markets and stress at other financial firms. These events raised the question of how nonbank financial companies should be supervised and regulated. In response, the Dodd-Frank Act established the Council and provided it with a number of tools to address potential risks to U.S. financial stability.¹² One of these tools is the authority for the Council to determine that certain nonbank financial companies shall be supervised by the Federal Reserve and subject to enhanced prudential standards.

However, stakeholders criticized the Council's implementation of its nonbank financial company designation authority. Some of these concerns focus on the Council's transparency, as well as the analytical process it applies in making decisions about particular firms. Designation has serious consequences for a company, including subjecting it to oversight by an additional regulator—the Federal Reserve—and new regulations, including capital requirements and a mandate to submit living wills to the Federal Reserve and FDIC. As a result, it is imperative that the Council's designation process be transparent and analytically rigorous. Further, the Council should promote designated nonbank financial companies' ability to take steps to reduce the risks they could pose to financial stability and thereby have their designations rescinded, which offers the double benefit of protecting the U.S. financial system and reducing the regulatory burden on the companies.

Appendix B contains a detailed overview of the Council's current approach to nonbank financial company designations and the applicable statutory standards and considerations. The framework for the Council's processes and analyses is explained in the Council's rule and interpretive guidance on nonbank financial company designations (the Nonbank Rule and Guidance),¹³ which were adopted in April 2012.

Section 2.2 assesses the effects of nonbank financial company determinations on companies and markets in which they operate, considers whether determinations serve their intended purpose of mitigating risks to U.S. financial stability, and makes recommendations regarding the appropriate use of the Council's designation authority. Sections 2.3 and 2.4 assess the Council's nonbank financial company designation processes and provide recommendations for enhancing the Council's analytical rigor, transparency, and engagement with companies. Section 2.5 includes recommendations for providing a clearer roadmap to enable designated companies to de-risk and be de-designated.

¹² Before the Council was established, the President's Working Group on Financial Markets served as an interagency mechanism to facilitate coordination and communication. The members of the President's Working Group are the Secretary of the Treasury and the chairmen of the Federal Reserve, the SEC, and the CFTC. See Executive Order 12631 (March 18, 1988).

¹³ 12 C.F.R. 1310.

2.2 Effects and Efficacy of Nonbank Financial Company Designations

The statutory purpose of nonbank financial company designations is to address risks that nonbank financial companies may pose to U.S. financial stability in the event of their material financial distress or failure, or because of their activities.¹⁴ To accomplish this goal, the Dodd-Frank Act also establishes the direct effects of a designation. Upon a final determination by the Council, the nonbank financial company becomes subject to consolidated supervision by the Federal Reserve and enhanced prudential standards.¹⁵ This supervision by the Federal Reserve is in addition to—not a replacement for—any other regulator that already supervises the company. The Federal Reserve is responsible for establishing, through the rulemaking process, the enhanced prudential standards that will be applicable to a designated nonbank financial company.¹⁶ These prudential standards generally include risk-based capital requirements and leverage limits (or in certain cases, other standards that result in similarly stringent risk controls), liquidity requirements, overall risk management requirements, resolution plan and credit exposure report requirements, and concentration limits.¹⁷ The Federal Reserve is authorized to tailor the enhanced prudential standards to covered companies on an individual basis or by category, including taking into consideration factors such as their riskiness, complexity, financial activities, and size.¹⁸ In addition, the Federal Reserve is required to take into account differences among nonbank financial companies and to adapt the required standards as appropriate in light of any predominant line of business of the company, including assets under management or other activities for which particular standards may not be appropriate.¹⁹

Pursuant to section 115 of the Dodd-Frank Act, the Council may make recommendations to the Federal Reserve concerning the establishment and refinement of enhanced prudential standards and reporting and disclosure requirements applicable to nonbank financial companies that are designated by the Council.²⁰ In making such recommendations, the Dodd-Frank Act authorizes the Council to differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Council deems appropriate.

2.2.1 Assessment of Designations in Achieving the Council’s Purposes

A consistent theme in feedback from stakeholders who were consulted for this review was that the Council’s authority to designate nonbank financial companies is only one of the Council’s tools for responding to potential risks to financial stability, and many commenters raised significant questions regarding the effectiveness of this tool.

¹⁴ Dodd-Frank Act section 112(a)(2)(H), 12 U.S.C. § 5322(a)(2)(H).

¹⁵ Dodd-Frank Act section 113(a), 12 U.S.C. § 5323(a).

¹⁶ Dodd-Frank Act sections 113, 165, 12 U.S.C. §§ 5323, 5365; 79 Fed. Reg. 17,245 (Mar. 27, 2014).

¹⁷ Dodd-Frank Act section 165(b)(1)(A), 12 U.S.C. § 5365(b)(1)(A).

¹⁸ Dodd-Frank Act section 165(a)(2)(A), 12 U.S.C. § 5365(a)(2)(A).

¹⁹ Dodd-Frank Act section 165(b)(3), 12 U.S.C. § 5365(b)(3).

²⁰ Dodd-Frank Act section 115, 12 U.S.C. § 5325.

Aside from the direct effects of designations, one argument is that designation may be valuable for its deterrent effect. According to this argument, nonbank financial companies will seek to avoid being designated by the Council, and to accomplish this goal they will avoid engaging in activities that could threaten U.S. financial stability. Some stakeholders also suggested that an important aspect of the Council’s designation authority is the leverage it provides the Council in its engagement with primary financial regulators of nonbank financial companies, to encourage them to address risks identified by the Council. Alternatively, designation may be best suited for nonbank financial companies that are outside the existing regulatory perimeter, or that are under the jurisdiction of a regulator that does not have authority or the ability to address risks posed by the company.

On the other hand, one of the most common criticisms of designation is a concern that a designation could result in a market expectation that the government would rescue the firm in the event of its failure. Such a market perception could create moral hazard at a company that could have the potential to increase, rather than mitigate, risks to financial stability.

Some studies indicate that global systemically important banks (G-SIBs) benefited from an implicit “too-big-to-fail” subsidy during the financial crisis, as G-SIBs’ funding costs and credit spreads were materially lower relative to smaller banks.²¹ Additionally, some research has found evidence that banks that are more likely to receive government support also engage in more risk taking.²² Other research indicates the funding advantage has since decreased for U.S. G-SIBs, and there is mixed evidence regarding the extent to which this advantage exists under current regulations.²³ While limited data are available in the context of nonbank financial companies, some research suggests that the identification of an insurance company as a global systemically important insurer by the Financial Stability Board could lead to a funding advantage in the short term but that the benefits of this subsidy might disappear after potential associated regulatory costs become clear.²⁴

In addition, industry participants have suggested that supervision by the Federal Reserve, which is imposed on designated nonbank financial companies, is not an appropriate remedy for potential risks to financial stability. These commenters argue that a regulator that is not primarily focused on a particular financial sector may not regulate firms in that sector effectively

²¹ See, e.g., Santos, J.A.C., “Evidence from the Bond Market on Banks’ Too-Big-to-Fail Subsidy.” Federal Reserve Bank of New York Economic Policy Review (December 2014); Li, Z., Qu, S., and Zhang, J., “Quantifying the Value of Implicit Government Guarantees for Large Financial Institutions,” Modeling Methodology, Moody’s Analytics (January 2011).

²² Afonso, G., J. Santos, and J. Traina, “Do “Too-Big-to-Fail” Banks Take on More Risk?” Federal Reserve Bank of New York Economic Policy Review (December 2014).

²³ See, e.g., International Monetary Fund, “How Big Is the Implicit Subsidy for Banks Considered Too Important to Fail?” Global Financial Stability Report, Ch. 3 (April 2014); Lester, J. and A. Kumar, “Do Bond Spreads Show Evidence of Too Big To Fail Effects? Evidence from 2009–2013 among US Bank Holding Companies,” Oliver Wyman Insights (April 2014).

²⁴ Zanghieri, P., “The Value and Price of a ‘Too-Big-to-Fail’ Guarantee: Evidence from the Insurance Industry,” Ernst & Young Journal of Financial Perspectives 4(1) (2017), pp. 21-49.

or efficiently, and they instead suggest an approach that relies more on action by a firm's existing regulators, who are already knowledgeable about the firm and its markets.

Some stakeholders also argued that if a designated nonbank financial company de-risks by spinning off businesses or selling assets to large, complex firms that are not subject to prudential supervision and regulation, the risk to financial stability could migrate within the financial system rather than be eliminated. In addition, the costs of supervision and regulation applicable to designated nonbank financial companies could be significant, depending on the enhanced prudential standards that are ultimately adopted by the Federal Reserve, and stakeholders argued that these costs could potentially put designated firms at a competitive disadvantage relative to their undesignated peers.

Finally, many stakeholders argued that the designation tool is a blunt instrument. They pointed out that accurately identifying nonbank financial companies that could present risks to financial stability is a time-consuming and analytically challenging exercise. These stakeholders suggested that rather than subject nonbank financial companies to an extensive and potentially burdensome process, the Council should instead attempt to address risks to financial stability in a manner that more effectively targets the source of risk and that relies more on the expertise of the existing regulatory structure. Some stakeholders also argued that, in the absence of explicit government guarantees of liabilities of nonbank financial companies, emphasis should be placed on market discipline rather than government supervision and regulation to address risks posed by these firms.

2.2.2 A New Approach to Mitigating Risks to Financial Stability

Many stakeholders who were consulted for this review expressed support for the Council's core mission of identifying risks to the financial stability of the U.S. financial system, and emphasized the importance of the Council as an interagency forum to monitor market developments and facilitate information-sharing and regulatory coordination. However, many of these stakeholders argued that a more effective approach to identifying and addressing potential risks to financial stability would be for the Council to prioritize activities-based or industry-wide reviews of potential risks, in close coordination with the relevant regulators. The Dodd-Frank Act gives the Council broad discretion in determining how to respond to potential threats to financial stability. Focusing on activities and products enables the Council to identify the underlying sources of risks to financial stability, rather than addressing risks only at a particular nonbank financial company that may be designated. This approach also addresses some of the potential limitations that could arise from designations, such as competitive disadvantages and unnecessarily burdensome regulatory requirements. At the same time, it would preserve the option to consider designation in the rare instance, such as the historical case of Fannie Mae and Freddie Mac, where it was clear that individual institutions could pose a threat to financial stability, but a primary regulator has not taken or cannot take adequate steps to address the risk.

Based on its assessment of the effectiveness of nonbank financial company designations for mitigating risks to financial stability, including consideration of feedback from trade groups, academics, public interest organizations, nonbank financial companies, regulators, and others,

Treasury recommends that the Council prioritize its efforts to assess and address potential risks to financial stability through a three-step process that emphasizes an industry-wide or activities-based approach.

Step One. The Council should prioritize its reviews of potential risks to financial stability from activities and products.

In its first step, the Council should prioritize identifying particular financial activities or products that could pose risks to U.S. financial stability. The purpose of this analysis would be to identify financial activities, products, market behaviors, structural vulnerabilities, or other factors that could threaten the stability of the U.S. financial system. In conducting this analysis, the Council should take into account available historical data, research regarding the behavior of financial market participants, and potential emerging threats that could arise in evolving marketplaces. This work would leverage the Council's existing processes, including frequent interagency discussions and analyses of financial market developments and potential risks to financial stability, and would provide an opportunity for a comprehensive analysis of risk.

Step Two. If the Council identifies a potential risk to financial stability, the Council should work with the relevant primary financial regulatory agencies to address the identified risks.

If the Council identifies a potential risk to financial stability in step one, the Council should work with the relevant regulators at both the federal and state levels to implement actions that could mitigate the identified risk. The goal of this step would be to have regulators modify their existing regulation or supervision of firms or markets under their jurisdiction in order to mitigate potential risks to financial stability identified by the Council. Rather than designating individual firms, the Council would look to primary regulators to address the risks through regulation within and across industries. The primary regulator has the relevant knowledge and expertise related to the activity or industry, and should be given an opportunity to address the risk. For example, if the Council finds that a particular type of financial product could present risks to financial stability, the primary regulator could restrict the offering of that product, or require firms to take additional risk-management steps that address the risks. The Council's communication of the risk to the primary regulator could be initiated through the Council's ongoing staff-level discussions, and could lead to recommendations in the Council's annual reports.

If the primary regulator's actions are insufficient to mitigate the identified potential risks to financial stability, the Council can make formal recommendations to the regulator under section 120 of the Dodd-Frank Act. Under section 120, the Council may, following consultation with the primary financial regulatory agency and public notice inviting comments, recommend that a primary financial regulatory agency impose new or heightened standards or safeguards for a financial activity or practice. To issue such a recommendation, the Council must determine that the conduct, scope, nature, size, scale, concentration, or interconnectedness of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems

spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities.²⁵ The primary regulator must either implement the standards recommended by the Council (or similar standards that the Council deems acceptable) or, within 90 days after the issuance of the recommendation, explain in writing to the Council why the agency has determined not to follow the Council’s recommendation. The Council must report its recommendations to Congress. Section 120 is a useful tool that allows the Council to coordinate closely with primary financial regulators to address identified potential risks.

The Council has previously taken this type of collaborative approach with respect to some issues, but this process should be adopted more broadly and formalized. One prominent example is the Council’s action on money market mutual funds (MMFs). Based on the experience of the financial crisis, the Council found that “the conduct and nature of MMFs’ activities and practices make MMFs vulnerable to destabilizing runs.”²⁶ The Council addressed that risk not by designating individual MMFs, but instead by issuing for public comment proposed recommendations regarding structural reforms to the MMF industry. In another example, the Council “sought to assess whether asset management products or activities could create, amplify, or transmit risk more broadly in the financial system in ways that could affect U.S. financial stability.”²⁷ The Council’s review of asset management products and activities focused on potential risks arising from five areas of potential risk, including liquidity and redemption risk at mutual funds and the use of leverage by hedge funds. Though some of its process related to the asset management industry was subject to significant critiques by market participants, the Council provided opportunities for public engagement and worked closely with interested regulators. See Appendix C for more detail regarding these initiatives.

Step Three. If, after consultation with the primary regulators, one or more companies may pose risks to financial stability, the Council should consider individual firms for designation.

The third step of the process would be for the Council to consider the company for potential designation—but only if consultation with the primary financial regulatory agencies is insufficient to mitigate the potential risk to financial stability identified by the Council. Further, to the extent that an entity-specific designation is considered to serve a valuable purpose as a backstop in the event that a risk to financial stability cannot be otherwise addressed, the Council’s processes for designations should be enhanced, pursuant to the recommendations in sections 2.3, 2.4, and 2.5 below.

²⁵ Dodd-Frank Act section 120(a), 12 U.S.C. § 5330(a).

²⁶ Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform (November 2012), p. 17, available at <https://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%202013,%202012.pdf>.

²⁷ Financial Stability Oversight Council, Update on Review of Asset Management Products and Activities (April 18, 2016), p. 3, available at <https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf>.

2.3 Increasing the Analytical Rigor of Designations Analyses

The Council’s analysis of any nonbank financial company must be conducted with the purpose of enabling the Council to determine if the company meets one of the two statutory standards for designation—either material financial distress at the company, or its nature, scope, size, scale, concentration, interconnectedness, or mix of activities, could pose a threat to U.S. financial stability.²⁸ As described in Appendix B, the Council is required to take into account the 10 considerations set forth in the Dodd-Frank Act, such as the company’s leverage, interconnectedness, and activities.²⁹ Beyond those minimum requirements, the statute gives the Council discretion to develop an appropriate method of analyzing nonbank financial companies for potential designation.

Based on the statutory requirements, the Council developed an analytic approach in its interpretive guidance issued in 2012. The guidance groups the 10 statutory considerations into six categories, and it identifies three transmission channels the Council intended to apply in assessing firms for potential designation. According to the Nonbank Rule and Guidance, three of these six categories seek to assess the potential impact of a nonbank financial company’s financial distress on the broader economy, and three of the categories seek to assess the vulnerability of a nonbank financial company to financial distress. For example, the guidance explains that nonbank financial companies that are highly leveraged, have a high degree of liquidity risk or maturity mismatch, and are under little or no regulatory scrutiny are more likely to be vulnerable to distress. The guidance also indicates that, in evaluating a nonbank financial company, the Council intends to assess how stress from the company could be transmitted to other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning. The Council identified three channels as most likely to facilitate the transmission of the negative effects of a nonbank financial company’s material financial distress to other financial firms and markets:

- Exposure. Through this transmission channel, the Council evaluates whether a nonbank financial company’s creditors, counterparties, investors, or other market participants have exposure to the company that is significant enough to materially impair those creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability.
- Asset liquidation. The Council assesses whether a nonbank financial company holds assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings.

²⁸ Dodd-Frank Act section 113(a)(1), 12 U.S.C. § 5323(a)(1).

²⁹ Dodd-Frank Act section 113(a)(2), 12 U.S.C. § 5323(a)(2). The statutory considerations relate to factors including the company’s leverage, off-balance-sheet exposures, interconnectedness, importance as a source of credit, assets under management, activities, existing regulatory scrutiny, and liabilities.

- Critical function or service. The Council considers the potential effects 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 and for which there are no ready substitutes.

The guidance also highlighted a firm’s complexity and resolvability as an additional relevant consideration. The guidance did not, however, indicate with specificity how the Council would determine whether a particular firm’s characteristics—for example, its leverage, its outstanding short-term debt, or its market share in a particular financial service—cause that firm to meet the statutory standards for designation. Instead, the guidance left the decision to the judgment and discretion of the 10 voting members of the Council. This approach has led to considerable and continuing uncertainty among market participants about how the Council makes its decisions, which factors the Council views as most relevant in identifying a company that could pose risks to financial stability, and how a company can take action to avoid designation.

There is no proven method for predicting with precision the effect that the failure of any nonbank financial company will have on financial stability. This difficulty underscores the need for the Council’s analyses to be exceedingly rigorous, clear, and comprehensible to firms and to the public, and undertaken only when the expected benefits to financial stability exceed the costs imposed on the designated firm.

Appendix B describes the Council’s framework for its analyses in detail, and Appendix D provides an assessment of the Council’s analyses that have been completed regarding nonbank financial companies the Council has designated or considered for designation. This assessment shows that increased analytical rigor would promote certainty in the Council’s conclusions and increase transparency to firms and the public.

2.3.1 Enhancing the Specificity of the Council’s Analyses

The Council’s past analyses have come under criticism and generated litigation concerning the Council’s adherence to its own interpretive guidance and the consistency of its analyses across firms. Designations have serious implications for affected entities, the industries in which they operate, and the economy at large. It is therefore imperative that the Council’s analyses be rigorous, transparent, and consistent.

Many stakeholders’ comments regarding different aspects of the Council’s analyses raise the same underlying concern—that before designating a nonbank financial company, the Council should more specifically identify the plausible scenarios in which the company could pose a threat to U.S. financial stability. These concerns arise in three key contexts, each described below.

Consideration of Mitigants to Exposures

As described in Appendix D, a key factor in the Council’s analyses is the exposure transmission channel. This inquiry considers whether the exposures of creditors, counterparties, investors,

and other market participants to the nonbank financial company under review are significant enough to materially impair those creditors, counterparties, and other market participants and thereby to pose a threat to U.S. financial stability. The Council’s analyses under the exposure transmission channel generally include considerable detail regarding these exposures—describing items such as the amounts and terms of the company’s outstanding debt, its derivatives activities, and its retail and institutional policyholder liabilities (in the case of an insurance company). These are all relevant factors. An equally relevant factor is the extent to which those exposures are mitigated in a manner that reduces the risks posed by the company. However, the Council has not adopted any specific standard with regard to how it considers mitigants to exposures.

Many types of exposures are significantly offset by mitigating factors that companies have tailored for that purpose, often based on regulatory mandate or market demand. For example, exposures of a company’s counterparties arising from repurchase agreements and securities lending activities have been significant factors in some of the Council’s analyses. Often, these types of transactions are fully collateralized by high-quality, highly liquid securities, such as U.S. Treasury securities. In those cases, the potential for the exposure to serve as a channel for the transmission of risk is remote.

The Council should identify risks only where they may plausibly arise—not where the risk is sufficiently offset by mitigants. Therefore, Treasury recommends that the Council develop a framework for taking into account factors that would reduce the losses a nonbank financial company’s counterparties and other market participants would experience in the event of the company’s material financial distress. This framework should quantify the losses that each of its counterparties would suffer in the event of its distress.

Identification of Plausible Asset Liquidation Risks

Another key factor in the Council’s analyses is the asset liquidation transmission channel. The Council’s Nonbank Rule and Guidance defined a risk arising through this channel if the nonbank financial company “holds assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings.” The Council’s analyses under this channel have been framed around three central questions:

- To what extent does the company have liabilities that are, or could become, short-term in nature?
- What assets does the company hold that it could rapidly liquidate, if necessary, to satisfy its obligations?
- Could the resulting asset liquidation disrupt financial markets or impair other market participants?

A number of historical examples demonstrate the potential for risks to financial stability to be caused by nonbank financial companies that rely heavily on short-term funding in capital markets.³⁰ But the Council has not adopted uniform thresholds for evaluating these three questions. Instead, it has performed company-specific analyses that often focus on the firm's aggregate liabilities and total investment portfolio. For example, the Council's evaluations regarding the first question—the extent of the company's short-term liabilities—have encompassed the company's short-term financial obligations (including outstanding commercial paper), financial arrangements that can be terminated by counterparties (including derivatives, securities lending, and repurchase agreements), and products that can be withdrawn by customers (including a life insurance company's annuities that build cash value and can be withdrawn by the policyholder with little or no penalty). With respect to the second question—the company's assets that could be liquidated—the Council has considered the company's investments, often grouped into categories such as highly liquid (including U.S. Treasury securities) and less-liquid (including private-label mortgage-backed securities). And the Council's analyses of the third question—whether the company's asset liquidation could threaten financial stability—reveal a heavy reliance on the judgment of the Council members. The effect of a firm's material financial distress on various financial markets is central to determining its potential threat to financial stability. But while the Council's evaluations have included some quantitative assessments of the impact that the particular company's asset liquidations could have on other firms and broader markets, not all of the Council's evaluations have included a rigorous quantitative impact assessment.

Treasury recommends that the Council's analyses under the asset liquidation transmission channel quantitatively and specifically identify the scope of plausible answers to the three framing questions listed above. A significant component of this analysis should involve the identification of the scale of potential liquidity needs that could plausibly arise. For example, for insurance companies, the Council has identified potential liquidity strains from two sources: institutional and capital markets products that can be terminated or not renewed by the counterparty, and insurance liabilities that can be withdrawn or surrendered by the contract holder or policyholder for cash on short notice. Importantly, unlike capital markets liabilities, retail insurance products that are available for immediate surrender or withdrawal are generally considered to be long-term liabilities, as these products may include features or characteristics that disincentivize withdrawals, such as penalties, taxes, and loss of guarantee accumulation. In its evaluations of insurance companies for potential designation, the Council has addressed the amounts of liabilities in these two categories that “could” be withdrawn, based on contractual terms. The Council has also noted that it has not relied on an assumption that all of an insurance company's counterparties or policyholders “would” withdraw. However, the Council has generally not attempted to calculate estimates of the extent to which it believes counterparties or policyholders might withdraw in extreme but plausible circumstances.

³⁰ For example, AIG experienced significant liquidity strains due to collateral calls related to its securities lending program and its derivatives portfolio in September 2008. Additionally, asset-backed commercial paper markets seized in 2007, and nearly 40 percent of asset-backed commercial paper programs were in a run at the end of 2007. Covitz, D., Liang, N., and G. A. Suarez, “The Evolution of a Financial Crisis: Collapse of the Asset-Backed Commercial Paper Market,” *The Journal of Finance* 68(3) (June 2013), 815-848, 818.

While generating quantified scenarios for runs on a financial institution is challenging, certain analytic methods are available for doing so. One relevant approach is to consider historical comparisons. There are few precedents for the failure of a large insurance company, but the limited available data indicate that while there may be elevated levels of policyholder surrenders and withdrawals, retail policy holders do not universally withdraw their policies from an insurer in material financial distress. The Council should apply withdrawal rates based on historical examples and other relevant models to assess the scope of plausible withdrawals. Further, the Council's analyses should highlight, in a clear manner, the ability of an insurance company and of its state insurance regulators to substantially reduce the potential risk of a company's asset liquidation by exercising their existing authorities to impose stays on policyholder withdrawals.

Treasury also recommends that the Council adopt a consistent approach to its analysis of the order in which a company may liquidate its portfolio of investment assets. The Council's previous evaluations have addressed the potential effects of asset sales assuming the company sells its most liquid assets first; sells its least liquid assets first; or sells assets at the midpoint between those two extremes. The Council should identify an appropriate approach to this issue that applies across firms in a particular industry, taking into account factors such as the benefits of selling highly liquid assets first, any first-mover advantage in the event of fire sales, and any regulatory requirements that may affect the order in which a company could liquidate its portfolio.

Finally, with respect to the third framing question—whether a company's rapid liquidation of a particular volume of particular assets could threaten U.S. financial stability—the Council should identify quantitative models that it can consistently apply across firms. For example, one appropriate approach is to compare the volume of the company's potential liquidation of particular categories of financial instruments with the average daily trading volume in the United States of those types of instruments. In general, a rapid liquidation of a significant amount of a relatively illiquid financial instrument will have a greater effect on the market than a liquidation of the same amount of a highly liquid instrument. The effect of these variables should be quantified to the extent possible and clearly explained. Only with a transparent and predictable method of analyzing this factor will firms be able to understand whether their own liquidity risk might lead to designation by the Council.

Evaluate Likelihood of Distress as a Threshold Question

Multiple stakeholders have noted uncertainty regarding whether the Council intended, under its interpretive guidance, to assess the likelihood of the distress of nonbank financial companies. Treasury recommends that the Council revise the guidance to provide clearly for assessment of likelihood of distress as part of its analytic framework for designations. Sound risk regulation requires consideration of not only the impact of an identifiable risk, but also the likelihood that the risk will be realized.³¹ The Council's designation process should not operate outside this

³¹ See Office of Management and Budget, Proposed Risk Assessment Bulletin, 71 Fed. Reg. 2600-01 (Jan. 17, 2006); see generally Stephen Breyer, *Breaking the Vicious Circle: Toward Effective Risk Regulation* (1993).

long-accepted model of effective regulation. Material financial distress at a nonbank financial company does not pose a threat to U.S. financial stability if the company will not experience material financial distress. Treasury recommends that the Council assess the likelihood of a firm's material financial distress as part of its determination whether designation would promote U.S. financial stability. To be sure, the Council already considers some factors relating to the likelihood of a firm's distress in the context of its evaluation of the potential for the negative effects of a company's material financial distress to be transmitted to other firms and markets. But a distinct evaluation of the factors that may lead to a firm's failure—and factors that mitigate those risks—will make the designation process more empirically grounded and focused on realizable risks.

2.3.2 Considering the Costs and Benefits of Designations

Cost-benefit analysis is a staple of major administrative rulemakings, and stakeholders and scholars have urged the Council to conduct cost-benefit analyses in connection with its designation decisions. These commenters have argued that the Council should not subject a nonbank financial company to Federal Reserve supervision and enhanced prudential standards if the costs of designation exceed the benefits. The Council has conducted no such analyses: it chose not to conduct a cost-benefit analysis in connection with issuing its Nonbank Rule and Guidance,³² and it has reiterated this approach in its designation decisions regarding particular nonbank financial companies.

Treasury believes cost-benefit analysis should inform the determination whether the designation of a nonbank financial company would enhance financial stability. The Dodd-Frank Act requires the Council to consider “any ... risk-related factors that the Council deems appropriate” in determining whether to designate a nonbank financial company.³³ There is no question that the Council has the discretion under the statute to consider the direct and indirect costs of designation—which may be risk-related, and indeed risk-enhancing, in some respects. The Council should only designate a company if the expected benefits to financial stability from Federal Reserve supervision and enhanced prudential standards outweigh the costs that designation would impose.

Financial stability benefits may be difficult to quantify, and some of the costs may be difficult to forecast with precision. But the analytical discipline of weighing costs against benefits—and quantifying those impacts to the extent feasible—improves the quality of administrative decision-making and ensures that agencies take account of the relevant trade-offs and alternatives. Notwithstanding the challenges of conducting cost-benefit analysis, agency action is appropriate only if it does more good than harm, and there can be no confidence on that point unless the Council weighs the costs and benefits of its actions. The interpretive guidance should be revised to conform to this principle.

³² 77 Fed. Reg. 21640 (April 11, 2012).

³³ Dodd-Frank Act section 113(a)(2)(K), 12 U.S.C. § 5323(a)(2)(K).

2.3.3 Additional Steps to Clarify the Council’s Analyses

In addition to the recommendations described above, Treasury has identified two changes to the preliminary stages in the Council’s process that would strengthen the Council’s analytic rigor.

The Council’s Nonbank Rule and Guidance establish a three-stage process for the Council to identify, evaluate, and communicate with nonbank financial companies. Each stage of the process involves an analysis based on an increasing amount of information to determine whether a company meets one of the statutory standards for a determination. In Stage 1, the Council applies six uniform quantitative thresholds to a broad range of nonbank financial companies to identify firms that may merit further review. In Stage 2, the Council contacts the firm and its regulators and conducts a preliminary analysis. In Stage 3, the Council conducts a lengthy and in-depth review of the company, after which the Council may vote to make a proposed (and subsequently a final) designation. See Appendix B for a detailed description of the three stages.

Amending the Total Consolidated Assets Threshold in Stage 1

As described in Appendix B, the Council’s Nonbank Rule and Guidance established a Stage 1 threshold of \$50 billion of total consolidated assets. According to the guidance, this threshold was set to be consistent with the \$50 billion threshold under section 165 of the Dodd-Frank Act for subjecting bank holding companies to enhanced prudential standards. Treasury has recommended that Congress amend the \$50 billion threshold under section 165 to more appropriately tailor those standards to the risk profile of bank holding companies.³⁴ Treasury recommends that the Council consider amending its Nonbank Rule and Guidance in light of any change to the threshold under section 165. While this Stage 1 threshold has no direct effect—most companies over the threshold are not designated, and companies under the threshold can nonetheless be subject to Council review for potential designation—the Council should consider amending this threshold as may be appropriate in accounting for the risk that an institution could pose to financial stability.

Combine Stages 1 and 2

The Council adopted different approaches regarding the number of stages of review for nonbank financial companies and for FMUs. While the Council uses a three-stage process for nonbank financial companies, it uses a two-stage process for FMUs. The three-stage process for nonbank financial companies has generated confusion among members of the public and should be reformed into a two-stage process by combining existing Stages 1 and 2. Under this revised approach, in Stage 1, the Council would apply the Stage 1 thresholds, and the Council could subject any company that exceeds the thresholds to active review in Stage 1. (The Council would retain its ability to evaluate any company that does not exceed the Stage 1 thresholds if the Council believes the company merits review.) Consistent with the existing practice in Stage

³⁴ See U.S. Department of the Treasury, “A Financial System That Creates Economic Opportunities: Banks and Credit Unions” (June 2017), p. 52, available at <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.

2, any company that comes under active review in Stage 1 would be notified immediately. After completing its analysis of a company in Stage 1, the Council could vote to advance the company to Stage 2. Any vote on a proposed or final designation would occur after the completion of Stage 2.

For purposes of clarity, other sections of this report describe the three stages of the nonbank financial company designation process based on the Council's existing interpretive guidance, without this proposed reform. If the Council combines Stages 1 and 2, the recommendations elsewhere in this report regarding enhancements to the Council's designation process should be implemented in Stage 1 or Stage 2, as applicable.

2.4 Enhancing Engagement and Transparency in the Designation Process

Robust engagement during the designation process can provide significant benefits: it helps ensure that the Council is making decisions based on the best possible data and analysis; it allows a company under review to provide the Council with relevant information and to understand the aspects of its business that may pose risks to U.S. financial stability; and it enables the company's existing regulators to offer their expertise and participate in the Council's consideration of potential risks.

Transparency to the public regarding the Council's designation process—and regarding the Council's decisions related to particular nonbank financial companies—can similarly help achieve the Council's goals. If the Council clearly communicates to the public how firms may be evaluated, why particular characteristics of a firm may or may not lead to its designation, and the risks a firm could pose to U.S. financial stability, then market participants will be able to avoid engaging in activities that the Council views as threatening the financial system. Further, public transparency enables public oversight of the Council's decisions, to ensure that the Council's decisions are analytically rigorous and consistent across firms and industries.

The Dodd-Frank Act mandates little engagement or transparency for the Council. The Council previously has taken steps to improve its engagement and transparency, as described in Appendix B. The steps include the adoption of the Council's Nonbank Rule and Guidance, which created the three-stage process for evaluating firms, and the Council's adoption in February 2015 of supplemental procedures for nonbank financial company determinations (the Nonbank Supplemental Procedures).³⁵ However, more should be done. Stakeholders pointed to significant shortcomings in the Council's public transparency. Following is an analysis of the Council's engagement with companies and their regulators during the designation process, and its public transparency regarding designations. This analysis leads to recommendations in three categories: (1) enhancing engagement with nonbank financial companies under review by the Council for potential designation; (2) undertaking greater engagement with a company's

³⁵ Financial Stability Oversight Council, Supplemental Procedures Relating to Nonbank Financial Company Determinations (Feb. 4, 2015), p. 4, available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf>.

regulator during the Council’s analysis of a company; and (3) publicly releasing additional information regarding the Council’s bases for its decisions to designate, or rescind the designation of, a company.

2.4.1 The Council’s Engagement With Nonbank Financial Companies

Enhancing Engagement Between the Council and Companies Under Review

While the volume of engagement between staff representing Council members and member agencies and a company under review during Stage 3 can be significant, the information flow is largely one way—from the company to the Council. For example, a company can respond to the Council’s data request, present at meetings with staff on the Council’s analytical team, and submit other written information. However, under the Council’s procedures, the only time before a proposed designation when the Council expressly identifies its concerns regarding the company is at the outset of Stage 3, when staff will notify the company of any specific aspects of the company’s operations or activities that have been identified as the primary focus for the evaluation. See Appendix B for a detailed overview of the Council’s processes in Stages 2 and 3.

Nonbank financial companies have argued that they could better participate in the process if the Council indicated earlier, more often, and more specifically the Council’s areas of focus. In particular, companies have stated that they would benefit from an indication during Stage 2 of the reasons why they were selected for review. Companies also stated that the Council should provide them with feedback during Stage 3, so that they can tailor their submissions appropriately. Treasury therefore recommends that the Council enhance its communication with companies during Stages 2 and 3 (as modified by the introduction of a streamlined two-stage process, as described in section 2.3.3). Specifically, during the discussions at those stages with the company, staff on the Council’s analytical team should explain to the company the key risks that have been identified in the analysis. Because the review of the company is preliminary and continues to change until the Council makes a final designation, these identified risks may shift over time; however, both the company and the Council would benefit from the company being aware of the Council’s focus.

This type of enhanced engagement would enable the company to take actions in response to the Council’s concerns—serving as a pre-designation “off-ramp.” If a company is aware of the potential risks the Council has identified during its preliminary review, the company can take action to mitigate those risks prior to a Council designation. Company actions that reduce their risks help achieve the Council’s goal of addressing potential threats to U.S. financial stability.

In addition, Treasury recommends that Congress amend section 113 of the Dodd-Frank Act to increase from 30 days to 60 days the statutory deadline for a company to request a hearing after a proposed designation, and increase from 60 days to 90 days the Council’s deadline for making a final designation after any hearing. This additional time would give the company a better opportunity to understand and respond to the Council’s written analysis in the proposed

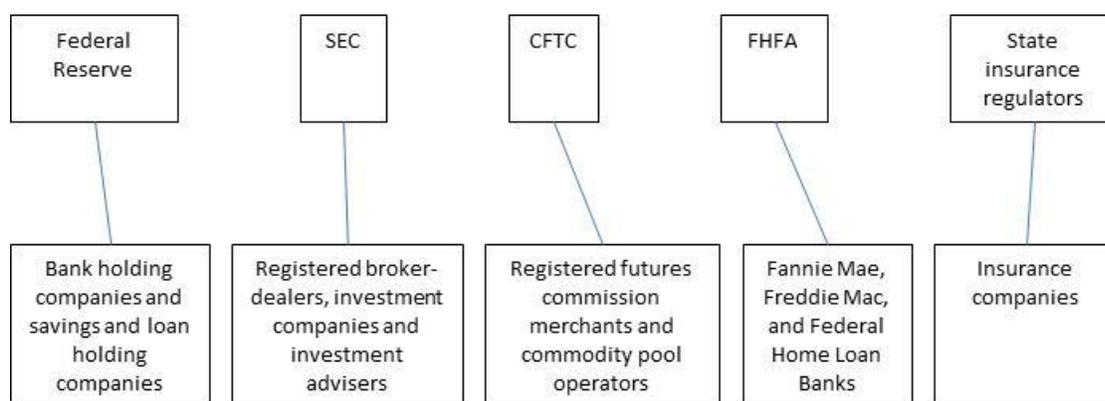
designation, and would ensure that the Council has time fully to consider the company’s submissions and arguments in any hearing.

2.4.2 The Council’s Engagement With Primary Regulators

Background

Under the Dodd-Frank Act, the Council is required to consult with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for a determination before the Council makes any final determination with respect to such company. Different types of companies have different types of primary financial regulators. For example, insurance companies are regulated by state insurance regulators; savings and loan holding companies are regulated by the Federal Reserve; broker-dealers and asset managers are regulated by the SEC. The following figure illustrates the primary financial regulatory agency, as defined in section 2 of the Dodd-Frank Act, for various types of nonbank financial companies.

Figure 1: Primary Financial Regulatory Agencies for Certain Types of Nonbank Financial Companies



The Council’s 15 members include the heads of all the major federal financial regulatory agencies, so for any company primarily regulated at the federal level, its regulator can participate in Council discussions and decisions throughout the designation process. However, for companies that are primarily regulated at the state level, including insurance companies, the specific state agency that serves as the primary regulator of the company might not be a Council member. Three Council members serve in an insurance-related capacity: the Council’s independent member with insurance expertise (who does not represent any federal or state regulator); the director of the Federal Insurance Office within Treasury; and a state insurance commissioner who is designated by the state insurance commissioners. Of these three members, only the independent member is a voting member of the Council; the other two are nonvoting members who serve in an advisory capacity. State banking supervisors and state securities commissioners are similarly represented by nonvoting Council members.

For any company under active review in Stage 2 that is regulated by a primary financial regulatory agency or home country supervisor, the Council notifies the regulator or supervisor that the company is under active review no later than such time as the company is notified. The Council then seeks to begin the consultation in Stage 2, before the Council votes on whether to advance the company to Stage 3. If the Council votes to advance a company to Stage 3, the Council seeks to continue its consultation with the regulator or supervisor during Stage 3, before voting on whether to make a proposed determination regarding the company. For example, in each of its previous Stage 3 evaluations of insurance organizations for potential designation, the Council consulted with the company's primary state insurance regulators five times. Finally, promptly after the Council votes to make a proposed or final determination regarding a company, the Council provides its primary financial regulatory agency or home country supervisor with the nonpublic written explanation of the basis of the Council's proposed or final determination. The Council has also invited companies' primary financial regulators to attend the Council's oral hearing after a proposed designation.

Enhancing Engagement Between the Council and a Company's Primary Financial Regulators

The Council can benefit from deep engagement with a nonbank financial company's primary financial regulator during the designation process. First, a regulator that regulates and supervises a company can provide the Council with unique insights into the company and its operations, activities, and risks. Second, a company's regulator can help the Council understand the plausibility of theoretical risks at the company. Third, a regulator with existing authority to address a company's risks identified by the Council can take action even without a Council designation, thus avoiding potentially duplicative supervision and regulation of the firm.

In order to achieve these benefits, Treasury recommends that the Council undertake greater engagement with a company's regulator during the Council's evaluation of the company for potential designation. In particular, the Council should actively solicit the regulator's views regarding risks at the company and potential mitigants. In order to enable the regulator to provide relevant information, the Council should share its preliminary views regarding potential risks at the company, and request that the regulator provide information regarding those specific risks, including whether the risks are adequately mitigated by factors such as existing regulation or the company's business practices. Finally, during the designation process, the Council should continue to encourage the regulator to address any risks to U.S. financial stability using the regulator's existing authorities.

2.4.3 The Council's Transparency Regarding Nonbank Financial Company Designations

Background

Determining the appropriate scope of public transparency regarding nonbank financial company designations requires balancing the public benefit from a clear understanding of the Council's actions and the need to maintain the confidentiality of nonpublic data regarding individual

companies. The Council’s public transparency regarding nonbank financial company designations should be further enhanced.

The Council provided an initial public explanation of its process for nonbank financial company designations in its Nonbank Rule and Guidance, which describe the Council’s process and analytic approach for designations. For example, the guidance sets forth the three transmission channels that the Council has considered in each of its designation analyses. In February 2015, in response to criticism regarding Council procedures and after several months of engagement with industry and interested parties, the Council adopted the Nonbank Supplemental Procedures, which included several new provisions. The Council has also published “frequently asked questions” on its website regarding the designation process,³⁶ and in June 2015 published staff guidance with details regarding how each of the six Stage 1 thresholds is calculated.³⁷

Another mechanism for public transparency regarding designations is the Council’s public explanations of the bases for its designation decisions. For each of its final designations, the Council has prepared two separate but related documents. One document contained the Council’s detailed analysis, including confidential information submitted to the Council by the company and its regulators. The Council delivered that document to the company and its regulators but did not publicly release it. The other document was a public explanation of the basis for the Council’s decision, which was considerably shorter than the Council’s nonpublic basis. The public basis omitted confidential information and addressed the key factors that the Council considered in its evaluation of the company and the primary reasons for the Council’s determination.

The three public bases issued by the Council in 2013 ranged from 12 to 14 pages and offered only a high-level explanation of the reasons for the Council’s decisions, although the Council’s public basis issued in 2014 totaled 31 pages and provided more specificity regarding the potential risks to U.S. financial stability identified by the Council. Similarly, the Council’s public basis for rescinding one of its designations, issued in 2016, was 23 pages and offered additional detail regarding the Council’s analysis.

In addition to the public statements described above, the public minutes of the Council’s meetings record all Council votes, including votes to advance a nonbank financial company to Stage 3 or to make a proposed or final designation. However, the minutes generally lack any substantive discussion regarding the firm under review, in order to protect confidential information and to avoid market speculation, and therefore the minutes do not provide the public with material insights into the Council’s process.

³⁶ Financial Stability Oversight Council, “Nonbank Designations—FAQs” (last updated February 4, 2015), available at <https://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx>.

³⁷ Financial Stability Oversight Council, Staff Guidance Methodologies Relating to Stage 1 Thresholds (June 8, 2015), available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf>.

Enhancing the Council's Public Transparency Regarding Nonbank Financial Company Designations

The Council has an obligation to maintain the confidentiality of information submitted to it by nonbank financial companies under review and by their regulators. Further, because these companies are often publicly held, the Council must exercise caution in releasing information that may be material to investors. At the same time, Council accountability requires transparency to the public regarding the Council's processes and analyses in designations.

While the Council has taken steps to improve its public transparency regarding designations, more should be done. Treasury recommends that the Council end its practice of publicly releasing only a short explanation of its bases for designations decisions. Instead, the Council should publicly release the explanation of the Council's basis for any future nonbank financial company designations or rescissions of designations, redacting as necessary to protect confidential information from the company or its regulators. The Council recently took this approach in its public explanation of the basis for rescinding the designation of American International Group, Inc. (AIG).³⁸ This approach will provide the public with the greatest possible understanding of the Council's reasons for its actions.

2.5 Providing a Clear Off-Ramp for Designated Nonbank Financial Companies

The Council is required by statute at least annually to reevaluate each of its previous designations.³⁹ These annual reevaluations are a key component of the designation process. The purpose of nonbank financial company designations is to promote U.S. financial stability, and maintaining a clear annual reevaluation process creates opportunities for designated firms to de-risk, address the risks the Council has identified, and ultimately have their designations rescinded.

However, the Council has adopted only minimal formal procedures for its annual reevaluations. Further, it has not clearly explained to designated firms the steps they could take that would result in a rescission of their designation. Following are an evaluation of the Council's approach and recommendations for enhancements.

2.5.1 The Council's Annual Reevaluations of Nonbank Financial Company Designations

The Council's formal procedures regarding its annual reevaluations of nonbank financial company designations are minimal. The Dodd-Frank Act merely provides that the Council must conduct these reviews and rescind a designation if the Council determines, by a two-thirds vote including the affirmative vote of the Chairperson of the Council, that the company no longer meets the standards for designation. The Council's Nonbank Rule and Guidance and its

³⁸ The Council's notice and explanation of the basis for its rescission of the designation of AIG is available at [https://www.treasury.gov/initiatives/fsoc/designations/Documents/American_International_Group,_Inc._\(Rescission\).pdf](https://www.treasury.gov/initiatives/fsoc/designations/Documents/American_International_Group,_Inc._(Rescission).pdf).

³⁹ Dodd-Frank Act section 113(d), 12 U.S.C. § 5323(d); see also 12 C.F.R. 1310.23(a).

Nonbank Supplemental Procedures provide some additional requirements, including that at the outset of an annual reevaluation, the company will be notified and provided an opportunity to submit information to the Council and to meet with staff of Council members and member agencies. The Nonbank Supplemental Procedures also state that if a company contests its designation during the Council's annual reevaluation, the Council intends to provide the company and its primary regulators with an explanation of any decision not to rescind the designation. In addition, the Council has clarified that it may consider a request from a company for a reevaluation before the next required annual reevaluation in the case of an extraordinary change that materially decreases the threat the nonbank financial company could pose to U.S. financial stability.⁴⁰

Compounding the lack of public clarity regarding its process, the Council has stated little publicly regarding the analytic approach it takes in annual reevaluations. The Council's reevaluations generally assess whether any material changes at the company since the previous reevaluation and since the designation justify a rescission of the designation, based on the same transmission channels and other factors that are considered during a designation decision. The Council has stated that it is not necessary, during an annual reevaluation, to replicate in full the Council's evaluation of the company in Stages 2 and 3.

To the extent that the Council provides designated companies with an opportunity to understand the Council's reasons for the designation, it is based almost entirely on the Council's written basis for the designation, which is provided to the company at the time of the designation, and the written explanation of any decision not to rescind the designation in an annual reevaluation, which addresses the material factors raised by the company in its submission to the Council during the annual reevaluation. However, those materials have generally not identified with specificity the key factors that led to the Council's designation, or the steps the company could take that would lead to the rescission of its designation. Some designated companies have noted that, as a result, it is not clear what steps they could take that would ensure a rescission of their designation.

Supporters of the Council's existing process have noted the example of GE Capital as evidence that the Council's process for reviewing and rescinding designations functions properly. That company has noted that the Council's written explanation of the basis for designation identified with sufficient specificity the risks the company posed to U.S. financial stability, so that the company could take action to address those risks. However, GE Capital presented a unique case. Alone among the designated nonbank financial companies, GE Capital could radically reduce its size and scope, due to its status as a subsidiary of a larger industrial conglomerate. GE Capital's approach would not be feasible for a nonbank financial company that is not part of a non-financial business.

⁴⁰ 77 Fed. Reg. 21650 (Apr. 11, 2012).

The Council's recent decision to rescind the designation of AIG provides compelling evidence that designation need not be permanent. If a designated company takes action to reduce the risks it could pose to U.S. financial stability, the Council should rescind its designation.

2.5.2 Clarifying the Off-Ramp for Designated Nonbank Financial Companies

Treasury recommends that the Council enhance its off-ramp for designated nonbank financial companies. First, the Council's explanation of the final basis for any designation should highlight the key risks that led to the designation. As discussed in Appendix D, the Council's written explanations of its designations decisions have been long and detailed but have frequently taken the form of a laundry list of potential risks. Treasury recommends that the Council's final bases include clear guidance regarding the factors that were most important in the Council's determination. Such an explanation would make clear to the company the steps it could take to address the Council's concerns.

Second, the Council should adopt a more robust and transparent process for its annual reevaluations. Such a process should make clear how companies can engage with the Council and its representatives, and what information companies should submit during a reevaluation. Importantly, it should also enable engagement with a company regarding the substance of the Council's analysis and changes to the company's risk profile over time. The process should be flexible and tailored to the risks posed by particular institutions, not hard-wired or overly prescriptive.

Third, the Council should develop a process to enable a designated company to discuss potential changes it could make to address the risks it could pose to financial stability, and to receive feedback regarding whether those changes may address the Council's concerns. Such a process may incentivize designated companies to address the key factors that led to designation—and would therefore help the Council achieve its goal of reducing risks to U.S. financial stability.

Finally, the Council should make clear that the standard it applies in its annual reevaluations is the same as the standard for an initial designation of a nonbank financial company: either the company's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could pose a threat to U.S. financial stability. If the company no longer meets those standards, as a result of the aggregate changes at the company or in its markets since the designation or based on changes in the Council's own analysis, the Council should rescind its designation.

3 Financial Market Utilities

3.1 Background Regarding FMU Designations

As discussed in more detail in the Treasury Capital Markets Report,⁴¹ FMUs form a critical part of the nation’s financial infrastructure, supporting and facilitating the transfer, clearing, or settlement of financial transactions in many markets. However, their function and interconnectedness also concentrate a considerable amount of risk in the financial system, due in large part to interdependencies, both directly through operational, contractual, and affiliation linkages, and indirectly through payment, clearing, and settlement processes. Problems at one FMU could trigger significant liquidity and credit disruptions at other FMUs or financial institutions.⁴²

The financial crisis revealed potential challenges in the structure and regulation of derivatives markets—including under-collateralization of positions, interconnectivity, and a lack of transparency—that some observers believe exacerbated the crisis. Title VII of the Dodd-Frank Act made a number of changes to the framework for derivatives regulation. However, some of these changes, most notably the central clearing requirements for certain derivatives markets, accelerated the growth of several FMUs, thereby further concentrating risks in a small number of institutions.

Appendix E contains a detailed overview of the Council’s current approach to FMU designations and the applicable statutory standards and considerations. Appendix F provides an assessment of the Council’s analyses that have been completed regarding FMUs the Council has designated.

3.2 Effects and Efficacy of FMU Designations

As discussed in Appendix E, under section 806 of the Dodd-Frank Act, the Federal Reserve may authorize a Federal Reserve Bank to establish and maintain an account for a designated FMU and provide certain other services to the designated FMU. This allows designated FMUs to deposit client margin in risk-free accounts; an additional economic advantage is that designated FMUs currently receive an interest rate (1.25%) well in excess of what is available from commercial banks. Section 806 also authorizes Federal Reserve Banks to provide discount and borrowing privileges to designated FMUs, subject to certain restrictions.

In exchange for receiving these privileges, which are otherwise available only to depository institutions, designated FMUs are subjected to a number of heightened regulatory and supervisory requirements under Title VIII of the Dodd-Frank Act. The Federal Reserve has prescribed the conditions under which a designated FMU may establish an account at a Federal Reserve Bank, including compliance with certain regulatory and other requirements. With respect to discount window lending, the Dodd-Frank Act requires an affirmative vote of a

⁴¹ Treasury Capital Markets Report, p. 151.

⁴² Financial Stability Oversight Council Final Rule: Authority to Designate Financial Market Utilities as Systemically Important, 76 Fed. Reg. 44763 (July 27, 2011).

majority of the Board of Governors of the Federal Reserve System, after consultation with the Secretary of the Treasury, “only in unusual or exigent circumstances,” and only if a designated FMU is unable to obtain private sector financing. Nevertheless, some have argued that granting FMUs access to deposit and payment services and to the discount window in effect codifies these entities as “too big to fail,” which in turn could decrease competition, distort markets, and increase the likelihood of future financial crises.

None of the designated FMUs contested its designation prior to the Council’s final designation in 2012, and these FMUs generally do not express opposition to their continued designation. Some designated FMUs have argued that Federal Reserve account access is an important systemic risk mitigation tool, as FMUs without account access would be required to rely on cash management alternatives that expose counterparties to credit risk that could increase instability during a financial crisis. In addition, some non-designated firms with significant foreign operations that clear large amounts of U.S. clearing business argued that their inability to use a Federal Reserve account for U.S. dollar margin could pose a threat to U.S. financial stability, particularly during periods of broader market stress.

3.3 Enhancing the Resilience of FMUs and the Rigor of the Council’s FMU Designations Analyses

Resilience, Recovery, and Resolution

The increasing importance of FMUs has heightened public and regulatory focus on their risk-management practices. In this context, and as discussed in more detail in the Treasury Capital Markets Report, the Federal Reserve, the CFTC, and the SEC have taken steps intended to enhance the resilience of designated FMUs and their ability to recover from stress events. Treasury recommends that the agencies continue to coordinate the supervision of designated FMUs and continue to work collaboratively to develop effective resolution strategies focused on ensuring the continuity of the critical services provided by these entities.

Considering the Costs and Benefits of Designations

As discussed above, designated FMUs are subject to additional regulatory and supervisory requirements imposed by the Federal Reserve, the SEC, and the CFTC. Designations therefore impose real costs on firms, including the costs of maintaining risk-management standards required by the relevant supervisory agency and compliance costs associated with additional supervision. Costs of FMU designations also include indirect costs that redirect the FMUs’ resources from other priorities and potential opportunity costs associated with not pursuing some growth opportunities, due to the requirement that a designated FMU provide advance notice to its supervisory agency of certain proposed changes to its rules, procedures, or operations, as described in detail in the Treasury Capital Markets Report.⁴³

⁴³ Treasury Capital Markets Report, p. 164.

At the same time, there are benefits of FMU designation, including potentially enhancing U.S. financial stability and forcing FMUs to internalize the costs of the risks they pose to financial stability. Designated FMUs also benefit from the safety associated with depositing client margin in Federal Reserve Bank accounts and the advantages associated with the interest rate paid on these reserves.⁴⁴

As discussed in section 2.3.2, cost-benefit analyses are a staple of administrative rulemakings. As with the designation of nonbank financial companies, the Council should only designate an FMU if the expected benefits, including the benefits to financial stability, outweigh the costs that designation would impose. Treasury therefore recommends that the Council consider incorporating cost-benefit analyses into its evaluations of FMUs for potential designation.

3.4 Enhancing Engagement and Transparency in the FMU Designation Process

Overview

This section evaluates and provides recommendations regarding the Council's engagement with FMUs and their primary regulators during the FMU designation process, and the Council's transparency to the public regarding its actions.

Many of the themes and concerns highlighted above regarding nonbank financial company designations also apply in the FMU context. For example, robust engagement during the FMU designation process can benefit the Council, the FMU under review, and the FMU's existing regulators. Further, public transparency regarding FMU designations is important for the Council to achieve its goals. Transparency to the public regarding the Council's processes and decisions will promote market certainty and enable oversight of the Council's actions.

This analysis leads to recommendations in three categories: (1) enhancing the Council's engagement with FMUs; (2) enhancing the Council's engagement with FMUs' regulators; and (3) enhancing the Council's transparency to the public regarding FMU designations.

Description of Engagement Between the Council and Companies in Stage 2

FMUs that reached the second stage of the Council's evaluation process were notified that they were under consideration for designation and provided with an opportunity to submit written materials concerning (1) whether the FMU is systemically important, taking into consideration the factors set out in the Dodd-Frank Act and in the Council's rule regarding FMU designations, and (2) proposed changes by the FMU that could reduce or increase the inherent systemic risk the organization poses and the need for designation by the Council. For each FMU that became subject to a proposed designation by the Council, the Council provided the FMU with an opportunity to request a written or oral hearing before the Council to demonstrate that the

⁴⁴ *Id.* at 165.

proposed determination was not supported by substantial evidence. None of the FMUs contested the proposed designation or requested a hearing before the Council.

All of the primary financial regulators of the designated FMUs are represented by voting members on the Council and were deeply engaged throughout the Council's analyses.

Enhancing Engagement Between the Council and FMUs Under Review

Treasury recommends that the Council enhance communication with FMUs during Stage 2. Once an FMU is under review in Stage 2, the Council should notify the company and communicate specific areas of focus identified by Council staff during the preliminary analysis. The firm should have to opportunity to respond to staff analysis with an explanation of its views on staff's considerations.

Enhancing Engagement Between the Council and FMUs' Primary Financial Regulators

Treasury recommends that the expertise of the primary financial regulatory agencies be leveraged to inform any consideration of whether to designate an FMU, and also to inform strategies for regulating and supervising designated FMUs. This engagement with primary regulators should include continued focus on steps to enhance the resilience of FMUs to address potential threats to financial stability, as well as consideration of improvements to current regulatory and supervisory processes to address inefficiencies and unnecessary burdens.

Enhancing the Council's Public Transparency Regarding FMU Designations

Consistent with the recommendation above regarding the public disclosure of the Council's reasons for designations of nonbank financial companies, Treasury recommends that the Council publicly release the explanation of the Council's basis for any future FMU designations, redacting as necessary to protect confidential information from the company or its regulators.

Appendix A: Participants in the Presidential Memorandum Engagement Process

Governmental and Related Entities

- Commodity Futures Trading Commission
- Consumer Financial Protection Bureau
- Conference of State Bank Supervisors
- Federal Deposit Insurance Corporation
- Federal Reserve Bank of New York
- Federal Reserve
- Federal Housing Finance Agency
- Federal Insurance Office
- Council Independent Member having Insurance Expertise
- National Association of Insurance Commissioners
- National Credit Union Administration
- North American Securities Administrators Association
- Office of the Comptroller of the Currency
- Office of Financial Research
- Securities and Exchange Commission

Think Tanks

- American Enterprise Institute
- Americans for Financial Reform
- Better Markets
- Bipartisan Policy Center
- Brookings Institution
- Committee on Capital Markets Regulation
- Hoover Institution

Academics

- Jeffrey Gordon (Columbia Law School)
- Matthew Richardson (Stern School of Business at New York University)
- Daniel Schwarcz (University of Minnesota Law School)
- Scott Harrington (The Wharton School, University of Pennsylvania)

Industry and Trade Groups

- American Council of Life Insurers
- American Insurance Association
- Association of Institutional Investors
- Financial Services Roundtable

- Investment Company Institute
- Managed Funds Association
- Property Casualty Insurers Association of America
- SIFMA
- U.S. Chamber of Commerce

Nonbank Financial Companies

- American International Group, Inc.
- BlackRock
- Fidelity Investments
- GE Capital Global Holdings, LLC
- John Hancock Financial
- MetLife, Inc.
- Navient
- Nomura
- PIMCO
- Prudential Financial, Inc.
- Toyota Motor Credit Corporation
- Vanguard Group

Financial Market Utilities

- Chicago Mercantile Exchange
- CLS Group
- The Clearing House
- The Depository Trust Company
- Intercontinental Exchange
- LCH.Clearnet Group Ltd.
- Options Clearing Corporation

Appendix B: Law and Procedures for Nonbank Financial Company Designations

The Council’s authority to designate nonbank financial companies was established by the Dodd-Frank Act. The Council issued a rule and interpretive guidance under the statute in 2012, and subsequently issued additional public guidance and procedures regarding this authority.⁴⁵ Following is a description of the Council’s existing procedures under these laws, regulations, and other documents.

Dodd-Frank Act Provisions Regarding Nonbank Financial Company Designations

The origin of the Council’s authority to designate nonbank financial companies is section 113 of the Dodd-Frank Act, which provides that the Council may determine that a nonbank financial company shall be supervised by the Federal Reserve and be subject to enhanced prudential standards if the Council determines that the company meets at least one of two alternative standards: either (1) material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States (the First Determination Standard), or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States (the Second Determination Standard).⁴⁶ The Council may subject a nonbank financial company to Federal Reserve supervision and enhanced prudential standards if either the First or Second Determination Standard is met. A determination requires a two-thirds vote of the Council’s voting members then serving, including the affirmative vote of the Chairperson of the Council.⁴⁷ A Council determination that a nonbank financial company meets one of these standards and that the company shall be subject to Federal Reserve supervision and enhanced prudential standards is commonly referred to as a designation of the company.

The statute also sets forth 10 factors that the Council must consider in making a determination regarding a nonbank financial company under section 113 of the Dodd-Frank Act. These statutory considerations include factors such as the company’s leverage, its interconnections with the financial system, its importance as a source of credit and liquidity, and its existing regulation.⁴⁸ The statute also expressly permits the Council to consider “any other risk-related factors that the Council deems appropriate.”⁴⁹

⁴⁵ In February 2015, the Council also posted frequently asked questions on nonbank financial company designations (the Nonbank Designations FAQ) on its website at <https://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx>. The FAQs answer questions such as: “Do companies have an opportunity to interact with the FSOC before a designation?” “Before the FSOC makes a final decision to designate a company, does the company know why it may be designated and have an opportunity to rebut those arguments?” “If a firm divests certain businesses or ceases certain risky activities, can the designation be reversed? How soon after designation?”

⁴⁶ Dodd-Frank Act section 113(a)(1), 12 U.S.C. § 5323(a)(1). The statute includes parallel provisions with respect to Council determinations regarding U.S. nonbank financial companies and foreign nonbank financial companies. For ease of reference, this report focuses on the authority with respect to U.S. nonbank financial companies.

⁴⁷ Dodd-Frank Act section 113(a)(1), 12 U.S.C. § 5323(a)(1).

⁴⁸ The statutory factors are: (1) the extent of the leverage of the company; (2) the extent and nature of the off-balance-sheet exposures of the company; (3) the extent and nature of the transactions and relationships of the

Before making a final determination regarding a nonbank financial company, the Council is required to provide the company with a written notice and explanation of the Council’s “proposed determination,” and give the company an opportunity for a written or oral hearing.⁵⁰

The Dodd-Frank Act subjects Council determinations to judicial review, and allows a court to rescind a Council determination if the court finds that it was arbitrary and capricious.⁵¹

For any nonbank financial company that is subject to a Council determination, the statute requires the Council to reevaluate the determination at least annually, and to rescind the determination if the Council, by a vote of at least two-thirds of the voting members then serving (including the affirmative vote of the Chairperson of the Council), determines that the company no longer meets the standards for a determination.⁵²

The Dodd-Frank Act also defines “nonbank financial company”—the only type of company that the Council can designate under section 113. A nonbank financial company is defined as one that is “predominantly engaged in financial activities,” with exceptions for firms including bank holding companies, SEC-registered national securities exchanges, and CFTC-registered derivatives clearing organizations.⁵³ The statute provides that a company is “predominantly engaged in financial activities” if either (1) the consolidated company’s annual gross revenues from activities that are “financial in nature” represents 85 percent or more of the company’s consolidated annual gross revenues, or (2) the consolidated company’s assets related to activities that are “financial in nature” represents 85 percent or more of the company’s consolidated assets. Under each of these definitions, an activity is “financial in nature” if it falls within the definition in section 4(k) of the Bank Holding Company Act, which includes, subject to certain restrictions, (a) lending, investing for others, or safeguarding money or securities; (b) insuring against loss, harm, damage, disability, or death, or providing and issuing annuities; (c) providing financial advisory services; and (d) underwriting or dealing in securities.

company with other significant nonbank financial companies and significant bank holding companies; (4) 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; (5) 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; (6) 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; (7) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (8) the degree to which the company is already regulated by one or more primary financial regulatory agencies; (9) the amount and nature of the financial assets of the company; and (10) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding. Dodd-Frank Act section 113(a)(2), 12 U.S.C. § 5323(a)(2).

⁴⁹ Dodd-Frank Act section 113(a)(2)(K), 12 U.S.C. § 5323(a)(2)(K).

⁵⁰ Dodd-Frank Act section 113(e), 12 U.S.C. § 5323(e).

⁵¹ If the Council makes a final determination under section 113 with respect to a nonbank financial company, the company may, not later than 30 days after the date of receipt of the notice of final determination, bring an action in U.S. district court for an order requiring that the final determination be rescinded. The court shall, upon review, dismiss such action or direct the final determination to be rescinded. Review of the action is limited to whether the Council’s final determination was arbitrary and capricious. Dodd-Frank Act section 113(h), 12 U.S.C. § 5323(h).

⁵² Dodd-Frank Act section 113(d), 12 U.S.C. § 5323(d); see also 12 C.F.R. 1310.23(a).

⁵³ Dodd-Frank Act section 102(a)(4)(B), 12 U.S.C. § 5311(a)(4)(B).

The Council's Rule and Guidance, Supplemental Procedures, and Other Public Guidance

In an effort to “explain and interpret the statutory factors”⁵⁴ that the Council would consider in the nonbank financial company determination process, in April 2012 the Council adopted a final rule and interpretive guidance (the Nonbank Rule and Guidance) that describe the manner in which the Council applies the statutory standards and considerations, and the processes and procedures that the Council follows, in making determinations under section 113 of the Dodd-Frank Act.⁵⁵

In February 2015, in response to criticism regarding Council procedures and after several months of engagement with industry and interested parties, the Council adopted supplemental procedures for nonbank financial company determinations (the Nonbank Supplemental Procedures).⁵⁶ The Nonbank Supplemental Procedures supplement the Nonbank Rule and Guidance with additional requirements related to engagement during evaluations for potential determinations, engagement during annual reevaluations of determinations, and transparency to the public. In addition, the Nonbank Supplemental Procedures state that the Council will publish in its annual reports the numbers of nonbank financial companies that, since the publication of the Council's prior annual report, (1) the Council voted to advance to Stage 3, (2) the Council voted not to advance to Stage 3, (3) became subject to a proposed or final determination, and (4) in the aggregate are subject to a final determination at that time.

Together, the Nonbank Rule and Guidance and the Nonbank Supplemental Procedures serve two primary purposes: (1) to explain the substantive analyses the Council intended to conduct regarding nonbank financial companies under review, and (2) to set forth the Council's process for these reviews.

The Nonbank Rule and Guidance do not provide a quantitative formula for assessing whether a nonbank financial company meets a statutory standard for determination, but instead state that each determination will be based on company- and industry-specific qualitative and quantitative information, taking into account facts and circumstances relevant to each company.⁵⁷ In the Nonbank Rule and Guidance, the Council defined key statutory terms relevant to the determinations process. It states that the Council will consider a “threat to the financial stability of the United States” to exist “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.” It also explains the Council's interpretation that “material financial distress” exists when a nonbank financial company “is in imminent danger of insolvency or defaulting on its financial obligations.”

⁵⁴ 77 Fed. Reg. 21,637, 21,647 (Apr. 11, 2012).

⁵⁵ 12 C.F.R. 1310.

⁵⁶ Financial Stability Oversight Council, Supplemental Procedures Relating to Nonbank Financial Company Determinations (Feb. 4, 2015), p. 4, available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf>.

⁵⁷ 77 Fed. Reg. 21,637, 21,642 (Apr. 11, 2012).

The Nonbank Rule and Guidance also group the 10 statutory considerations described above into six categories: size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The Nonbank Rule and Guidance state that the first three categories seek to assess the potential impact of a nonbank financial company's financial distress on the broader economy, and the latter three categories seek to assess the vulnerability of the company to financial distress. The Council analyzes a nonbank financial company using data relevant to each of these six categories.

According to the Nonbank Rule and Guidance, in evaluating a nonbank financial company, the Council intends to assess how stress from the company could be transmitted to other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning. The Council noted that an impairment of financial intermediation and financial market functioning can occur through several channels, and identified three channels as most likely to facilitate the transmission of the negative effects of a nonbank financial company's material financial distress to other financial firms and markets:

- Exposure. Through this transmission channel, the Council evaluates whether a nonbank financial company's creditors, counterparties, investors, or other market participants have exposure to the company that is significant enough to materially impair those creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability.
- Asset liquidation. The Council assesses whether a nonbank financial company holds assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings.
- Critical function or service. The Council considers the potential effects 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 and for which there are no ready substitutes.

In addition to these three transmission channels, the Nonbank Rule and Guidance note that the threat a nonbank financial company may pose to U.S. financial stability is likely to be exacerbated if the company is sufficiently complex, opaque, or difficult to resolve in bankruptcy such that its resolution in bankruptcy would disrupt key markets or have a material adverse impact on other financial firms or markets. A company's resolvability may mitigate or aggravate the potential for the company to pose a threat to U.S. financial stability.

With regard to the Council's process, the Nonbank Rule and Guidance establish a three-stage process for the Council to identify, evaluate, and communicate with nonbank financial companies. Each stage of the process involves an analysis based on an increasing amount of information to determine whether a company meets one of the statutory standards for a determination. These three stages form the procedural framework for the Council's analyses.

Stage 1. Stage 1 of the process involves a quarterly review of public and regulatory data to identify nonbank financial companies that meet certain uniform quantitative thresholds identified and discussed in the Nonbank Rule and Guidance. Stage 1 is a mechanical step that the Council uses to identify nonbank financial companies that may merit further review, based on information gathered from public and regulatory sources by the Office of Financial Research on behalf of the Council. The Nonbank Rule and Guidance state that Stage 1 is not intended to identify nonbank financial companies for a final determination, but rather to help the Council, nonbank financial companies, market participants, and other members of the public assess whether a nonbank financial company will be subject to evaluation in Stage 2. A nonbank financial company is automatically advanced to Stage 2 if it has at least \$50 billion in total consolidated assets and also meets any of the five following thresholds:

- \$30 billion in credit default swaps (CDS) for which the company is the reference entity;
- \$3.5 billion in derivative liabilities;
- \$20 billion in total debt outstanding;
- 15 to 1 leverage ratio; or
- 10% short-term debt-to-asset ratio.

In June 2015, staff guidance was issued providing additional information regarding the Stage 1 thresholds.⁵⁸ The staff guidance states that the Stage 1 thresholds are designed to be uniform, transparent, and readily calculable by the Council, nonbank financial companies, market participants, and other members of the public. The staff guidance provides detailed explanations of how each of the six Stage 1 thresholds is calculated, including information on the Council's accounting standards and data sources.

These thresholds are calculated based on information available to the relevant company, giving the company an opportunity to know whether it is likely to be considered for potential designation. At the same time, because the uniform 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, the Council may conduct a Stage 2 analysis of a nonbank financial company based on other firm-specific factors, irrespective of whether such company meets the Stage 1 thresholds.

Stage 2. If a company is to be reviewed in Stage 2, the Council's staff-level Deputies Committee instructs the Nonbank Designations Committee to form an analytical team to commence an active review of the company. The Council notifies the company and its primary financial regulatory agency or home country supervisor within 30 days after the Deputies Committee issues this instruction.⁵⁹

⁵⁸ Financial Stability Oversight Council Staff Guidance Methodologies Relating to Stage 1 Thresholds (June 8, 2015), available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf>.

⁵⁹ Nonbank Supplemental Procedures, p. 2.

During active review in Stage 2, the Council conducts a preliminary assessment of a company, based primarily on existing public and regulatory information. In addition, a company under active review in Stage 2 may submit to the Council any information it deems relevant to the Council's evaluation and may, upon request, meet with staff on the analytical team. In addition, staff on the analytical team will, upon request, provide the company with a list of the primary public sources of information being considered during the Stage 2 analysis, so that the company has an opportunity to understand the information the Council may rely upon during Stage 2. The Council will also consider in Stage 2 information available from the company's primary financial regulatory agency or home country supervisor, as appropriate.

Based on the initial evaluation in Stage 2, the Council may vote to begin a more detailed analysis of the company by advancing the company to Stage 3, or it may decide not to evaluate the company further. If the Council votes not to advance a company from Stage 2 to Stage 3, the Council will notify the company in writing of the Council's decision. The notice will clarify that a vote not to advance the company from Stage 2 to Stage 3 at that time does not preclude the Council from reinitiating active review and notifying the company in the future that it is again under active review in Stage 2.

Stage 3. If the Council advances the company to Stage 3, the Council immediately notifies the company and makes staff on the analytical team available to meet with the company's representatives to explain the evaluation process and the framework for the Council's analysis. If the analysis in Stage 2 has identified specific aspects of the company's operations or activities as the primary focus for the evaluation, staff will notify the company of those issues, although the issues will be subject to change based on the ongoing analysis.

The Council's engagement with a company during Stage 3 takes two forms. First, staff representing Council members and member agencies meet with the company. Companies in Stage 3 have been able to meet with staff of Council members and member agencies as many times as they wish, and in one case there were approximately 12 such meetings. In addition, the Council's Deputies Committee will grant a request to meet with a company in Stage 3 to allow the company to present any information or arguments it deems relevant to the Council's evaluation.⁶⁰ However, while the Council's staff-level teams have maintained an open-door policy, the Council's practice has been not to allow companies in Stage 3 to meet with the Council itself (that is, with the 15 members of the Council).

The other form of engagement with the company during Stage 3 is written information that the company submits to the Council. At the outset of Stage 3, the Council provides the company with a written request for information that generally indicates how the requested items relate to the Council's framework for analyzing potential risks. The Council (or staff of Council members and member agencies) jointly determines what information to request from the company and its regulators, and the Office of Financial Research gathers the information on behalf of the Council. These requests tend to be lengthy, with dozens of specific data requests.

⁶⁰ Nonbank Supplemental Procedures, p. 3.

In some cases, the Council has submitted numerous information requests to the company, and companies have typically submitted thousands of pages of material to the Council, although the Council has generally not informed companies in advance specifically how the Council intended to use or analyze the data. During Stage 3, the company can also submit any other information that it deems relevant to the Council's evaluation. Information considered by the Council includes details regarding the company's financial activities, legal structure, liabilities, counterparty exposures, resolvability, and existing regulatory oversight.

In addition, during Stage 3 the Council seeks to continue its consultation with the company's primary financial regulatory agency or home country supervisor.

Proposed and Final Determinations. At the end of Stage 3, the Council may vote to make a proposed determination. A proposed determination requires a two-thirds vote of the Council's voting members then serving, including the affirmative vote of the Chairperson of the Council.⁶¹ If the Council makes a proposed determination regarding a nonbank financial company, it provides the company with an explanation setting forth the Council's basis for the proposed determination.⁶² The Council's written bases for proposed designations have ranged from 124 to 270 pages.

Under the Dodd-Frank Act, there is limited time for engagement between the Council and a company after a proposed designation. Any company subject to a proposed designation can request a hearing before the Council to contest the proposed designation.⁶³ The company must request any hearing within 30 days after the proposed designation; the Council must hold a hearing within 30 days of the request; and the Council must make any final designation within 60 days after any hearing. As a result, the Council's only engagement with companies after a proposed designation has typically been the written and oral hearings. The Council published hearing procedures on its website.⁶⁴ A company has a right to a written hearing, in which it submits information and arguments to the Council.⁶⁵ In addition, the Council has stated that it intends to grant any timely request for an oral hearing from a company subject to a proposed designation, and for any such hearing to be conducted by the Council members (rather than by staff).⁶⁶

Of the four nonbank financial companies that have been subject to proposed designations by the Council, only two requested a written or oral hearing; in each case, the Council granted the

⁶¹ 12 C.F.R. 1310.10(b).

⁶² Dodd-Frank Act section 113(e)(1), 12 U.S.C. § 5323(e)(1).

⁶³ Dodd-Frank Act section 113(e)(2), 12 U.S.C. § 5323(e)(2); see also 12 C.F.R. 1310.21(c).

⁶⁴ Financial Stability Oversight Council Hearing Procedures for Proceedings Under Title I or Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, available at <https://www.treasury.gov/initiatives/fsoc/designations/Pages/Hearing-Procedures.aspx>.

⁶⁵ Dodd-Frank Act section 113(e)(2), 12 U.S.C. § 5323(e)(2); see also 12 C.F.R. 1310.21(c); see also Financial Stability Oversight Council Hearing Procedures for Proceedings Under Title I or Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, section 4.

⁶⁶ Nonbank Supplemental Procedures, p. 3.

request and conducted written and oral hearings.⁶⁷ Finally, after any written or oral hearing, the Council may vote to make a final determination regarding the company. If the Council makes a final determination, it provides the company with a written analysis that updates the explanation of the basis for the Council's decision.⁶⁸ The Council's bases for its final determinations have been as long as 341 pages.

The Council has published a public explanation of the basis for each of its four final determinations.⁶⁹ In each case, the Council's nonpublic explanation of the basis for its final determination—which was provided to the relevant company and to its primary financial regulatory agencies—was many times longer than the public basis. The Council is subject to statutory and regulatory requirements to maintain the confidentiality of certain information submitted to it by a nonbank financial company under review for a potential determination.⁷⁰ In light of these confidentiality obligations, the public explanation of the basis for the Council's final determinations omits such information, but addresses the key factors that the Council considered in its evaluation and the primary reasons for the Council's determination.

Of the four nonbank financial companies that the Council has designated, the process from the advancement of the company to Stage 3 until the final designation took between nine and 17 months.

Annual Reevaluations. As noted above, for any nonbank financial company that is subject to a final determination, the Council is required to reevaluate the determination at least annually, and to rescind the determination if the Council determines that the company no longer meets the statutory standards for a determination.⁷¹ The Council has stated that it may also consider a request from a company for a reevaluation before the next required annual reevaluation, in the case of an extraordinary change that materially decreases the threat the nonbank financial company could pose to U.S. financial stability.⁷² The Council's reevaluation process focuses on whether any material changes—including changes at the company, in its markets, or otherwise—result in the designation no longer being warranted. The Council's analyses in annual reevaluations have typically focused on changes since the Council's previous review, but also evaluate whether changes in the aggregate since the company's designation have caused the company to cease meeting the standards for designation.

Before the Council's annual reevaluation of a designated nonbank financial company, the company is provided an opportunity to meet with staff on the Council's Nonbank Designations Committee to discuss the scope and process for the review and to present information regarding

⁶⁷ Nonbank Designations FAQ, Question 15.

⁶⁸ Dodd-Frank Act section 113(e)(3), 12 U.S.C. § 5323(e)(3); see also 12 C.F.R. 1310.21(d)(2), (e)(2).

⁶⁹ See Financial Stability Oversight Council Designations,

<https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>.

⁷⁰ Dodd-Frank Act section 112(d)(5), 12 U.S.C. § 5322(d)(5); see also 12 C.F.R. 1310.20(e).

⁷¹ Dodd-Frank Act section 113(d), 12 U.S.C. § 5323(d); see also 12 C.F.R. 1310.23(a).

⁷² Nonbank Rule and Guidance, 77 Fed. Reg. 21637, 21650 (Apr. 11, 2012).

any change that may be relevant to the threat the company could pose to financial stability, including a company restructuring, regulatory developments, market changes, or other factors.

If a company contests its designation during the Council's annual reevaluation, the Council has stated that it intends to vote on whether to rescind the designation and to provide the company, its primary financial regulatory agency, and the primary financial regulatory agency of its significant subsidiaries with a notice explaining the primary basis for any decision not to rescind the designation. The notice will address the material factors raised by the company in its submissions to the Council contesting the designation during the annual reevaluation.⁷³

In addition, the Council's procedures state that each designated nonbank financial company will be provided an opportunity for an oral hearing before the Council once every five years at which the company can contest the designation.⁷⁴

⁷³ Nonbank Supplemental Procedures, p. 4; Nonbank Designations FAQ, Question 18.

⁷⁴ Nonbank Supplemental Procedures, p. 4; Nonbank Designations FAQ, Question 18.

Appendix C: Non-Designation Examples of Addressing Potential Financial Stability Risks

Council Review of MMFs

The financial crisis demonstrated the susceptibility of MMFs to runs that could have destabilizing implications for financial markets and the economy. In the days after Lehman Brothers Holdings, Inc. failed and the Reserve Primary Fund, a \$62 billion prime MMF, “broke the buck,” investors redeemed more than \$300 billion from prime MMFs and commercial paper markets shut down for even the highest-quality issuers. Treasury’s guarantee of more than \$3 trillion of MMF shares and a series of liquidity programs introduced by the Federal Reserve were needed to help stop the run on MMFs during the financial crisis and ultimately helped MMFs to continue to function as investment vehicles in the financial markets.

Following the financial crisis, the SEC took important steps in 2010 by adopting regulations to improve the resiliency of MMFs. But the 2010 reforms did not address the structural vulnerabilities of MMFs that leave them susceptible to destabilizing runs. In October 2010, the SEC issued a formal request for public comment on the reforms initially described in a report issued in 2010 by the President’s Working Group on Financial Markets, and in May 2011 the SEC hosted a roundtable on MMFs and systemic risk in which several Council members and their representatives participated. However, in August 2012, SEC Chairman Mary Schapiro announced that the SEC would not proceed with a vote to publish a notice of proposed rulemaking to solicit public comment on potential structural reforms of MMFs.

Under section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of a financial activity or practice conducted by bank holding companies or nonbank financial companies could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, U.S. financial markets, or low-income, minority, or underserved communities, the Council may provide for more stringent regulation of the financial activity or practice by issuing recommendations to a primary financial regulatory agency to apply new or heightened standards or safeguards.

In November 2012, after Chairman Schapiro’s announcement, the Council took the first step under section 120 by releasing a set of proposed recommendations for public comment. In its request for comment, the Council requested input on a number of recommended changes to the regulation and structure of MMFs that could address the risks that the Council believed remained after the initial 2010 reforms by the SEC.

The SEC then released a proposed rulemaking in June 2013 to implement structural and operational reforms to the rules governing MMFs, and the SEC adopted a final rule in July 2014. The Council stated that after the SEC’s measures were implemented, the Council intended to review and consider the effects of the reforms and their implications for financial stability.

Council Review of Asset Management Industry

Since the financial crisis, the asset management industry has increased in importance to the financial system and economy as the amount of assets under management has grown. Given the size of industry assets under management, the complexity of some of the companies providing asset management services, and the industry's importance to the provision of capital and credit to the economy, the Council considered it prudent to evaluate the industry for potential systemic risk.

In light of the unique structure of the asset management industry, including that most asset management entities act as agents in their investment activities, the Council initially requested feedback from the public and relevant stakeholders to better understand the industry and potentially any risks. The Council began by hosting a public conference in May 2014 that convened academics, policymakers, and industry representatives to discuss both the unique structure of the asset management industry as well as potential risks.

After this initial fact-finding period, the Council determined that it would be appropriate to focus on an evaluation of potential risks to financial stability arising from asset management products and activities. However, the Council did not foreclose on the possibility of designating an asset management company.

Following the asset management conference, the Council issued a public request for information in December 2014 on potential risks from certain products and activities, in particular those that might arise from mutual funds and hedge funds. The Council was particularly interested in the potential for risks arising from liquidity and redemption risk in registered funds, leverage risks in registered and private funds, and operational risks and resolution across the industry more broadly.

Stakeholders representing public interest groups, industry stakeholders, and academics provided extensive comments in response to the request for information. The Council issued a public update in April 2016 that highlighted some of the potential risks. In its statement, the Council focused on two key areas: liquidity and redemption risk, and leverage. With respect to liquidity and redemption risk, the Council highlighted the need for robust risk management practices to ensure that funds are able to meet redemption requests from investors. The Council also noted the need for clearer guidelines about the extent to which funds can hold assets with very limited liquidity, and noted that enhanced reporting and disclosure by mutual funds would help regulators and investors better monitor and mitigate potential liquidity risk. The Council also found that leverage is concentrated in larger hedge funds, but that individual regulators lack access to the data necessary to develop a comprehensive understanding of the risk such leverage may pose. The Council created a working group to address this gap. The working group shared information to better understand fund activities, including whether their use of leverage poses potential risks, and whether additional actions should be considered. Additionally, the Council's update highlighted potential risks and the need for more analysis related to the use by asset managers of one or a small group of service providers for key functions, data collection and reporting on securities lending activities, and transition plans for certain stress scenarios.

After the Council began its review, the SEC, which is the primary regulator of a significant portion of the asset management industry issued a series of proposed and final rules regarding issues including the data reporting requirements for large asset management companies and the funds they manage, rules governing liquidity risk at mutual funds, and permissible derivative investments in registered funds.

In its April 2016 statement, the Council noted the progress on reforms undertaken at the SEC and indicated that, as the SEC rulemaking process progressed, the Council intended to monitor the effects of any regulatory changes and their implications for financial stability. The Council received an update from staff at a public meeting in November 2016, at which the Council's hedge fund working group reported on its initial findings.

Appendix D: Background on the Council’s Nonbank Financial Company Designation Analyses

Following are highlights of the analyses that have been completed regarding nonbank financial companies the Council has designated or considered for designation. This information is provided as helpful context for this report’s recommendations for changes to the Council’s approach.

The Council’s Final Determinations

The Council has voted nine times whether to advance a nonbank financial company from Stage 2 to Stage 3. Of those, the Council advanced four of the companies—American International Group, Inc. (AIG), General Electric Capital Corporation, MetLife, Inc. (MetLife), and Prudential Financial, Inc.—all of which were ultimately designated by the Council. For each of the four companies, the Council’s analysis focused primarily on the exposure and asset liquidation transmission channels. For three of the companies, the Council also determined that the critical function or service transmission channel may exacerbate the risks that the company’s material financial distress could pose to financial stability. In addition, for all four of the companies, the Council determined that their complexity and potential difficulty to resolve the company aggravated the risk that the company’s material financial distress could materially impair financial intermediation and financial market functioning. The Council’s analysis of these four companies, based on the framework described in the interpretive guidance (summarized in Appendix B), is described below.

Exposure Transmission Channel. For each of the four designated nonbank financial companies, the Council analyzed direct and indirect exposures to the company arising from capital markets activities as a key source of potential risk, but the Council did not establish quantitative thresholds that, if exceeded, indicate that the company could pose a threat to U.S. financial stability. The Council’s written explanations of its final determinations describe how these companies could pose a threat to U.S. financial stability through counterparty exposures from the companies’ outstanding debt, derivatives activities, securities financing transactions, and credit lines with other large financial institutions. The final determinations also included analyses of the extent to which the firms were reference entities for single-name CDS contracts. In one case, the Council considered a company’s diversification of funding sources, as well as its capital and liquidity positions, as mitigants to the transmission of distress through the exposure channel. The analyses cite collateralization as a potential mitigating factor, but generally did not attempt to estimate net exposures based on assumptions of collateral values. For example, for repurchase agreement and securities lending transactions, the final determinations cite gross estimates of exposures against which the value of collateral held by counterparties is not netted.

In certain cases, the Council’s analysis of exposures to the relevant nonbank financial company through derivatives activities included the firm’s estimates of exposures of its largest counterparties, including an estimate of potential future exposures using value at risk or other similar methodologies, net of cash collateral and counterparty netting. In at least one case, the Council’s final determination cited fair value of the company’s derivatives liabilities to

individual counterparties without an estimate of potential future exposures. With respect to calculations of exposures related to the nonbank financial companies' outstanding debt, due to limited data availability, all four final determinations used data on top institutional buyers of the relevant nonbank financial company's debt at the time of issuance, but acknowledged that this measure might not be an accurate representation of current exposures due to secondary market transactions.

The four final determinations also discuss the risks created through indirect exposures and contagion. The Council's analyses noted that the negative effects of the material financial distress of a large, interconnected financial firm are not limited to the amount of direct losses suffered by the firm's counterparties, creditors, and customers. The final determinations stated that in general, the broader and more interconnected a firm's network of financial counterparties, the greater the potential effect of uncertain loss exposures resulting from the material financial distress of the firm. All four final determinations noted that the individual exposures of other large financial institutions to the companies may be relatively small, but argued that in the aggregate these exposures could be a potential threat to U.S. financial stability if they led to the spread of contagion among counterparties and financial markets more broadly. With limited exceptions, the final determinations did not, however, provide estimates of specific counterparty losses that would occur if the company failed, and generally provided limited analysis of specific financial markets that could be destabilized. The potential magnitude of these effects sheds light on the market impacts a firm's distress could have and illustrates the potential risk to U.S. financial stability.

For the designated insurance companies, the Council analyzed customer exposures to the companies, including institutional and retail policyholder exposures. The Council found significant exposures of a large number of corporate and financial entities that could incur meaningful losses if the insurance companies were to experience material financial distress. The final determinations also discussed the possibility of losses for retail policyholders, mitigated to some extent by protections from the state guaranty and security fund associations, and highlighted the potential for the insolvency of a large insurer to put unprecedented strain on those associations and potentially undermine confidence in other U.S. insurers, particularly during a period of general macroeconomic and financial stress.

Asset Liquidation Transmission Channel. In its analyses under the asset liquidation transmission channel, the Council analyzed the potential for the negative effects of a company's material financial distress to be transmitted if the company holds large amounts of assets that, if liquidated quickly, could significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings. As part of this analysis, the Council also considered whether a deterioration in asset pricing or market functioning could pressure other financial firms to sell their holdings of affected assets in order to maintain adequate capital and liquidity, which, in turn, could produce a cycle of asset sales that could lead to further market disruptions. However, the Council did not establish clear thresholds that, if exceeded, suggested that a company's material financial distress could pose a threat to financial stability. Further, the Council generally did not perform extensive analysis of the specific financial markets that could be disrupted by a company's asset fire sale.

The Council has begun each of its asset liquidation transmission channel analyses with an evaluation of the potential scale of a liquidity strain that the nonbank financial company under review could experience. As part of this evaluation, the Council examined the liquidity characteristics of the company's liabilities, including the company's liabilities that are short-term; liabilities that can be terminated by the counterparty and therefore could become short-term; and long-term liabilities that will come due in a short-term period. The Council has focused in particular on companies' reliance on short-term, wholesale funding, such as commercial paper and secured financing transactions. The Council also considered the companies' use of non-recourse asset-backed securities, other collateralized borrowings, and deposits.

For the designated insurance companies, the Council's analyses recognized that some products, such as term life insurance policies and payout annuities, are relatively stable because they do not accumulate a cash value that can be withdrawn at the discretion of the policyholder. However, the Council's analyses noted that other life insurance and annuity liabilities, including certain investment-oriented products such as fixed deferred annuities, build cash value over time that may be withdrawn by the policyholder with little or no penalty. In the case of each of the three designated insurance companies, the Council focused on the potential for asset liquidation to be triggered through the early withdrawal or surrender of the company's life insurance, annuity, and retirement products. The Council considered factors that could make policyholders reluctant to surrender their contracts, including surrender penalties and potential tax consequences. Despite these considerations, the Council noted that policyholder behavior might deviate from expectations in the event of a company's material financial distress, such that even "less-liquid" liabilities could be subject to material surrenders, as policyholders could be willing to incur substantial costs in order to reduce their exposure to the failing insurer.

The Council did not, in all cases, perform extensive analyses to attempt to assess how an insurance company's annuity holders and life insurance policyholders would actually behave in the event of the firm's distress (for example, whether policyholders would surrender or withdraw their contractually surrenderable or withdrawable policies). For example, the Council generally noted the volume of policies that could be withdrawn or surrendered pursuant to their terms, but the Council did not generally use historical precedents to calculate detailed estimates to assess the potential for significant policyholder withdrawals from an insurer experiencing material financial distress. The Council did apply other models, including a liquidity stress model developed by A.M. Best, as a representation of the range of potential withdrawals, but the A.M. Best model does not cite specific data or historical examples to support its assumptions. Further, use of the A.M. Best model required the Council to rely solely on publicly available statutory data rather than the proprietary data provided by the companies.

In all four of the final determinations, after assessing the liquidity of a company's liabilities, the Council considered the liquidity characteristics of the company's investment portfolio to assess the impact of the company liquidating its assets to satisfy its obligations. The Council's analyses compared the companies' investment portfolios to the average daily trading volume of each asset class to evaluate how many days it would take the companies to liquidate their entire portfolios.

In addition, for some of the companies, the Council took into account the companies' internal estimates of potential liquidity needs in a distress scenario.

For each company, to further inform the Council's understanding of fire sales, the Council conducted a relative impact analysis to assess the impact of negative shocks to the equity or assets of certain financial institutions on other financial institutions. For purposes of this analysis, the Council used an academic model that was developed to assess the potential for deleveraging at one bank to affect other banks and applied that same methodology to insurance companies and other nonbank financial companies.

Critical Function or Services Transmission Channel. The Council's analyses under the critical function or services transmission channel generally focused on the company's market share in specific product lines. The Council also attempted to assess the ability of substitutes to replace a service or function provided by the company during a period of overall stress in the financial services industry or in a weak macroeconomic environment. All four final determinations cited market share data but included primarily qualitative conclusions regarding the extent to which the company is an important source of credit to households, businesses, and to state or local governments, whether the company is an important source of liquidity to the U.S. financial system, and whether the company serves as a source of credit for low-income, minority, or underserved communities. In those cases in which the Council cited a potentially critical function or service provided by a company, it was typically based on the company having a significant market share for a function or service that the Council argued would not easily be substitutable due to its capital-intensive or bespoke nature.

Existing Regulatory Supervision and Regulation. In its analyses of the existing regulatory scrutiny to which a nonbank financial company under review is subject, the Council has considered whether the company is subject to consolidated supervision, and assessed the extent to which a company conducts activities that are regulated by non-U.S. regulatory authorities or that are not subject to any significant regulation. The Council's analyses also evaluated the nature, purpose, and limitations of the existing regulation. For example, with respect to the designated insurance companies, the final determinations pointed to limitations in state regulators' authorities with respect non-insurance affiliates, and stated that state regulators have limited expertise in identifying and addressing potential threats to financial stability.

Complexity and Resolvability. The Council's final determinations included an evaluation of the company's resolvability, as a factor that could either mitigate or aggravate the threat the company's material financial distress could pose to U.S. financial stability. These analyses examined the company's legal, funding, and operational structure. The examination of a company's legal structure considered factors including the number of countries the company operates in, the number of subsidiaries, and organizational structure. Analyses of funding structures examined the company's treasury operations, intercompany loans and borrowings, capital maintenance and other financial support agreements, and liquidity provided by its parent company. Operational structure analyses included an examination of the number of employees, number of locations, and the degree of inter-company dependency in regard to financial guarantees and support arrangements.

All four final determinations concluded that the difficulty of resolving the companies would exacerbate the threat the companies' distress could pose to U.S. financial stability. The Council identified similar obstacles to each company's resolvability, including its size, scope, and complex structure; its multi-jurisdictional operations and regulatory regimes; its funding structures; the potential loss of key personnel; and its shared services among affiliates. The final determinations for the insurance companies also considered the limited capacity of the state guaranty associations as an additional potential obstacle to resolution.

The Council's Stage 2 Evaluations

The Council's previous written evaluations of nonbank financial companies in Stage 2 are preliminary analyses that have not reflected any significant engagement with the company under review. These memoranda are authored by the Council's Nonbank Financial Company Designations Committee and are not formally approved by the Council, although they are the basis for the Council's decision whether to advance a company from Stage 2 to Stage 3.

The written analyses in Stage 2 generally describe the same factors that are addressed in the Council's bases for its final determinations. The Stage 2 documents also apply some of the same metrics as the final determination analyses. However, while the final determination analyses are organized around the three transmission channels, the Stage 2 analyses are organized around both the six-category analytic framework (which constitutes a grouping of the 10 statutory considerations, as set forth in the Council's interpretive guidance) and also the three transmission channels. The Stage 2 memoranda are primarily based on publicly available data, supplemented in some cases by a limited amount of regulatory data, and are more descriptive than analytical. As with the final determinations, the Council did not establish specific quantitative thresholds for the analyses in Stage 2, but considered various quantitative and qualitative aspects relevant to each company. The level of detail in most of the nine Stage 2 memoranda, including one recommending that the company be advanced to Stage 3, was comparable, ranging from 18 to 23 pages. However, the Stage 2 memoranda for the three insurance companies that were advanced to Stage 3 ranged from 38 to 67 pages.

For the nonbank financial companies that the Council advanced to Stage 3, the Stage 2 memoranda include recommendations regarding specific areas of inquiry meriting additional analysis in Stage 3. For example, one memorandum includes an assessment of the company's liquidity risks to determine whether it could satisfy its debt obligations, and cited its funding strategy for recommending the company be advanced to Stage 3. For all of the insurance companies that were advanced to Stage 3, the Stage 2 memoranda applied the assumptions from an A.M. Best liquidity model to the companies' insurance liabilities to estimate potential liquidity outflows in a 30-day stress scenario and in a six- to twelve-month stress scenario.

The Council's Annual Reevaluations of Previous Designations

The Dodd-Frank Act requires the Council to annually reevaluate its nonbank financial company designations. In its annual reevaluations, the Council has reviewed key financial and regulatory developments related to the designated firms.

In all cases, the annual reevaluations focused on business characteristics and activities that were highlighted in the final determinations, comparing current levels to levels at the time of the prior reevaluation and at the time the companies were designated. In addition, the reevaluations were organized around the three transmission channels described above as well as existing regulatory scrutiny and the company's complexity and resolvability. The annual reevaluations in which a company was contesting the Council's determination (i.e., where the company requested that the Council rescind the designation in the annual reevaluation) were generally more in-depth, in part reflecting additional data provided to the Council by the contesting company. Consistent with the analyses in the final determinations, the Council did not establish specific quantitative thresholds that, if not exceeded, suggested a company would no longer pose a threat to financial stability. The annual reevaluations also did not explicitly articulate the Council's view of specific risks that the companies should prioritize in order to address the Council's concerns.

MetLife Litigation

After the Council made a final determination regarding MetLife in December 2014, the company brought suit against the Council seeking a rescission of its designation. In March 2016, the U.S. District Court for the District of Columbia rescinded the designation of the company on three independent grounds.⁷⁵

First, the court held that the Council had violated its interpretive guidance by failing to assess the likelihood of MetLife's material financial distress. Second, the court held that the Council "hardly adhered to any standard when it came to assessing MetLife's threat to U.S. financial stability"; the court emphasized that the Council did not support its predictive judgments by estimating counterparty losses that would occur if MetLife experienced material financial distress and did not adequately explain how those losses would cause markets to destabilize.⁷⁶ Third, the court held that the Council was required to weigh the benefits of designation against the costs to the company.

The Department of Justice filed an appeal with the U.S. Court of Appeals for the District of Columbia Circuit in April 2016. The appeal is currently pending.

⁷⁵ See *MetLife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016).

⁷⁶ *Id.* at 237-38.

Appendix E: Laws and Procedures for FMU Designations

Dodd-Frank Act Provisions Regarding FMU Designations

One of the Council's statutory duties is to "identify systemically important FMUs."⁷⁷ The Dodd-Frank Act requires the Council to designate FMUs that the Council determines are, or are likely to become, systemically important. Subject to certain exclusions, the Dodd-Frank Act defines an FMU as "any person that manages or operates a multilateral system for the purposes of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person."⁷⁸ An FMU is systemically important if a failure of or disruption to the FMU could create, or increase, the risk of significant liquidity or credit problems spreading across financial institutions and markets and thereby threaten the stability of the U.S. financial system.⁷⁹ Before designating an FMU, the Council is required to consult with the Federal Reserve and the relevant federal agency that has primary jurisdiction over the FMU under federal banking, securities, or commodity futures laws.

In determining whether an FMU is, or is likely to become, systemically important, the Council is required to take into consideration the following factors: (a) the aggregate monetary value of transactions processed by the FMU; (b) the aggregate exposure of the FMU to its counterparties; (c) the relationship, interdependencies, or other interactions of the FMU with other FMUs; (d) the effect that the failure of or a disruption to the FMU would have on critical markets, financial institutions, or the broader financial system; and (e) any other factors that the Council deems appropriate.⁸⁰

The Council's Rule on FMU Designations

In July 2011, the Council adopted a final rule to implement its authority to designate FMUs under section 804 of the Dodd-Frank Act (the FMU Rule).⁸¹ The FMU Rule established an analytic framework for evaluating FMUs for potential designation that incorporates the statutory considerations set forth in the Dodd-Frank Act and adds sub-categories with more detailed analytic metrics. For example, the FMU Rule incorporates the statutory requirement to consider the aggregate monetary value of transactions processed by an FMU, and added sub-categories to include the number of transactions processed, cleared, or settled by the FMU, and the value of transactions processed, cleared, or settled by the FMU, among other metrics.⁸²

The FMU Rule also established a two-stage process the Council uses for evaluating FMUs for potential designation. The first stage is based on the statutory considerations and sub-categories

⁷⁷ Dodd-Frank Act section 112(a)(2)(J), 12 U.S.C. § 5322(a)(2)(J).

⁷⁸ Dodd-Frank Act section 803(6), 12 U.S.C. § 5462(6).

⁷⁹ Dodd-Frank Act section 803(9), 12 U.S.C. § 5462(9).

⁸⁰ Dodd-Frank Act section 804(a)(2), 12 U.S.C. § 5463(a)(2).

⁸¹ Financial Stability Oversight Council Final Rule: Authority to Designate Financial Market Utilities as Systemically Important, 76 Fed. Reg. 44763 (Jul. 27, 2011).

⁸² 12 C.F.R. 1320.10.

described above.⁸³ This stage is intended as a largely quantitative process for the Council to preliminarily identify a set of FMUs whose failure or disruption could potentially threaten the stability of the U.S. financial system. In the second stage, the FMUs identified through the first stage of review are subject to a more in-depth review, with a greater focus on qualitative factors, in addition to other institution- and market-specific considerations.⁸⁴

The FMU Rule provides that before making any final determination with respect to an FMU, the Council must notify the FMU that the Council is considering a proposed determination, and must provide the FMU an opportunity to submit written materials to the Council. These submissions may address whether the FMU is systemically important, taking into consideration the designation factors, and proposed changes by the FMU that could reduce or increase the inherent systemic risk the FMU poses and the need for designation.⁸⁵ Before making a final designation, the Council must make a proposed determination and provide the FMU with advance notice of the proposed determination and proposed findings of fact supporting that determination.⁸⁶ Within 30 days after the date of the notice, the FMU may request a hearing before the Council to demonstrate that the proposed designation is not supported by substantial evidence.⁸⁷ The Council must make any final designation within 60 days after any hearing.⁸⁸

The Dodd-Frank Act and the FMU Rule also include a mechanism for the Council to rescind FMU designations. The Council must rescind an FMU designation if the Council determines, by a two-thirds vote (including the affirmative vote of the Chairperson of the Council), that the FMU no longer meets the standards for systemic importance.⁸⁹

Risk-Management Standards and Other Results of FMU Designation

Section 805(a) of the Dodd-Frank Act authorizes the Federal Reserve, in consultation with the Council and certain supervisory agencies, and taking into consideration relevant international standards and existing prudential requirements, to prescribe risk management standards governing the operations related to the payment, clearing, and settlement activities of systemically important FMUs.⁹⁰ The objectives and principles for the risk management standards are to promote robust risk management and safety and soundness, reduce systemic risk, and support the stability of the broader financial system.⁹¹ These standards may address the following areas:

- risk management policies and procedures;
- margin and collateral requirements;

⁸³ 12 C.F.R. 1320.10.

⁸⁴ 12 C.F.R. 1320.11.

⁸⁵ 12 C.F.R. 1320.11(b).

⁸⁶ 12 C.F.R. 1320.12(a).

⁸⁷ 12 C.F.R. 1320.12(b).

⁸⁸ 12 C.F.R. 1320.15.

⁸⁹ 12 C.F.R. 1320.13(b), (c).

⁹⁰ Dodd-Frank Act section 805(a)(1), 12 U.S.C. § 5464(a)(1).

⁹¹ Dodd-Frank Act section 805(b), 12 U.S.C. § 5464(b).

- participant or counterparty default policies and procedures;
- the ability to complete timely clearing and settlement of financial transactions;
- capital and financial resource requirements for designated FMUs; and
- other areas that are necessary to achieve these objectives and principles.⁹²

In addition, the Federal Reserve may authorize a Federal Reserve Bank to establish and maintain an account for a designated FMU and provide the services listed in section 11A(b) of the Federal Reserve Act,⁹³ including wire transfer services, automated clearinghouse services, and settlement services, to the designated FMU.⁹⁴

In addition, the Federal Reserve may authorize a Federal Reserve Bank to provide to a designated FMU discount and borrowing privileges,⁹⁵ under section 10B of the Federal Reserve Act.⁹⁶ This action may occur only in unusual or exigent circumstances, upon the affirmative vote of a majority of the Board of Governors of the Federal Reserve System then serving after consultation with the Treasury Secretary, and upon a showing by the designated FMU that it is unable to secure adequate credit accommodations from other banking institutions.

⁹² Dodd-Frank Act section 805(c), 12 U.S.C. § 5464(c).

⁹³ 12 U.S.C. § 248a(b).

⁹⁴ Dodd-Frank Act section 806(a), 12 U.S.C. § 5465(a).

⁹⁵ Dodd-Frank Act section 806(b), 12 U.S.C. § 5465(b).

⁹⁶ 12 U.S.C. § 347b.

Appendix F: Background on the Council's FMU Designations Analyses

The Council has designated eight FMUs as systemically important. All of these designations occurred on July 18, 2012. The eight designated FMUs serve various roles in the financial system, including acting as central counterparties, settlement systems, and security depositories. The designated FMUs are:

- The Clearing House Payments Company L.L.C. on the basis of its role as the operator of the Clearing House Interbank Payments System
- CLS Bank International
- Chicago Mercantile Exchange, Inc.
- The Depository Trust Company
- Fixed Income Clearing Corporation
- ICE Clear Credit LLC
- National Securities Clearing Corporation
- The Options Clearing Corporation

The FMU Rule provides guidance regarding how the statutory factors would be applied. However, in addition to the functional heterogeneity of the designated FMUs, the nature of the financial products these FMUs are involved in creates significant variation in the nominal sizes of many of the factors considered. For example, although a settlement system may nominally handle higher dollar volumes than a central counterparty, the risk profile of the settlement system's activities is not necessarily greater than that of a central counterparty. Similarly, even when comparing entities providing the same function, such as two central counterparties, the entities' financial product mixes can lead to large variations in the dollar volume and number of transactions cleared and their accompanying risk profiles. For example, interest rate contracts tend to be frequently traded and have high nominal values compared to other products such as commodity futures, but are generally less risky than many other types of contracts.

In light of the difficulty in comparing the different types of FMUs using a consistent set of quantitative measures, qualitative considerations, particularly the substitutability of the FMUs, were important factors in the Council's Stage 2 analyses. Each of the designated FMUs, to varying degrees, provides services or deals in products that at the time of designation did not have readily available substitutes if there were financial distress at the FMU. A brief summary of the primary activities of each designated FMU, and some of the key considerations of their systemic importance, are detailed below. (See the Treasury Capital Markets Report and Appendix A to the Council's 2012 annual report for more detail.⁹⁷)

Following are summaries of the Council's findings in its final determinations regarding FMUs.

⁹⁷ Treasury Capital Markets Report, pp. 152-161; Appendix A to the Council's 2012 annual report, which sets forth the Council's public bases for its FMU designations, is available at <https://www.treasury.gov/initiatives/fsoc/Documents/2012%20Appendix%20A%20Designation%20of%20Systemically%20Important%20Market%20Utilities.pdf>.

Clearing House Interbank Payments System (CHIPS)

In its designation of CHIPS, the Council stated that “a failure of or disruption to CHIPS could increase the risk of significant liquidity problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States.” Among the factors cited by the Council is that CHIPS is the only private-sector system in the United States for settling large-value U.S. dollar payments continuously throughout the day. Large-value payment systems play a key role in financial markets by providing a means for banks to discharge payment obligations related to important financial market activities, such as money market and commercial transactions. Payments settled by such systems are often high in value and require secure, reliable, and timely settlement.

CHIPS participants are U.S. commercial banks and foreign banks with offices in the United States. These participants constitute some of the largest banks in the world by asset size, and include bank subsidiaries of financial institutions identified as global systemically important banks by the Financial Stability Board. Participants also send and receive payments over CHIPS on behalf of thousands of customers, including a large number of correspondent banks.

CLS Bank International (CLS Bank)

In its designation of CLS Bank, the Council stated that a “failure of or long-term disruption to CLS Bank would have negative effects on both its members and the FX market resulting in significant credit, liquidity, and operational disruptions” that “would likely spillover into U.S. and global financial markets.” CLS Bank is the sole multi-currency settlement system of its kind, offering both liquidity savings and settlement risk mitigation across all major currencies. The CLS Bank system links more than 8,000 institutions, including many of the largest banks, investment companies, and non-financial corporations, both domestic and foreign. Through CLS Bank, these institutions are able to reduce their settlement risk in the foreign exchange market by an average daily value of approximately \$2.3 trillion through the use of payment-versus-payment settlement.

Chicago Mercantile Exchange, Inc. (CME)

In its designation of CME, the Council stated that, due to its large role in the futures and options market, “a failure or disruption of CME would likely have significant detrimental effect on the liquidity of the futures and options markets, clearing members, which include large financial institutions, and other market participants, which would, in turn, likely threaten the stability of the broader U.S. financial system.”

CME, through its U.S. clearing division, CME Clearing, is one of the largest central counterparty clearing services providers in the world. CME clears all contracts traded on the designated contract markets owned by CME Group, Inc. (the Chicago Mercantile Exchange, the Board of Trade of the City of Chicago, Inc., the New York Mercantile Exchange, and the Commodity Exchange, Inc.). CME serves direct participants that are financial institutions and, through such direct participants, indirect participants including large commercial market participants, money

managers, and pension plans. The futures and options cleared by CME are based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. In addition, CME clears the largest and most liquid futures contracts based on the S&P 500 Index, Eurodollar, U.S. Treasuries, and energy products, as well as interest rate swaps.

The Depository Trust Company (DTC)

In its designation of DTC, the Council stated that “DTC plays an important role in financial markets in particular because it holds in its custody substantially all corporate debt and equity securities available for trading in the United States,” and as a result, a failure of or disruption to the functioning of DTC could “have cumulative negative effects on U.S. domestic equity and debt markets, financial institutions, and the broader financial system that are substantial in their own right, and so severe as to create a risk that liquidity and credit problems experienced could spread among financial institutions and other markets and therefore threaten the stability of the financial system.”

DTC serves as the central securities depository for substantially all corporate and municipal debt and equity securities available for trading in the United States. DTC also facilitates trade processing of related transactions such as distribution of dividends, principal, and interest for such securities (also known as “asset servicing”). Participants include U.S. broker-dealers, banks, trust companies, non-U.S. central security depositories, and government-sponsored enterprises. DTC clears and settles virtually all broker-to-broker equity and corporate and municipal debt securities transactions in the United States and supports a significant number of trading venues for which it provides services.

Fixed Income Clearing Corporation (FICC)

In its designation of FICC, the Council stated that, due to the importance of its role in the U.S. government securities and mortgage-backed securities markets, “a failure of or a disruption to FICC could increase the risk of significant liquidity problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States.” FICC plays a prominent role in the fixed income market as the sole clearing agency in the United States acting as a central counterparty and provider of significant clearance and settlement services for cash-settled U.S. Treasury and agency securities and the non-private label mortgage-backed securities markets. Each of FICC’s two divisions, the Government Securities Division and Mortgage Backed Securities Division, has relationships with over 100 participants. While FICC only clears approximately half of all domestic trades involving cash-settled U.S. government and agency securities and mortgage-backed securities, it is the predominant provider in its market, as no other clearing agencies provide the same depth and scale of services.

U.S. government securities and mortgage-backed securities play an important role in the financial markets as hedging and collateral for a wide range of purposes. Due to the high volume of trading in these markets, the multilateral netting and central counterparty services provided by

FICC play an important role in maintaining liquidity and efficiency while minimizing the risk of failed settlements due to the default of a single counterparty.

ICE Clear Credit LLC (ICE Clear Credit)

ICE Clear Credit clears a majority of the CDS products in the United States that are eligible for clearing by a central counterparty, including active CDS indexes and the most liquid U.S. single names in the CDS market. ICE Clear Credit's clearing members include a number of firms identified as global systemically important financial institutions by the Financial Stability Board. For centrally cleared CDS contracts, ICE Clear Credit reduces the credit and liquidity risks between the two original bilateral counterparties, and improves market transparency and functioning by establishing daily settlement prices for the trades it clears.

In its designation of ICE Clear Credit, the Council highlighted its processing of "high-dollar-value transactions on a daily basis for critical U.S. financial markets" and the "large amounts of collateral on deposit." The Council stated, "Coupled with the unique nature of CDS and the attendant jump-to-default risk that has to be managed, as well as the size and nature of ICE Clear Credit's clearing members, a significant disruption or failure of ICE Clear Credit could create instability in the U.S. CDS and securities markets." The significant margin deposits held by ICE Clear Credit could lead to a period in which affected entities may be unable to access, or in a worst case scenario would lose, the collateral they posted with the clearinghouse. Further, if ICE Clear Credit does not have sufficient financial resources to satisfy its obligations to surviving market participants, the ability of those participants to meet other financial obligations could be adversely impacted. An ICE Clear Credit failure or disruption of its services could directly pose credit and liquidity risk to other financial market infrastructures, which include depositories, other clearinghouses, custodians, DCMs, trade repositories, and swap execution facilities.

National Securities Clearing Corporation (NSCC)

NSCC provides clearing, settlement, risk management, central counterparty services, and a guarantee of completion for virtually all broker-to-broker trades involving equity securities, corporate and municipal debt securities, American depository receipts, exchange-traded funds, and unit investment trusts. Clearance and settlement generally occurs through NSCC's Continuous Net Settlement system under which all eligible compared and recorded transactions for a particular settlement date are netted by issue into one net long (buy) or net short (sell) position. NSCC plays an important role in managing the risks of these markets while maximizing their efficiency. NSCC guarantees the settlement of matched trades. As the central counterparty, NSCC is the legal counterparty to all of its members' net settlement obligations, which limits the risk that individual market participants will fail to deliver on their side of a trade securities transaction. Additionally, NSCC nets trades and payments among its members, reducing the value of securities and payments that need to be exchanged by an average of over 97 percent each day.

The Options Clearing Corporation

Options Clearing Corporation is the predominant clearing organization for U.S. options markets. Options Clearing Corporation provides clearing members with clearing and settlement services that eliminate the need for individual counterparties to bilaterally exchange option premiums and collect and maintain margin on a daily basis. These services increase the speed and efficiency of trading and settlement while reducing members' operational expenses. Additionally, Options Clearing Corporation acts as a central counterparty for certain options and other derivatives therefore reducing credit risk for its members. The types of options cleared include those on equities, indices, currency, and commodities. Equity options account for the majority of total clearing volume. Options Clearing Corporation is the sole issuer and settling agent for all stock options, equity index options, and single-stock futures listed on U.S. exchanges.