Financial Services Management

Systemic Designation for Non-Bank/ Non-Insurance Companies

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Financial Stability Board (FSB)
International Organization of Securities Commissions (IOSCO)
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Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions -- Proposed High-Level Framework and Specific Methodologies

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Impact Assessment

- Large finance companies, broker-dealers, asset managers, and investment funds (including hedge and private-equity funds) now face renewed prospect of systemic designation. This could lead to significant prudential regulation in sectors now largely exempt from it.
- Only U.S. asset managers would meet the proposed materiality thresholds, creating competitiveness concerns for this sector while addressing regulatory worries about cross-border contagion risk. If these criteria are finalized, implementation in the U.S. will face political obstacles.
- Bank- or insurance-owned NBNIs could be designated even if their parent company is not a G-SIB or G-SII. Even if it is, G-SIB or G-SII managed investment funds could be subject to designation if managed outside the bank or insurer.
- Even if global systemic designations are blocked, the proposed framework of risk indicators may lead to new prudential rules (including leverage capital) and resolution standards for NBNIs. This is particularly likely in the U.S., where the SEC is exploring rules in this sector and the FRB may do so for activities under its jurisdiction at G-SIBs and G-SIIs.

Overview

Global regulators have continued their effort to designate systemically-important financial institutions (G-SIFIs), moving on from final standards on global systemically-important banks (G-SIBs)[1] and insurance companies (G-SIIs)[2] now to a methodology governing non-bank, non-insurance (NBNI) entities. NBNIs include finance companies, market intermediaries (e.g., broker-dealers and investment banks), asset managers and investment funds (including hedge and private-equity funds). The new proposal is more of a "high-level" document and thus considerably less binding than the 2014 consultation,[3] attempting by this less prescriptive approach to recognize different business models and, likely, reduce opposition. However, given the cost of G-SIFI regulation in nations likely to follow global precepts, firms exposed to designation (including those owned by large banks or insurance companies) will nevertheless continue to oppose this approach. Even if they do not throw it off course, final action on the NBNI standards is on a very slow track compared with the G-SIB capital standards now in effect and those for G-SIIs soon to be proposed.

As a result, many of the risks cited in this consultation may be addressed by individual nations either for G-SIFIs under their jurisdiction or for G-SIFIs and smaller firms in targeted sectors. Given the general absence of prudential rules for NBNIs, statutory authority for implementing G-SIFI regulation in many nations is uncertain.

Impact

The approach for NBNIs is, FSB believes, broadly consistent with that for G-SIBs and G-SIIs. It is, however, considerably more general in key respects and thus could lead to difficulty naming G-NBNIs in global lists used to date for G-SIBs and G-SIIs, as well as to still more challenges getting nations to follow global edicts. As noted, even in nations like the U.S. that might wish to establish G-SIFI designations, the ability of primary regulators to implement G-SIFI regulations following designation is uncertain. Considerable political challenges are also brewing with regard to G-SIFI designations in the U.S. that could throw the FSB/IOSCO effort off-track, an issue of particular importance given the concentration of U.S. firms that meet the proposed materiality thresholds.

The FSB/IOSCO designation approach differs from that being adopted in major markets considering NBNI-related risk. Although the U. S. Financial Stability Oversight Council (FSOC) has the authority to designate NBNIs, it has retreated from discussions about doing so after naming one systemic finance company (GE Capital) instead to focus on activities and practices in

[1] See **CAPITAL180**, *Financial Services Management*, November 16, 2011.

[2] See **INSURANCE43**, *Financial Services Management*, November 12, 2014.

[3] See **SYSTEMIC70**, *Financial Services Management*, January 28, 2014.

the asset-management arena that might pose systemic risk.[4] The United Kingdom is focused on broader efforts to reduce the role of the largest banks, as well as on competition issues that might warrant intervention.[5] It thus remains to be seen if NBNIs would indeed be designated according to the FSB/IOSCO approach should it survive withering criticism from affected entities.

Were designation in fact to advance, it would impose on covered NBNIs significant capital, liquidity and, perhaps, resolution regulation by nations that agreed to adhere to the final designation methodology. This would not, however, necessarily address broader market dislocations resulting from the cost of bank-centric regulation that sparked the initial G-20 initiative governing shadow banking. Because NBNI companies do not face the barriers to entry common for banks and insurance companies, many very significant market players will not only escape initial designation, but also likely gain market share as industry dynamics change as a result of the G-SIB and G-SII standards. The FSOC and FCA approaches are intended to apply like-kind rules to like-kind companies, but FSOC's ability to ensure that U.S. primary regulators act on any recommendations it makes on an activity-or-practice – not designation – basis for NBNIs remains to be seen.

However, even if global designations do not advance or do so in an uneven fashion, the proposed indicators of systemic risk may spark national regulators to govern either the firms they choose to designate or covered sectors in ways global regulators believe reduce not only systemic risk, but also prudential hazard to domestic financial systems. The Federal Reserve is, for example, likely to be guided by the FSB's proposed approach to risk indicators at finance companies as it finalizes new G-SIFI prudential rules for GE Capital.[6] The focus here on leverage, liquidity, and counterparty-exposure risk for broker-dealers, investment funds, and asset managers is already a major FRB concern and it may thus advance new standards for these subsidiaries at firms in the U.S., going beyond those already imposed on broker-dealers of considerable size in the U.S. within foreign banking organizations.[7] The SEC chair has spoken not only of new liquidity and reporting standards for U.S. asset managers, but also of imposing a leverage-capital standard on large U.S. broker-dealers. Dodd-Frank highlighted hedge funds and private-equity (PE) funds as a priority systemic-risk issue, but the SEC has so far advanced only new reporting standards and certain compliance rules, not anything like the standards proposed here.

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[4] See **SYSTEMIC75**, *Financial Services Management*, January 5, 2014.

[5] See Client Reports in the **STRUCTURE** series.

[6] See Client Report **SIFI2**, December 22, 2014.

[7] See **FBO3**, *Financial Services Management*, February 25, 2014.

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What's Next

This consultation continues work demanded of global regulators in 2011 at that year's G-20 summit,[8] where the focus was beginning to shift to "shadow banks" due to growing worries that all the rules for banks would drive many businesses outside the scope of prudential and resolution regulation. The FSB and IOSCO have since finalized a resolution protocol for non-bank, non-insurance companies that hold other people's money,[9] standards that cover asset managers and broker-dealers within the ambit of this consultation. It could not, however, finalize its 2014 effort at systemic designation for all of the entities covered by this NBNI rubric, hence this latest proposal.

This consultation was issued on March 4 with comments due by May 29. The final methodologies are set for completion by the end of 2015. The FSB will lay out the policy requirements applicable to designated NBNIs. This policy framework would focus on systemic externalities, with the new consultation not making clear if it will be released for public consultation. Once the policy framework is finalized, a complex process leading to NBNI designation would ensue. No timeframe for designation or subsequent implementation of the policy framework is provided. However, the overall approach would be subject to review every three years after it is finalized to, among other things, identify new sectors warranting designation.

Because of the issues raised by NBNIs housed in BHCs, Basel is planning a consultation later this year on how to ensure consolidated supervision. This would affect treatment of managed investment funds.

Analysis

A. Methodology

1. Principles

Following extensive discussion of how systemic risk can be transmitted and several issues specific to NBNIs, those on which this consultation is based are:

- NBNI systemic criteria should be based on externalities resulting from size, leverage for investment funds, complexity, substitutability, inter-connectedness, and global reach; and
- this "general framework" should be "broadly consistent" with that for G-SIBs and G-SIIs.

Each sectoral methodology is based on quantitative and qualitative factors identifying these systemic indicators. However, because most NBNIs are not subject to prudential regulation and many data are protected by confidentiality

8 See Client Report **SUMMIT15**, November 2, 2011.

9 See **RESOLVE29**, *Financial Services Management*, November 6, 2014.

agreements, significant subjectivity and supervisory judgment will be employed here. Home-country supervisors will use indicators as guidance, with home-host coordination and international oversight designed to limit inconsistency.

2. *Materiality*

Materiality criteria would guide G-SIFI designation, but are not binding. The FSB would use them to list companies that would need to be assessed for designation and they would be:

- balance sheets over $100 billion for finance companies and broker-dealers;
- for private funds, $400 billion of gross notional exposures, with views requested on this;
- two options for traditional investment funds, either: 1) $30 billion in net asset value, balance-sheet leverage of three times NAV assessed against a size-only backstop of assets under management of $100 billion or 2) $200 billion in gross AUM unless the fund can demonstrate it is not a dominant player in its market judged by substitutability or firesale indices. Views are also solicited on these options and on a simpler one also described in the consultation;
- two options also for asset managers. These would be adopted exclusively or together and are 1) a size threshold such as $100 billion in balance-sheet assets and/or 2) and a value such as $1 trillion in AUM; and
- a $100 billion threshold for other NBNIs.

Despite the inclusion of cross-border activities in the designation criterion, there is no materiality threshold for it due to measurement concerns.

3. *Exclusions*

In addition to the NBNIs discussed below, global regulators are considering treatment for other NBNIs. These are:

- multilateral development banks;
- national export-import banks;
- sovereign wealth funds; and
- pension funds.

All of these entities other than pension funds are clearly governmental, and the paper thus does not appear to contemplate reconsideration of their current exclusions despite a request for views on it. A rationale for excluding pension funds – i.e., that they are usually indirectly but still contractually linked to asset and fund managers, is discussed with comment solicited.

B. Finance Companies

1. Definition

These firms are NBNIs that finance individuals and businesses funded via wholesale sources. They are split into:

- bank subsidiaries or affiliates;
- captive finance companies;
- monolines; and
- independent and captives that operate in various sectors across different markets.

2. Indicators

These would be:

- size, judged by factors such as global off-balance sheet exposures and assets;
- inter-connectedness, judged by factors such as intra-financial system assets and liabilities. Implicit parent-company guarantees should be assessed;
- leverage;
- substitutability, which should be qualitatively assessed;
- complexity, with factors like OTC derivatives exposures not cleared through CCPs assessed here;
- resolvability, which should be assessed using the FSB's key attributes;[10]
- illiquid assets; and
- cross-border activities.

C. Market Intermediaries

1. Definition

Although focused on broker-dealers, this NBNI activity is defined to include any entity that:

- receives or transmits orders;
- engages in proprietary trading;
- underwrites securities;
- provides client funding (e.g., margin loans, repos); or
- places financial instruments without a firm commitment.

[10] See **RESOLVE29**, *Financial Services Management*, November 6, 2014.

2. Indicators

For market intermediaries, these would include:

- size, measured by a holding company's consolidated assets if the parent is an NBNI. Additional proxy size indicators should be considered, including off-balance sheet assets, client assets (where the principal risk here is lack of resolvability, not investor risk);
- inter-connectedness, which is to be judged by intra-system assets and liabilities, as well as leverage (with the calculation methodology described as noted above). Additional factors here are funding through short-term debt (judged in a manner comparable to the Basel standards limiting credit exposures[11]), OTC-derivatives exposures (with assessment here based largely on qualitative factors), and required margins;
- substitutability, measured by factors such as market share and global transaction volume;
- structural complexity, judged by factors such as organizational design;
- operational complexity measured by holdings of less-liquid assets; and
- cross-border activity.

D. Investment Funds

1. Definition

Individual investment funds that could be subject to designation are collective-investment schemes (CIS) whether open- or closed-end. This definition covers entities such as:

- mutual funds and MMFs;
- hedge funds;
- exchange-traded funds;
- private-equity funds; and
- venture-capital funds.

2. Indicators

For investment funds, these are complicated by data limitations that may be addressed through subsequent actions. Still, the indicators would be:

- The materiality thresholds noted above, with additional size assessment related to gross notional exposure for hedge funds due to potential leverage;
- Leverage, as measured under various options laid out in the consultation. These would judge risk to the financial system by an array of quantitative

[11] See **CONCENTRATION5**, *Financial Services Management*, April 23, 2014.

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factors, as well as by qualitative ones like the nature of fund investors to determine the extent to which a fund's distress could create contagion risk;

- Substitutability indices such as daily trading or holding volume in various asset classes compared to the market;
- Complexity measures such as the amount of trades conducted off CCPs, high-frequency trading, or rehypothecation. Various liquidity measures are also proposed; and
- Cross-border activities.

E. Asset Management

1. Definition

This largely specifies that asset managers act on behalf of investors and follow investment practices specified by the investor in funds that are either separately managed or commingled. Third parties generally provide services such as custody. However, asset managers may also engage in securities-lending agent services (including with indemnification), risk-management platform or pricing services, and consulting/advisory services. Views are solicited on additional activities in this sector that could pose systemic risk.

2. Indicators

Comments are solicited on whether these indicators are appropriate. They would be:

- The materiality thresholds noted above, which would set the size criterion, although additional issues (e.g., size of the relevant market) are also noted;
- Inter-connectedness, which should be judged based on both funds managed and the manager itself taking into account other activities in which it may engage. Factors here would include the leverage ratio (measured by shareholder equity versus on-balance sheet assets and off-balance sheet exposures);
- Substitutability, judged by factors like the manager's revenues compared to those of key activities as a whole in relevant markets or by market share;
- Organizational-structure complexity, looking at affiliation with other activities such as broker-dealers, commodity-pool operators or trading advisers, FCMs, banks, trust companies, municipal advisers, or swaps dealers or participants;
- Resolution difficulty, which would in part be judged on how easily contracts can be transferred and intra-group complexity; and
- Cross-jurisdiction activity.

F. Other NBNIs

Other NBNIs include any entity primarily engaged in financial intermediation or related activities not captured above. They include:

- Deposit-takers other than banks;
- Finance companies and investment funds (despite the treatment referenced above); and

- Specialized-vehicle companies.

The indicators are the same size, inter-connectedness, complexity, substitutability, and cross-border ones noted above. However, they are not defined and could be expanded based on subsequent regulatory work.

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