

# Systemic Risk and Nonbank Companies

How current systemic risk  
proposals threaten bank-  
like regulation for non-  
primarily financial  
companies

# What are the proposals?

- The U.S. Treasury, Senate Banking Chairman Dodd and House Financial Services Chairman Frank all have systemic risk proposals
- These proposals broadly follow the same approach: create a systemic risk regulator to oversee companies that pose a "threat" to the U.S. economy
- What happens to a company that is identified as systemically risky? It is subject to greater capital requirements, greater supervision, potential limits on activities and placement in a special insolvency regime outside of bankruptcy
- The proposals vary in certain important aspects but all follow the same outline



# What types of companies are covered?

- (4) The term 'financial company' means **a company or other entity--**
- (A) that is--
- (i) incorporated or organized under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Mariana Islands, Guam, American Samoa, or the United States Virgin Islands; or (ii) a company incorporated in or organized in a country other than the United States that has significant operations in the United States (hereafter in this title referred to as a 'foreign financial parent') after through--
- (I) a Federal or State branch or agency of a foreign bank as such terms are defined in the International Banking Act of 1978 (12 U.S.C. 3101 et seq.); or (II) a United States affiliate or other United States operating entity;
- (B) **that is, in whole or in part, directly or indirectly, engaged in financial activities;** and (C) that is not a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 et seq.).

# What are "financial activities"?

- The context of H.R. 4173 and the plain language of the Dodd draft defines "financial activities" in reference to section 4(k) of the Bank Holding Company Act
- Under 4(k) a broad range of activities are listed as "financial". In addition, the Fed is given authority to further define the term
- Among other activities that are "financial" are trading derivatives, acting as an intermediary, factoring, extending credit and keeping assets in trust

# What happens to a non-bank company that is systemically important?

- A company that is not a bank or otherwise regulated by the SEC or CFTC can be required to separate its “financial activities” into a new type of special purpose bank holding company-
- (2) APPLICATION OF ACTIVITY RESTRICTIONS AND SECTION 6 HOLDING COMPANY REQUIREMENTS-(A) IN GENERAL- Except as provided in subparagraphs (B) and (C)-
- (i) a financial holding company subject to stricter standards that conducts activities that do not comply with section 4 of the Bank Holding Company Act shall be required to establish or designate a section 6 holding company in accordance with section 6 of the Bank Holding Company Act of 1956 through which it conducts activities of the company that are determined to be financial in nature or incidental thereto under section 4(k) of the such Act; and
- (ii) such section 6 holding company shall be the financial holding company subject to stricter standards for purposes of this title.

# Exceptions

- The Fed can exempt companies from the requirement by weighing whether the company's financial activities:
- "facilitate the extension of credit to individuals, households and businesses; improve efficiency or customer service or result in other public benefits; potentially threaten the safety and soundness of the financial holding company or any of its subsidiaries; potentially increase systemic risk or threaten the stability of the overall financial system; potentially result in unfair competition; and potentially have anticompetitive effects that would not be outweighed by public benefits."

# Exceptions (cont.)

The following activities are explicitly excluded:

- `(i) internal financial activities conducted for such company or any affiliate, including, but not limited to internal treasury, investment, and employee benefit functions, provided that with respect to any internal financial activity engaged in for the company or an affiliate and a non-affiliate during the year prior to date of enactment, the company (or an affiliate not a subsidiary of the section 6 company) may continue to engage in that activity so long as the at least 2/3 of the assets or 2/3 of the revenues generated from the activity are from or attributable to the company or an affiliate, subject to review by the Board to determine whether engaging in such activity presents undue risk to the section 6 company or undue systemic risk; and
- `(ii) financial activities involving the provision of credit for the purchase or lease of products or services from an affiliate or for the purchase or lease of products produced by an affiliate of such section 6 holding company that is not a subsidiary of such section 6 holding company, in accordance with regulations prescribed by or orders issued by the Board, pursuant to section 6 of this Act.



# In Summary

- While some credit functions to customers are excluded, other basic activities such as derivatives trading will continue to be considered “financial activities”
- A non-primarily financial company that is considered systemically important will be looked at for the totality of the company’s operations, notwithstanding the fact only a part of its activities are “financial”

# Does it matter?

- These are the criteria the systemic risk regulator will look to:
- b) Criteria- In making a determination under subsection (a), the Council shall consider the following criteria:
  - (1) The extent of the company's leverage.
  - (2) The extent and nature of the company's off-balance sheet exposures.
  - (3) The extent and nature of the company's transactions and relationships with other financial companies.
  - (4) The company's importance as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the financial system.
  - (5) The company's importance as a source of credit for low-income, minority, or underserved communities and the impact the failure of such company would have on the availability of credit in such communities.
  - (6) The extent to which assets are simply managed and not owned by the financial company and the extent to which ownership of assets under management is diffuse.
  - (7) The nature, scope, and mix of the company's activities.
  - (8) The degree to which the company is already regulated by one or more Federal financial regulatory agencies or, in the case of a foreign financial parent, the extent to which such foreign parent is subject to prudential standards on a consolidated basis in the home country of such financial parent that are administered and enforced by a comparable foreign supervisory authority.
  - (9) The amount and nature of the company's financial assets.
  - (10) The amount and nature of the company's liabilities, including the degree of reliance on short-term funding.
  - (11) Any other factors that the Council deems appropriate.

# Examples

A company that is engaged in energy exploration and production maintains a separate division that trades derivatives. Because the company has in-depth knowledge about the energy business it is able to compete with the proprietary trading desks of banks while providing customers risk management options. Because the energy company's trading operation competes with banks the market for energy derivatives is more competitive offering greater choice and better prices to end users. Trading in derivatives is a "financial activity". Thus the energy company could be required to submit its trading operations to systemic risk regulation; create a separate holding company for trading and other "financial activities"; and submit the parent company to source of strength, anti-tying restrictions and other regulation applicable to bank holding companies.

# Example (cont.)

A large U.S. manufacturer exports American-made products around the world. Because the manufacturer operates in many countries it needs access to foreign currencies and the ability to hedge exchange and interest rate risk. Because it has such a large global presence it manages a large foreign exchange trading operation. These activities are "financial" and could be forced into a separate holding company subject to Fed regulation. The fx operation could be required to be moved to a special purpose holding company along with any other "financial activities". The parent could be subject to source of strength, anti-tying and other bank holding type regulation.

## Does it matter? (cont.)

- The powers of the systemic risk regulator are intentionally broad. Will they ever be used against a truly non-financial business?

# Clean Air Act of 1963

- **Justices Say E.P.A. Has Power to Act on Harmful Gases**
- Car and truck tailpipe emissions account for about one-fourth of the country's greenhouse gas emissions.
- By LINDA GREENHOUSE
- New York Times, April 3, 2007
- WASHINGTON, April 2 – In one of its most important environmental decisions in years, the Supreme Court ruled on Monday that the Environmental Protection Agency has the authority to regulate heat-trapping gases in automobile emissions. The court further ruled that the agency could not sidestep its authority to regulate the greenhouse gases that contribute to global climate change unless it could provide a scientific basis for its refusal.