Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

Systemically Significant Financial Companies: Do the Standards Make Sense?*

Raymond Natter

October, 2010

Title I of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act establishes the Financial Stability Oversight Council, composed of ten financial services regulators and chaired by the Secretary of the Treasury. Perhaps the most significant function of the Council is to designate non-bank financial institutions as systemically important, and therefore subject to heightened supervision by the Federal Reserve Board. These institutions will also be subject to stricter prudential regulations, including minimum capital requirements, liquidity requirements, limits on credit exposures, new risk management obligations, and concentration limits.

The Council held its inaugural meeting on October 6, 2010, and at that meeting agreed to issue an advanced notice of proposed rulemaking (ANPR) seeking comments on the factors that the Council should review when considering if a non-bank financial company is systemically significant. However, the Council is required by the Dodd-Frank Act to consider ten specific factors, and has the discretion to consider other factors as well. The ANPR noted these ten factors, and in addition asked for comments on how the Council should apply these factors, for example, if metrics should be used, and if so, how to incorporate these quantitative inputs. Unfortunately, neither the ANPR nor the statute explains how the ten factors relate to the ultimate finding that a firm is systemically important, and if there is little or no relation to the systemic significance of a company, how the Council should apply the statute to avoid absurd results.

What is Meant by Systemically Significant

The Dodd-Frank Act states that the purpose of these provisions is to identify risk to financial stability that could arise from the material financial

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

distress or failure, or ongoing activities, of large, interconnected financial companies. The Act also seeks to promote market discipline by eliminating expectations that such companies are "too big to fail" and will be assisted by the government in the event of failure.

In short, the goal of these provisions is to identify interconnected financial companies that could cause a risk to financial stability if the company is in distress or fails. There are two key elements. One, the company must be interconnected, such that other firms would be threatened if the company were to default on its obligations. Second, the size of the exposures must be so significant that if the company were to default, the other firms that were exposed to the failed company would themselves suffer significant losses as to impair their ability to function or be a reliable counterparty.

In other words, a company is systemically important only if its failure or financial distress would be transmitted to its counterparties, and the exposures are of a size or nature that the counterparties would themselves be subject to potential failure, which in turn would spread to yet additional financial companies. Unless a company is both interconnected with other financial firms, and its failure or distress threatens significant losses to the exposed firms, a company does not meet the statutory criteria for being systemically significant.

Do the Factors Identify Systemically Significant Companies?

Most of the factors that the Council will consider have little or nothing to do with the systemic significance of a financial firm. This can be easily seen by examining the legislative language and the ANPR.

Leverage. The first factor noted is the extent of leverage of the company. Leverage relates to the extent to which a company is using borrowed funds to run its business. High leverage typically indicates risk, but it has nothing to do with the interconnectedness of the firm or its systemic significance. The fact that a financial firm may have a high risk profile may be a matter of concern to the firm's primary regulator, but it certainly is not an indication that the company is systemically significant.

Off-Balance Sheet Exposures. Off-balance sheet exposures may present safety and soundness concerns, and may raise questions about the reliability of accounting rules. But such exposures do not, in and of themselves, indicate that the failure of the company would cause material harm to numerous counterparties. Therefore, off-balance sheet exposures should be part of a review of the interconnections that a firm might have, but should not be a stand-alone factor of systemic importance.

Source of Credit for Low-Income, Minority or Underserved Communities. It is difficult to see how this factor relates to systemic importance. In fact, including this factor may well motivate financial companies to avoid providing credit to these communities. If a financial firm is deemed to be systemically important, it will be subject to additional regulatory limitations, and will have to hold higher levels of capital than its non-systemically important competitors. In order to avoid these consequences, a financial company that is concerned about becoming designated as systemically significant might well be motivated to reduce its funding in low-income, minority or underserved communities. It's hard to understand why Congress would want to see this result.

Managed Assets vs. Owned Assets. The legislation directs the Council to consider the extent to which assets are managed rather than owned by the financial company. It is not clear if managed assets are to be considered less systemically significant or more systemically significant. If a company has a large portfolio of managed assets and those assets are lost due to fraud or malfeasance, the harm would be spread to potentially many more entities than if the assets were owned by the company. In any case, the question should not be whether the company manages or owns assets, but what impact would the failure of the company have on other interconnected firms.

The Degree to Which the Company is Already Regulated. This factor relates to the current governmental oversight of the company. The Dodd-Frank Act appears to be based on a Congressional determination that new and more stringent oversight by the Federal Reserve Board is necessary for systemically significant companies. Relying on non-Federal Reserve Board oversight of the company could be viewed as at odds with the apparent Congressional conclusion that existing regulation is not sufficient. On the other hand, if the Council determines that a financial institution is already under stringent oversight, and that this oversight is comparable to the oversight that the Federal Reserve would provide, a good case could be made that Federal Reserve Board supervision is not necessary. In this situation, it would make sense for the Council to determine that a systemic finding is counterproductive.

Amount and Nature of the Financial Assets. This factor seems to say that a large financial firm is per se systemically important. However, it ignores the question of the interconnections the company may or may not have with other firms. While there is a strong likelihood that a large financial firm will have significant interconnections with other companies, it is important that size alone will not be used to determine which companies are systemically important.

Amount and Types of Liabilities Including Reliance on Short-Term Funding. The use of short-term funding raises concerns about liquidity risk, and may indicate that a company has a riskier profile than companies that use a liability structure that relies on a broader range of maturities. However, this is a concern for the company's primary regulator, and is not a basis for concluding that a company is systemically significant. Risk is simply not the same as systemic importance.

Recommendation for the Council

Of the ten factors listed in the statute and in the ANPR, only three seem to bear on the actual systemic significance of the firm. These factors are the extent and nature of the transactions and relationship of the company with other significant financial companies, the importance of the company as a source of credit and liquidity in the financial system, and the "interconnectedness" of the company. These are the factors that are truly relevant, and it is important that the Council concentrate on these concerns. While the Council may be statutorily required to consider all ten factors, there is no requirement that it give equal weight to each factor. The public interest would best be served if only those companies that meet the statutory definition of systemically significant were so designated.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.