Client Alert

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Now the Fun Begins: FSOC Proposes the First Three Nonbank SIFIs

In a June 3, 2013 closed-door meeting, the Financial Stability Oversight Council ("FSOC") voted to propose the designation of three financial services companies—American International Group ("AIG"), Prudential Financial and GE Capital—as the first systemically significant nonbank financial institutions ("nonbank SIFIs") under section 113 of the Dodd-Frank Act.

The FSOC decision, announced by the Treasury Secretary, did not identify specific names, but all three companies publicly confirmed their proposed nonbank SIFI status. If these proposed designations become final, these three companies will become the first nonbank SIFIs to be subjected to stringent Federal Reserve Board oversight and supervision, as well as capital and other regulatory requirements, under Title I of the Dodd-Frank Act. In addition, these designations will bring to life the Dodd-Frank Act's orderly liquidation authority that applies to systemically significant financial firms, in the event that one of these companies may fail or be in danger of failing in the future.

The FSOC's action to begin the process of designating nonbank SIFIs has been long awaited—some would say long-overdue—and the identities of the three companies that have been proposed for SIFI designation come as no real surprise. Nonetheless, the FSOC's action marks an important milestone in the implementation of the Dodd-Frank Act's systemic regulation framework. While the actual significance of these designations likely will emerge more clearly in the coming weeks and months, the FSOC's action brings into sharper focus the questions and challenges that the designated firms and their regulators will face.

Does saying it's so make it so? A continuing question about the nonbank SIFI process is whether it amounts to a self-fulfilling prophecy. In other words, does the act of designating a company as a nonbank SIFI effectively make the company "too big to fail"? We do not know for sure, but the designation process sends an obvious message that the FSOC believes that the failure of a designated nonbank SIFI could pose a material risk to the financial system. How the markets will react to this message remains to be seen. To be sure, the markets will watch closely how these designations affect the companies' financial and performance metrics, including stock prices and funding costs. In addition, the FSOC's action is sure to add further fuel to the ongoing political and public policy debate over "too big to fail" and the impact of Dodd-Frank regulation on the financial markets.

Regulating the companies—easier said than done? The Dodd-Frank Act specifies in broad terms the consequences of nonbank SIFI designation, including new Federal Reserve Board oversight and supervision, regulatory capital standards, stress-testing and liquidity requirements, counterparty exposure restrictions, as well as regulation of proprietary trading and private fund activities under the Volcker Rule, to name a few specific elements. But the challenges that the federal regulatory agencies will face in implementing and administering these requirements will be formidable, inasmuch as the three companies in question have widely divergent balance sheets, asset portfolios, business and operational profiles, and capital structures that may not lend themselves to a uniform regulatory framework. Among other things, the balance sheets and capital structures of consolidated insurance enterprises such as Prudential and AIG may not easily adapt to bank-like capital requirements, and the federal regulatory superstructure will have to take into account the presence of longstanding and possibly inconsistent state-level insurance financial and solvency regulation. These and many other substantive and operational supervisory and regulatory issues will have to be carefully addressed by the Federal Reserve Board.

The companies themselves—their challenges. The three designated companies will now face the challenge of adapting to regulatory oversight that is dramatically different, and significantly more intrusive, than anything they have experienced before. Although these enterprises previously were subject to Office of Thrift Supervision jurisdiction because they owned federal savings bank subsidiaries, the scope and intensity of that former regime was materially less than what these firms may encounter going forward. In turn, these firms now must become deeply informed on the nature, tenor and impact of the bank regulatory supervisory structure, which includes understanding the powers, functions, priorities and attitudes of the Federal Reserve Board, and its approach to supervision and regulation matters. Compliance with specific prudential rules, however, will not be possible until the Federal Reserve Board adopts nonbank SIFI rules.

So what happens next? There are actually three subparts embedded in this broader question: first, the short-term regulatory process for these three proposed nonbank SIFIs; second, the prospects for other FSOC nonbank SIFI designations in the future; and third, the form and content of the nonbank SIFI regulatory framework that the Federal Reserve Board must put into place.

For the three proposed nonbank SIFIs, the Dodd-Frank Act allows 30 days from the receipt of the FSOC's notification for them to contest the proposed SIFI designation. If one or more of the companies decide to challenge the FSOC's action, the challenging firm is entitled to a written or oral hearing before the FSOC within 30 days of the FSOC's receipt of a company's written request for a hearing, and the FSOC then has 60 days after the hearing date to issue a final determination decision. In turn, the FSOC's designation decision is reviewable in federal district court if a petition for review is filed within 30 days of the FSOC's final determination. If a designated company decides not to challenge a proposed FSOC determination, the FSOC must make a final determination within 10 days of the expiration of the 30-day hearing request period.

The second subpart of this question—the prospects for further nonbank SIFI designations—is harder to answer. Several key segments of the financial services industry, including the large investment advisers, mutual funds (including money market funds) and insurance companies, have been watching closely the FSOC's actions in this area and have argued against their designation as nonbank SIFIs. Yesterday's FSOC action does not offer any new clues as to how the FSOC will proceed with other designations, or which firms—or classes of firms—will be designated. All three of the proposed nonbank SIFIs have total reported assets in the range of $550 billion to $650 billion, but the nature and composition of these assets diverges very substantially among the three companies, and in the case of the two insurance firms, does not reflect the very substantial amounts of off-balance sheet assets under management or administration that these two firms hold. One can logically conclude that the very substantial—but not overwhelming—sizes of these three firms, and the nature and extent of their relationships in the financial markets, contributed to their FSOC determination decision, but how these and other designation factors were applied (the Dodd-Frank Act identifies 10 specific factors that FSOC must consider), individually and in relation to one another, cannot be ascertained from the FSOC's actions. In short, the scope and direction of future nonbank SIFI designation activity by the FSOC continues to be murky.

With respect to the actual nonbank SIFI regulatory framework, the Federal Reserve Board has indicated that systemic regulatory requirements will be tailored to reflect the differences between traditional bank holding companies and nonbank financial companies, where appropriate. How this tailoring will be implemented, however, is not yet known at this time, because the Federal Reserve Board has not yet adopted prudential regulations for nonbank SIFIs. Presumably, however, nonbank SIFI rules will be forthcoming in the reasonably near future, and the answer to this question will become clearer.

In sum, the FSOC's actions yesterday were not surprising or particularly enlightening, but are an important step in the scheme of systemic financial regulation. And, for the regulators charged with implementation of the FSOC's actions, as well as the firms tapped for nonbank SIFI designation, the fun now begins.

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