



Report to the Ranking Member,  
Committee on Banking, Housing, and  
Urban Affairs, U.S. Senate

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November 2014

# FINANCIAL STABILITY OVERSIGHT COUNCIL

## Further Actions Could Improve the Nonbank Designation Process

# GAO Highlights

Highlights of [GAO-15-51](#), a report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

## Why GAO Did This Study

FSOC has authority to designate systemically important nonbank financial companies for enhanced supervision by the Board of Governors of the Federal Reserve System. GAO was asked to review these designations because they may have significant implications for the companies as well as the stability of the financial system. This report examines how FSOC has managed the designation process to date and the extent to which FSOC's process has been transparent and systematic, among other objectives.

GAO analyzed FSOC documents, including the final rule and guidance on the designation process, bylaws, and nonpublic documentation supporting determination decisions. GAO also collected data about FSOC members' participation in determination evaluations and interviewed FSOC staff, FSOC members and their staffs, officials of evaluated companies, and external stakeholders, including industry groups.

## What GAO Recommends

GAO makes several recommendations to help enhance the accountability and transparency of FSOC's determination process, such as tracking key evaluation information, including additional details in public documentation about the rationale for determination decisions, and establishing procedures to evaluate companies under both statutory determination standards. Treasury neither agreed nor disagreed with the recommendations but said (in its capacity as Council chair) that FSOC would consider the recommendations.

View [GAO-15-51](#). For more information, contact Lawrence L. Evans, Jr. at (202) 512-8678 or [EvansL@gao.gov](mailto:EvansL@gao.gov).

November 2014

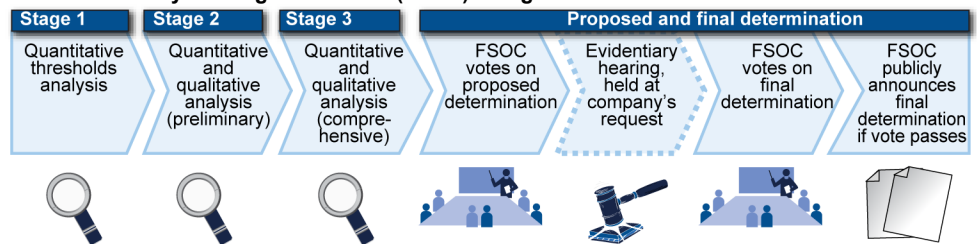
# FINANCIAL STABILITY OVERSIGHT COUNCIL

## Further Actions Could Improve the Nonbank Designation Process

### What GAO Found

The Financial Stability Oversight Council (FSOC) uses committees comprising staff from member agencies to help it evaluate nonbank financial companies and determine if they will receive enhanced supervision. FSOC has developed and followed a process for making determination decisions that is, in part, systematic and transparent. FSOC published a final rule and guidance that establish a three-stage process and an analytical framework for evaluating whether nonbank financial companies meet a statutory determination standard and for proposing and finalizing determinations. Generally, companies told GAO they were satisfied with FSOC's communication with them during the evaluation process.

### Financial Stability Oversight Council's (FSOC) Designation Process



Source: GAO analysis of FSOC's final rule and guidance. | GAO-15-51

However, GAO identified key areas in which FSOC could enhance the accountability and transparency of the designation process.

- **Tracking and monitoring.** Federal internal control standards call for clear documentation of transactions and monitoring to assess the quality of performance over time. FSOC has not centrally recorded key processing dates, tracked the duration of evaluation stages, or collected information on staff conducting evaluations, such as the number or type of staff contributed by member agencies. Without such data, FSOC's ability to effectively monitor the progress and evaluate the quality and efficiency of determination evaluations is limited.
- **Disclosure and transparency.** FSOC's transparency policy states its commitment to operating transparently, but its documentation has not always included certain details. For example, FSOC's public documents have not always fully disclosed the rationales for its determination decisions. The lack of full transparency has resulted in questions about the process and may hinder accountability and public and market confidence in the process.
- **Scope of evaluation procedures.** FSOC has evaluated how companies might pose a threat to financial stability using only one of two statutory determination standards (a company's financial distress, not its activities). By not using both standards when appropriate, FSOC may not be able to comprehensively ensure that it has identified and designated all companies that may pose a threat to U.S. financial stability.

Making FSOC's designation process more systematic and transparent could bolster public and market confidence in the process and also help FSOC achieve its intended goals.

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## Abbreviations

AIG	American International Group, Inc.
Basel Committee	Basel Committee on Banking Supervision
CFTC	Commodity Futures Trading Commission
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
FAQ	frequently asked questions
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FIO	Federal Insurance Office
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
GE Capital	General Electric Capital Corporation
G20	Group of Twenty
IAIS	International Association of Insurance Supervisors
IOSCO	International Organization of Securities Commissions
MetLife	MetLife, Inc.
NAIC	National Association of Insurance Commissioners
Nonbank Designations Committee	Designations of Nonbank Financial Companies Committee
OCC	Office of the Comptroller of the Currency
OFR	Office of Financial Research
Prudential	Prudential Financial, Inc.
SEC	Securities and Exchange Commission
Treasury	Department of the Treasury

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November 20, 2014

The Honorable Michael Crapo  
Ranking Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

Dear Senator Crapo:

The 2007-2009 financial crisis threatened the stability of the U.S. financial system and the U.S. and international economy. The crisis also revealed weaknesses in the U.S. regulatory structure, including differences in the amount and nature of supervision and regulation among financial institutions such as banks, broker-dealers, and bank and nonbank holding companies. For example, certain nonbank financial companies were subject to less stringent oversight than bank holding companies. Some of these companies posed systemic risk during the crisis and were recipients of federal assistance.

In response to the crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted in July 2010.<sup>1</sup> Among its regulatory reforms, the act established the Financial Stability Oversight Council (FSOC) to monitor the stability of the U.S. financial system and take actions to mitigate risks that might destabilize the system.<sup>2</sup> Congress gave FSOC a number of significant authorities to help it execute its broad mission, including authority to designate nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System (Federal Reserve) and enhanced prudential standards. According to the Dodd-Frank Act, nonbank financial companies are domestic companies or foreign companies that predominantly are engaged in financial activities (such as insurance companies, consumer finance providers, commercial lenders, asset managers, and investment funds) but that are not bank holding

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<sup>1</sup>Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup>FSOC comprises 15 members generally representing federal and state financial regulators. The provisions of the Dodd-Frank Act dealing with FSOC are contained primarily in subtitle A of title I, §§ 111-123, codified at 12 U.S.C. §§ 5321-5333, and title VIII, codified at 12 U.S.C. §§ 5461-5472.

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companies or certain other types of firms (such as registered securities exchanges, clearing agencies, and swap execution facilities).<sup>3</sup> The designations are intended to help avoid the regulatory gaps that existed before the crisis and minimize the risk of a nonbank financial company threatening the stability of the financial system.<sup>4</sup> As of September 2014, FSOC had determined that three nonbank financial companies—American International Group, Inc. (AIG), General Electric Capital Corporation, Inc. (GE Capital), and Prudential Financial, Inc. (Prudential)—should be supervised by the Federal Reserve.<sup>5</sup>

Some members of Congress and others have raised questions about how and on what basis FSOC made its determinations.<sup>6</sup> To help provide oversight of FSOC, the Dodd-Frank Act gave GAO authority to audit the activities of FSOC and entities acting on its behalf, including its decision-making processes related to nonbank financial company determinations. In prior work on the establishment of FSOC, we reported that FSOC's management mechanisms to carry out its mission could be enhanced to provide greater accountability and transparency.<sup>7</sup> You asked us to review the process that FSOC uses to designate nonbank financial companies

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<sup>3</sup>The Dodd-Frank Act defines a foreign company as one that is incorporated or organized in a country other than the United States. Pub. L. No. 111-203, § 102(a)(4), 124 Stat 1376, 1391 (2010) (codified at 12 U.S.C. § 5311(a)(4)). The act also states that a company is predominantly engaged in financial activities if either (1) the annual gross revenues derived by the company and all of its subsidiaries from financial activities, as well as from the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated annual gross revenues of the company; or (2) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated assets of the company. Pub. L. No. 111-203, § 102(a)(6), 124 Stat 1376, 1392 (2010) (codified at 12 U.S.C. § 5311(a)(6)).

<sup>4</sup>The Dodd-Frank Act allows FSOC, on its own initiative or at the request of the Federal Reserve, to determine that a company organized or operating in such a manner as to evade FSOC's designation authority shall have its financial activities supervised by the Federal Reserve if the company's material financial distress related to its financial activities or the financial activities themselves would threaten U.S. financial stability.

<sup>5</sup>In September 2014, FSOC made a proposed determination regarding a fourth nonbank financial company.

<sup>6</sup>For this report, we use designation and determination interchangeably.

<sup>7</sup>GAO, *Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions*, [GAO-12-886](#) (Washington, D.C.: Sept. 11, 2012).

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for Federal Reserve supervision and enhanced prudential standards. This report examines (1) how FSOC oversees and manages the nonbank financial company determination process; (2) the extent to which FSOC has followed a systematic process for designating nonbank financial companies; (3) how the analysis and criteria used in FSOC's determination process compare with methodologies proposed by international institutions; and (4) the progress that the Federal Reserve has made in defining a supervision framework for designated nonbank financial companies.

To examine FSOC's management of the determination process, we reviewed the Dodd-Frank Act, FSOC's bylaws, our prior reports on FSOC, and other documents describing its organizational structure, and FSOC's final rule and guidance outlining its determination process. We interviewed officials from FSOC member agencies, designated companies, and FSOC staff involved in coordinating and assisting the Council's determination work. We collected information on staff contributions from FSOC and its member agencies. To address the extent to which FSOC used a systematic process in designating companies, we collected and analyzed documentation of FSOC's determination reviews and decisions, including correspondence with nonbank financial companies. We reviewed documents on FSOC's determination process and interviewed officials from FSOC member agencies and designated companies. To assess how FSOC's determination process compares with international methodologies, we examined documents on the evaluation of global systemically important institutions from four international institutions: the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (Basel Committee), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissions (IOSCO). We interviewed FSOC member agency officials on the different approaches to evaluating nonbank financial companies. To determine the Federal Reserve's progress in establishing a framework for supervising designated companies, we reviewed documents including statutory requirements and proposed and final regulations and interviewed FSOC and Federal Reserve officials. For more information on our methodologies, see appendix I.

We conducted this performance audit from October 2013 to November 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe



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that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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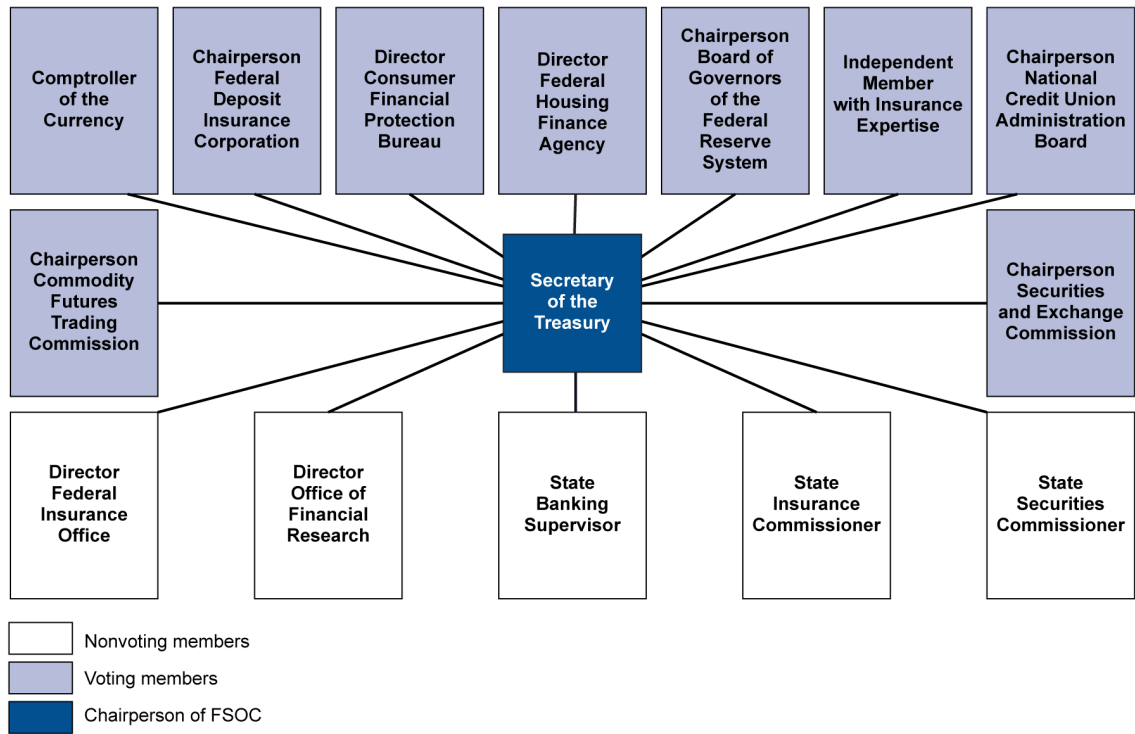
## Background

FSOC consists of 15 members (or principals)—10 voting and 5 nonvoting members (see fig. 1). The 10 voting members (including the heads of nine federal agencies) provide a federal regulatory perspective and the view of an independent insurance expert (who is appointed by the President with the advice and consent of the Senate).<sup>8</sup> The 5 nonvoting members, who serve in an advisory capacity, offer different insights as state-level bank, securities, and insurance regulators or as the directors of offices in the Department of the Treasury (Treasury)—the Office of Financial Research (OFR) and the Federal Insurance Office (FIO)—that were established by the Dodd-Frank Act. FSOC is chaired by the Secretary of the Treasury. As the chairperson of FSOC, the Secretary has certain powers and responsibilities related to FSOC’s meetings and reports and testimony to Congress. For example, the Dodd-Frank Act states that the chairperson may call for meetings of the Council and must testify before Congress at least annually to discuss the Council’s activities. The Secretary, in his or her capacity as chairperson of FSOC and in consultation with the other FSOC principals, also is responsible for regular consultation with the financial regulatory entities and other appropriate organizations of foreign governments or international organizations on matters relating to systemic risk to the international financial system.

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<sup>8</sup>Although not all FSOC members represent federal agencies, in this report we use “member agencies” to represent all FSOC members, including their agencies, offices, or staff.

**Figure 1: Financial Stability Oversight Council (FSOC) Membership**



Source: GAO analysis of Dodd-Frank Act. | GAO-15-51

## FSOC Determination Process

The Dodd-Frank Act requires that FSOC consider certain factors in making its nonbank financial company determinations. These factors include a company's financial characteristics—such as the amount and nature of the company's assets and the amount and types of the company's liabilities—and factors such as the degree of existing financial

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regulation and the company's importance as a source of credit.<sup>9</sup> Additionally, the Dodd-Frank Act sets forth two determination standards—FSOC can designate a nonbank financial company if FSOC determines that the company's (1) material financial distress; or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of activities could pose a threat to the financial stability of the United States. Although a rulemaking was not statutorily required to implement this authority, in April 2012, FSOC voluntarily issued a final rule and interpretive guidance that outline and clarify its authority to make determinations under section 113 of the Dodd-Frank Act.<sup>10</sup> The final rule and guidance, which were adopted following three rounds of public comment, also establish a process and an analytical framework for making determinations that incorporate the statutory considerations and determination standards.

FSOC's final rule and guidance established a three-stage process for evaluating nonbank financial companies for possible designation as part of its overall determination process, as shown in figure 2. As its assessment of a company progresses through the three stages, FSOC conducts increasingly in-depth quantitative and qualitative evaluations that may lead to a proposed determination that the material financial

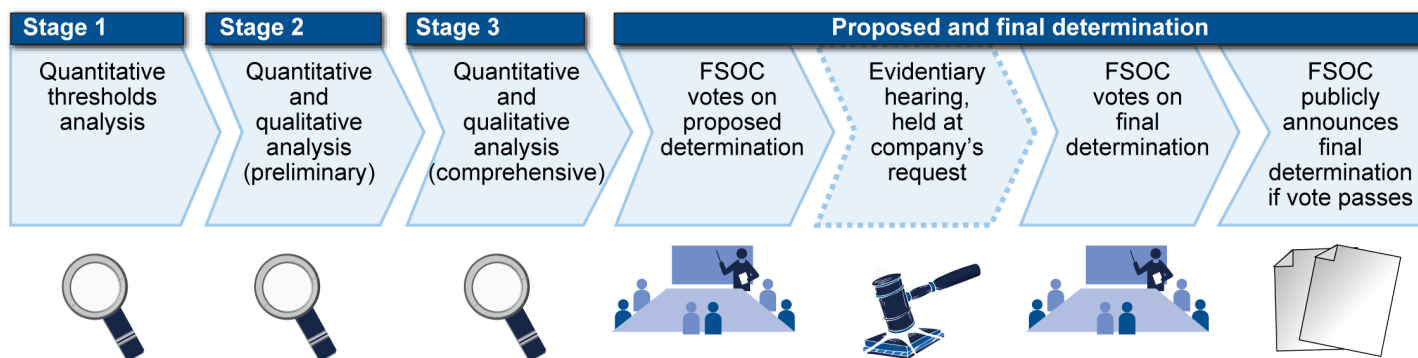
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<sup>9</sup>For U.S. nonbank financial companies, the statutory considerations are (1) the extent of leverage of the company; (2) the extent and nature of the off-balance-sheet exposures of the company; (3) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (4) 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 U.S. financial system; (5) 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 a company would have on the availability of credit in such communities; (6) 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; (7) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (8) the degree to which the company is already regulated by one or more primary financial regulatory agencies; (9) the amount and nature of the financial assets of the company; (10) the amount and types of the liabilities of the company including the degree of reliance on short-term funding; and (11) any other risk-related factors that the Council deems appropriate. For considerations of foreign nonbank financial companies, the list is similar but in certain aspects more specific to U.S. activities, including the extent and nature of the U.S. off-balance-sheet exposures; the importance of the company as a source of credit for U.S. households and businesses; the importance of the company as a source of credit for low-income, minority, or underserved communities in the United States; the amount and nature of the U.S. financial assets in the company; and the amount and nature of the liabilities of the company used to fund activities and operations in the United States.

<sup>10</sup>12 C.F.R. § 1310.1 et seq.

distress or activities of a nonbank financial company could pose a threat to the financial stability of the United States and that the company should be subject to Federal Reserve supervision and prudential standards.<sup>11</sup>

**Figure 2: The Financial Stability Oversight Council’s (FSOC) Determination Process Involves Multiple Stages and Votes by FSOC Members**



Source: GAO analysis of FSOC’s final rule and guidance. | GAO-15-51

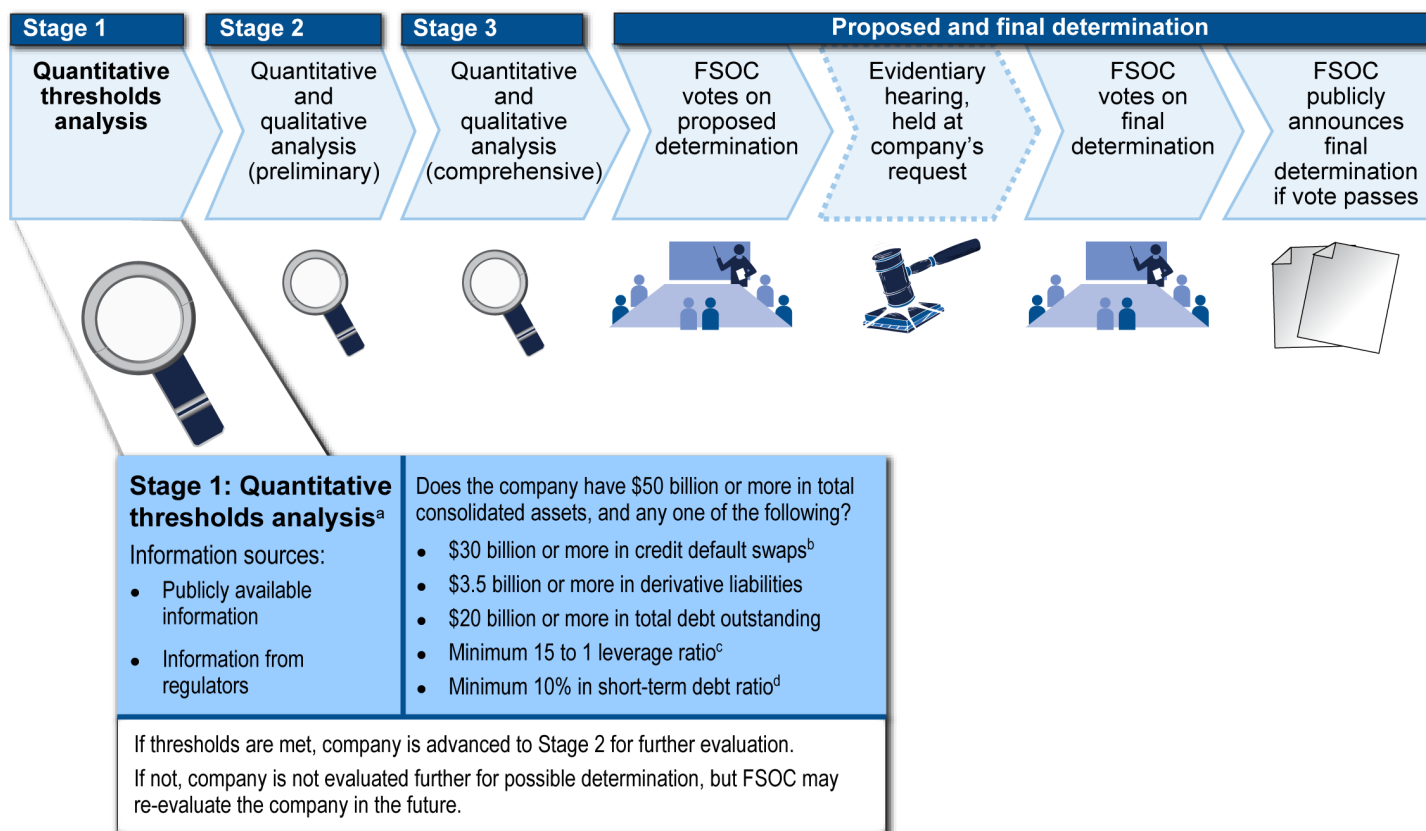
**Stage 1.** To identify companies that merit company-specific evaluation, FSOC applies a set of uniform quantitative thresholds to a broad group of companies generally considered to be nonbank financial companies (see fig. 3). The Council retains discretion to consider nonbank financial companies not identified by the Stage 1 thresholds for any reason, including a lack of available data in Stage 1.<sup>12</sup> FSOC relies solely on

<sup>11</sup>In an emergency, FSOC can modify or waive any or all of the notices and procedures required by regulation, beginning with the notice of consideration of determination. 12 C.F.R. § 1310.22; Dodd-Frank Act, Pub. L. No. 111-203, § 113(f), 124 Stat. 1367, 1401-1402 (2010) (codified at 12 U.S.C. § 5323(f)). FSOC must determine that the waiver or modification is necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States and provide a written notice of the waiver or modification to the company no later than 24 hours after it is granted. 12 C.F.R. § 1310.22(a). At least a two-thirds majority vote, including the vote of the Secretary of the Treasury, is required to invoke the emergency exception. 12 C.F.R. § 1310.22(e). The company is permitted an appeals process if it disagrees with the determination to waive or modify the requirements. 12 C.F.R. § 1310.22.

<sup>12</sup>According to FSOC’s final rule and guidance, the Stage 1 quantitative thresholds were selected based on (1) their applicability to nonbank financial companies that operate in different types of financial markets and industries, (2) the meaningful initial assessment that such thresholds provide about the potential for a nonbank financial company to pose a threat to the financial stability in diverse financial markets, and (3) the current availability of data.

information available through existing public and regulatory sources in this stage. A company automatically advances to Stage 2 if it meets the total consolidated assets threshold and any one of the other thresholds.<sup>13</sup>

**Figure 3: Stage 1 of the Financial Stability Oversight Council’s (FSOC) Determination Process**



Source: GAO analysis of FSOC’s final rule and guidance. | GAO-15-51

<sup>a</sup>FSOC intends to review the thresholds at least every 5 years and to adjust them as FSOC may deem advisable.

<sup>b</sup>Using the gross notional amount of credit default swaps outstanding for which the company is the reference entity.

<sup>c</sup>Using a ratio of total consolidated assets to total equity.

<sup>13</sup>For a U.S. nonbank financial company, the Council will apply the thresholds based on global assets, liabilities, and operations of the company and its subsidiaries. For a foreign nonbank financial company, the Council will apply the thresholds based solely on the U.S. assets, liabilities, and operations of the foreign nonbank financial company and its subsidiaries.

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<sup>d</sup>Using a ratio of total debt outstanding with a maturity of less than 12 months to total consolidated assets.

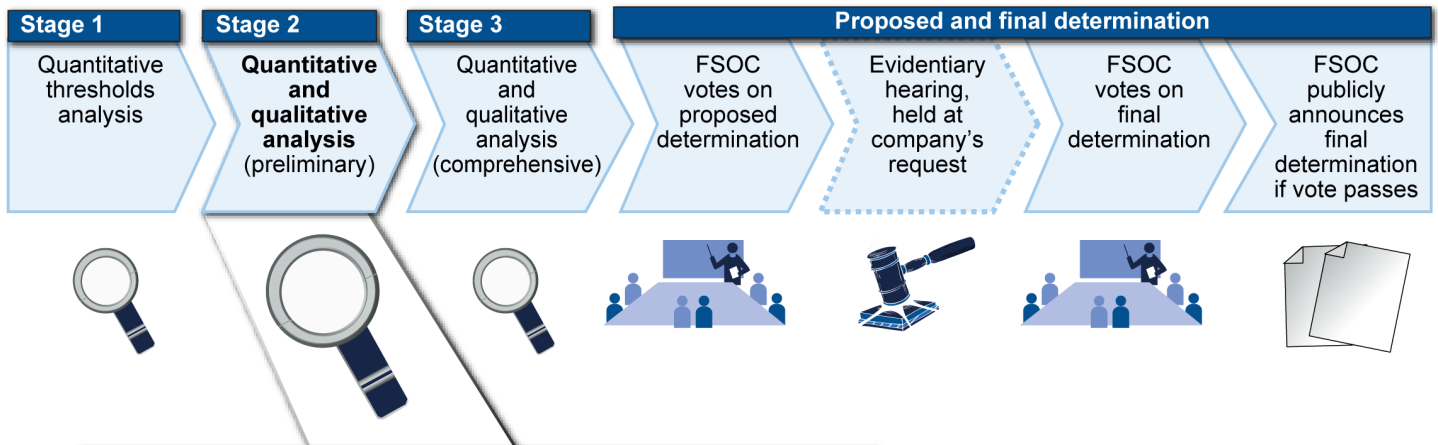
**Stage 2.** FSOC evaluates a company's risk profile and characteristics using a range of quantitative and qualitative industry- and company-specific factors (see fig. 4). These include a six-category analytical framework (described later in this Background section) and a review of qualitative factors such as whether the resolution of a nonbank financial company could pose a threat to financial stability. As part of the review in Stage 2, FSOC begins consulting with relevant primary financial regulatory agencies or home country supervisors, as it considers appropriate.<sup>14</sup> As in Stage 1, the analysis primarily will use data collected from public and regulatory sources.<sup>15</sup> FSOC's guidance states that FSOC can advance companies to Stage 3 that it decides warrant additional review to determine if the company could pose a threat to U.S. financial stability.

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<sup>14</sup>FSOC must consult with the primary financial regulatory agency of any nonbank financial company or subsidiary of a nonbank financial company prior to making a final determination.

<sup>15</sup>According to its final rule and guidance, FSOC intends to rely on information from OFR, FSOC member agencies, and relevant primary financial regulatory agencies whenever possible before requiring a company to submit information. FSOC's guidance also states that it may consider information voluntarily submitted by the company.

**Figure 4: Stage 2 of the Financial Stability Oversight Council’s (FSOC) Determination Process**



**Stage 2: Quantitative and qualitative analysis (preliminary)**

Information sources:

- Publicly available information
- Information from regulators<sup>a</sup>
- Information voluntarily submitted by companies

FSOC conducts quantitative and qualitative analysis of individual companies, using company- and industry-specific metrics. Analysis is focused on whether a company’s material financial distress or a company’s activities<sup>b</sup> could pose a threat to U.S. financial stability. Analysis is primarily based on the six-category framework:

- Size
- Interconnectedness
- Substitutability
- Leverage
- Liquidity risk and maturity mismatch
- Existing regulatory scrutiny

In addition, FSOC considers:

- Resolvability
- Channels of transmission: exposure, asset liquidation, and critical function or services

Council will advance to Stage 3 companies that it believes merit further review.

- If so, the company is advanced to Stage 3 for further evaluation.
- If not, company is not evaluated further for possible determination, but FSOC may re-evaluate the company in the future.

Source: GAO analysis of FSOC’s final rule and guidance and Stage 2 memorandums. | GAO-15-51

<sup>a</sup>Includes information from the primary financial regulatory agencies and home country supervisors, as appropriate.

<sup>b</sup>We use the term activities to represent what the Dodd-Frank Act defines as “the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities” of the nonbank financial company.

**Stage 3.** At the start of Stage 3, FSOC provides the company a written notice of consideration to inform the company that it is being considered for a proposed determination and submits one or more written requests for certain information to the company (see fig. 5). A company receiving

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such notice may submit written information to contest the Council's consideration of the company for a proposed determination. The Stage 3 analysis considers whether the company meets either one or both of the two statutory determination standards by assessing the channels (transmission channels) that FSOC identifies as most likely to facilitate the transmission of the negative effects of a company's material financial distress or activities to other firms and markets.<sup>16</sup> FSOC's evaluation considers quantitative and qualitative information collected directly from the company with information collected during prior stages.<sup>17</sup>

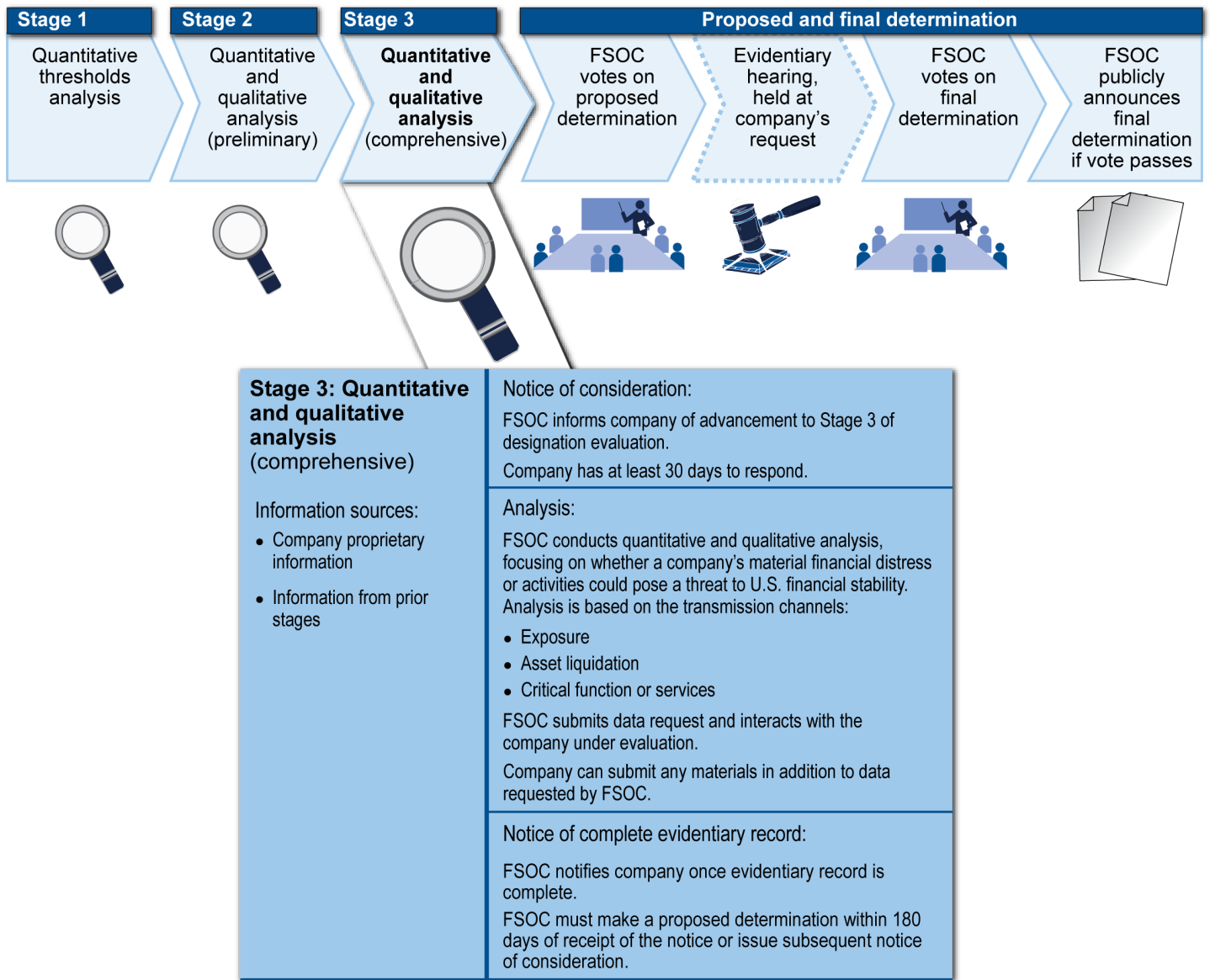
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<sup>16</sup>FSOC can designate a nonbank financial company if FSOC determines that the company's (1) material financial distress or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities could pose a threat to the financial stability of the United States.

<sup>17</sup>In evaluating qualitative factors in Stage 3, FSOC has said that it also will evaluate a company's resolvability, including the company's operations and complexity, which may mitigate or aggravate the potential of the company to pose a threat to U.S. financial stability.



**Figure 5: Stage 3 of the Financial Stability Oversight Council's (FSOC) Determination Process**



Source: GAO analysis of FSOC's final rule and guidance and FSOC documentation. | GAO-15-51

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**Proposed determination.** At the conclusion of the Stage 3 analysis, FSOC notifies the company in writing that the evidentiary record is complete, and the Council has 180 days to vote on whether to make a proposed determination regarding the company.<sup>18</sup> If the Council votes to make a proposed determination that the company's material financial distress or activities could pose a threat to U.S. financial stability and that the company will be subject to Federal Reserve supervision and prudential standards, FSOC provides the company a written notice of the proposed determination. This notice includes an explanation of the basis for the Council's decision. Any proposed determination may be made only with the affirmative vote of at least two-thirds of the Council's voting members then serving, including the vote of the Secretary of the Treasury.

**Right to a hearing and final determination.** As shown in figure 6, within 30 days of receipt of the notice of proposed determination, a company may request in writing a nonpublic hearing before the Council to contest a proposed determination and a company has a right to a hearing that is timely requested.<sup>19</sup> After the hearing—or after a brief notice period if a company does not request a hearing or notifies FSOC that it does not intend to request a hearing—the Council may vote on a final determination. Any final determination may be made only with the affirmative vote of at least two-thirds of the Council's voting members then serving, including the vote of the Secretary of the Treasury. FSOC provides designated companies with a written notice of a final determination (nonpublic basis document), including an explanation of the basis for its decision, when practical at least 1 business day before making a public announcement. FSOC also publicly releases a memorandum (public basis document) that includes a summary discussion of the conclusions supporting its determination. A designated

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<sup>18</sup>If the Council fails to make a proposed determination within that time, the Council cannot thereafter make a proposed determination regarding the company without first sending it another written notice of consideration.

<sup>19</sup>The request for a hearing can be made in accordance with Dodd-Frank Act § 113(e) (Pub. L. No. 111-203, § 113(e), 124 Stat 1376, 1401 (2010) (codified at 12 U.S.C. § 5323(e))) and 12 C.F.R. § 1310.21(c).

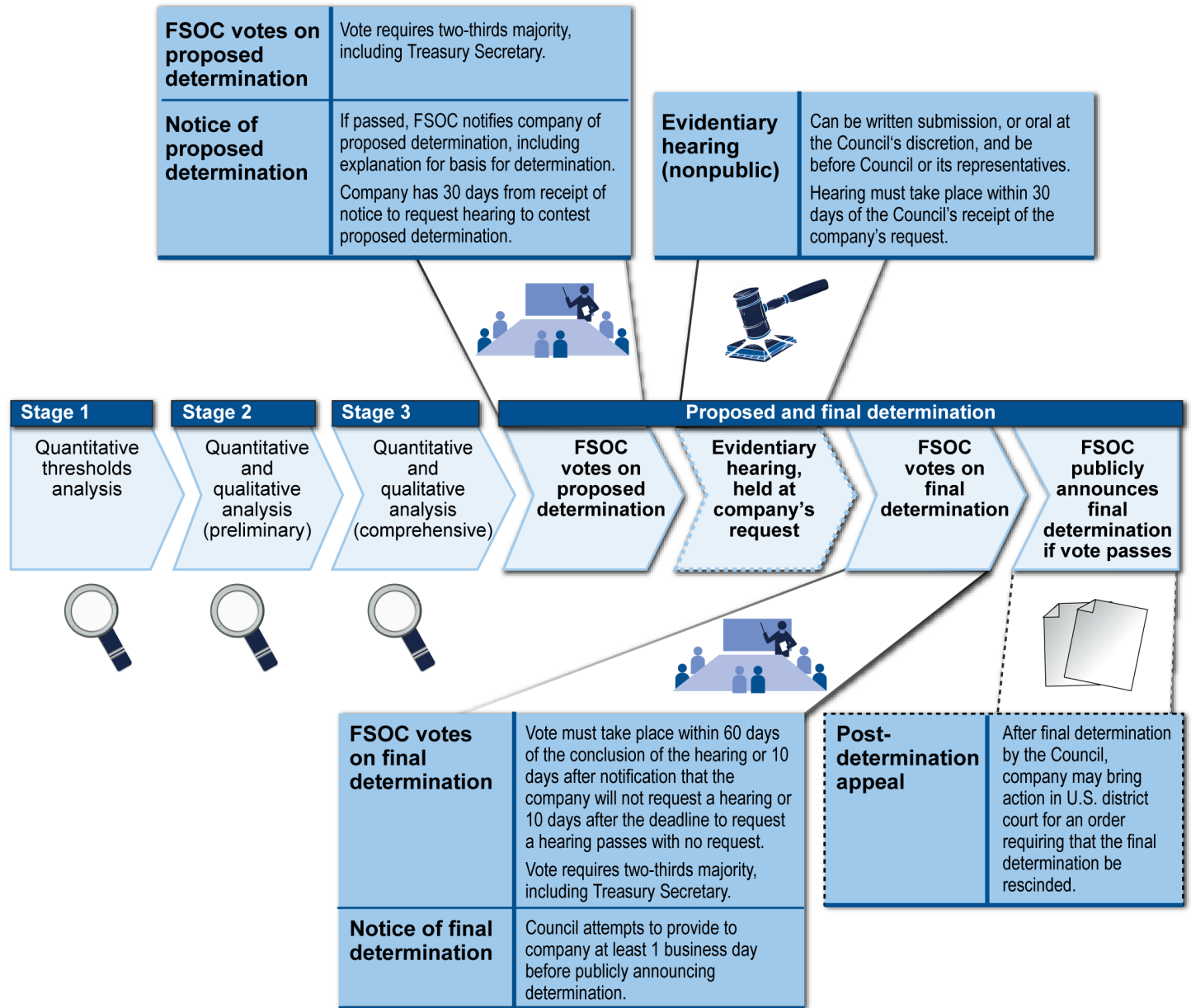
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company may bring an action in U.S. district court for an order requiring that the determination be rescinded.<sup>20</sup>

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<sup>20</sup>The legal action may be instituted in accordance with section 113(h) of the Dodd-Frank Act. Pub. L. No. 111-203, § 113(h), 124 Stat 1376, 1402 (2010) (codified at 12 U.S.C. § 5323(h)).

**Figure 6: Hearing Request and Final Determination in the Financial Stability Oversight Council’s (FSOC) Determination Process**



Source: GAO analysis of FSOC's final rule and guidance. | GAO-15-51

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## FSOC Analytical Framework

In addition to establishing a process, FSOC's final rule and guidance also set out an analytical framework for making determinations. The framework incorporates the statutory considerations into six general categories:

1. **Size.** The amount of financial services or intermediation that a nonbank financial company provides, which may affect the extent to which a company's financial distress is transmitted to other firms and the financial system.
2. **Interconnectedness.** The direct or indirect linkages between financial companies that may be conduits for the transmission of the effects resulting from the company's material financial distress or activities.
3. **Substitutability.** The extent to which other firms could provide similar financial services in a timely manner at a similar price and quantity if a nonbank financial company withdrew from a particular market, including situations in which the company was the primary or dominant provider of services in a market that FSOC determines to be essential to U.S. financial stability.
4. **Leverage.** The company's exposure or risk in relation to its equity capital, which may amplify a company's risk of financial distress by raising (a) the likelihood that a company will suffer losses exceeding its capital, and (b) a company's dependence on its creditors' willingness and ability to fund its balance sheet.
5. **Liquidity risk and maturity mismatch.** Respectively, the risk that a company may not have sufficient liquidity (funding), such as cash flow or access to funding markets, to satisfy its short-term needs; and the difference between the maturities of a company's assets and liabilities, which affects a company's ability to survive a period of stress that may limit its access to funding.
6. **Existing regulatory scrutiny.** The extent to which nonbank financial companies are already subject to regulation; including the consistency of regulation across companies within and across sectors, and providing similar services; and the statutory authority of regulators.

According to FSOC's rule and guidance, these six categories guide FSOC's evaluation of whether a nonbank financial company could pose a threat to U.S. financial stability. The first three categories assess the potential effects of a company's financial distress on the broader economy; the last three categories assess a company's vulnerability to financial distress. FSOC's guidance also identified three channels by which to assess how the material financial distress or activities—the

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statutory determination standards—of a nonbank financial company could be transmitted to other firms or markets and impair market functions.

- **Exposure.** A nonbank financial company’s creditors, counterparties, investors, or other market participants have exposure to the company that is significant enough to materially impair those creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability.
- **Asset liquidation.** A nonbank financial company holds assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings.
- **Critical function or services.** A nonbank financial company is no longer able or willing to provide a critical function or service upon which market participants have relied and for which there are no ready substitutes.

In its final rule and guidance, FSOC explained that it will consider a wide range of quantitative and qualitative information, including industry- and company-specific factors. The final rule and guidance also provide examples of metrics FSOC may use to evaluate companies under the six categories, and analysis it may use under the three transmission channels. For example, for the interconnectedness category, FSOC’s assessment could include the company’s total debt outstanding (which captures a company’s funding sources), and counterparties’ exposures to the company and the characteristics of those exposures. For the critical function or service transmission channel, examples of possible analysis include the competitive landscape for the markets in which the company operates and for the services it provides; the company’s market share; the company’s provision of credit to low-income, minority, or underserved communities; and the ability of other firms to replace those services.

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## International Methodologies

International institutions have developed several methodologies intended to identify global systemically important financial institutions, including nonbank financial companies. Since 2010, the Financial Stability Board (FSB) has worked with international standard-setting bodies on the

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development of these methodologies.<sup>21</sup> The Group of Twenty (G20)—a forum for international cooperation on important global economic and financial topics—mandated the establishment of the FSB in 2009 as the successor to the Financial Stability Forum to coordinate at the international level the work of national financial authorities and international standard-setting bodies to develop and promote the implementation of effective regulatory, supervisory, and other financial-sector policies.<sup>22</sup> FSB member institutions include finance ministries, financial regulatory authorities, and central banks of the G20 members and several other countries. FSB members also include international bodies—such as the International Monetary Fund, the Organisation for Economic Co-operation and Development, and the World Bank—and international standard-setting bodies, such as the Basel Committee on Banking Supervision (Basel Committee), International Organization of Securities Commissions (IOSCO), and International Association of Insurance Supervisors (IAIS).

FSB first assessed global systemically important banks and then considered different assessment methodologies for identification of other global systemically important financial institutions, thereby expanding possible identification incrementally to a wider group of potential global systemically important financial institutions. Subsequently, the Basel Committee, IAIS, and FSB, in consultation with IOSCO, developed and published five sector-specific methodological frameworks for identifying global systemically important financial institutions:

- the Basel Committee methodology to identify global systemically important banks;<sup>23</sup>

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<sup>21</sup>See Financial Stability Board, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines* (Oct. 20, 2010). Also see GAO, *International Financial Reforms: U.S. and Other Jurisdictions' Efforts to Develop and Implement Reforms*, [GAO-14-261](#) (Washington, D.C.: Apr. 3, 2014).

<sup>22</sup>The G20 was established in 1999 as a forum for finance ministers and central bank governors and was elevated to the political leader level in 2008 when its member countries' heads of state or government first met to respond to the global economic and financial crisis. The G20 members include 19 countries and the European Union.

<sup>23</sup>Bank for International Settlements, Basel Committee on Banking Supervision, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (Basel, Switzerland: July 2013).

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- the IAIS initial methodology to identify global systemically important insurers;<sup>24</sup> and
  - the FSB's (in consultation with IOSCO) three nonbank, noninsurer methodologies to identify global systemically important finance companies, market intermediaries, and investment funds (which are not yet final).<sup>25</sup>

The Basel Committee is the primary international standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Established in 1975, it sets supervisory standards and guidelines to promote global financial stability. The standards are not legally enforceable, but are developed and issued by Basel Committee members with the expectation that individual national authorities will implement them. Members include central banks or bank supervisors for 27 jurisdictions, including the United States.

IAIS is the international standard-setting body responsible for developing and assisting in the implementation of principles, standards, and other supporting material for the supervision of the insurance sector. Established in 1994, IAIS's objectives are to promote effective and globally consistent supervision of the insurance industry; develop and maintain fair, safe, and stable insurance markets; and contribute to global financial stability. Its members include insurance supervisors and regulators from more than 200 jurisdictions in approximately 140 countries, including the United States.

IOSCO sets international standards for the securities sector to protect investors, ensure efficient markets, and address systemic risks. Its members include more than 120 securities regulators, including the U.S. Securities and Exchange Commission (SEC). It also has affiliated members, including 80 other securities markets participants (such as stock exchanges). Established in 1983, IOSCO develops, implements, and promotes adherence to internationally recognized standards for

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<sup>24</sup>International Association of Insurance Supervisors, *Global Systemically Important Insurers: Initial Assessment Methodology* (Basel, Switzerland: July 18, 2013).

<sup>25</sup>Financial Stability Board and International Organization of Securities Commissions, *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Basel, Switzerland: Jan. 8, 2014). In addition to the three sector-specific methodologies, the nonbank, noninsurer methodologies include a guiding methodology for all other types of nonbank, noninsurer financial entities.



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securities regulation. It works with the G20 and FSB to develop standards and guidance to implement the global regulatory reforms that apply to securities markets and institutions.

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## FSOC Manages the Determination Process through Its Committee Structure but Limited Recording or Tracking of Data May Hinder Its Ability to Monitor Performance

FSOC conducts its nonbank determination process largely through its committee structure, which generally comprises staff from member agencies. All FSOC member agencies have contributed staff to evaluations, but the extent of participation and leadership varied by member agency—with the Federal Reserve often at the forefront. FSOC uses a practice that relies on volunteers to lead and conduct company evaluations. However, FSOC does not track certain information critical for managing results—specifically, the dates of key process steps or the number of staff from each member agency working on determination evaluations. Companies that FSOC evaluated generally were satisfied with FSOC’s communication throughout the process, but were unclear about how and when they could access deputies and principals.

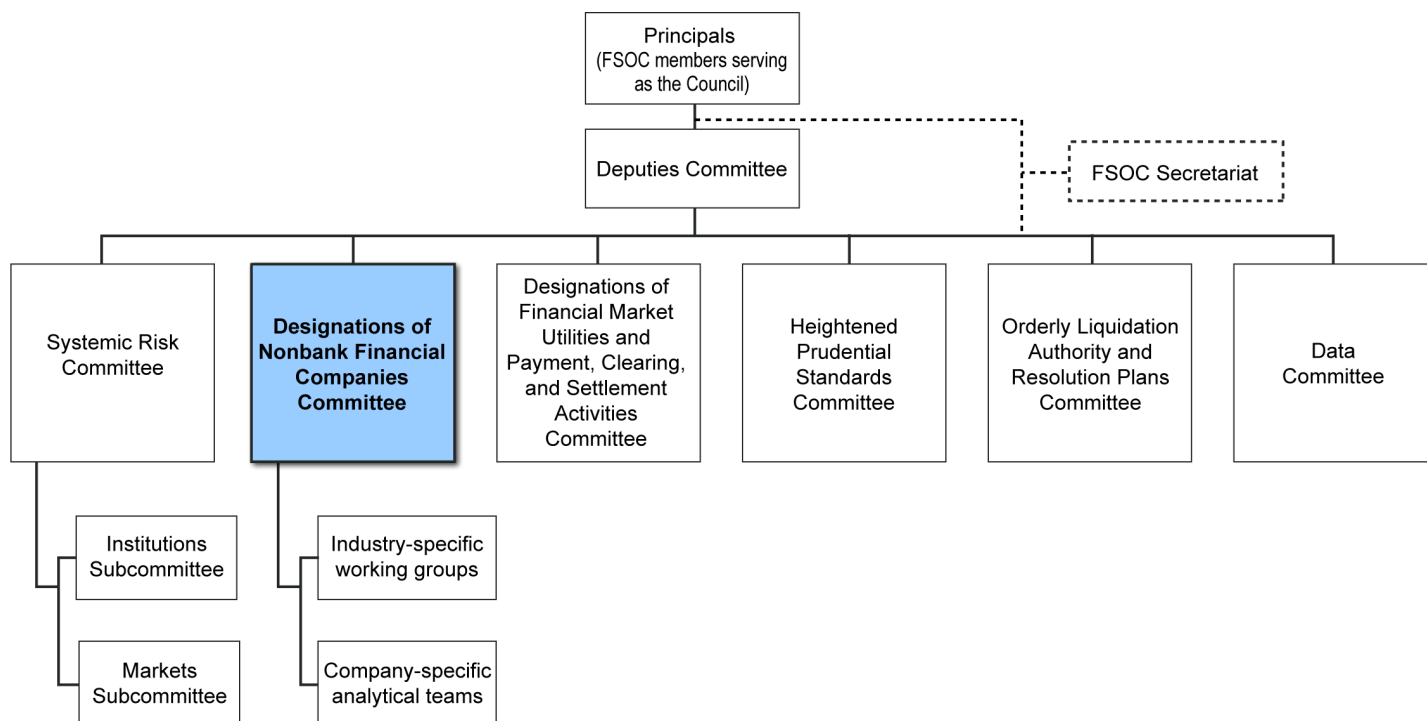
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## FSOC Manages the Determination Process through Its Committee Structure

FSOC conducts its nonbank determination process largely through its committee structure (see fig. 7). FSOC’s committees generally comprise staff from each of its member agencies. FSOC’s standing functional committees help the Council carry out its responsibilities. The Designations of Nonbank Financial Companies Committee (hereafter, referred to as the Nonbank Designations Committee)—one of the functional committees and the focus of our review—supports FSOC in evaluating nonbank financial companies for enhanced prudential standards and supervision by the Federal Reserve. The Deputies Committee, which meets about every 2 weeks and consists of senior officials designated by principals, is responsible for overseeing the work of the committees. The deputies may resolve questions or concerns that arise in the other committees and review information that will be provided to principals. For example, according to Secretariat staff, in deciding which companies to prioritize for review in Stage 2, if the Nonbank Designations Committee is unable to reach consensus, the decision is elevated to the Deputies Committee, where the deputies make a decision after discussion and consideration of the Nonbank Designations Committee’s views and the principals’ priorities. Additionally, the FSOC Secretariat—a dedicated policy office (24 staff, led by a Deputy Assistant Secretary) in Treasury’s Office of Domestic Finance—coordinates the work of the committees and assists the chairperson of the Council (the

Secretary of the Treasury) in carrying out his responsibilities. For a detailed description of the committees, see appendix II.

**Figure 7: Committee Structure of the Financial Stability Oversight Council (FSOC)**



----- Responsible for coordinating the work of the committees

Source: GAO analysis of FSOC information. | GAO-15-51

The Nonbank Designations Committee conducts some of its work using working groups and analytical teams from member agencies. According to Secretariat officials, working groups have served as forums for discussing industry-specific topics and hosted a range of outside experts, such as state insurance regulators. Currently, the committee has one

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active working group—the Insurance Working Group.<sup>26</sup> FSOC Secretariat officials said that analytical teams primarily focus on conducting company evaluations. For instance, analytical teams conducted evaluations of the three companies—AIG, GE Capital, and Prudential—that FSOC had designated as of September 2014. The Nonbank Designations Committee also participated in FSOC’s evaluation of the asset management industry. The evaluation included reviewing risks that may be posed by certain large asset management companies, and identifying industry-wide data gaps or activities that may merit further consideration. According to FSOC Secretariat officials, the Nonbank Designations Committee, including its working groups and analytical teams, has no authority to make decisions on behalf of the Council. Rather, it presents the results of its work in draft memorandums, and periodic briefings and updates to the Deputies Committee, which then reviews and provides feedback on this work before providing it to the Council for any action.

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### Member Agencies Contributed Varying Levels of Staff to FSOC’s Evaluation Teams

All member agencies participated on the Nonbank Designations Committee to some extent, although the majority of leaders and participants doing analytical work came from a few member agencies (see table 1). According to Secretariat and Federal Reserve officials, analytical teams typically consisted of about 6-10 active staff members but might include additional member agency staff with relevant subject-matter expertise, as necessary.

### Agency Involvement in Analytical Teams or Working Groups Varied

With three exceptions—the Commodity Futures Trading Commission (CFTC), state banking supervisor, and state securities commissioner—each member agency contributed at least one staff member to analytical teams or working groups during this period.<sup>27</sup> However, the amount of involvement varied widely. For agencies that contributed staff to the committee’s analytical work, the estimated number of staff participants

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<sup>26</sup>The Insurance Working Group is led by the independent member with insurance expertise. According to Secretariat staff, in the early stages of its existence, FSOC staff formed multiple working groups that were part of FSOC’s effort to determine how it would implement its statutory authority. These working groups existed from around 2010 to 2012 and were most active before FSOC issued its final rule establishing the designation process.

<sup>27</sup>We collected information from each member agency on its estimates of staff contributions to the committee’s evaluations, including the amount and type of staff involvement, from 2012—the calendar year FSOC issued its final rule and guidance on nonbank designations—through the middle of 2014.

varied from 1 in 1 year for the Consumer Financial Protection Bureau to 20 or more staff in 3 consecutive years for the Federal Reserve. Six member agencies contributed at least 5 staff in each of the last 2 years—including 12 from the Federal Deposit Insurance Corporation (FDIC) and 9 from Treasury.

**Table 1: Estimated Number of Staff Who Performed Company- and Industry-Specific Analytical Work for the Nonbank Designations Committee, by Financial Stability Oversight Council (FSOC) Member Agency, 2012 through July 2014**

FSOC Member	2012	2013	2014
Board of Governors of the Federal Reserve System	20	25	25
Federal Deposit Insurance Corporation	5	12 <sup>a</sup>	12 <sup>a</sup>
Securities and Exchange Commission	0	2	12
Department of the Treasury	4	9	9
State insurance commissioner	5	7	7
Office of Financial Research	0	1	7 <sup>b</sup>
Federal Housing Finance Agency	9 <sup>a</sup>	5	5
Office of the Comptroller of the Currency	3	5	5
Independent member with insurance expertise	3	3	4
Federal Insurance Office	2	3	3
National Credit Union Administration	2	2	0
Consumer Financial Protection Bureau	1	0	0
Commodity Futures Trading Commission	0	0	0
State banking supervisor	0	0	0
State securities commissioner	0	0	0

Source: GAO summary of information from FSOC member agencies. | GAO-15-51

Notes: Staff estimates were provided by officials from each member agency and represent individuals involved in analytical work and not those who may have participated in other capacities. These estimates do not reflect full-time equivalents, and should be considered part-time contributors unless otherwise noted. According to member agency officials, part-time contributions varied from 5 percent to almost 100 percent of a staff person's time. The numbers for 2014 represent data collected through July 2014.

<sup>a</sup>This figure includes one full-time detailee.

<sup>b</sup>The Office of Financial Research estimated that the number of staff ranged from 7 to 10 in calendar year 2014.

The Federal Reserve and Treasury most often led the teams conducting the comprehensive Stage 3 evaluations, which typically had from two to four co-leads. Lead or co-lead analysts coordinate interagency efforts during the Stage 2 and Stage 3 evaluations and coordinate the drafting of the evaluation memorandums. According to information from FSOC member agencies, about half of the 15 agencies led or co-led a Stage 2

or Stage 3 evaluation team (see table 2).<sup>28</sup> Additionally, staff from five agencies co-led Stage 3 evaluations—the most in-depth review of the determination process.<sup>29</sup> Of the five, the Federal Reserve and Treasury co-led the most Stage 3 evaluations. Although they have not co-led any Stage 3 evaluations, staff from other agencies, including the Office of the Comptroller of the Currency (OCC) and FDIC, said they have been active participants in some or all of the Stage 3 evaluation teams. For example, FDIC officials said that FDIC was involved in all Stage 3 evaluations and contributed 15 staff over the course of the four evaluations. Although they have not co-led a Stage 3 evaluation, SEC has co-led four Stage 2 evaluations, and OCC co-led two Stage 2 evaluations.

**Table 2: Financial Stability Oversight Council (FSOC) Member Agencies Leading Company Evaluations for the Nonbank Designations Committee, 2011 through July 2014**

FSOC member	Stage 2	Stage 3	Stage 3 company
Board of Governors of the Federal Reserve System	6	3	AIG, GE Capital, company currently subject to proposed determination
Department of the Treasury	0	3	AIG, GE Capital, company currently subject to proposed determination
Independent member with insurance expertise	2	2	AIG, company currently subject to proposed determination
Federal Insurance Office <sup>a</sup>	1	2	Prudential, company currently subject to proposed determination
Federal Housing Finance Agency	1	1	Prudential
Securities and Exchange Commission	4	0	N/A
National Credit Union Administration	2	0	N/A
Office of the Comptroller of the Currency	2	0	N/A
Federal Deposit Insurance Corporation	1	0	N/A
Commodity Futures Trading Commission	0	0	N/A
Consumer Financial Protection Bureau	0	0	N/A
Office of Financial Research <sup>a</sup>	0	0	N/A
State banking supervisor <sup>a</sup>	0	0	N/A
State insurance commissioner <sup>a</sup>	0	0	N/A

<sup>28</sup>We did not include information on member agencies leading Stage 1 because OFR has performed the analysis (of uniform quantitative metrics and thresholds) on a regular basis.

<sup>29</sup>Each Stage 3 evaluation has included staff of multiple FSOC member agencies serving as co-leads.

FSOC member	Stage 2	Stage 3	Stage 3 company
State securities commissioner <sup>a</sup>	0	0	N/A

Source: GAO summary of information from FSOC member agencies. | GAO-15-51

Notes: The numbers for 2014 represent data collected through July 2014. N/A indicates that a member agency has not led a company evaluation.

<sup>a</sup>Nonvoting member of FSOC.

The amount of time each staff participant on the Nonbank Designations Committee contributed varied by individual and the nature of the work. Most staff participated on a part-time basis—they continued to fulfill work responsibilities at their home agencies. However, agency officials told us that the Federal Housing Finance Agency and FDIC each provided one full-time detailee to conduct work for FSOC’s Nonbank Designations Committee. Some staff participated in general committee work—for example, conference calls and monitoring e-mails—for a minimal amount of their time.<sup>30</sup> According to member agencies’ officials, other staff contributed from 5 percent to almost 100 percent of their time to the evaluative work of analytical teams, depending on the circumstances of the evaluation and the applicable time period.

Member agency staff who contributed to company evaluations also held various positions and contributed a range of expertise. Officials from member agencies told us that different aspects of the evaluation process required different types of staff expertise. For example, FSOC might use financial analysts to examine companies’ financial statements and economists to review broader systemic effects related to a company’s risks. The officials explained that the staff of their agencies who conducted analytical work for the committee generally included financial analysts, economists, policy analysts, specialists, and attorneys. For example, one agency indicated that its staff contributors included one senior advisor, two specialists, and two economists. According to officials from some member agencies, in the later stages of the determination process, the Deputies Committee, other senior staff, and some smaller member agencies became more involved.

Although some member agencies may not have participated in working groups or on analytical teams, they participated in other ways. For

<sup>30</sup>Table 1 reflects staff contributions to only the analytical work conducted by the Nonbank Designations Committee and not participation at a more general level.

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example, all member agencies participated in the overall evaluation of nonbank financial companies through their deputies and principals and some member agencies were involved on other FSOC committees. CFTC officials explained that while they were not heavily involved in the Nonbank Designations Committee, CFTC staff members helped to lead the Designations of Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee.

Finally, FSOC Secretariat officials stated that all member agencies were invited to participate on the Nonbank Designations Committee and member agencies' officials generally felt that they had sufficient opportunities to participate, including conducting and leading analytical work. One agency official stated that some agencies played a larger role in the process because they are the primary regulatory agencies and may have more resources to contribute. Officials from two member agencies stated that despite having limited staff resources their offices contributed all, or nearly all, of their staff to participate in the Nonbank Designations Committee. Some agencies' officials said that they chose to limit the extent of their participation because of resource constraints or lack of a direct interest or expertise in the companies or industries being evaluated. However, officials from each member agency also said that they remained involved in monitoring the committee's work and engaging in discussions.

#### FSOC Selects and Assigns Staff from among Member Agency Volunteers

FSOC uses a volunteer staffing practice for selecting and assigning staff to conduct and lead company evaluations. Secretariat and member agency officials explained that FSOC uses a practice that relies on member agencies volunteering staff for the Nonbank Designations Committee and its analytical teams as agencies deemed appropriate. According to Secretariat officials, FSOC relies on volunteers because the Council does not have staff resources of its own to conduct evaluations. Secretariat officials and member agencies said that the Secretariat coordinated the volunteer process and worked with team leads, committees (Nonbank Designations and Deputies Committees), and principals to help ensure the involvement of sufficient agencies and staff with relevant expertise.<sup>31</sup>

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<sup>31</sup>According to Secretariat staff and a member agency official, analysts who worked on the Stage 2 analytical team for a company generally also worked on the Stage 3 analytical team for that company.

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FSOC also uses a practice that relies on volunteers to lead its analytical teams. However, all agencies volunteering staff to lead evaluations may not be assigned as team leaders. According to officials, the Secretariat asks for volunteers to lead specific company evaluations and coordinates the selection process. Secretariat officials said that if the number of volunteers exceeded the need for team leads, the Secretariat would negotiate among various parties (including deputies) to select the team leads. Secretariat staff also said that analytical teams could have from two to four co-leads, thus allowing more volunteers to lead the team. Member agencies' officials generally felt that they had sufficient opportunities to lead analytical work. However, one agency official said that team lead selections were contentious in some instances. For example, staff from this agency and another member agency stated that although they each attempted to have an experienced staff member co-lead an evaluation, FSOC denied the request without explanation. Secretariat staff and member officials said that, in general, FSOC selects team leaders and participants based on their expertise.<sup>32</sup> Furthermore, Secretariat staff stated that in reviewing decision memorandums prepared by analytical teams, the Nonbank Designations Committee, deputies, and principals have multiple opportunities to provide input and identify any topical areas for which input by individuals with relevant expertise would be helpful or that require further analysis. Secretariat officials said that FSOC has not experienced any shortcomings or challenges related to staff resources or the expertise of staff. FSOC member agency officials generally indicated that their agency's expertise was well utilized. But, two of the four companies we interviewed that FSOC evaluated in Stage 3 indicated that some of the analysts conducting the evaluation had limited expertise in their company's industry.

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## FSOC Has Not Centrally Recorded or Tracked Information Critical for Managing Results

The determination process to evaluate companies has been in place for more than 2 years, but FSOC has not systematically recorded or monitored data related to the occurrence of significant events or comprehensive information on staff working on evaluations. Such actions constitute important control activities that are critical for managing results. As we previously reported, agencies are better equipped to address management and performance challenges when managers effectively

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<sup>32</sup>We did not examine the extent to which staff of analytical teams had requisite expertise or what was implied by "expertise" in each context.



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use performance information—such as the duration of evaluations, and staff utilization—to track and monitor progress for decision making.<sup>33</sup> Federal internal control standards identify control activities as an integral part of an entity’s planning, implementing, reviewing, and accountability for achieving effective results.<sup>34</sup> Such activities include the accurate and timely recording of transactions and events. Federal internal control standards also highlight the need for analytical information to help managers identify specific actions that need to be taken. Furthermore, internal control monitoring should include assessments of the quality of performance over time.

In the initial Stage 1 analysis conducted in June 2012, FSOC—using information that OFR gathered from public and regulatory sources—identified fewer than 50 nonbank financial companies that qualified for Stage 2.<sup>35</sup> Since that time, FSOC began Stage 2 evaluations of 14 of these companies and completed the evaluation process for 8, either by making a final determination or deciding not to further evaluate the company.<sup>36</sup> FSOC determined that 3 companies should be supervised by the Federal Reserve and that the other 5 companies did not warrant further evaluation at that time and thus did not advance to Stage 3 for consideration for a proposed or final determination.<sup>37</sup> As of September

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<sup>33</sup>GAO, *Managing For Results: Agencies’ Trends in the Use of Performance Information to Make Decisions*, [GAO-14-747](#) (Washington, D.C.: Sept. 26, 2014); and *Managing For Results: Implementation Approaches Used to Enhance Collaboration in Interagency Groups*, [GAO-14-220](#) (Washington, D.C.: Feb. 14, 2014).

<sup>34</sup>See GAO, *Internal Control: Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

<sup>35</sup>According to FSOC and OFR officials, OFR has been conducting the Stage 1 analysis on behalf of FSOC on a quarterly basis. The number of companies meeting thresholds for Stage 2 generally remained constant and was fewer than 50 through September 2014. Secretariat officials explained that although FSOC has staff to conduct more Stage 2 evaluations, each requires a significant amount of time for deputies and principals, which can constrain the number of simultaneous evaluations. The officials said that, over time, FSOC expects to complete evaluations of the initial companies that advanced to Stage 2 and focus on additions to the list.

<sup>36</sup>FSOC did not complete the evaluation for one company undergoing Stage 2 evaluation because, after FSOC began the evaluation, that company no longer met the required quantitative Stage 1 thresholds and did not qualify for Stage 2. Moreover, although the overall number was generally consistent, some companies were removed from and others added to the list of companies qualifying for Stage 2.

<sup>37</sup>FSOC may re-evaluate the companies in the future.

2014, FSOC had five evaluations in process—it completed the Stage 3 evaluation for 1 company, which received a proposed determination, and was evaluating 4 other companies in Stage 2. Table 3 summarizes the status of the company evaluations initiated by the Nonbank Designations Committee.

**Table 3: Status of Company Evaluations Conducted by the Financial Stability Oversight Council's (FSOC) Nonbank Designations Committee, as of September 2014**

Status	Stage 2	Stage 3	Total
Final decision	5	3	8
In process	4	1 <sup>a</sup>	5

Source: GAO summary of FSOC information. | GAO-15-51

<sup>a</sup>This company received a proposed determination in September 2014.

However, FSOC has not centrally recorded the dates when significant events in the process occurred—such as the initiation of Stage 2 analysis—or tracked the duration of key stages in each evaluation. Secretariat officials said that FSOC has not centrally recorded or tracked key processing dates because, if necessary, it can approximate or determine this information by analyzing documents such as memorandums completed at each stage of the determination process, notices, e-mails, or Council meeting minutes. For example, officials explained that quarterly Stage 1 memorandums contain conclusions and dates that provide information on the status of Stage 2 evaluations, and FSOC staff members use the Stage 1 memorandums to keep deputies and principals informed of the status of Stage 2 evaluations. Secretariat staff stated that the frequency and level of detail in the memorandums have been sufficient for FSOC's purposes of monitoring progress on nonbank financial company determinations, and they have not found it necessary to track specific dates for process steps such as when work on a particular analysis began. However, FSOC ultimately was unable to provide us with this information for 2012 because it has not systematically recorded or monitored the dates of key processing steps. Officials from one member agency stated that the Nonbank Designations Committee and Deputies Committee monitor the progress of the analytical teams and provide direction on key issues through periodic updates. These officials and Secretariat officials indicated that FSOC has not established or tracked time frames for the analytical work conducted during Stages 2 and 3 because the time required may vary considerably based on the

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complexity of the company being evaluated and the volume of information that the company may submit for consideration during Stage 3.

FSOC also has not centrally collected data on all member agency staff who conducted company evaluations. For example, FSOC did not know the number or types of staff that member agencies contributed to evaluations or all of the staff who participated in any one company's evaluation. Secretariat staff stated that FSOC has not collected or tracked information on team membership because assigned team members often bring in additional experts or make substitutions and obtaining the information from all member agencies would be burdensome.

Without data on when staff conduct, or which staff participate in, determination evaluations, FSOC's ability to effectively monitor the progress and evaluate the efficiency of determination evaluations may be limited. Specifically, FSOC may not be able to identify resource needs, revise its process to maximize the effective use of resources, or plan for future determination evaluations. The lack of such information also may hinder FSOC's ability to inform companies about how long the determination process took in the past. Furthermore, FSOC might not be able to determine whether the most relevant member agencies and their staff representatives conducted evaluations or help to ensure the broad participation of member agencies in company evaluations.

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**FSOC Frequently Communicated with Companies Undergoing Evaluation, but Was Unclear about Companies' Ability to Access Certain Officials**

Companies that FSOC evaluated generally were satisfied with FSOC's communication throughout the process, but were unclear about how and when they could access deputies and principals. As previously discussed, FSOC's communication with companies under review includes several formal notifications:

- **Notice of consideration.** Following a vote to advance a company to Stage 3, FSOC informs a nonbank financial company that it is considering whether to make a proposed determination and that the company can submit written materials to contest FSOC's consideration of the company for a proposed determination.
- **Notice of completion of evidentiary record.** FSOC informs the company that it has completed the evidentiary record for the company, after which it must make a proposed determination within 180 days of the company's receipt of this notice, unless FSOC issues a new notice of consideration.
- **Notice of proposed determination.** FSOC informs the company of a proposed determination, including the basis for such determination.

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The company has 30 days after receipt of the notice to request a hearing to contest the proposed determination. The hearing can be limited to written submissions, or at FSOC's discretion may include oral testimony and oral argument, and may occur before the Council or its representatives.

- **Notice of final determination.** After any hearing, FSOC informs the company that it has made a final determination and provides an explanation of the basis for its decision. When practical, FSOC provides this notice at least 1 business day before publicly announcing the determination.

In addition to these notices, FSOC submits one or more written data requests to the company through OFR at the start of Stage 3. According to officials of companies evaluated in Stage 3, OFR sends the initial request about 2 weeks after FSOC sends the notice of consideration and this initiates FSOC's Stage 3 interactions with companies under evaluation.

According to their officials, three of the four companies that were evaluated in Stage 3 generally were satisfied with their interactions with FSOC. For example, officials from some of the companies noted that at the beginning of Stage 3, FSOC held an in-person meeting to discuss the process and regularly communicated with the companies throughout the evaluation. These officials also said that FSOC staff made themselves available to discuss data requests and respond to questions and concerns. FSOC Secretariat officials stated that their interactions with companies included extensive discussions, generally related to information being analyzed by the Council. For example, over a 12-month period staff from member agencies engaged with one company 20 times, including seven meetings with senior management and numerous telephone meetings, and considered more than 200 data submissions. For the three companies that received a final determination, we reviewed summary documentation of FSOC's interactions with each and found that FSOC staff had at least 13 separate communications with each company, in addition to the formal notifications. The interactions were predominantly by telephone and generally involved discussions about specific information related to FSOC's evaluation of the company. Officials from all four companies said that FSOC adjusted the deadline for responding to its data requests when the company asked for an extension. Company officials stated that they also were allowed to provide additional information beyond the specific data that FSOC requested. However, they said that they were unsure to what extent FSOC had considered the information or how FSOC incorporated it into the determination decision.

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FSOC member agency officials also indicated that significant communication occurred with companies under evaluation. For example, some of these officials said that evaluation teams made themselves available to companies undergoing evaluation whenever companies requested a discussion. Additionally, FSOC granted these companies the ability to submit statements and any other information about why they should not receive a determination.

However, officials from several of the companies with whom we spoke expressed some concerns about the level and extent of FSOC representation at meetings. Officials from three of the four Stage 3 companies said that they communicated primarily with analytical staff rather than deputies or principals. Officials from two companies stated that while staff from multiple member agencies attended meetings, some agencies never had any staff present at any of the meetings. Officials from some companies also indicated varying access to deputies and principals. For example, two companies' officials stated that only one principal attended any of their meetings, and he did so regularly. Officials from one of the companies stated that despite their requests, none of the other principals or any deputies came to the meetings. Officials from the other company said FSOC turned down their request to meet with principals and that FSOC indicated to them that some principals felt uncomfortable meeting with a company before a determination. However, the officials said that FSOC later offered the company a meeting with all of the deputies. According to officials from some FSOC member agencies, companies had ample opportunities to communicate with FSOC even before having the opportunity to request a formal hearing with principals.

Secretariat officials said that in Stage 3 FSOC accepted all requests by companies under evaluation to meet with staff from member agencies and the Deputies Committee. In addition, the officials stated that one company requested a meeting with deputies in Stage 3 and that the deputies hosted a 2-hour meeting with the company.<sup>38</sup> Secretariat officials also said that they believe one or more deputies attended at least one meeting with each company. For meetings with principals, Secretariat officials explained that under the Dodd-Frank Act and FSOC's final rule

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<sup>38</sup>According to officials, this company originally requested an opportunity to meet with the voting member principals, and FSOC later offered the company a meeting with the deputies.

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on nonbank determinations, companies can request a hearing with principals before a final determination.<sup>39</sup> Two companies requested such a hearing, and Secretariat officials said FSOC granted both requests and the principals conducted the hearings in person. However, the Dodd-Frank Act and FSOC's final rule do not contemplate such a formal hearing until after FSOC has completed its Stage 3 analysis and made a proposed determination. According to Secretariat officials, FSOC's practice has been that principals not meet with companies under Stage 3 evaluation because the evaluation was ongoing with no proposed designation made. They said that they recognize that individual principals retain ultimate discretion about whether to meet with companies during Stage 3.

FSOC has not established documentation clarifying access to deputies and principals beyond the formal hearing process, including whether, when, and on what terms companies under evaluation may meet with deputies and principals. Although FSOC has adopted a final rule on its determination process, bylaws for the Council (principals) and Deputies Committee, and procedures for hearings in connection with proposed determinations, these documents do not describe to what extent, if at all, companies under consideration may be able to access deputies and principals before a proposed designation. Moreover, FSOC provides notices to companies, and on its website has frequently asked questions (FAQ) about nonbank designations—which includes some information about the opportunities companies have to interact with FSOC before a designation—but neither the notices nor the FAQ section describe companies' ability to access deputies and principals before a proposed designation.

According to federal internal control standards, formally documented policies and procedures that are clear and readily available are an essential part of an agency's internal control system and help to ensure that activities are performed consistently across an agency. Furthermore, federal internal control standards state the importance of relevant,

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<sup>39</sup>On April 11, 2012, FSOC issued a final rule and interpretive guidance outlining how it would evaluate and designate nonbank financial companies for supervision by the Federal Reserve. See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637.

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reliable, and timely communications within an organization, as well as with external stakeholders.<sup>40</sup>

Secretariat officials stated that they have not established any formal documentation relating to companies' interactions with principals and their deputies before a proposed designation, because so far they have received only one request to meet with deputies—which was granted—and the Council has followed a practice of declining requests from companies undergoing Stage 3 evaluation to meet with principals. These officials also stated that the determination of whether FSOC principals collectively meet with a company is made on the basis of a particular request. Furthermore, Secretariat officials were not aware of other agencies—such as member agencies including the Federal Reserve, SEC, CFTC, the National Credit Union Administration, and FDIC—that have formal written procedures for when a company may meet with the principals of that agency. However, FSOC has established written procedures for certain instances when companies can meet with principals but it has not defined such procedures beyond the formal hearing process or for meeting with deputies. Without clear documentation of its practices, FSOC may not be able to ensure the consistency and transparency of interactions among principals, deputies, and companies undergoing evaluation. Furthermore, companies under evaluation by FSOC may not have had complete information about the extent to which they could meet with deputies and principals. For example, as discussed earlier one company requested and received a meeting with deputies in Stage 3 of the evaluation process, but other companies in a similar situation may not have been aware that such an opportunity existed.

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<sup>40</sup>[GAO/AIMD-00-21.3.1.](#)

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## FSOC's Determination Process Could Be Improved for Greater Transparency and Accountability

FSOC has developed and followed a process for making determination decisions that includes systematic elements. However, FSOC's public documentation has not always fully disclosed the specific bases for its determination decisions. FSOC's nonpublic documentation could have benefitted from inclusion of additional detail about some aspects of its designation decisions. Also, as of September 2014, FSOC had not evaluated companies based on whether their activities alone could threaten financial stability, but only on whether their material financial distress could. Furthermore, data limitations prevented FSOC from including some types of nonbank financial companies in its scope of review.

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## FSOC Has Followed Its Analytic Process, Which Provides a Degree of Consistency and Transparency

FSOC has developed and followed a process for making determinations that is in part systematic and transparent. A systematic process can be defined as one that is methodical, based on criteria, and applied consistently. For example, the final rule and guidance established a determination process comprising three stages in which FSOC conducts increasingly detailed analysis of selected companies. For the first stage of the process, FSOC defined specific quantitative metrics to be used as criteria for identifying companies for further evaluation—which can provide transparency to the markets, the public, and companies that may be identified for review. FSOC also defined a framework for its analysis, including evaluation categories and transmission channels (that is, exposure, asset liquidation, and critical function or services) upon which it would base its evaluations. In addition, FSOC committed to providing notice to companies about their status in the process, such as advancement to Stage 3 and decisions about proposed and final determinations. FSOC sought information from and provided information to the public and market participants about these and other aspects of its determination process by soliciting public comments on its proposed rule and publishing its final rule and guidance.

In its completed reviews, FSOC followed its determination process and analytical framework. We reviewed FSOC documentation for eight nonbank financial companies, including nonpublic analysis memorandums (from Stage 2 and Stage 3 evaluations), notices that FSOC sent to these companies, and other communications between



FSOC and the companies.<sup>41</sup> Based on our review, we found that FSOC implemented the three-stage process for making determinations as outlined in its final rule and guidance. In its evaluations, FSOC conducted quantitative and qualitative analyses that followed its six-category and transmission-channel framework. As described previously, FSOC established a framework for its determination evaluations composed of six analytical categories and three channels that it deemed most likely to transmit the effects of a company’s financial distress or activities to other financial firms and markets. FSOC’s Stage 2 analysis primarily involved the six analytical categories and its Stage 3 analysis focused on the three transmission channels.

In evaluating the categories and channels, FSOC analyzed a variety of metrics. For example, FSOC used both quantitative and qualitative metrics to evaluate a company’s total assets, including the types of assets, and ranked companies against their competitors according to asset size and other characteristics. In assessing interconnectedness, FSOC evaluated a company’s financial and business relationships with its counterparties, along with other factors. To analyze substitutability, FSOC’s analysis included using industry-specific metrics related to market implications of the company withdrawing due to material financial distress or failure. Table 4 provides examples of metrics and other factors FSOC considered in applying its analytical framework.

**Table 4: Examples of Metrics and Analysis Used in the Financial Stability Oversight Council’s (FSOC) Evaluations of Nonbank Financial Companies**

Categories of analysis	Examples of information used
<b>Six-category framework</b>	
Size	<ul style="list-style-type: none"> <li>Total consolidated assets, including types of assets.</li> <li>Ranking, by asset size, compared with competitors.</li> <li>Company locations and structure, including international operations and the number of major business units.</li> <li>Sales volumes in the United States by operating segment or product line.</li> </ul>
Interconnectedness	<ul style="list-style-type: none"> <li>Sources of funding and reliance on such sources.</li> <li>Counterparties, including types of parties and amounts and types of exposures to those parties.</li> </ul>

<sup>41</sup>We did not review FSOC documentation for the company that received a proposed determination in September 2014 because FSOC was evaluating the company and had not made a final designation.

Categories of analysis	Examples of information used
Substitutability	<ul style="list-style-type: none"> <li>• Foreign operations and exposure to foreign markets.</li> <li>• Financial and business relationships with parent company and affiliates.</li> <li>• Products and services and availability of competitors and substitutes that provide the same products and services.</li> <li>• Market share of products and services and comparison with competitors' market shares.</li> <li>• Barriers for competitors to enter the markets of company's products and services.</li> </ul>
Leverage	<ul style="list-style-type: none"> <li>• Ratios of total assets and total debt to total equity.</li> <li>• Leverage position and comparison with that of other large financial institutions (including banks and nonbank financial companies).</li> <li>• Efforts to decrease current and future leverage.</li> </ul>
Liquidity risk and maturity mismatch	<ul style="list-style-type: none"> <li>• Ratios of assets to long-term and short-term debt.</li> <li>• Total debt outstanding and amount of debt due in future years.</li> <li>• Available cash flow and funding sources, including existing lines of credit, and ability to meet debt commitments.</li> <li>• Reliance on government financial support during recent financial crisis.</li> </ul>
Existing regulatory scrutiny	<ul style="list-style-type: none"> <li>• Relevant federal, state, and local laws and regulations that apply to the company.</li> <li>• Current financial supervisors and the nature and extent of oversight of the company and its subsidiaries.</li> <li>• Extent of state and foreign regulation of certain subsidiaries, such as insurers.</li> <li>• Additional regulatory authorities resulting from a designation by FSOC.</li> </ul>
<b>Other factors from FSOC guidance</b>	
Resolvability	<ul style="list-style-type: none"> <li>• Legal, business, and operating structure, including its significance in terms of size and complexity.</li> <li>• Ability to resolve company in a rapid and orderly fashion and potential obstacles to doing so.</li> <li>• Whether company provides critical functions or services.</li> <li>• Extent to which company's domestic and foreign operations are connected and share critical services.</li> <li>• Potential consequences of a subsidiary's failure for other subsidiaries and parent company.</li> </ul>
<b>Transmission channels</b>	
Exposure	<ul style="list-style-type: none"> <li>• Amount of capital markets activities and debt and equity outstanding, including by instrument type and by counterparty.</li> <li>• Exposure to company's products and services, such as insurance coverage.</li> <li>• Exposures of large financial companies (including global banks) to the company resulting from company-issued debt or reliance on company as a provider of credit.</li> <li>• Potential negative effects of company's failure on customers, competitors, other financial companies, and state-based guaranty and security funds.</li> </ul>
Asset liquidation	<ul style="list-style-type: none"> <li>• Reliance on particular types of funding and the stability of these funding sources.</li> <li>• Amount and characteristics of assets, including the extent to which assets are liquid.</li> <li>• Potential events or triggers that could force a liquidation of assets, the consequences of liquidation for the company, and potential effects on other companies (including large bank holding companies and insurance companies) with similar assets to those held by the company.</li> </ul>

Categories of analysis	Examples of information used
Critical function or services	<ul style="list-style-type: none"> <li>• Potential mitigating factors, such as the availability of options for the company to generate cash and funding in a timely manner.</li> <li>• Core products and market shares, detailed by lines of business.</li> <li>• Role in providing services—such as insurance coverage—for large financial companies (including global banks) and consequences if company were unable to provide those services.</li> <li>• Extent to which company provides a critical function or service in particular markets—such as providing credit to low-income, minority, or underserved communities or state and local governments—and potential effects of disruption in service to market customers and marketplace.</li> <li>• Relevant attributes that distinguish operations from peers or make products difficult to replace.</li> <li>• Potential mitigating factors, including availability of competitors and substitutes.</li> </ul>

Source: GAO analysis of FSOC documents. | GAO-15-51

Note: The table is for illustrative purposes only—the listed metrics and analysis represent only a sampling of those FSOC used in its evaluation process.

Furthermore, for each of the companies for which we reviewed documentation and that advanced to Stage 3, FSOC complied with the notification requirements in its final rule and guidance. These included sending companies notice that FSOC was reviewing them in Stage 3, that it had completed its evidentiary record, and that it had made a proposed and final determination, as applicable. For the only company that requested a hearing to contest a proposed determination, FSOC granted the company’s request and held the hearing in compliance with the time frame specified in its final rule and guidance.

### FSOC Has Not Always Fully Disclosed to the Public the Specific Bases for Its Determination Decisions

FSOC has a transparency policy that states that it is committed to operating in an open and transparent manner while recognizing the need to protect confidential and market-sensitive information. This transparency policy is reflected in the analytical framework in FSOC’s final rule and guidance, which describes how FSOC will conduct determination evaluations (including sample metrics). However, FSOC’s public documentation of its designation decisions has not always included all details of the specific bases for making those decisions. FSOC’s nonpublic documentation of Stage 3 evaluations contains extensive facts,

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analysis, and evaluation but could have benefitted from inclusion of additional detail about some aspects of its designation decisions.<sup>42</sup>

FSOC's final rule and guidance state that the Council recognizes that each company may pose unique risks to U.S. financial stability and that tailoring the determination evaluation to individual companies rather than using predefined analyses or criteria would enable the Council to reflect such risks. According to Secretariat officials, FSOC did not develop a process or additional guidance for identifying detailed and specific analytical methods or prescriptive criteria for applying the analytical framework in evaluating companies because the framework and guidance itself is sufficient and each nonbank financial company is complex and unique and therefore evaluations warrant a company-specific approach. Thus, officials said that FSOC staff, deputies, and principals used their judgment, expertise, and discretion—as authorized by and within the scope of the statutory considerations and the analytical framework in FSOC's final rule—when applying qualitative and quantitative criteria for determining if companies met one of the statutory determination standards. While FSOC's determination evaluations may benefit from flexibility in applying criteria to different companies, the judgment and discretion involved in the process underscore the importance of disclosing how the criteria were applied and the basis for a determination decision.

FSOC's public documentation supporting its three final determinations made through September 2014 included only a small portion of the information and analysis in its nonpublic documentation, including information from publicly available sources. According to the Office of Management and Budget's directive on open government, transparency promotes accountability by providing the public with information about government activities.<sup>43</sup> For example, for each of the three determinations, the public documentation ranged from 12 to 14 pages, compared with the nonpublic documentation that ranged from about 140

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<sup>42</sup>While we reviewed FSOC's nonpublic documentation, we did not evaluate the quality of FSOC's analysis. Our review was limited to FSOC's documentation of its analysis for the three nonbank financial companies receiving a final determination as of September 2014, and our findings pertain only to that documentation. Our findings do not reflect conclusions regarding legal compliance.

<sup>43</sup>Office of Management and Budget, Open Government Directive, OMB Memorandum M-10-06 (Washington, D.C.:2009). The directive also recognizes that the presumption of openness does not preclude the need to protect confidential information.

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to 190 pages, including supporting information and analysis. The public basis documents generally included summaries of information about the transmission channels and analytical categories more fully discussed in the nonpublic documents.

Although the nonpublic memorandums for Stage 3 and the nonpublic basis documents include extensive information collected directly from companies that may be considered proprietary or market-sensitive, sizeable amounts of information were obtained from public sources, according to source notations included in the documents. For example, publicly sourced information that did not appear in the public versions of the basis documents included

- information from an international research organization’s public report on the insurance industry’s resolution process (used in discussion about the interconnectedness of banks, corporations, and insurers);
- information from fee-based data providers (used in evaluating a company’s size and market share);
- information from an industry association’s survey of commercial and multifamily mortgage data (used in analyzing whether a company provides credit to low-income communities);
- information from academic studies about the 2007-2009 financial crisis and its effect on commercial investment products (used in discussion about counterparties’ exposures to the company); and
- information from a company’s SEC filings, including audited financial statements and an overview of business and financial conditions (used in evaluating a company’s upcoming contract payment obligations).

An appropriate level of transparency recognizes the need to maintain confidential and sensitive information. At the same time, our prior work has recognized that transparency is a key feature of accountability even when there is a need to safeguard certain sensitive information to protect companies and markets.<sup>44</sup>

Secretariat staff said that FSOC endeavors to make as much information available to the public as possible, but noted that it abides by its statutorily mandated obligation to maintain the confidentiality of data,

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<sup>44</sup>See GAO, *Troubled Asset Relief Program: Continued Stewardship Needed as Treasury Develops Strategies for Monitoring and Divesting Financial Interests in Chrysler and GM*, [GAO-10-151](#) (Washington, D.C.: Nov. 2, 2009).

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information, and reports submitted by a company undergoing review or by a regulator.<sup>45</sup> In addition, Treasury officials noted that releasing only public information could be misleading as it would not represent the totality of the information considered by FSOC. Instead, officials said that the Council has taken the approach of tracking the public disclosures to the executive summaries of the nonpublic memorandums, so the public documents could include the key issues that the Council considered. FSOC's transparency policy and annual reports have emphasized a goal of maximizing transparency and accountability while also protecting market-sensitive and confidential information. However, without more fully disclosing the nonsensitive information and analysis supporting its determinations as included in its nonpublic basis documents, the public and the markets receive limited information on the bases for FSOC's determinations—which in turn may undermine the public's and the market's confidence in the determination process.

In the nonpublic documentation—Stage 3 memorandums and notices of proposed and final determinations—for FSOC's three final determinations, FSOC generally identified the potential for the companies to meet a determination standard based on the size or significance of certain of the company's characteristics evaluated under the transmission channels in FSOC's analytical framework. FSOC designated each of the three companies based on its determination that the company's material financial distress could pose a financial stability threat primarily from the exposure and asset liquidation channels. The documentation did not include details about precisely how FSOC determined that the stated characteristics were significant or sufficiently large in the context of meeting one or both of the determination standards, and FSOC's documentation could have benefitted from inclusion of such additional details.

For example, when evaluating one of these companies under the exposure channel, FSOC clearly set out the company's corporate counterparties and customers, along with the dollar values of transactions with counterparties, in support of FSOC's finding that the company had significant exposures to a large number of corporate and financial entities that could suffer meaningful losses should the company experience

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<sup>45</sup>For FSOC's obligation to maintain confidentiality, see Dodd-Frank Act § 112(d)(5). Pub. L. No. 111-203, § 112(d)(5), 124 Stat 1376, 1397 (2010) (codified at 12 U.S.C. § 5322(d)(5)), and 12 C.F.R. § 1310.20(e).

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material financial distress. In evaluating another company's exposure risk, FSOC concluded that large corporate and financial entities had significant exposures to the company through specific company products and listed major liabilities and contracts and the total dollar values of those exposures. When assessing the company under the asset liquidation channel, FSOC found that the company's material financial distress could result in a forced liquidation of assets that could cause significant disruptions to key markets and significant damage to the broader economy. However, as noted above, FSOC's documentation could have benefitted from inclusion of additional detail about how it determined that the companies' counterparty exposures and potential systemic effects were significant in the context of meeting one or both of the statutory determination standards.

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### FSOC Has Evaluated Companies Only under One of Two Statutory Determination Standards

FSOC has evaluated companies (including those not advanced to Stage 3 for further review) using only the determination standard based on material financial distress. None of the analyses considered whether the companies' activities—the second statutory determination standard—could pose systemic threats. According to Secretariat staff, Nonbank Designations Committee staff and deputies consider which determination standard is most relevant to each company and then use that standard in conducting determination evaluations. To reach a decision about which standard should apply to a company's evaluation, Secretariat staff told us FSOC staff hold discussions on the topic. If the analytical team conducting an evaluation were to determine that the second standard would be more relevant, the team would raise the matter with the Nonbank Designations Committee, Deputies Committee, or principals for a decision and other FSOC staff would have an opportunity to provide input. However, officials from two member agencies told us that they did not recall having formal discussions to reach decisions on which determination standard should apply.

According to FSOC documentation of its eight Stage 2 and three Stage 3 evaluations that we reviewed, in each case FSOC used only the material financial distress standard, including cases in which FSOC decided not to advance the company to Stage 3. For example, in the eight completed Stage 2 evaluations, the six-category analysis for each company was focused on the potential impact of the company's financial distress on the economy and the company's vulnerability to financial distress. Likewise, for the three completed Stage 3 evaluations we reviewed, FSOC's memorandums state the proposed determinations were based on the

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potential for the companies' material financial distress to pose threats to financial stability.

The Dodd-Frank Act tasks FSOC with identifying financial stability risks including those that could arise from nonbank financial companies' material financial distress or activities. The act does not require FSOC to evaluate companies using both determination standards and allows FSOC to designate any nonbank financial company based on either standard. Secretariat staff said evaluations were in accordance with Dodd-Frank, which focuses on whether a company could pose a threat to financial stability. The staff further explained that FSOC has not conducted evaluations under both standards because FSOC staff, deputies, and principals consistently reached consensus that the material financial distress standard was more relevant to their evaluations.

However, in considering companies for designation using only one standard—and ultimately making determination decisions based only on that standard—FSOC may not be identifying companies that meet the other determination standard and therefore may warrant designation. The 2007-2009 financial crisis illustrated the role that financial activities can play in financial instability, even absent the distress of the companies engaged in the activities. In the years preceding the crisis, a wide range of companies engaged in financial activities that many market observers believe contributed, at least in part, to the conditions leading to or exacerbating problems in the mortgage market and the broader financial system. For example, nonbank mortgage lenders weakened their underwriting standards and made mortgage loans to homebuyers who could not afford them or engaged in questionable lending practices before the crisis. In addition, investment banks and other finance companies engaged in financial innovation in the form of asset securitization, which reduced mortgage originators' incentives to be prudent in underwriting loans and made it difficult to understand the size and distribution of loss exposures throughout the system. Although Secretariat staff told us that FSOC staff and deputies discuss and decide which determination standard is relevant for each company's evaluation, that decision takes place before the Stage 2 or Stage 3 analysis of the company and therefore may not be informed by the company-specific analysis or detailed information the company provided. As a result, FSOC may not be able to ensure that it will achieve its intended results by identifying all companies that may pose financial stability threats and be subject to determination.



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## FSOC Faces Data Challenges in Including All Nonbank Financial Companies in Its Initial Scope of Review

Data limitations have prevented FSOC from including some types of nonbank financial companies in its scope of review. For Stage 1, FSOC relies solely on information available through public and regulatory sources to calculate the Stage 1 quantitative thresholds for the purpose of identifying companies most likely to satisfy one of the determination standards. Our review of OFR's Stage 1 analysis memorandums—which include a list of companies that exceed the Stage 1 thresholds and therefore advance to Stage 2—found that OFR had not included at least two large companies that are privately owned, do not disclose financial statements, and may fit the definition of a nonbank financial company. In some cases, because Stage 1 metrics are by regulation derived only from public and regulatory sources, OFR analysis included only certain (nonbank financial company) subsidiaries of larger parent companies that also may be nonbank financial companies due to data limitations. For example, OFR reviewed privately owned parent insurance companies using only data about the companies' U.S. insurance subsidiaries because data on privately owned holding companies are not readily available.<sup>46</sup> Insurance subsidiaries submit regulatory filings to the National Association of Insurance Commissioners (NAIC), which aggregates the data by parent insurance company. The aggregated data do not include information from noninsurance subsidiaries or subsidiaries that do not report data to NAIC.

Under the direction of FSOC, OFR's analysis followed a similar approach for analyses of U.S.-based subsidiaries of some private companies, including some private foreign-owned companies. The reviews either reflected an aggregation of data from certain subsidiaries that were regulated nonbank financial companies or used data from a single (nonbank financial company) subsidiary of a parent company because that was the subsidiary for which information was available. For instance, one Stage 1 analysis included a subsidiary broker-dealer for which regulatory filing information is available through SEC, but not the parent company. The parent company was private and did not file comprehensive financial information.

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<sup>46</sup>FSOC's documentation of its Stage 1 analysis recognizes that parent insurance companies generally include subsidiaries that do not provide statutory filings to the National Association of Insurance Commissioners, including noninsurance financial subsidiaries and foreign subsidiaries, and that information about these entities may not be included in the Stage 1 analysis. Therefore, the analysis may understate the extent of financial activities conducted by such companies.

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FSOC acknowledged that relevant data likely were not available in the public and regulatory domain to assess all nonbank financial companies in its Stage 1 analysis. According to FSOC's Stage 1 documentation, private companies and U.S. subsidiaries of foreign companies with no single intermediate U.S. holding company presented challenges, both in identifying the companies for inclusion in the list of nonbank financial companies for Stage 1 analysis and in gathering Stage 1 data. In response to these challenges, and in consultation with the Secretariat, OFR adopted the approach of aggregating data for subsidiaries of a nonbank financial company for which data were available. Secretariat officials said that OFR used available data on a company's subsidiaries to approximate the Stage 1 thresholds for the parent company. Other than this approach, OFR officials confirmed that nonbank financial companies that are privately held and do not file public financial statements are not included in the Stage 1 analysis that OFR conducts for FSOC—even if those companies have a regulated nonbank financial company subsidiary that triggered requisite Stage 1 thresholds—if data regarding the parent are unavailable. However, OFR officials said that there likely are few private nonbank financial companies that have more than \$50 billion in assets and are unregulated. For example, OFR officials said they were aware of at least one large private company not currently included in the Stage 1 analysis, and that the Nonbank Designations Committee is aware of this company.

Secretariat staff said that FSOC has been working to improve its information access to address data gaps, including efforts to incorporate information that SEC collects from certain private funds.<sup>47</sup> OFR officials told us that they have not yet used the private fund data in a Stage 1 analysis because of ongoing efforts to improve the data's quality and reliability. Although they agreed that it could take at least one year, OFR officials indicated that it was too early in the data improvement process to determine a time frame for when they could use SEC's private fund data for Stage 1 analyses. However, even when usable, the private fund data will not provide FSOC with necessary information on other types of nonbank financial companies, such as some privately held companies, for which data are unavailable.

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<sup>47</sup>In 2011, SEC introduced Form PF to collect information from certain registered investment advisers about the hedge funds, private equity funds, and other private funds they advise.

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The Dodd-Frank Act grants FSOC authority to direct OFR to obtain information from nonbank financial companies if such action were necessary to assess risk to the U.S. financial system, but OFR officials said that FSOC has not yet requested that OFR use this authority—except in the context of gathering data from companies being evaluated in Stage 3.<sup>48</sup> Secretariat staff said that FSOC has not found it necessary to develop a process for collecting data for Stage 1 analysis directly from certain nonbank financial companies for which it lacks necessary information because it could collect information as needed on a case-by-case basis without establishing an ongoing process. These staff also said that obtaining necessary information might require OFR to collect it directly from certain companies and to date FSOC has not contacted companies before Stage 3 of the determination process. FSOC acknowledged in its final rule and guidance that not all relevant data were likely to be available for all nonbank financial companies in Stage 1 and stated that it therefore could review any nonbank financial company in Stage 2 if further analysis were warranted to determine if the company could pose a threat to U.S. financial stability.

Without data necessary to include all nonbank financial companies that might warrant further evaluation in its determination process or evaluate such companies as a consolidated entity, FSOC may not be able to ensure that it identifies and ultimately designates all nonbank financial companies that may pose a threat to U.S. financial stability. For example, if AIG were a privately owned company, the necessary data would be available only for some of its regulated insurance subsidiaries. Thus, an assessment of the Stage 1 quantitative thresholds using only such data could produce different results than an assessment of the thresholds using consolidated data for the entire company.

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<sup>48</sup>Section 112 of the Dodd-Frank Act grants FSOC authority to direct OFR to collect information from nonbank financial companies and the act also grants OFR the authority to collect data on behalf of FSOC. Pub. L. No. 111-203, §§ 112(a)(2)(A), 153(a)(1), 124 Stat 1376, 1395, 1415 (2010) (codified at 12 U.S.C. § 5322(a)(2)(A)).

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## International Institutions and FSOC Have Similar Assessment Methodologies but Differ in Their Use of Quantitative Measures

FSB has led international efforts to develop methodologies to identify global systemically important financial institutions. The determination standards and analytical categories in international institutions' five methodologies are similar to FSOC's assessment methodology for nonbank financial companies. However, differences among the methodologies include their use of indicators, aggregation of risk scores, and their scope of analysis. Some FSOC voting members have been involved in both FSOC and FSB assessment processes, but U.S. regulators view the processes as separate and distinct.

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## International and FSOC Methodologies Have Similar Assessment Categories and Standards but Differ in Several Key Areas

FSOC's and international institutions' methodologies have a number of similar features. For example, both approaches intend to identify companies that may pose threats to financial stability and assign a company-wide supervisor to apply more intensive and consolidated supervision (for certain institutions under the international methodologies). The methodologies also have similar supervisory goals (from FSB's 2010 systemically important financial institutions framework), including reducing the likelihood of and mitigating the potential risks from the material financial distress or failure of a systemically important company. However, unlike FSOC's designations, FSB's identification of systemically important nonbank financial companies does not have any binding effect in any jurisdiction. FSOC's and several of the international institutions' methodologies consider three transmission channels through which a company's activities or material financial distress may endanger the broader financial system—exposure, asset liquidation, and critical function substitutability. As shown in table 5, the methodologies include similar analytical categories. The five international methodologies have similar categories of analysis because the methodological approach for banks served as the model for the other methodologies. Three of FSOC's categories overlap directly with those of the international methodologies—size, interconnectedness, and substitutability. Some of the differences in the methodologies represent different configurations and nomenclature. For example, the international methodologies include assessment categories for global and cross-jurisdictional activity and complexity, which are not explicit FSOC assessment metrics (although FSOC does examine these factors as part of its Stage 3 evaluation). In addition, three

FSOC metrics are represented in international assessments although not as separate analytical categories.<sup>49</sup>

**Table 5: Analytical Categories of Financial Stability Oversight Council (FSOC) and International Assessment Methodologies**

Category of analysis	International assessment methodologies					
	FSOC: nonbanks	Basel Committee: banks	IAIS: insurers <sup>a</sup>	FSB and IOSCO: finance companies <sup>b</sup>	FSB and IOSCO: market intermediaries <sup>b</sup>	FSB and IOSCO: investment funds <sup>b</sup>
Size	√	√	√	√	√	√
Interconnectedness	√	√	√	√	√	√
Global or cross-jurisdictional activities	-	√	√	√	√	√
Substitutability	√	√	√	√	√	√
Complexity	-	√	-	√	√	√
Nontraditional and noninsurance activities	-	-	√	-	-	-
Leverage	√	-	-	-	-	-
Liquidity risk and maturity mismatch	√	-	-	-	-	-
Existing regulatory scrutiny	√	-	-	-	-	-
Resolvability	√ <sup>c</sup>	-	-	-	-	-

Legend: √ / (-) = category is / (is not) present in methodology

Sources: GAO analysis of FSB, Basel Committee, IAIS, IOSCO, and FSOC information. | GAO-15-51

Notes: The table illustrates categories included in FSOC's and international institutions' analytical frameworks. The absence of a category does not indicate that FSOC and the international institutions do not consider certain factors in their evaluations.

<sup>a</sup>IAIS is the International Association of Insurance Supervisors.

<sup>b</sup>The Financial Stability Board (FSB) proposed the methodologies—which have not been finalized—in consultation with the International Organization of Securities Commissions (IOSCO).

<sup>c</sup>While not part of the six-category framework, resolvability is cited in FSOC's final rule and guidance as a consideration.

Several important differences exist between the methodologies. First, in the international context, the standard setters and FSB developed—or have been developing—assessment methodologies for five sectors. In contrast, FSOC applies an analytical framework that tailors the specific

<sup>49</sup>The FSOC metrics are the categories of (1) leverage and (2) liquidity risk and maturity mismatch and a consideration factor—resolvability.

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considerations to each company that it examines. The international institutions stated that they intend to apply the sector-specific methodologies to companies and plan to reconsider the finished methodologies (Basel and IAIS) at least every 3 years. But not all of the international assessment analysis occurs at the sector level. For example, IAIS's methodology for insurers incorporates a supplementary assessment framework that uses company-specific considerations (including analysis of companies' activities). The supplementary assessment framework segments insurers' activities by type and assigns different risk weights to the activities according to their size relative to the company's overall activities.

Second, unlike FSOC's approach to assessing companies' potential to pose a threat to U.S. financial stability, some of the international methodologies are based on a more formulaic approach, in which institutions are scored using specific indicators and criteria.<sup>50</sup> For example, some of the international methodologies define specific indicators under each analytical category. In certain cases, national regulators collect nonpublic data from companies and provide the data to the relevant standard-setting body for calculating the indicators. For the international methodologies that apply a more formulaic approach and rely on indicators, much of the judgment exercised by the international institutions occurs during the development of methodologies rather than in their application. By comparison, FSOC retains some discretion in applying metrics and criteria that it deems most appropriate during its evaluation of specific companies. Thus, conceptually similar analytical categories and indicators may be applied differently by FSOC and FSB when evaluating companies. For example, FSOC may examine different measurements of market exposures than the international institutions when computing a company's leverage. Furthermore, two of the international methodologies—those for banks and insurers—include specific calculations for weighting the analytical indicators and categories used to produce an aggregate risk score. In contrast, FSOC's determination methodology does not have a formal mechanism for weighting evaluation criteria, but instead relies on the judgment of FSOC staff and principals in evaluating companies and making determination decisions.

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<sup>50</sup>After scoring institutions, FSB determines a threshold score to identify firms that are systemically important.

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Although a subset of the international assessment methodologies rely on scoring calculations as the primary basis for company evaluations, they also incorporate some supplementary subjective analyses. Specifically, the banking and insurance methodologies allow members of the standard-setting body to challenge the scoring results for a given company based on a quantitative or qualitative rationale related to a company's particular circumstances. The methodologies aim to establish a high threshold for such adjustments to the initial indicator score, particularly if the adjustment may be self-interested—for example, if a national regulator argues for a downward adjustment to the risk score of a company in its jurisdiction. In addition, FSB stated that limitations in the availability of consistent data for assessing nonbank, noninsurer financial companies may restrict the use of scoring indicators.

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### Several FSOC Voting Members Also Participate in FSB Processes but View Them as Separate and Distinct

Some U.S. financial regulators and Treasury, as members of FSB and international standard-setting bodies, have been actively involved in developing international financial standards. FSB's membership includes three U.S. entities (the heads of which are voting members of FSOC): the Federal Reserve, SEC, and Treasury. FSOC member agencies also participate in the international standard-setting bodies that developed FSB's methodologies. These are CFTC and SEC in IOSCO; FDIC, OCC, and the Federal Reserve in the Basel Committee; and FIO, the state insurance commissioner, and the Federal Reserve in IAIS. Treasury officials said that U.S. participation in FSB safeguards the U.S. financial system by strengthening international regulation and promoting a "level playing field" for U.S. firms that operate internationally.

FSB operates through an informal process—reaching consensus through discussions among its members, according to Treasury and Federal Reserve staff. Federal Reserve officials stated that while FSB does not take formal votes, its members may provide input that influences the outcome of its decisions to identify systemically important companies but that, ultimately, the FSB chair is the final arbiter of whether the group has reached consensus. However, as indicated in the proposed methodologies for identifying the nonbank, noninsurer institutions, the

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FSB and the national authorities together will determine the final list of global systemically important financial institutions.<sup>51</sup>

FSB identified two U.S. nonbank financial companies as systemically important before FSOC made final determinations regarding the companies. On July 18, 2013, FSB published a list identifying AIG, MetLife, Inc. (MetLife), and Prudential as systemically important, along with several non-U.S. companies. At that time, Prudential had received FSOC's proposed determination; FSOC made a final determination on September 19, 2013. MetLife announced on July 16, 2013, that it had reached Stage 3 of FSOC's determination process; FSOC had not made a final determination as of September 2014.<sup>52</sup> In contrast, FSOC designated AIG and GE Capital on July 8, 2013, while FSB identified AIG as systemically important on July 18, 2013. FSB has not yet evaluated GE Capital because the methodologies for nonbank noninsurers are still under development.

Officials from two companies that FSOC evaluated and several business and industry membership organizations that we interviewed said that the involvement of some FSOC members in FSB's identification processes raised questions about whether those international efforts could influence FSOC's evaluations and determination decisions. Some market observers, members of Congress, and an FSOC member have expressed similar concerns. However, Treasury officials said the FSB action carried no regulatory consequences for the companies in the United States unless they also were designated by FSOC. Treasury officials stated that FSB's process has not affected the U.S. nonbank financial company determination process because the processes are separate and distinct—with FSOC following the standards and criteria in the Dodd-Frank Act and FSOC's final rule and interpretive guidance. Treasury officials also said that FSB's identification of a U.S. company as systemically important creates no regulatory or supervisory consequences for the company or obligation for FSOC to evaluate the company, because in the United States only FSOC has the authority to

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<sup>51</sup>Also, in 2013, FSB stated that it had identified an initial list of global systemically important insurers in consultation with IAIS and national authorities.

<sup>52</sup>FSOC follows a practice of not commenting on any company under consideration until a final determination is made. As of October 2014, FSOC had not publicly stated that MetLife was under consideration for a determination.



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subject a nonbank financial company to Federal Reserve supervision and enhanced prudential standards. According to these officials, the only consequence of an FSOC determination contradicting that of FSB might be a negative peer evaluation of the United States by FSB in cases in which FSOC does not designate an entity identified by FSB as systemically important.<sup>53</sup> Federal Reserve officials also said that FSOC's determination process is separate and independent of FSB's identification of global systemically important financial companies, but described an FSB identification as one of many factors that FSOC may consider in the course of its nonbank financial company evaluations. In our review of the documentation supporting FSOC's determination decisions, we did not find references to FSB's evaluations or designations of global systemically important financial companies in FSOC's evaluation considerations, although the absence of such references does not necessarily indicate that FSOC did not consider this factor in its deliberations.

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## Federal Reserve Plans to Tailor Its Supervision of Nonbank Financial Companies

The Federal Reserve has been conducting rulemaking associated with Dodd-Frank requirements for supervision of nonbank financial companies. Section 165 of the Dodd-Frank Act directs the Federal Reserve to establish enhanced prudential standards for (1) nonbank financial companies that FSOC determined will be supervised by the Federal Reserve and for (2) bank holding companies with total consolidated assets of \$50 billion or more.<sup>54</sup> The act requires the enhanced prudential standards to be more stringent than the standards applicable to bank holding companies and nonbank financial companies that do not present similar risks to U.S. financial stability.<sup>55</sup> The standards must increase in stringency based on several factors (including a company's size and risk characteristics) and the Federal Reserve must consider the differences among bank holding companies and nonbank

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<sup>53</sup>To encourage voluntary compliance, FSB utilizes a process of periodic peer review. Explicit measures to encourage compliance for countries that do not pass peer review include discussions with national authorities and public reports published by FSB.

<sup>54</sup>Pub. L. No. 111-203, § 165(a)(1), 124 Stat 1376, 1423 (2010) (codified at 12 U.S.C. § 5365(a)(1)).

<sup>55</sup>Pub. L. No. 111-203, § 165(a)(1)(A), 124 Stat 1376, 1423 (2010) (codified at 12 U.S.C. § 5365(a)(1)(A)).

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financial companies based on the same factors. The prudential standards must include

- risk-based and leverage capital requirements,
- liquidity requirements,
- risk-management and risk committee requirements,
- resolution-planning requirements,
- single counterparty credit limits,
- stress-test requirements, and
- a debt-to-equity limit for companies that FSOC has determined pose a grave threat to U.S. financial stability.<sup>56</sup>

Section 165 also permits the Federal Reserve to establish additional prudential standards, including three specified standards—a contingent capital requirement, enhanced public disclosures, and short-term debt limits.

The Federal Reserve’s final rule establishing enhanced prudential standards for bank holding companies did not apply to nonbank financial companies.<sup>57</sup> In 2012, the Federal Reserve proposed rules to implement enhanced prudential standards for nonbank financial companies, bank holding companies, and foreign banking organizations.<sup>58</sup> It adopted the enhanced prudential standards for bank holding companies and foreign banking organizations in its final rule (issued in March 2014), but decided not to impose the standards on designated nonbank financial companies as part of that particular rulemaking. Instead, the Federal Reserve stated that it would separately issue orders or rules imposing enhanced prudential standards on each designated nonbank financial company or category of companies.<sup>59</sup> In the final rule, the Federal Reserve recognized that the types of risks that nonbank financial companies posed to financial stability likely would vary by company and that the enhanced prudential

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<sup>56</sup>79 Fed. Reg. 17420, 17421 (Mar. 27, 2014).

<sup>57</sup>79 Fed. Reg. 17240, 17244-45 (Mar. 27, 2014).

<sup>58</sup>The Federal Reserve issued proposed rules for bank holding companies and designated nonbank financial companies on January 5, 2012, and for foreign banking organizations and designated foreign nonbank financial companies on December 28, 2012. 77 Fed. Reg. 594 (Jan. 5, 2012) and 77 Fed. Reg. 76628 (Dec. 28, 2012).

<sup>59</sup>The Federal Reserve stated in the final rule that it plans to ensure that nonbank financial companies receive notice and opportunity to comment before determination of their enhanced prudential standards.

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standards applicable to bank holding companies might not be appropriate for all designated nonbank financial companies.

For nonbank financial companies designated by FSOC, the Federal Reserve intends to assess the company's business model, capital structure, and risk profile to determine how the proposed enhanced prudential standards should apply and tailor the application of the standards as appropriate.<sup>60</sup> The Federal Reserve expects to apply tailored standards to nonbank financial companies that differ from bank holding companies in their activities, risk profile, and other characteristics. If the activities and risk profile do not differ, the Federal Reserve expects to apply standards similar to those applied to bank holding companies.

Federal Reserve officials said that they have been working to develop a supervisory framework for designated nonbank financial companies, but did not have a specific time frame for imposing the enhanced standards on currently designated companies. Although the standards remain in development, officials told us that the Federal Reserve has been supervising the three designated companies since their designation in 2013 and working with the companies on risk management and safety and soundness matters. Officials also said that the Federal Reserve already was familiar with the designated companies because each had been organized as a savings and loan holding company at some point before designation.<sup>61</sup> Moreover, the Federal Reserve has been gathering additional company-specific information from the companies, which has been helping to inform its development and application of enhanced prudential standards.

In addition, the Federal Reserve and FSOC have shared information about the proposed standards. The Dodd-Frank Act grants FSOC the authority to make recommendations to the Federal Reserve about the establishment of heightened prudential standards for nonbank financial

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<sup>60</sup>The Dodd-Frank Act grants the Federal Reserve the authority to differentiate prudential standards 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 that the Federal Reserve deems appropriate. Pub. L. No. 111-203, § 165(a)(2), 124 Stat 1376, 1423-24 (2010) (codified at 12 U.S.C. § 5365(a)(2)).

<sup>61</sup>Under the Dodd-Frank Act, the Federal Reserve assumed supervision of savings and loan holding companies from the Office of Thrift Supervision. Pub. L. No. 111-203, § 312, 124 Stat 1376, 1521 (2010)(codified at 12 U.S.C. § 5412(b)(1)).

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companies, including standards addressing resolution plans, enhanced public disclosures, and overall risk management.<sup>62</sup> However, according to Secretariat officials, FSOC has not utilized its authority to make such recommendations. Secretariat officials said that FSOC has formed a Heightened Prudential Standards Committee, through which FSOC consulted with and provided informal input to the Federal Reserve on proposed rulemakings. The Federal Reserve stated that it provided periodic updates on the development of enhanced prudential standards to all FSOC member agencies. Officials from some FSOC member agencies said that they expected that FSOC would comment on and discuss whether to make recommendations about enhanced prudential standards once the Federal Reserve finalized the standards.

Furthermore, the Federal Reserve issued specific rules requiring designated nonbank financial companies to conduct resolution planning and stress testing.<sup>63</sup>

- The rule on resolution plans—jointly issued with FDIC—includes requirements for the submitting company to describe its strategy for rapid and orderly resolution in the event of its material financial distress or failure. The three designated nonbank financial companies submitted their resolution plans on or before July 1, 2014.<sup>64</sup>
- The Federal Reserve’s stress test regulations require a designated nonbank financial company to conduct stress tests if the entity is made subject to the provisions pursuant to a rule or order of the

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<sup>62</sup>Pub. L. No. 111-203, § 112(a)(2)(I), 124 Stat 1376, 1395 (2010)(codified at 12 U.S.C. § 5322(a)(2)(I)). See also, for further description and discussion of these recommendation provisions, Pub. L. No. 111-203, § 115, 124 Stat 1376, 1403 (2010)(codified at 12 U.S.C. § 5325).

<sup>63</sup>In addition, both Treasury and the Federal Reserve assess fees directly on nonbank financial companies designated by FSOC. Under an interim final rule, Treasury assesses fees for a fund to cover FSOC’s and OFR’s operating and capital costs, as well as some other costs. 77 Fed. Reg. 29884 (May 21, 2012). The Federal Reserve’s assessment covers the supervisory and regulatory responsibilities for the designated nonbank financial companies. 78 Fed. Reg. 52391 (Aug. 23, 2013). Also, FDIC has the authority under Dodd-Frank to assess designated nonbank financial companies to recover the portion of money obligated in resolving a failed institution under Title II that was not otherwise repaid within 60 months of obtaining the funds. (Pub. L. No. 111-203, § 210(o)(1)(D)(ii), 124 Stat. 1376, 1509-1510 (2010)(codified at 12 U.S.C. § 5390(o)(1)(D)(ii)).

<sup>64</sup>For resolution plan submissions, see Board of Governors of the Federal Reserve System, *Resolution Plans*, accessed on August 5, 2014, available at <http://www.federalreserve.gov/bankinfo/reg/resolution-plans.htm>.

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Federal Reserve.<sup>65</sup> The regulations are effective November 26, 2014.<sup>66</sup>

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## Conclusions

The recent financial crisis illustrated the importance of addressing systemic risks that exist outside traditional banking institutions. Congress established FSOC to monitor the stability of the U.S. financial system and take actions to mitigate risks that might destabilize the system and endowed FSOC with broad authorities, including authority to designate nonbank financial companies for Federal Reserve supervision and enhanced prudential standards. FSOC has begun evaluating and designating such companies and continues to refine and expand its efforts. Consistent with its final rule and statutory requirements, FSOC used a three-stage process and analytical framework to evaluate companies and provided notice to companies and the public with an explanation of its determination decisions. However, some market participants and observers, financial regulators, and members of Congress have questioned the bases of FSOC's determinations and how FSOC evaluates nonbank financial companies. These criticisms underscore the importance of FSOC enhancing the transparency and systematization of its determination process. This is particularly important because of the judgment and discretion involved in applying its analytical framework to evaluate different institutions. While FSOC's transparency policy states that it is committed to operating in an open and transparent manner, additional clarity could maximize public and market confidence in the process.

More generally, FSOC's ability to effectively identify nonbank financial companies for heightened supervision in a way that supports public and market confidence could help mitigate the potential for such firms to endanger the stability of the U.S. financial system. Specifically, in accord with federal internal control standards, OMB policy, and FSOC guidance, weaknesses remain in the following areas:

- **Tracking and monitoring.** FSOC has not centrally collected or monitored certain information related to its determination process that is critical for internal control activities and managing results—

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<sup>65</sup>12 C.F.R. § 252.53(a).

<sup>66</sup>Capital Plans and Stress Test Rules, 79 Fed. Reg. 64026 (Oct. 27, 2014).

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specifically, information on dates needed to track the occurrence and duration of key process steps and staff working on determination evaluations. The lack of such information may hinder FSOC's ability to effectively monitor the progress and evaluate the efficiency of determination evaluations and to ensure the broad participation of relevant member agencies and their staff in company evaluations.

- **Disclosure and transparency.** FSOC lacks full disclosures and transparency in certain areas. Currently, FSOC's final rule and bylaws do not address the extent to which companies under evaluation may be able to meet with deputies and principals, creating questions among companies under review in Stage 3. Although FSOC has developed and followed a three-stage process and analytical framework for making determination decisions, FSOC's public basis documents have not always fully disclosed or explained the specific rationales for determination decisions. FSOC's public basis documents supporting its determinations included only a small portion of the information and analysis in its nonpublic basis documents (which include information from publicly available sources). FSOC's public disclosures could provide greater insight into why a company's characteristics were or were not considered significant or substantial in terms of meeting one of the two statutory determination standards. Improved transparency and accountability could bolster public and market confidence and help FSOC achieve its goals.
- **Scope of evaluation procedures.** In conducting determination evaluations, FSOC has evaluated companies (including those not advanced to Stage 3 for further review) using only the determination standard based on a company's financial distress, not its activities. In considering companies for determination using only one standard, FSOC may not be identifying companies that meet the other standard and therefore may warrant designation. Additionally, data limitations have prevented FSOC from including some types of nonbank financial companies in its scope of review, and FSOC has not exercised its authority to direct OFR to obtain otherwise unavailable data from certain nonbank financial companies. As a result, FSOC may not be able to ensure that it identifies and ultimately designates all nonbank financial companies that may pose a threat to U.S. financial stability.

Making FSOC's designation process more systematic and transparent could enhance accountability, bolster public and market confidence in the process, and also help FSOC achieve its intended goals.

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## Recommendations for Executive Action

We are making the following six recommendations:

To improve FSOC's control activities and help ensure that it better manages its determination process and achieves intended results, the Secretary of the Treasury, in his capacity as the Chairperson of FSOC and in consultation with FSOC members, should systematically record (1) the dates of key process steps and (2) the staff contributing to determination evaluations, and monitor such information to help assess the progress and efficiency of determination evaluations.

To enhance disclosure and strengthen transparency, the Secretary of the Treasury, in consultation with FSOC members, also should take the following actions:

- Document and publicly disclose FSOC's practices regarding the circumstances under which companies undergoing Stage 3 evaluations can interact with FSOC deputies or principals. For example, FSOC's practices could be documented in writing, such as in its bylaws, notices to companies, or in the Nonbank Designations FAQ section on FSOC's website, and include whether, when, and on what terms companies can access deputies and principals beyond the formal hearing process.
- For future determinations, to the maximum extent possible, include additional details in its public basis documentation about why FSOC determined that the company met one or both of the statutory determination standards. Specifically, in addition to identifying that the size, significance, or other attributes of the company's characteristics could pose a threat to U.S. financial stability, FSOC should explain—without revealing sensitive information—how it concluded that the characteristics were sufficiently large or significant enough, or had other attributes, to meet one or both of the statutory determination standards.

Finally, to help ensure that FSOC is comprehensively identifying and considering companies, the Secretary of the Treasury in consultation with FSOC members, should take the following actions:

- Establish procedures to evaluate companies in Stage 2 and Stage 3 under both statutory determination standards when an evaluation in either stage concludes that a company does not meet one of the standards, or document—on a company-specific or more general basis—why the second determination standard is not relevant for determination evaluations.

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- Develop a process to collect information necessary for Stage 1 analysis, as appropriate, from certain nonbank financial companies for which public or regulatory information is otherwise unavailable. For example, FSOC could have companies for which such information is unavailable and that meet certain characteristics (such as quantitative thresholds similar to those used in Stage 1) report necessary information to OFR.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Secretary of the Treasury—as the Chairperson of FSOC—for review and comment. Treasury provided written comments, which are reprinted in appendix III. Treasury also provided extensive technical comments on the draft report, which we incorporated as appropriate. Treasury distributed the draft report to staff of the FSOC member agencies. Staff of the Consumer Financial Protection Bureau, the Federal Reserve, FIO, the independent member with insurance expertise, and OFR separately provided technical comments on the draft report, which we incorporated as appropriate.

In its comment letter, Treasury stated that it will consider the report’s recommendations but did not say whether it agreed or disagreed with the recommendations. Treasury emphasized that FSOC followed the nonbank financial company designation process laid out in its final rule and interpretive guidance, as we noted in our report. Treasury’s letter highlighted statements from the report related to FSOC’s designation process, including statements about FSOC’s communication with companies under evaluation and the contributions of member agency staff. Treasury also wrote that in recent months FSOC received suggestions from stakeholders regarding its process for evaluating nonbank financial companies and that FSOC has directed staff to review and evaluate those and other potential changes. Treasury noted that the report’s recommendations complement some of the suggestions previously made by other stakeholders and will be included as part of its analysis of these suggestions.

Regarding the recommendation to increase the amount of information included in public explanations of the basis for any future designations, Treasury pointed out that the nonpublic documentation includes extensive, specific, confidential information. Treasury also stated that FSOC was committed to operating in an open and transparent manner. Treasury wrote that FSOC will consider ways to implement this recommendation, while continuing to satisfy statutory requirements and provisions of the Open Government Directive and FSOC’s transparency



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policy relating to the protection of nonpublic information FSOC receives from companies under review. In the draft report, we recognized that FSOC has responsibilities to protect sensitive information collected from companies and explained that FSOC's nonpublic documentation included publicly sourced information that did not appear in the public versions of the basis documents.

Treasury staff and Federal Reserve staff also provided technical comments on the draft report. In addition to clarifying and correcting factual statements, some of these comments highlighted concerns with the tone and conclusions of some of the draft report's findings. We summarize the most significant comments and our responses below.

- Treasury staff commented that the tone of the draft report's title and headings was inconsistent with the report's overall findings. In particular, Treasury staff noted that the report's findings largely were positive, yet the findings associated with the recommendations appeared exaggerated, with broad statements unsupported by the majority of the report's findings. We believe the headings and title have struck the proper tone and appropriately reflect the evidence in the report. While the report identifies steps that FSOC has taken to make its designation process systematic and transparent, the report also describes parts of the process that are not systematic or transparent and recommends additional steps that FSOC could take to further improve the process.
- Treasury and Federal Reserve staff provided comments in which they disagreed with the draft report's findings about the extent to which FSOC's documentation disclosed the rationales for determination decisions. We maintain that FSOC's public documentation has not always fully disclosed the specific bases for its determination decisions and that FSOC's nonpublic documentation could benefit from inclusion of additional detail about some aspects of its designation decisions. However, we made certain revisions to the report to clarify that the findings and conclusions related to FSOC's documentation of its determination decisions, not to the quality of its decisions. We also note that the report's methodology involved examining the process FSOC used to designate nonbank financial companies—including the extent to which the process was systematic and transparent—and did not evaluate the quality of FSOC's analysis supporting its determination decisions.
- Treasury and Federal Reserve staff commented that the draft report's findings about recording and tracking information on the designation

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process were inaccurate. Specifically, Treasury staff indicated that they now record all dates other than when FSOC begins actively reviewing a company in Stage 2. In addition, Federal Reserve staff stated that correspondence and records have been maintained and important events could be recreated easily through a review of the documentation. Federal Reserve staff also disagreed with the report's statements about the potential negative effects of not recording and tracking information on the designation process. We made certain revisions to the report to clarify the findings and conclusions related to recording and tracking information. Although FSOC may record certain information in its correspondence and other documents, having information dispersed throughout the various documents does not facilitate the systematic collection and tracking of information that is necessary to monitor performance and manage results.

- Federal Reserve staff provided comments highlighting concerns with the draft report's findings related to using both statutory determination standards when evaluating companies for possible designation. Federal Reserve staff wrote that the report suggested that FSOC should have used the second statutory determination standard (related to a company's activities) in certain situations but instead chose to use only the first standard (related to a company's material financial distress). Federal Reserve staff noted that FSOC has not determined to use only the first standard, although in its past evaluations the Council and staff concluded that the second standard was not appropriate. They also commented that FSOC has not been required to consider both standards for any particular nonbank financial company. While the report states (for the instances we reviewed) that FSOC used only the first standard in evaluating the nonbank financial companies—including cases in which FSOC decided not to advance the company to Stage 3—the report does not make any statements about whether FSOC should have used the second standard in those evaluations. As noted in the report, the Dodd-Frank Act does not require FSOC to evaluate companies using both determination standards and allows FSOC to designate any nonbank financial company based on either standard. However, we point out that in using only one standard to evaluate companies FSOC may not identify companies that may meet the other standard and possibly warrant designation.

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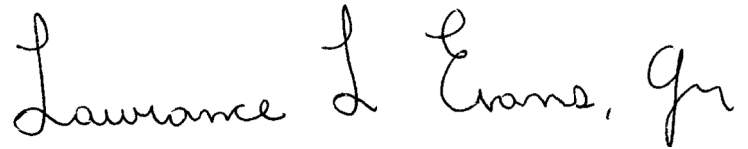
We are sending copies of this report to interested congressional committees and members, the Secretary of the Treasury, and other

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members of FSOC. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or [evansl@gao.gov](mailto:evansl@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix IV.

Sincerely yours,

A handwritten signature in black ink that reads "Lawrence L. Evans, Jr." The signature is written in a cursive style with a large initial 'L' and a distinct 'Jr.' at the end.

Lawrance L. Evans, Jr.  
Director, Financial Markets and  
Community Investment

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# Appendix I: Objectives, Scope, and Methodology

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Our objectives were to examine (1) how the Financial Stability Oversight Council (FSOC) oversees and manages the nonbank financial company determination process; (2) the extent to which FSOC followed a systematic process for designating nonbank financial companies; (3) how the analysis and criteria used in FSOC's determination process compares with methodologies proposed by international institutions; and (4) the progress that the Board of Governors of the Federal Reserve System (Federal Reserve) made in defining a supervision framework for designated nonbank financial companies. We did not include FSOC's designation of systemically important financial market utilities in the scope of our review because the Council of Inspectors General on Financial Oversight completed an audit of this authority in July 2013.

To examine FSOC's management of the determination process, we reviewed our prior report on FSOC, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), FSOC's bylaws and other documents describing its organizational structure, and FSOC's final rule and guidance outlining its determination process. We reviewed FSOC documentation about the status and outcome of its determination evaluations, including the number of companies that have reached different stages in the process. We also collected and analyzed information from FSOC members on their participation in the determination process from 2011 until the middle of 2014, including the number of staff contributors, the amount and type of their contributions, and their roles in leading company evaluations. We interviewed officials and staff from FSOC members and member agencies on the determination process, the components within FSOC involved in making determination decisions (including FSOC's committee structure), FSOC's identification of members and staff to conduct evaluations, and FSOC's communication with companies undergoing evaluation. We also interviewed officials from four companies that were evaluated or were in the final stage of the process about their interactions with FSOC, including the method, content, and timing of communications. We used criteria from *Standards for Internal Control in the Federal Government* to evaluate FSOC's efforts to manage the determination process.

To address the extent to which FSOC has used a systematic process in designating companies, we reviewed the Dodd-Frank Act and publicly available FSOC documents, including its final rule and guidance on the determination process, Council and committee bylaws, and documents supporting its final determinations. We analyzed nonpublic records that document FSOC's determination evaluations and decisions, including determination basis documents for Stage 2 and Stage 3 reviews,

documentation of the Stage 1 methodology that the Office of Financial Research uses, quarterly Stage 1 analysis results, and FSOC's communications and data requests to companies from Stage 3 to the end of the determination process. We used a uniform data collection instrument to collect and analyze information from the nonpublic documents. The collected information included the metrics and analysis FSOC used in applying its analytical framework, committee recommendations about advancing or not advancing companies to Stage 3, and the basis for FSOC's final determination decisions. We used the collected information to assess the extent to which FSOC followed the process established in its rule and guidance and provisions in the Dodd-Frank Act. We conducted this assessment by comparing FSOC's analysis of each company that it evaluated in each stage of its process with FSOC's analytical framework. We also collected and reviewed information on how FSOC advanced companies through its evaluation and determination process, communicated with companies undergoing evaluation, and collected information from third parties. We assessed the collected information within and across the companies that FSOC evaluated to determine the extent to which FSOC conducted the evaluations consistently. In addition, we interviewed officials and staff from FSOC members and member agencies and discussed, among other things, the determination process and how FSOC formulated the approach and analytical framework for the process. To obtain additional information on FSOC's determination process, we interviewed four industry trade groups, including those representing insurers and asset managers, and one company. We used criteria from *Standards for Internal Control in the Federal Government*, Dodd-Frank Act provisions on FSOC's authorities, and transparency principles, including directives issued by the Office of the Management and Budget and FSOC's own transparency policy to evaluate FSOC's determination process.

To assess how FSOC's determination process compares with the methodologies of international institutions, we examined documents on the evaluation of systemically important institutions from four international institutions: the Financial Stability Board, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions. We identified five sector-specific methodologies that these organizations developed to identify systemically important banks and nonbank financial companies and compared the methodologies with FSOC's. We focused our analysis on identifying similarities and differences in approaches—including analytical categories and metrics—to evaluating the importance of bank and company activities and financial

condition to financial stability. We interviewed officials and staff from FSOC members and member agencies about the international methodologies, the extent to which FSOC or FSOC member agencies participated in those processes, including developing analytical frameworks or identifying systemically important nonbank financial companies. To obtain additional information on the international methodologies and the sequence of their identifications and FSOC determinations, we also interviewed four nonbank financial companies that FSOC evaluated and four industry trade associations.

To determine the Federal Reserve's progress in establishing a framework for supervising designated companies, we reviewed the Dodd-Frank Act and the Federal Reserve's proposed and final regulations about enhanced prudential standards for nonbank financial companies and bank holding companies. We also interviewed FSOC and Federal Reserve officials about the Federal Reserve's development of a supervision framework and prudential standards for designated nonbank financial companies and FSOC's role in the process.

We conducted this performance audit from October 2013 to November 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions, based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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# Appendix II: Committees of the Financial Stability Oversight Council

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The Financial Stability Oversight Council (FSOC) has established seven committees, which are listed and briefly described below.

- **Deputies Committee:** Coordinates and oversees the work of the interagency staff committees. The members of the Deputies Committee are senior officials from each of the member agencies. A senior official of the Department of the Treasury chairs this committee.
- **Systemic Risk Committee:** Monitors systemic risk and plays a role in prioritizing the review of sources of systemic risk and guiding the work of staff. Includes senior staff and reports to the Deputies Committee.
- **Institutions Subcommittee:** Focuses on identifying and analyzing topics that affect financial institutions in the medium and longer term. It also attempts to identify structural concerns in financial institutions that could threaten financial stability, such as trends in leverage or funding structure, new products, or exposures to particular risks.
- **Markets Subcommittee:** Focuses on identifying and analyzing topics that affect financial markets in the medium and longer term, including structural concerns within financial markets that could threaten financial stability, such as trends in volatility or liquidity, market structure, or asset valuations.
- **Designation of Nonbank Financial Companies Committee:** Supports FSOC in considering, making, and reviewing designations of nonbank financial companies to be supervised by the Board of Governors of the Federal Reserve System (Federal Reserve).
- **Designation of Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee:** Supports FSOC in considering, making, and reviewing designations of financial market utilities and payment, clearing, and settlement activities.
- **Heightened Prudential Standards Committee:** Supports FSOC in making recommendations for heightened prudential standards for designated nonbank financial companies and large, interconnected bank holding companies, and for other financial activities and practices that could affect financial stability. This committee also supports FSOC in monitoring regulatory developments, facilitating information sharing, recommending supervisory priorities and principles, and identifying gaps in regulation that could pose risks.
- **Orderly Liquidation Authority, Resolution Plans Committee:** Supports any FSOC recommendations on resolution plan requirements, consideration of filed resolution plans, and consideration of Federal Deposit Insurance Corporation and Federal Reserve proposed orders to require divestiture; and consults with FSOC on rulemakings to implement the Title II orderly liquidation authority.

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- **Data Committee:** Supports FSOC coordination of, and consultation on, agency rulemakings on data collection, and seeks to minimize duplication of data-gathering operations. Supports a coordinated approach to information sharing and provides direction to, and requests data from, the Office of Financial Research and works with that office on data standardization.



# Appendix III: Comments from the Department of the Treasury



UNDER SECRETARY

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

November 10, 2014

Mr. Lawrance L. Evans, Jr.  
Director, Financial Markets and Community Investment  
Government Accountability Office  
441 G St., NW  
Washington, D.C. 20548

Dear Mr. Evans:

I am writing on behalf of Secretary Lew, who serves as the Chairperson of the Financial Stability Oversight Council (Council). We appreciate the opportunity to review the Government Accountability Office's (GAO) draft report GAO-15-51 (the Draft Report) regarding the Council's process for designating nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System (Federal Reserve) and enhanced prudential standards.

To assist GAO in this year-long review, the Council provided GAO with access to extensive materials documenting the Council's implementation of its analytic process for designating specific nonbank financial companies. As the Draft Report notes, the Council has followed its process, including through its application of the analytic framework described in the Council's rule and interpretive guidance regarding its nonbank financial company designations authority.<sup>1</sup> This three-stage process, established by the Council in its guidance, provides consistency and transparency to both the public and firms that may come under consideration by the Council, as demonstrated by the GAO's findings that the Council "frequently communicates with companies under evaluation" and that "[g]enerally, companies told GAO they were satisfied with [the Council's] communication with them during the evaluation process." The Draft Report also notes that "member agency staff who contributed to company evaluations held various positions and contributed a range of expertise" and that "member agency officials generally indicated that their agency's expertise was well utilized."

The Draft Report recommends that the Council gather some additional data on how it internally monitors the progress of its work, clarify existing practices regarding when companies may meet with the Council or Council members' deputies, and develop processes for expanding on available data and the scope of its analyses to ensure that it identifies any company that could pose a threat to financial stability. As Chairperson Lew noted at the Council's open meeting on October 6, in recent months, the Council has received a number of suggestions proposed by stakeholders regarding its process for evaluating nonbank financial companies. The Council has

<sup>1</sup>Specifically, the Draft Report describes the Council's extensive process for designating nonbanks, including its analytical framework for considering companies for designation (pages 5-14); the collaborative nature of the work across the Council's members and member agencies (pages 17-24); the Council's frequent communication with companies (pages 27-29); and how the Council has followed its analytic process in its completed reviews (pages 31-34).

directed staff to continue to review and evaluate those and other potential changes for further discussion. These Draft Report's recommendations complement a number of the suggestions previously made by other stakeholders and will be included as part of this analysis.

The Draft Report also recommends that the Council increase the amount of information that is included in the public explanations of the basis for any future designations. It is important to note that the nonpublic bases that are provided to companies under consideration for a final designation include extensive, specific, confidential information so that the companies have a detailed understanding of the Council's analysis. The Council is committed to conducting its work in an open and transparent manner, and will consider ways that this recommendation can be implemented while continuing to satisfy the statutory requirement and provisions of the Open Government Directive and the Council's transparency policy relating to the protection of nonpublic information the Council receives from companies under review.

We support GAO's work. Since its creation four years ago, the Council has participated in more than a dozen performance audits by the Government Accountability Office and the Council of Inspectors General for Financial Oversight reviewing almost every aspect of our work. These reviews have in many cases reaffirmed the important role of the Council and reported positive findings as well as ways to help improve a new organization.

Thank you again for the opportunities to engage with your staff and to review and comment on the Draft Report. We look forward to working with you in the future.

Sincerely,



Matthew Rutherford

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# Appendix IV: GAO Contact and Staff Acknowledgments

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## GAO Contact

Lawrance L. Evans, Jr., (202) 512-8678, [evansl@gao.gov](mailto:evansl@gao.gov).

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## Staff Acknowledgments

In addition to the contact named above, Debra R. Johnson (Assistant Director), Kevin Averyt (Analyst-in-Charge), Nancy Barry, Andrew Kurtzman, Risto Laboski, Kun-Fang Lee, Barbara Roesmann, Jessica Sandler, Jena Sinkfield, and Verginie Tarpinian made key contributions to this report. Other assistance was provided by William Chatlos, Rachel DeMarcus, Janet Eackloff, Michael Hoffman, and Susan Sawtelle.

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