

FSOC Finalizes Rule for Designation of Insurance Company and Other Nonbank “Systemically Important Financial Institutions”

April 17, 2012

On April 3, 2012, the Financial Stability Oversight Council (FSOC) approved by unanimous vote a final rule for designating nonbank financial companies as systemically important financial institutions.¹ An FSOC determination of systemic importance will subject a nonbank financial company to the prudential standards of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) and to the supervision of the Board of Governors of the Federal Reserve System (Board of Governors). The final rule follows a second notice of proposed rulemaking on October 11, 2011 (Second Notice) and a first notice of proposed rulemaking on January 26, 2011.²

Background

In issuing the final rule and related interpretive guidance, the FSOC noted that it received 41 comment letters to the Second Notice, including 12 comment letters from companies or trade associations in the insurance industry. The Second Notice followed the addition of the Director of the Federal Insurance Office (Michael McRaith) and the confirmation of the “Independent Insurance Expert” (Roy Woodall) to the FSOC after members of the insurance industry expressed concern at the absence of sufficient insurance industry input and representation among the FSOC members.³ In its introductory discussion of the comments received in response to the Second Notice, the FSOC cited comments from the insurance industry arguing “that the products and services of regulated, traditional insurance companies are highly substitutable and that these companies operate without significant leverage or reliance on short-term debt and are subject to high levels of existing regulatory scrutiny.” Responding to such comments, the FSOC noted that “[t]he [FSOC] does not intend to provide industry-based exemptions from potential determinations under section 113 of the Dodd-Frank Act, but the [FSOC] intends to give these comments due consideration in the Determination Process.”

The process for making determinations outlined by the final rule and interpretive guidance is substantially identical to that outlined in the Second Notice. Specifically, a three-stage process “of increasingly in-depth evaluation” will be used to consider the 11 factors enumerated in Section 113 of the Act, in addition to “any other risk-related factors that the [FSOC] deems appropriate.” As in prior FSOC proposals, the interpretive guidance distills the statutory considerations into the following six conceptual categories: (i)

¹ The final rule was published in the Federal Register on April 11, 2012, and is available at <http://federalregister.gov/a/2012-8627>. The final rule becomes effective on May 11, 2012.

² These earlier releases were discussed in several previous Sutherland Legal Alerts, see “The Financial Stability Oversight Council Holds Inaugural Meeting; Proposed Rulemakings on Nonbank Financial Companies and the Volcker Rule Will Impact Insurers” (October 13, 2010); “The Financial Stability Oversight Council Takes Action: New Insight into Determination of Which Insurers May be Subject to Enhanced Oversight” (February 18, 2011); “FSOC Proposed Rulemaking on Fed Supervision of Nonbank Financial Companies: Critics Submit Comments and Ask Who is Speaking on Behalf of the Insurance Industry” (March 7, 2011); “FSOC Proposed Rulemaking on Fed Supervision of Nonbank Financial Companies: Congress Questions Transparency” (May 23, 2011); and “FSOC Proposal Further Clarifies Which Nonbank Financial Companies Could Be Designated ‘Systemically Important Financial Institutions’” (October 17, 2011). These Legal Alerts are available at www.regulatoryreformtaskforce.com.

³ See “FSOC Proposal Further Clarifies Which Nonbank Financial Companies Could Be Designated ‘Systemically Important Financial Institutions’” (October 17, 2011).

interconnectedness, (ii) substitutability, (iii) size, (iv) leverage, (v) liquidity risk and maturity mismatch, and (vi) existing regulatory scrutiny. The interpretive guidance explains these categories in detail, including how each category relates to the various statutory factors, and discusses the types of metrics that the FSOC will review.

Stage 1

Stage 1 will begin with an assessment of which nonbank financial companies with at least \$50 billion in total consolidated assets also meet or exceed any one of certain uniform quantitative thresholds. The companies identified in Stage 1 will be further assessed in Stage 2 and possibly Stage 3. The quantitative thresholds are designed to reflect only some of the six conceptual categories. The final rule expressly notes the FSOC's determination that quantitative thresholds measuring substitutability and existing regulatory scrutiny would not be appropriate to the Stage 1 review. As noted above, insurance industry comments pointed to precisely these qualities of insurance companies as factors to support their argument for a general exemption of insurance companies from potential FSOC determinations. The authors of the final rule and interpretive guidance likely perceived quantitative thresholds relating to substitutability and existing regulatory scrutiny as stand-ins for industry-based exemptions, which the FSOC strongly avoids throughout the final rule and interpretive guidance.

The current quantitative thresholds (the Stage 1 thresholds) are as follows:

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

The final interpretive guidance incorporates several clarifying changes in response to comments received by the FSOC with regard to the Stage 1 thresholds. The comments received generally fell into the following three categories: (i) the level of a threshold should be changed; (ii) the method of calculating a threshold should be refined; and (iii) a threshold is inappropriate.

Among the changes adopted was a revision of the former "loans and bonds outstanding" threshold to a "total debt outstanding" threshold. The interpretive guidance also now states that this threshold will be defined broadly, and regardless of maturity, to include loans, bonds, repurchase agreements, commercial paper, securities lending arrangements, surplus notes and other forms of indebtedness.

Additional clarifications to the Stage 1 thresholds include clarification that for foreign nonbank financial companies, only U.S. assets, liabilities and operations of the foreign nonbank financial company and its subsidiaries will be evaluated. In contrast, for U.S. nonbank financial companies, the FSOC will apply the Stage 1 thresholds based on the global assets, liabilities and operations of the U.S. company and its subsidiaries. In response to numerous suggestions that the thresholds be adjusted periodically over time based on indexes such as inflation or economic growth, the FSOC included language in the final interpretive guidance indicating that the FSOC intends to review the dollar-denominated thresholds at least every five years. The FSOC also left room for the possibility of adopting new thresholds "as reporting requirements evolve and new information about certain industries and nonbank financial companies become available." Finally, with regard to accounting issues, the interpretive guidance now

states that the FSOC will use the most recently available data, either on a quarterly or less frequent basis, for companies for which quarterly data is not available, and that the FSOC will use Generally Accepted Accounting Principles (GAAP) when such information is available or otherwise rely on Statutory Accounting Principles (SAP). The FSOC did receive some suggestions to rely on SAP when analyzing insurance companies; however the FSOC determined that GAAP is more suited for purposes of consistency and uniformity in the application of the Stage 1 thresholds. Both GAAP and SAP will be evaluated in Stages 2 and 3 for insurance companies.

It initially appears that few nonbank financial companies, including insurance companies, are likely to meet the Stage 1 thresholds.⁴ The final interpretive guidance does, however, retain a controversial provision that “the [FSOC] may initially evaluate any nonbank financial company based on other firm-specific qualitative or quantitative factors, irrespective of whether such company meets the thresholds in Stage 1,” thus granting a great deal of discretion to the FSOC in choosing which companies to evaluate as potentially significant. It is therefore impossible to predict precisely how many nonbank financial companies will be evaluated by the FSOC for a possible determination of systemic importance.

Stages 2 and 3

Companies identified by the FSOC in Stage 1 will be further assessed in Stage 2 based on publicly available information and information “voluntarily submitted by the company.” The interpretive guidance characterizes Stage 2 as a “robust analysis of the potential threat that each of those nonbank financial companies could pose to U.S. financial stability.” Based on the Stage 2 analysis, the FSOC will contact those nonbank financial companies that the FSOC believes merit further evaluation in Stage 3.

The FSOC received many suggestions with regard to the timing of, and the process for, the review in Stages 2 and 3. For example, several commenters suggested that the nonbank financial companies that are evaluated in Stage 2 receive notice at the beginning of Stage 2 or that a company be notified if it is evaluated in Stage 2 but will not be evaluated in Stage 3. Responding to these comments, the FSOC noted that Stage 2 is intended to comprise the FSOC’s initial analysis and that Stage 3 will provide nonbank financial companies with a sufficient opportunity to participate in the determination process. The FSOC stated that while it does not currently intend to provide notice of not continuing a review to Stage 3, the FSOC may, in the future, adjust the notification process as it gains experience. Furthermore, in responding to requests for a timetable of review, the FSOC noted that “[d]ue to the diverse types of nonbank financial companies that may be evaluated in Stages 2 and 3 and the unique threats that these nonbank financial companies may pose to U.S. financial stability, the analysis and timing of review will depend on the particular circumstances of each nonbank financial company under consideration and the unique nature of the threat it may pose to U.S. financial stability.”

The final interpretive guidance was revised to clarify that in Stage 2 the FSOC will, to the extent deemed appropriate, consult with the primary financial regulator of each significant subsidiary of a nonbank financial company. For insurance companies, Section 1310.2 of the final rule defines “primary financial regulatory agency” as “[t]he State insurance authority of the State in which an insurance company is domiciled,” but only “with respect to the insurance activities and activities that are incidental to such insurance activities of an insurance company that is subject to supervision by the State insurance authority under State insurance law.” This definition leaves open the possibility that the FSOC may or

⁴ See “FSOC Proposal Further Clarifies Which Nonbank Financial Companies Could Be Designated ‘Systemically Important Financial Institutions’” (October 17, 2011).

may not consult with an insurance company group's lead regulator when reviewing the non-insurance activities of the group.

The guidance also clarified that in evaluating existing regulatory scrutiny, the FSOC will consider both the existence and effectiveness of consolidated supervision (proposed language from the Second Notice referenced only existence, not effectiveness) and will determine whether and how non-regulated entities are supervised on a group-wide basis (former language referenced only whether, not how). In noting these revisions, the FSOC reiterated that its analyses would not be industry-specific (i.e., one analysis for the insurance sector) but will be company-specific. The inclusion of the "effectiveness" and "how" language noted above may be an indication, however, that where the FSOC deems existing regulation to be sufficient, a determination would likely be made not to subject a company to a Stage 3 review.

In Stage 3, the FSOC will conduct an in-depth review focused on whether the nonbank financial company could pose a threat to U.S. financial stability because of the company's material financial distress or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company. This review will be conducted using information collected directly from the company, as well as the information used in the first two stages of review. In Stage 3, the FSOC will also work with the Office of Financial Research (OFR) to collect information from the company under review. The Stage 3 examination will be much deeper and specifically targeted and may include an examination of confidential business information. While Section 1310.20(e) of the final rule provides that the FSOC shall maintain the confidentiality of any data, information and reports submitted by a company, either voluntarily or in response to a request from the FSOC or OFR under the rule, some companies have expressed concern that confidential information may inadvertently become public despite this administrative protection.

Proposed and Final Determinations

Following the Stage 3 analysis, the company will receive written notice that the FSOC is considering the company for a determination as systemically important. In newly included language of the final rule, the company will then have at least 30 days to submit written materials to contest the FSOC's consideration for the proposed determination. The FSOC may, by a vote of two-thirds of its members (including an affirmative vote of the Secretary of the U.S. Treasury acting in his capacity as the FSOC Chairperson (Chairperson)), make a proposed determination with respect to the nonbank financial company. Upon issuing the proposed determination, the FSOC will also provide the company with a written explanation of the basis of its determination. The FSOC will also notify a company evaluated in Stage 3 if it ceases to be considered for determination.

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

The FSOC declined to include a suggestion that the names of companies under evaluation for a determination be published prior to a final determination. The FSOC did, however, include new language in the interpretive guidance that it intends to provide a nonbank financial company with a notice of a final

determination at least one business day before publicly announcing the final determination “to prepare any public communications and disclosures.” Finally, in response to a request that the FSOC include, in every notice of proposed and final determination, the regulatory approach recommended to the Board of Governors, the FSOC stated that, pursuant to the Act, the establishment of prudential standards is within the purview of the Board of Governors and, as such, the FSOC “does not generally intend to make company-specific regulatory recommendations to the Board of Governors in connection with determinations.”



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Eric A. Arnold	202.383.0741	eric.arnold@sutherland.com
B. Scott Burton	404.853.8217	scott.burton@sutherland.com
James M. Cain	202.383.0180	james.cain@sutherland.com
James R. Dwyer	212.389.5046	james.dwyer@sutherland.com
Daphne G. Frydman	202.383.0656	daphne.frydman@sutherland.com
Ling Ling	202.383.0236	ling.ling@sutherland.com
David A. Massey	202.383.0201	david.massey@sutherland.com
John S. Pruitt	212.389.5053	john.pruitt@sutherland.com
Stephen E. Roth	202.383.0158	steve.roth@sutherland.com
Cynthia R. Shoss	212.389.5012	cynthia.shoss@sutherland.com
Mary Jane Wilson-Bilik	202.383.0660	mj.wilson-bilik@sutherland.com
Earl Zimmerman	212.389.5024	earl.zimmerman@sutherland.com

For more information on Dodd-Frank, please visit www.regulatoryreformtaskforce.com.