

# SYSTEMIC DESIGNATION Institutions, Activities, Financial Market Utilities, and Payment Clearing and Settlement Activities

March 9, 2011  
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# Global Financial Panic

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- August 2007 TED Spread Widens
- March 2008 Bear Stearns Acquired by JPMorgan Chase
- September 2008
  - Lehman fails
  - AIG rescued
  - Money market fund runs
  - Fannie Mae and Freddie Mac takeovers
- October 2008 Emergency Economic Stabilization Act
- July 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act

# Systemic Risk

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- Two Flavors
- Knock-On, or Domino, Risk
  - Failure of one institution triggers failures of other institutions due to credit exposure to the failing institution
- Panic
  - A failure or other event causes a loss of confidence in financial institutions or assets
  - Liquidity disappears
  - Asset prices decline due to lack of buyers triggering widespread failures that increase the loss of confidence

# Domino Risk

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“With regard to Continental Illinois, the regulators’ greatest concern was systemic risk, and therefore handling Continental through a payoff and liquidation was simply not considered a viable option. Continental had an extensive network of correspondent banks, almost 2,300 of which had funds invested in Continental; more than 42 percent of those banks had invested funds in excess of \$100,000, with a total investment of almost \$6 billion. The FDIC determined that 66 of these banks, with total assets of almost \$5 billion, had more than 100 percent of their equity capital invested in Continental and that an additional 113 banks with total assets of more than \$12 billion had between 50 and 100 percent of their equity capital invested.”

FDIC, An Examination of the Banking Crises of the 1980s and Early 1990s, p.250

# Panic

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“The end is to stay the panic; and the advances should, if possible, stay the panic. And for this purpose there are two rules: First. That these loans should only be made at a very high rate of interest. This will operate as a heavy fine on unreasonable timidity, and will prevent the greatest number of applications by persons who do not require it. The rate should be raised early in the panic, so that the fine may be paid early; that no one may borrow out of idle precaution without paying well for it; that the Banking reserve may be protected as far as possible.”

# Panic

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“The amount of bad business in commercial countries is an infinitesimally small fraction of the whole business. That in a panic the bank, or banks, holding the ultimate reserve should refuse bad bills or bad securities will not make the panic really worse; the ‘unsound’ people are a feeble minority, and they are afraid even to look frightened for fear their unsoundness may be detected. The great majority, the majority to be protected, are the ‘sound’ people, the people who have good security to offer. If it is known that the Bank of England is freely advancing on what in ordinary times is reckoned a good security on what is then commonly pledged and easily convertible the alarm of the solvent merchants and bankers will be stayed. But if securities, really good and usually convertible, are refused by the Bank, the alarm will not abate, the other loans made will fail in obtaining their end, and the panic will become worse and worse.”

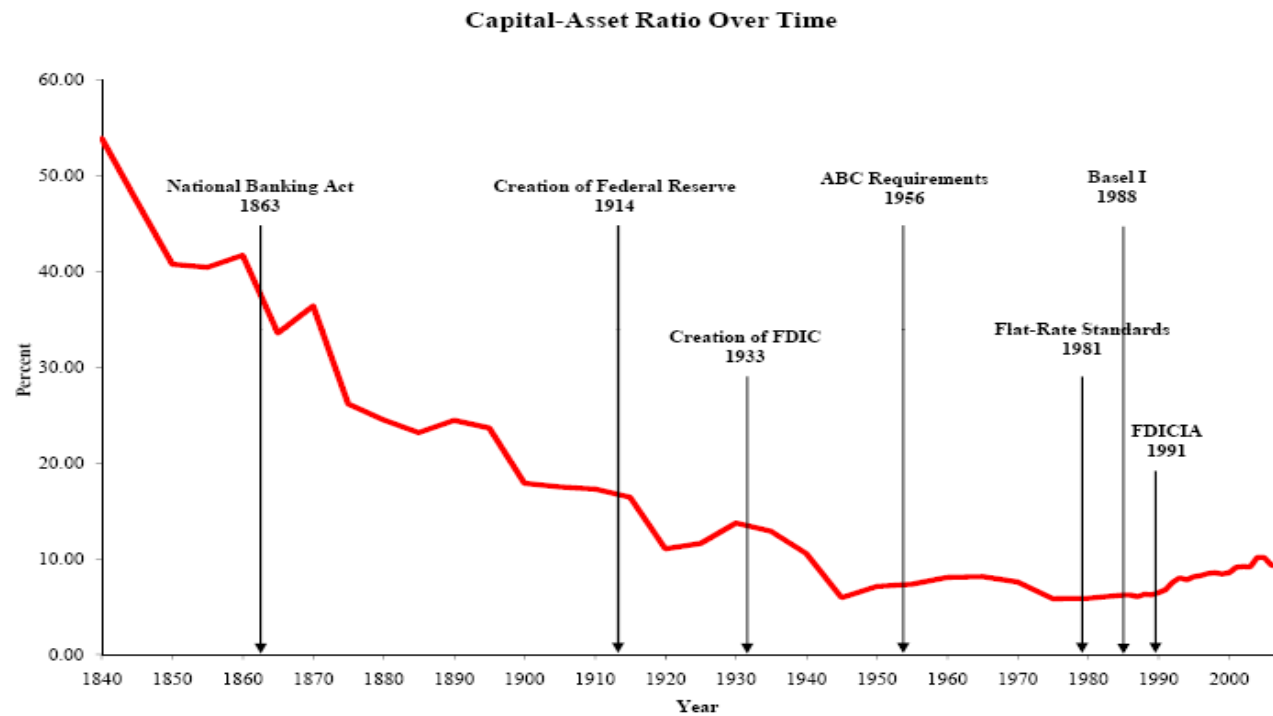
Walter Bagehot, Lombard Street, 1873

# Dodd-Frank Approach

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- Increase Capital and Supervision
  - Basel III
  - Collins
- Limit Activities
  - Volcker
  - Lincoln
- Oversight of Systemic Institutions
  - Resolve institutions to contain too big to fail
- Oversight of Systemic Activities
- Oversight of Payment, Clearing and Settlement

# Will it Work?



# Financial Stability Oversight Council

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## Creation of the Financial Stability Oversight Council ("Council")

- §111 Dodd-Frank Act
- Chaired by the Secretary of the Treasury
- 10 Voting members: Treasury Secretary; the heads of the Federal Reserve, OCC, Bureau of Consumer Financial Protection, SEC, FDIC, CFTC, FHFA, and NCUA; and an independent member with insurance expertise
- 5 Non-voting members: the directors of the Office of Financial Research and the Federal Insurance Office; a state insurance commissioner, a state banking supervisor and a state securities commissioner

# Financial Stability Oversight Council

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- **Meetings:** The Council will meet quarterly or at the call of the Treasury Secretary or the majority of the members
- **Vote:** The Council's votes generally require simple majority; however, certain actions require a 2/3 vote including the affirmative vote of the Treasury Secretary

# Systemically Important Institutions

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- Bank holding companies (“BHCs”) with total consolidated assets of at least \$50bn (no designation) (§115 and §165 Dodd-Frank Act)

and

- Nonbank financial companies designated by the Council as being systemically important (regardless of size) (§113 Dodd-Frank Act)
- BHCs with at least \$50bn in assets as of January 1, 2010 that (i) ceased to be a BHC after this date and (ii) received financial assistance under the TARP Capital Purchase Program, will be treated as being systemically important (§117 Dodd-Frank Act)

# Nonbank Financial Companies

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## Nonbank Financial Companies (“NBFC”) (§102 Dodd-Frank Act)

- NBFC: any company, other than a BHC, that is predominantly engaged in financial activities
- Predominantly engaged in financial activities: 85% or more annual gross revenues or consolidated assets must be attributable to financial activities
- Financial activities: activities that are financial in nature according to Section 4(k) BHC Act and ownership or control of one or more insured depository institutions

# Exclusion

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The definition of NBFC explicitly excludes the following:

- National securities exchanges (or parent)
- Clearing agencies (or parent, unless it's a BHC)
- Security-based swap execution facilities
- Registered security-based swap data depositories
- Boards of trade designated as a contract market (or parent)
- Derivatives clearing organizations (or parent, unless it's a BHC)
- Swap execution facilities
- Registered swap data repositories
- Farm credit institutions

# Systemically Important NBFCs

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- Designation of an NBFC as systemically important must be done by a 2/3 vote of the Council including affirmative vote of the Treasury Secretary
- Designation must be reevaluated annually and can be rescinded upon a 2/3 vote of the Council including affirmative vote of the Treasury Secretary
- Council must determine whether material distress at the NBFC or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities could pose a threat to U.S. financial stability
- §113 Dodd-Frank Act

# Systemically Important NBFCs

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- Council must consider the following factors (§113 Dodd-Frank Act):
  - Extent of leverage of the company
  - Extent and nature of the off-balance sheet exposures of the company
  - Extent and nature of the transactions and relationships of the company with other significant NBFCs and significant bank holding companies
  - 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 U.S. financial system
  - Importance of the company as a source of credit for low-income, minority, and underserved communities, and the impact that failure of such company would have on the availability of credit in such communities
  - Extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse
  - Nature, scope, size, scale, concentration, interconnectedness, and mix of activities of the company
  - Degree to which the company is already regulated by one or more primary functional regulatory agencies
  - Amount and nature of the financial assets of the company
  - Amount and type of liabilities of the company, including the degree of reliance on short-term funding
  - Any other risk-related factors that the Council deems appropriate

# Notice and Review

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- Council must provide NBFC with a notice of the proposed designation including an explanation of the basis of such designation
- NBFC may request a hearing within 30 days after receiving the notice
- Hearing must take place within 30 days of the request and Council must make a final decision within 60 days after the hearing
- NBFC may request judicial review in U.S. District Court within 30 days after receipt of the Council's final decision. Review is conducted under the "arbitrary and capricious" standard
- Emergency Exception: Council, by a 2/3 vote including the affirmative vote of the Treasury Secretary, may shorten NBFC's period to request a hearing to 10 days. Council must inform NBFC about such decision within 24 hours. A hearing, if requested, must take place within 15 days. Council's final decision is subject to judicial review
- §1113 Dodd-Frank Act

# Intermediate Holding Company

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- Federal Reserve may require an NBFC designated as systemically important (or such NBFC may choose) to establish an intermediate holding company in which all financial activities are conducted
- Only the intermediate holding company with its financial activities will be subject to Federal Reserve supervision and prudential standards
- The direct or indirect parent company must serve as a source of strength to the intermediate holding company and is subject to limited reporting requirements to the Federal Reserve
- §167 Dodd-Frank Act

# Foreign Financial Institutions

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- Council must consult with the appropriate foreign regulatory authorities to the extent appropriate in exercising its systemic oversight authority with respect to foreign nonbank financial companies, foreign-based BHCs and cross-border activities and markets
- Foreign banks that own a U.S. bank are BHCs
- Foreign banks that maintain a U.S. branch or agency or commercial lending subsidiary are treated as BHCs
- Unclear whether only U.S. assets considered for the \$50bn asset threshold
- Council can designate a foreign NBFC as systemically important, regardless of size of U.S. operations => Council has to consider similar factors as for the designation of U.S. NBFCs, with a focus on U.S.-related assets, activities, and operations
- §113 Dodd-Frank Act

# Anti-evasion

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- Council may determine, on its own or upon request by the Federal Reserve, that the financial activities of a company that is not an NBFC should be treated like a systemically important NBFC (§113 Dodd-Frank Act)
- Determination must be made with a 2/3 vote including the affirmative vote of the Treasury Secretary
- Council must find that (i) the material distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the financial activities conducted directly or indirectly by a U.S. company or a foreign company with U.S. activities would pose a threat to U.S. financial stability, and (ii) such company is organized or operates in such a manner as to evade the application of the systemic risk regime under the Dodd-Frank Act
- Council must consider the same factors as for the designation of NBFCs, and the notice and review procedure is identical to the one applicable for NBFCs
- Financial activities: activities that are financial in nature according to Section 4(k) of the BHC Act and ownership or control of one or more insured depository institutions; does not include internal financial activities conducted for the company or an affiliate (including internal treasury, investment, and employee benefit functions)

# NPR-January 6, 2011

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- NPR is almost entirely procedural
- Supplementary Information identifies six factors
  - Size
  - Lack of substitutes for financial services and products the company provides
  - Interconnectedness with other financial firms
  - Leverage
  - Liquidity risk and maturity mismatch
  - Existing regulatory scrutiny

# NPR Factor Matrix

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- The extent of the leverage of the company--Leverage
- The extent and nature of the off-balance-sheet exposures of the company--Size; Interconnectedness
- The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies--Interconnectedness
- 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--Size; Lack of substitutes
- 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--Lack of substitutes
- 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--Size; Interconnectedness
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company--Size; Lack of substitutes; Interconnectedness
- The degree to which the company is already regulated by 1 or more primary financial regulatory agencies--Existing regulatory scrutiny
- The amount and nature of the financial assets of the company--Size; Interconnectedness
- The amount and types of the liabilities of the company, including the degree of reliance on short-term funding--Liquidity risk and maturity mismatch; Size; Interconnectedness

# Enhanced Supervision and Prudential Standards

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- Federal Reserve, on its own or at the Council's recommendation, must establish prudential standards for systemically important institutions that are more stringent than those applicable to non-systemically important NBFCs and BHCs
- To prevent or mitigate risk to U.S. financial stability that could arise from the material distress, failure or ongoing activities of these companies
- Council may also recommend heightened standards and safeguards for financial activities and practices if Council determines that their scope, size or interconnectedness could create or increase the risk of significant liquidity, credit or other problems (§120 Dodd-Frank Act)
- §115 and §165 Dodd-Frank Act

# Prudential Standards

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- Federal Reserve must establish more stringent prudential standards for:
  - Risk-based capital requirements
  - Leverage limits
  - Liquidity requirements
  - Overall risk management requirements
  - Resolution plan and credit exposure report requirements
  - Concentration limits
- Federal Reserve may establish more stringent prudential standards for:
  - A contingent capital requirement
  - Enhanced public disclosures
  - Short-term debt limits
  - Such other prudential standards as deemed appropriate by the Federal Reserve, on its own or based on the Council's recommendations

# Considerations

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- In prescribing or recommending more stringent prudential standards the Federal Reserve and the Council must take the following factors into consideration:
  - All factors considered by the Council in designating NBFCs as being systemically important (§113 Dodd-Frank Act)
  - Whether a company owns a depository institution
  - Non-financial activities and affiliations
  - Other criteria the Federal Reserves determines to be appropriate, including those recommended by the Council
- Tailored Application: Federal Reserve, on its own or on recommendation by the Council, may differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors => NOT one size fits all approach

# Additional Requirements

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In addition, Federal Reserve shall require the following (§165 Dodd-Frank Act):

- Establishment of a risk committee (including BHCs with \$10bn-\$50bn assets) for publicly traded companies
- Semi-annual stress tests (annually for BHCs with \$10bn-\$50bn assets). Federal Reserve will also conduct its own stress tests
- A maximum leverage ratio of 15:1 if Council determines that the company poses a “grave threat” to U.S. financial stability
- Inclusion of off-balance-sheet activities in computing capital requirements

# Mitigation of Risks

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- If Federal Reserve determines, and upon 2/3 affirmative vote of Council, that a systemically important institution poses a great threat to the U.S. financial stability it can
  - limit such company's ability to merge with, acquire, consolidate with, or otherwise become affiliated with another systemically important institution
  - restrict the company's ability to offer a financial product
  - require such company to terminate one or more activities, or
  - impose conditions on the manner in which such company conducts one or more activities (§121 Dodd-Frank Act)
- Federal Reserve may also require a systemically important institution to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities, if other measures are deemed to be inadequate

# Systemic Activities or Practices

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- §120 Dodd-Frank Act permits Council to recommend heightened prudential standards or safeguards for particular financial activities or practices conducted by any company that is regulated by a primary financial regulatory agency
- Council must determine that the conduct, scope, nature, size, scale, concentration, or interconnectedness of the financial activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among BHCs and NBFCs, financial markets of the U.S., or low-income, minority, or underserved communities
- Primary financial regulatory agency must impose Council's recommendations or explain to Council within 90 days, why the agency has not followed the recommendations

# Payment, Clearing & Settlement

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- Title VIII Dodd-Frank Act
- Council can designate important payment, clearing and settlement activities (“designated activities”) carried out by financial institutions and financial market utilities (“FMUs”) engaged in such activities as being, or likely to become, systemically important (§804 Dodd-Frank Act)
- Designation must be made by a 2/3 vote including an affirmative vote of the Treasury Secretary
- Rescission of designation also requires a 2/3 vote by Council including an affirmative vote of the Treasury Secretary
- Systemically important means a situation where the failure of or a disruption to the functioning of an FMU or the conduct of a designated activity could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threatening the stability of the U.S. financial system

# Designated Activities

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- “Payment, clearing, or settlement activity” means an activity carried out by one or more financial institutions to facilitate the completion of “financial transactions”
- Does not include any offer or sale of a security under the Securities Act of 1933, or any quotation, order entry, negotiation, or other pre-trade activity or execution activity
- Financial transactions are (§803 Dodd-Frank Act):
  - Funds transfers
  - Securities contracts
  - Contracts of sale of a commodity for future delivery
  - Forward contracts
  - Repurchase agreements
  - Swaps
  - Security-based swaps
  - Swap agreements
  - Security-based swap agreements
  - Foreign exchange contracts
  - Any similar transaction that the Council determines to be a financial transaction

# Included Activities

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When conducted with respect to a “financial transaction” designated activities (*i.e.* payment, clearing, and settlement) may include (§803 Dodd-Frank Act):

- Calculation and communication of unsettled financial transactions between counterparties
- Netting of transactions
- Provision and maintenance of trade, contract, or instrument information
- Management of risks and activities associated with continuing financial transactions
- Transmittal and storage of payment instructions
- Movement of funds
- Final settlement of financial transactions
- Other similar functions that the Council may determine
- The public reporting of swap transaction data under the Dodd-Frank Act is excluded

# Systemically Important

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In determining whether an FMU or a designated activity is, or is likely to become, systemically important the Council has to consider the following factors (§804 Dodd-Frank Act):

- The aggregate monetary value of transactions processed by the FMU or carried out through the designated activity
- The aggregate exposure of the FMU or a financial institution engaged in a designated activity to counterparties
- The relationship, interdependencies, or other interactions of the FMU or the designated activity with other FMUs or designated activities
- The effect that the failure of or a disruption to the FMU or the designated activity would have on critical markets, financial institutions, or the broader financial system
- Any other factors that the Council deems appropriate

# Notice and Review

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- Prior to making a designation, Council must consult with the Federal Reserve
- Council must give advance notice to the FMU or the financial institution that is carrying out the designated activity and must publish such notice in the Federal Register
- FMU or the respective financial institution may request a written or oral hearing within 30 days after receiving the notice, which must take place within 30 days after receiving the request
- Council must make final decision within 60 days after the hearing or, if no hearing was requested, within 30 days after the period for requesting a hearing has expired
- Emergency exception: notice and hearing requirement may be waived if Council deems it necessary with a 2/3 vote including an affirmative vote of the Treasury Secretary
- No specific provision for a judicial review, as there is for NBFC designation

# FMU ANPR--December 21, 2010

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- Question 4.e.
  - Should certain payment systems that transfer relatively low aggregate values be considered by the Council for designation as systemically important given that the system's failure or disruption could still cause widespread disruption, especially if there is no ready alternative means of making payments? For example, the failure or disruption of a system used extensively to make payments could leave a significant portion of the general public with unexpected overdrafts and/or lack of liquid funds. If so, what factors should the Council consider in making a determination of systemic importance for such systems?

# Standards

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- The Federal Reserve will prescribe risk management standards governing (a) the operations related to designated activities of an FMU that is systemically important, and (b) the conduct of designated activities by financial institutions
- CFTC and the SEC may prescribe similar risk management standards for clearing entities and financial institutions engaged in designated activities for which they have primary jurisdiction
- §805 Dodd-Frank Act

# Objects & Principles, Areas

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- Objects and principles of such standards shall be:
  - Promote robust risk management
  - Promote safety and soundness
  - Reduce systemic risk
  - Support the stability of the broader financial system
- Standards may address the following areas:
  - Risk management policies and procedures
  - Margin and collateral requirements
  - Participant or counterparty default policies and procedures
  - Ability to complete timely clearing and settlement of financial transactions
  - Capital and financial resource requirements for designated FMUs
  - Other areas that are necessary to achieve the objects and principles
- §805 Dodd-Frank Act