THE ARBITRARY AND INCONSISTENT FSOC NONBANK DESIGNATION PROCESS

REPORT PREPARED BY THE REPUBLICAN STAFF OF THE
COMMITTEE ON FINANCIAL SERVICES, U.S. HOUSE OF REPRESENTATIVES

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This report has not been officially adopted by the Committee on Financial Services and may not necessarily reflect the views of its Members.

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I. Executive Summary

In May 2015, the Committee on Financial Services (Committee) initiated a review of the Financial Stability Oversight Council's (FSOC) designations of nonbank financial companies as Systemically Important Financial Institutions (SIFIs), which are subject to enhanced prudential standards prescribed and enforced by the Board of Governors of the Federal Reserve System. As part of its review, the Committee obtained nonpublic internal FSOC documents and solicited testimony from FSOC officials. The information that the Committee obtained demonstrates that the FSOC's nonbank designation process is arbitrary and inconsistent. Specifically, the documents show that:

- The FSOC does not follow its own rules and guidance in multiple ways.
    - The FSOC considers non-systemic risks in its determination of whether to designate a company as systemically important.
    - The FSOC does not determine whether material financial distress at a company will cause "impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy," as required by the FSOC's rules, and instead simply assumes both impairment and significant damage on the economy.
    - The FSOC does not follow its own requirement that evaluations of the systemic risk posed by individual firms be done in the "context of a period of overall stress in the financial services industry and in a weak macroeconomic environment," and instead the FSOC has analyzed some companies only in a normal macroeconomic environment and then declined to designate those companies.
- The FSOC's analysis of companies has been inconsistent and arbitrary.
    - The FSOC performed, for some companies, an analysis of that company's vulnerability to financial distress, and declined to designate those companies.
    - The FSOC did not perform an analysis of vulnerability to financial distress for all of the companies that it designated as SIFIs.
    - For some companies that it declined to designate, the FSOC considered the use of collateral in certain financial transactions as a mitigating factor against designation.
    - For companies that it designated as SIFIs, the FSOC did not consider the use of collateral in certain financial transactions to be a mitigating factor.

II. Introduction

Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") (Pub. L. 111-203) created the Financial Stability Oversight Council (FSOC).[1] Dodd-Frank gave the FSOC the power and responsibility to designate nonbank financial companies for enhanced prudential supervision by the Board of Governors of the Federal Reserve System.[2] The FSOC explains this power as follows:

> Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) authorizes the Financial Stability Oversight Council (the Council) to determine that a nonbank financial company shall be supervised by the Board of Governors of the Federal Reserve System and be subject to enhanced prudential standards if the Council determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States.[3]

The FSOC promulgated through notice and comment a final rule and interpretive guidance to explain how the FSOC would conduct its determination of whether a nonbank financial company could pose a threat to the financial stability of the United States.[4] A final determination by the FSOC that a company poses such a threat is often referred to as a designation. Companies designated by the FSOC under Section 113 of Dodd-Frank are commonly called nonbank Systemically Important Financial Institutions, or nonbank SIFIs. The FSOC determined that it would use a three-step process to evaluate companies for designation. The FSOC summarized the process detailed in the rule and interpretive guidance as follows:

> The Rule and Guidance provide a detailed description of the analysis that the Council intends to conduct, and the processes and procedures that the Council intends to follow, during its review of nonbank financial companies. In the Rule and Guidance, the Council created a three-stage process for identifying companies for determinations. Each stage of the process involves an analysis based on an increasing amount of information to determine whether a company meets one of

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[1] 12 U.S.C. § 5321.
[2] 12 U.S.C. § 5323.
[3] Financial Stability Oversight Council, Supplemental Procedures Relating to Nonbank Financial Company Determinations 1, Feb. 4, 2015, [hereinafter FSOC Supplemental Procedures], https://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf.
[4] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 12 C.F.R. § 1310 (2012) [hereinafter FSOC Rule and Guidance].

> the statutory standards for a determination. In the first stage of the process (Stage 1), the Council applies six quantitative thresholds (described in the Rule and Guidance) to a broad group of nonbank financial companies to identify a set of companies that merit further evaluation. In Stage 2, the Council conducts a preliminary analysis of the potential for the companies identified in Stage 1 to pose a threat to U.S. financial stability. Based on the analysis conducted during Stage 2, the Council identifies companies that merit further review in Stage 3, which builds on the Stage 2 analysis with additional quantitative and qualitative analyses. The Council may make a proposed determination regarding a company based on the results of the analyses conducted during this three-stage review. If the Council makes a proposed determination, the Council provides the company with notice and an explanation of the basis of the proposed determination. The company may request a hearing to contest the proposed determination. After any hearing, the Council may make a final determination regarding the company.[5]

As explained above, the FSOC's statutory standard for designations hinges on whether a nonbank financial company "could" pose a threat to the financial stability of the United States.[6] But under that standard, any nonbank financial company can meet the standard of a threat. Risk is inherent in financial markets, and any company could have a minimal but nonzero likelihood of being a threat to financial stability.[7] The FSOC, however, has not designated every nonbank financial company under its authority even though each could potentially pose some threat. In fact, of all of the numerous nonbank financial companies that the FSOC potentially could designate, the FSOC has only designated four. Since this limited number of designations establishes that the FSOC does not designate all nonbank financial companies based on the standard of any conceivable threat, a key question is what level of threat the FSOC considers sufficient to warrant designating a nonbank financial company. Put another way, what was it about the four nonbank financial companies the FSOC designated that made them different from all other nonbank financial companies? This question has remained unanswered in the FSOC's guidance and other public documents and statements. The FSOC has only explained the process by which a company will be evaluated, not the analysis or the standard that underlies the evaluation.

Because the public information the FSOC had provided on this issue was not clear, this Committee undertook this inquiry to answer, among other questions, what led the FSOC to designate some nonbank financial companies and not others.

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[5] FSOC Supplemental Procedures, at 1-2.
[6] 12 U.S.C. § 5323(a)(1).
[7] Memorandum from the Congressional Research Service to the House Committee on Financial Services 4 (Dec. 30, 2016) (on file with Committee) [hereinafter CRS Memo].

The Committee sought nonpublic documents and testimony from the FSOC to aid in this effort. The FSOC was not forthcoming in providing the nonpublic information the Committee requested, even though the Dodd-Frank Act mandates—without exception—that the basis for all designations of nonbank financial companies shall be reported to Congress.[8] After over a year the FSOC finally provided all documents that it claimed were responsive to the Committee's requests for information.

Unfortunately, neither the nonpublic evaluation memoranda documenting the FSOC's decisions nor the other materials and testimony the FSOC provided to the Committee shed meaningful light on the FSOC's justifications for designating some non-bank financial institutions and not others. The FSOC has indicated that it has provided all relevant information on this issue, and if that is the case, it appears that the FSOC lacks a sufficient rationale for its designations.

To be sure, the FSOC's nonpublic evaluation memoranda for individual companies contain the FSOC's self-stated justification for its actions with respect to that particular company. The FSOC designated some companies as SIFIs, while declining to advance a number of other companies from Stage 2 to Stage 3 in its evaluation process. The memoranda associated with those decisions contain what the FSOC says is its explanation for the decision. Accordingly, this report does not argue that the FSOC did not document some reasons for its decisions. It instead argues that the FSOC's stated reasons for its decisions do not sufficiently explain its actions.

The FSOC's actions are not sufficiently explained in either individual evaluation memos or the FSOC's actions in the aggregate. For individual memos, the explanations given do not sufficiently explain the conclusions reached by the FSOC, a point made by the Independent Member with Insurance Expertise in his dissent from the FSOC's designation of the large insurance company MetLife: "I do not believe that the analysis' conclusions are supported by substantial evidence in the record, or by logical inferences from the record."[9] The Independent Member's statement was specifically referencing analysis of the Asset Liquidation Transmission Channel for MetLife, but his critique can apply broadly to much of the

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[8] 12 U.S.C. § 5322(a)(2)(N)(iv). The FSOC is required by statute to maintain the confidentiality of any data or information submitted to it, but the statute also makes clear that the Freedom of Information Act applies to any submitted data or information. 12 U.S.C. § 5322(d)(5). The Freedom of Information Act explicitly states the law "is not authority to withhold information from Congress." 5 U.S.C. 552(d). Congress placed no restriction upon itself in the Dodd-Frank Act with regard to its ability to seek information from the FSOC.

[9] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc., Views of the Council's Independent Member Having Insurance Expertise at 2, Dec. 18, 2014, https://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.

FSOC's nonpublic analysis for all of the companies it evaluated.[10] The FSOC's evaluation memoranda contain data and information about the nonbank financial companies considered for designation, but the memoranda do not sufficiently explain how the information provided supports the FSOC's conclusions about those companies.

The federal district court that struck down the FSOC's designation of MetLife in March 2016 noted the disconnect between the data provided and the FSOC's conclusions. The court wrote that the FSOC's "exposure channel analysis merely summed gross potential market exposures," and then "assumed that any such losses would affect the market in a manner that 'would be sufficiently severe to inflict significant damage on the broader economy.'"[11] The court then criticized the FSOC for "never project[ing] *what* the losses would be, *which* financial institutions would have to actively manage their balance sheets, or *how* the market would destabilize as a result."[12]

This report, however, does not focus on the failure of individual FSOC evaluation memoranda to explain the FSOC's conclusions about those companies, for a number of reasons. First, these critiques about the sufficiency of the FSOC's support for its conclusions have been made in a number of places, including in dissents to FSOC designations of nonbank financial companies, by the District Court in the MetLife litigation, and by some of the designated companies themselves during the designation process. Second, an exhaustive critique of the FSOC's nonpublic evaluation memoranda would likely require the disclosure of confidential information about the companies that the FSOC evaluated. The FSOC designation process is already an invasive and expensive process for the companies under evaluation, and placing confidential, proprietary information on these firms on the public record would only compound that harm. Third, the identities of a number of companies that the FSOC evaluated are not publicly known, and critiques in this report of those evaluations might unnecessarily reveal the identities of those companies.

This report instead compares the FSOC's evaluation memoranda against one another to measure the consistency of the FSOC's analysis. There are a number of advantages to this approach. First, it more easily allows for critiques of the FSOC's designation decisions while not divulging the identities of certain companies and preserving the confidentiality of information relating to the companies under evaluation. Second, no other entity has reviewed all of the FSOC's evaluation

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[10] The Independent Member's dissent is noteworthy as well because it does not merely disagree with the voting majority of the FSOC's conclusions, but instead rejects those conclusions as lacking sufficient evidence and logical foundation.

[11] MetLife, Inc. v. Financial Stability Oversight Council, No. 15-45, slip op. at 25 (D.D.C Mar. 30, 2016) (citing 12 C.F.R. § 1310 App. A.II.a).

[12] *Id.* at 25-26.

memoranda, other than the FSOC itself and the GAO in a report issued to the Senate Committee on Banking, Housing, and Urban Affairs more than two years ago.[13] In fact, the FSOC did not even provide its Stage 2 evaluation memoranda to the evaluated companies. Third, comparing the FSOC's evaluation memoranda against one another allows for a critique of the consistency of the reasoning of the FSOC's designations without necessarily second-guessing the FSOC's conclusions about any individual company.

The Committee's comparison of the FSOC's evaluation memoranda suggests that the FSOC's evaluation process was anything but consistent. The FSOC did not follow its own guidance or analytical framework on designations, including its own definition for what constitutes a Threat to the Stability of the United States[14] and its own requirement that company analysis be done in the "context of a period of overall stress in the financial services industry and in a weak macroeconomic environment."[15] The FSOC also repeatedly evaluated similar aspects of different companies differently, by performing a vulnerability analysis for some of the companies that it declined to designate, and by treating the use of collateral differently for companies it declined to designate.

It is important to note the difference between the Committee's findings in this report from that of the GAO's in its 2014 report.[16] The two reports address different issues. The GAO's review was a procedural audit to determine whether the FSOC's designation decisions had followed the proper process.[17] To that end, the GAO found that the FSOC's completed company evaluations "followed its determination process and analytical framework."[18] The GAO's finding about the FSOC's documentation of its procedure is not inconsistent with this report, which evaluates the *quality* of the FSOC's analysis, and finds various inconsistencies in that approach.

The GAO's report identified several deficiencies in the FSOC's designation process. The GAO found that the FSOC did not document in its designations why a company had met the designation standard, in that the FSOC's "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 of

[13] GAO-15-51, Financial Stability Oversight Council, Further Actions Could Improve the Nonbank Designation Process (Nov. 2014).
[14] FSOC Rule and Guidance, 12 C.F.R. § 1310 App. A.II.a.
[15] *Id.* at 1310 App. A.II.b.
[16] GAO-15-51, Financial Stability Oversight Council, Further Actions Could Improve the Nonbank Designation Process (Nov. 2014).
[17] The GAO's "review was limited to FSOC's documentation of its analysis for the three nonbank financial companies receiving a final determination as of September 2014," that review "did not evaluate the quality of the FSOC's analysis," and the GAO's "findings do not reflect conclusions regarding legal compliance." *Id.* at 39 fn.42.
[18] *Id.* at 35.

both of the determination standards."[19] The GAO also observed that other than the public guidance, the "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."[20] This means that other than the public guidance, the FSOC did not have any internal guidance or standards on how nonbank financial companies were to be evaluated. This complete lack of standards is borne out by this report's findings about the inconsistencies in the FSOC's process.

The Committee also asked specialists in financial economics at the Congressional Research Service (CRS) to review the FSOC's evaluation memoranda. Similar to the Committee's findings, CRS found that there were issues in the replicability of the FSOC's evaluations of nonbank companies for designation:

> Replication is not merely confirming mathematical calculations. Economist Daniel Hamermesh has identified three types of replication: confirmation of the same results using the same data, model, and estimation methods (pure replication); use of alternative comparable datasets, variable constructions, or estimation methods (statistical replications); and application of alternative theoretical or conceptual approaches (scientific replication).[21] Although CRS analysis of the documents provided did not identify any errors in calculation (pure replication), some elements of the FSOC's analysis are difficult to replicate in the second two categories of replication (statistical replication and scientific replication). The reason is in part because the documents did not include a framework for combining different sources of financial stability into a standard that could be used to distinguish between firms. In summary, while the FSOC's analysis of a firm in isolation might identify a plausible threat to financial stability, CRS was not able to replicate that the FSOC's process was more likely to designate a firm if it posed a greater threat to financial stability than if it did not. CRS could only confirm that all of the evaluated firms posed some threat to financial stability. The FSOC's decisions to designate or rescind designation might be plausible in isolation, but are difficult to replicate when treating some firms differently from others.[22]

The remainder of this report documents some of the problems and inconsistencies with the FSOC's evaluations of nonbank financial companies. The report contains excerpts from nonpublic FSOC evaluation memoranda. Because of

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[19] *Id.* at 41.
[20] *Id.* at 39.
[21] Hamermesh, Daniel S., 2007, "Replication in Economics." Canadian Journal of Economics 40 (3):715–733.
[22] CRS Memo at 2.

the confidential nature of most of the information in the FSOC's nonpublic evaluation documents, these excerpts have been anonymized to the extent possible to protect the proprietary information of the companies the FSOC evaluated. For this reason, the report redacts or summarizes certain business or financial activities of these companies. Those redactions or summaries will appear in brackets around the text.

Additionally, to preserve the anonymity of some companies and the confidentiality of the information of all of the companies, the names of the evaluated companies in the excerpts have been redacted and replaced with placeholder names, such as [COMPANY 1]. These placeholder names are consistent within a section of the report, but will not be consistent between sections of the report. This means that the company referred to in this report by the placeholder name [COMPANY 1] for the section on vulnerability will not necessarily be the same underlying company as [COMPANY A] in the section on collateral. The only information about companies that were under evaluation revealed in the report is whether the FSOC designated the company or declined to designate it by voting not to advance the company to Stage 3 of the process. This information has been disclosed in some instances because of the pattern that emerges between how the FSOC evaluated companies it designated and how it evaluated companies it declined to designate. The inconsistencies in the FSOC's analysis are not random; to a large degree the designated companies were evaluated in one fashion, and the non-designated companies were evaluated a different way.

Also of note is that this report does not document all of the problems and inconsistencies with the FSOC's evaluations of nonbank financial companies. Important examples of inconsistent treatment of evaluated companies have been deliberately omitted from this report because discussion of those inconsistencies would potentially reveal the identities of the companies and confidential information about those companies. That this report is unable to publicly present evidence of the FSOC's methodological problems without potentially causing collateral damage to evaluated companies is indicative of the lack of accountability to the FSOC's nonbank designation process. The reasoning and judgments of the FSOC in the nonbank designation process have been hidden from public scrutiny because the FSOC has structured that process to intertwine its reasoning with the confidential information of evaluated companies.

Lastly, in the course of this inquiry the Committee identified an issue at the FSOC that is of serious concern but that is outside the scope of this report, the focus of which is on the designation process. The FSOC appears to be seriously deficient in keeping records of the meetings of its committees. The FSOC has established a Deputies Committee,[23] as well as five subcommittees on specific subject matters.[24]

[23] Financial Stability Oversight Council, Bylaws of the Deputies Committee of the Financial Stability Oversight Council,

Other than the nonpublic record of votes taken at the Deputies Committee, it appears that the FSOC keeps no records of the activities of any of its committees or subcommittees. At most, it appears that the FSOC keeps records of the agendas of Deputies Committee meetings, and any distributed materials.[25] The FSOC also does not keep a record of the membership of the committees, beyond an email distribution list.[26] None of these agendas or distribution lists has been produced by the FSOC to the Committee; FSOC officials have merely represented that they exist.[27] Combined with the lack of transcripts of Council meetings, this lack of record keeping means that there is no way for future FSOC participants to understand the substance of past FSOC deliberations or the merits of the recommendations that grew out of those discussions.

III. The FSOC Does Not Follow Its Own Framework for Designations

A. The FSOC does not follow its own definition of a Threat to the Stability of the United States

The FSOC does not follow the framework for designations of nonbank financial companies that is laid out in its rule and interpretive guidance. In particular, the FSOC does not follow its own definitions for what constitutes a threat to the stability of the United States. As a result, the FSOC appears to base its designation decisions on factors other than the ones stated in its rules and interpretive guidance.

The FSOC explains its authority and rationale for nonbank designations as follows:

> Under section 113 of the Dodd-Frank Act, the Council may determine that a nonbank financial company will be supervised by the Board of Governors and be subject to enhanced prudential standards if the Council determines that (1) material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States (the First Determination Standard) or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the

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https://www.treasury.gov/initiatives/fsoc/Documents/The%20Council%27s%20Deputies%20Committee%20Bylaws.pdf.

[24] Financial Stability Oversight Council, The Council's Committee Charters, https://www.treasury.gov/initiatives/fsoc/governance-documents/Documents/The%20Council%27s%20Committee%20Charters.pdf.

[25] Deposition of: Patrick Pinschmidt Before the H. Comm. on Fin. Serv., 114th Cong. 2:29-30 (2016) [hereinafter Pinschmidt Deposition].

[26] Pinschmidt Deposition at 2:60-62.

[27] *Id.* at 2:29-30.

> activities of the nonbank financial company could pose a threat to the financial stability of the United States (the Second Determination Standard).[28]
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> The Council will consider a "threat to the financial stability of the United States" to exist if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy.[29]

This standard appears in the Stage 2 memoranda for all nine of the evaluated nonbank financial companies. All of the evaluations of nonbank financial companies that the FSOC has performed to date have been under the First Determination Standard, "material financial distress," and not the Second Determination Standard, "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of a company (commonly known as "products and activities"). That the FSOC has not evaluated a nonbank financial company for designation under the Second Determination Standard has no impact on whether it may choose to do so in the future. But for the nine nonbank financial companies that the FSOC has evaluated to date, the FSOC's standard for designating a company as a SIFI focused on whether the company's material financial distress could cause an impairment of financial intermediation or could cause an impairment of financial market functioning, either of which is sufficiently severe to inflict significant damage on the broader United States economy.

The FSOC's guidance states that the Council identified three transmission channels that could cause an impairment of financial intermediation or financial market functioning.[30] These three channels are exposure, asset liquidation, and critical function or service.

For the exposure channel, the FSOC stated that it would evaluate whether a "nonbank financial company's creditors, counterparties, investors, or other market participants have exposure to the nonbank financial 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."[31]

For the asset liquidation channel, the FSOC stated that it would evaluate whether a "nonbank financial company holds assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or

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[28] Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc., July 8, 2013, at 4.
[29] FSOC Rule and Guidance, 12 C.F.R. § 1310 App. A.II.a.
[30] *Id.*
[31] *Id.*

funding in key markets or cause significant losses or funding problems for other firms with similar holdings."[32]

For the critical function or service channel, the FSOC stated that it would evaluate whether a "nonbank financial company is no longer able or willing to provide a critical function or service that is relied upon by market participants and for which there are no ready substitutes."[33]

The FSOC states that its evaluation of the three transmission channels will "assess how a nonbank financial company's material financial distress or activities could be transmitted to, or otherwise affect, other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning."[34]

This standard for identifying the existence of a threat to the financial stability of the United States has a number of methodological problems. The first relates to the definition of the asset liquidation channel. This definition does not require losses from holders of specific assets to arise from a systemic event. This is important because the FSOC is designed to address issues of systemic risk in U.S. financial markets. Systemic risk has been described as pertaining "to risks of breakdown or major dysfunction in financial markets."[35] Systemic risks differ from *systematic* risks, which have been described as "macroeconomic or aggregate risks that cannot be avoided through diversification."[36] The difference between these two types of risk is important for the purposes of the FSOC. A realized systematic risk may cause a broad downturn in financial markets and resulting losses, but these losses are not necessarily *systemic*. Instead, losses arising from systemic risks are more than mere losses, and arise specifically from breakdowns in financial markets. The FSOC's definition of a "threat to the financial stability of the United States" reflects this distinction between systematic and systemic risks. The FSOC defines a threat to financial stability as occurring through an impairment of financial intermediation or financial market functioning. The FSOC's definition is analogous to the one provided for systemic risk above – a "breakdown or major dysfunction in financial markets."

Once the FSOC defined a threat to financial stability of the United States as solely resulting from systemic risks, however, it then defined one of the transmission channels to include systematic risks. The "asset liquidation channel" contains as a definition of a threat to financial stability "assets that, if liquidated quickly, would … cause significant losses or funding problems for other firms with

[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] Lars Peter Hansen, Challenges in Identifying and Measuring Systemic Risk 4 (Feb. 14, 2013).
[36] *Id.*

similar holdings."[37] It does not appear from this definition that the FSOC requires these "significant losses" to then "impair financial intermediation or financial market functioning" in order to consider those losses "a threat to the financial stability of the United States."

Intermediation and market functioning can be analogized to the architecture and machinery of financial markets. When that architecture and machinery are functioning properly, the financial markets can generate innovation, competition, capital formation and gains or losses to firms and the broader United States economy. The FSOC's definition of a threat to the financial stability of the United States, however, concerns damage to the economy that results specifically from the breakdown of the architecture and machinery of financial markets. This means, conceptually, that the FSOC's mechanism for a threat to financial stability of the United States is relatively narrow; it cannot be just significant damage on the broader economy, or losses at financial firms; it instead must be that the architecture and machinery of financial markets are damaged, and that damage is what harms the broader economy. If a large nonbank financial company experiences material financial distress it is likely that its investors and counterparties will experience losses, and the broader economy could suffer damage. But the task the FSOC set for itself is much more specific than identifying if insolvent companies might inflict losses on their counterparties – it is to determine if an insolvent nonbank financial company would cause breakdown and dysfunction in financial markets. Thus, defining as a threat to financial stability asset liquidation that results in significant losses is far too broad a definition. This distinction between mere losses and financial dysfunction is practically important because the FSOC relies on this specific criterion often in justifying its non-bank SIFI designations, and treats some large losses that do not result from a systemic event as sufficient to support designation.

CRS also flagged the FSOC's failure to differentiate between systemic and systematic risks in the context of the exposure channel, or interconnectedness. CRS observed that a "potential problem with the replicability of the FSOC designations is that it does not seem to distinguish between normal losses (internalized) and systemic losses."[38] CRS explains that:

> In general, the economic benchmark for efficiency occurs when all the parties to a decision take full account of the costs and benefits of their decisions. This does not suggest that there are no losses or no risks; rather, it is where the market participants have internalized those risks when they make their decisions. Fully internalizing all costs and benefits is an impossible standard, and so market failure in this sense occurs in almost all market actions –but not all market failures are

[37] FSOC Rule and Guidance, 12 C.F.R. § 1310 App. A.II.a.
[38] CRS Memo at 5.

equally severe. From an economic perspective, there are degrees of market failure and policy response.

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To see the problem, consider the discussion of interconnectedness. By definition, contracts connect the parties to the contract. Thus, if an intermediary loans money to another firm, then the two are interconnected. However, the terms of the contract often tend to internalize the costs and benefits, such as when interest rates adjust when perceived risks change. Traditionally, the term market failure would not be used to describe such a contract unless there was some other identifiable information problem (of which there are potentially many).

But some financial contracts reference third parties, such as credit default swaps (CDS). The managers of a reference entity have not negotiated prices with holders of CDS and so it may be possible for markets to fail to internalize some aspects of a CDS contract. On the other hand, the holder of the debt of a reference entity may purchase a CDS in order to transfer costs to another firm. If so, then the costs may have been internalized when the holder of the debt negotiated its contract with the reference entity.

Without going into greater detail of the intricacies of market failure and the use of contract to internalize it, the point is that the stage 2 documents did not include a framework for identifying when interconnectedness is destabilizing compared to when interconnectedness is actually a form of internalizing costs and benefits and thus helping approach the economic benchmark. Nor did the stage 2 documents seem to distinguish interconnectedness that is a form of reducing market failure from interconnectedness that tends to increase market failure.[39]

In sum, the FSOC's treatment of interconnectedness does not distinguish whether interconnections between companies are likely to "impair financial intermediation or financial market functioning," or instead prevent that impairment.

The second conceptual issue is that the FSOC's guidance appears to assume that transmission of material financial distress through the exposure or asset liquidation channel automatically causes an impairment of financial intermediation or market functioning. This is distinct from the previously discussed conceptual

[39] CRS Memo at 5-6.

issue. Whereas the FSOC relies upon losses that are not systemic to justify designation, the FSOC further assumes certain types of losses will become systemic. The FSOC's guidance states the FSOC will "assess how a nonbank financial company's material financial distress or activities could be transmitted to, or otherwise affect, other firms or markets, *thereby causing* a broader impairment of financial intermediation or of financial market functioning."[40] This sentence could plausibly be read to mean that the FSOC is determining whether a causal chain of events exists – that material financial distress at one company can affect a number of other companies so significantly that a broader impairment of financial intermediation or market functioning occurs. In practice, however, the FSOC's designations often operate on the premise that *any* effect a company's material financial distress has on other firms or markets will cause a broader financial impairment. If the FSOC's standard for designation is whether a company's material financial distress could cause a broader impairment, then the FSOC essentially treats any effect one company has on a number of firms or markets as grounds for designation.

This deficiency in the FSOC's designation process was highlighted by the district court that invalidated the MetLife designation:

> The Exposure channel analysis merely summed gross potential market exposures, without regard to collateral or other mitigating factors. For example: "In the event that MetLife were to experience material financial distress, the holders of its $30.6 billion in [Funding Agreement Backed Securities (FABS)], including investment funds and large banking organizations, could sustain losses." From that point, FSOC assumed that any such losses would affect the market in a manner that "would be sufficiently severe to inflict significant damage on the broader economy." These kinds of assumptions pervade the analysis; every possible effect of MetLife's imminent insolvency was summarily deemed grave enough to damage the economy.[41]

The District Court's observations are not limited to MetLife. The FSOC took this approach with the three other companies that it designated as well. This approach is inconsistent with the FSOC's guidance on its designation process, which, at a minimum, raises serious issues of procedural fairness. But what is of greater concern than mere issues of adherence to guidance is that this demonstrates that in its nonbank designation process the FSOC is not fulfilling its statutory mandate of actually analyzing whether companies are systemically risky.

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[40] FSOC Rule and Guidance, 12 C.F.R. § 1310 App. A.II.a (emphasis added).

[41] MetLife, Inc. v. Financial Stability Oversight Council, No. 15-0045, slip op. at 25 (D.D.C. Mar. 30, 2016) (internal citations omitted).

Based on the FSOC's issued standards and guidance for nonbank designations, one could logically assume that the FSOC's task in assessing whether a company could be a threat to the financial stability of the United States was to engage in a process of evaluating a wide range of potential scenarios and market indicia. It should evaluate the vulnerability of a nonbank financial company to material financial distress; evaluate the effect material financial distress had upon that nonbank financial company; evaluate how the effects of the company's distress were transmitted to, or affected, other firms or markets; evaluate if the effects on the affected firms or markets were significant enough to cause a broader impairment of financial intermediation or of financial market functioning; and lastly to evaluate if that impairment of financial intermediation or market functioning was sufficiently severe to inflict significant damage on the broader United States economy.[42] But in practice the FSOC often skips many of those steps, as it does not consistently assess the vulnerability to financial distress of companies it designates; does not analyze whether the effects of a company's material financial distress on other firms and markets impairs financial intermediation or market functioning; and does not evaluate whether that impairment would be sufficiently severe to inflict significant damage on the broader United States economy.

In fact, surprisingly, the FSOC does not define or set standards for a number of key terms in this analysis. The FSOC's explanation of the transmission channel analysis in the guidance relies on a number of key terms and concepts, such as "significant damage on the broader economy," "significantly disrupt trading," or "cause significant losses," that function as indicia of whether a nonbank financial company could pose a threat to the financial stability of the United States.[43] These key concepts, however, are not defined in the guidance. This lack of definition for key terms is not limited to the FSOC's public documentation. The FSOC's Stage 2 memos and Stage 3 designation documents contain no additional explanation of what these terms mean. The FSOC does not have internal documents or guidance that explain what these key terms mean, nor does it have documents or guidance to direct FSOC staff on how to conduct an evaluation of a nonbank financial company for designation as a SIFI. The Committee requested these documents from the FSOC, but was told that they did not exist.

In a sworn deposition of Patrick Pinschmidt, the Executive Director of the FSOC, Mr. Pinschmidt was asked what "significant damage on the broader economy" meant and how the FSOC assessed it. Mr. Pinschmidt responded that

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[42] The described process is merely limited to the FSOC's assessment of a threat; it does not reach other important issues and tasks the FSOC should address and consider in the nonbank designation process, such as: whether any identified threats can be mitigated through the authorities provided to the FSOC over a designated company, whether the identified risks can be mitigated through existing regulatory authorities without relying on designation, and whether the costs of designation to the company exceed the benefits of designation.

[43] FSOC Rule and Guidance, 12 C.F.R. § 1310 App. A.II.a.

"there are no bright-line thresholds,"[44] and that "it's up to each voting member of the Council to decide for him or herself as to what constitutes a significant threshold…"[45] When Mr. Pinschmidt was asked how the FSOC assured that its analysis was consistent across evaluated companies, in light of his explanation that it was up to individual FSOC members to determine what significant damage on the broader economy meant, he did not directly answer the question and only explained that statutes, public rule, and guidance outline the analysis that the FSOC is to undertake.[46]

While the FSOC claims that it "conducts its analysis on a company-by-company basis in order to take into account the potential risks and mitigating factors that are unique to each company," the lack of definitions of key concepts and these explanations from Mr. Pinschmidt reveal that the FSOC's nonbank designation process is entirely subjective.[47]

B. The FSOC does not follow its own requirement that company analysis will be done in the "context of a period of overall stress in the financial services industry and in a weak macroeconomic environment."

The FSOC's guidance on non-bank SIFI designations states that:

> Under the First Determination Standard, the Council may subject a nonbank financial company to supervision by the Board of Governors and prudential standards if the Council determines that "material financial distress" at the nonbank financial company could pose a threat to U.S. financial stability. The Council believes that material financial distress exists when a nonbank financial company is in imminent danger of insolvency or defaulting on its financial obligations.
>
> For purposes of considering whether a nonbank financial company could pose a threat to U.S. financial stability under this Determination Standard, the Council intends to assess the impact of the nonbank financial company's material financial distress in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment.[48]

[44] Pinschmidt Deposition at 1:87-88.
[45] *Id.* at 1:89.
[46] *Id.* at 1:90-91.
[47] Financial Stability Oversight Council, Nonbank Designations – FAQs, https://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx (last visited Jan. 18, 2017).
[48] FSOC Rule and Guidance, 12 C.F.R. § 1310 App. A.II.b.

The FSOC's guidance is clear that the evaluation of a nonbank financial company will be done in the "context of a period of overall stress in the financial services industry and in a weak macroeconomic environment." The FSOC has not applied this standard, however, in all of its evaluations. For two companies, the conclusions of the FSOC were reached "in isolation," and not "in the context of a period of overall stress." Essentially, the FSOC made its determinations regarding these companies based on an evaluation of the threat these companies posed to U.S. financial stability in a normal financial and macroeconomic situation, and not "in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment."

The written documentation of the evaluation of both of these companies by the FSOC does not hide the fact that the analysis did not follow the rules and was done "in isolation" and not "in the context of a period of overall stress." In fact, the analysis describes both an "isolation" and "period of overall stress" scenario at some length, but then the document specifies that the conclusions the analysis reaches about the company are "based solely on the probability of a disruption related to a failure of [the company] in isolation."

That the FSOC's conclusions about two companies were reached in an "isolation" scenario is significant because not only were the conclusions regarding the seven other company evaluations not reached in an "isolation" scenario, but in fact those seven other evaluations do not even mention or discuss an "isolation" scenario. The FSOC substantially deviated from its prior practice by even doing an analysis of these two companies in an "isolation" scenario. That deviation alone would raise questions about the consistency and integrity of the FSOC's evaluations, if it were not also the case that the FSOC clearly broke its own rules by not reaching its conclusions for two companies "in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment."

It is worth quoting one of these evaluations at length:

> "If [COMPANY] experiences material financial distress in isolation, its difficulties would be unlikely to pose a threat to U.S. financial stability. However, if [COMPANY] were to experience material financial distress in combination with, or as a result of, a systemic event, then a sale of [SPECIFIC FINANCIAL ASSET] by [COMPANY] or its secured counterparties could amplify stress throughout the financial system.
>
> It is difficult to assess the likelihood that distress at [COMPANY] would be the starting point for a significant financial system

> disruption. It is also difficult to assess the extent to which distress at [COMPANY] would amplify broader stress throughout the financial system, or to predict the new equilibrium state for the [SPECIFIC FINANCIAL ASSET] market, if an amplified event were to occur.[49]

Later in the document, the analysis turns to transmission channels for the company's material financial distress:

> **Transmission Channels:** The characteristics described above suggest that a failure of [COMPANY] in isolation would not pose a threat to U.S. financial stability. … However, while the financial system would appear to be able to adjust to an isolated [COMPANY] failure, it could face a serious threat from developments that cause distress at [COMPANY] and other firms simultaneously.[50]

The evaluation memo for the company then continues with two pages of analysis describing common market developments that could cause distress at the company and other firms simultaneously. The evaluation memo concludes:

> It is difficult to assess the degree of instability in the [SPECIFIC FINANCIAL ASSET] market that is needed to generate a broader, financial system-wide disruption. It is also difficult to assess the likelihood if, or the extent to which, distress at [COMPANY] could become the starting point for an amplified event.
>
> **CONCLUSION**
>
> The Nonbank Designations Committee believes that the foregoing analysis establishes a reasonable basis not to advance [COMPANY] to Stage 3 for further consideration for potential designation. That belief, based solely on the probability of a disruption related to a failure of [COMPANY] in isolation, arises from the following conclusions:[51]

The evaluation memo then presents a summary of the conclusions. For the second company, the evaluation memo contains analysis that is similar to that of the first company quoted above.

These passages from FSOC Stage 2 evaluations establish quite clearly that the FSOC is not conducting all of its evaluations in the "context of a period of

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[49] Financial Stability Oversight Council, Stage 2 of the Determination Process for [COMPANY] under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at 2.
[50] *Id*. at 11-12.
[51] *Id*. at 13.

overall stress in the financial services industry and in a weak macroeconomic environment" as required by the guidance. This indicates a fundamental methodological error in the way that the FSOC conducts evaluations. At a minimum, it establishes that the FSOC treats certain companies differently than other companies. The reason for this disparate treatment is unclear. It could be because the FSOC has no internal procedural controls, even though the FSOC's methodology is clear on the issue, or it could be the case that the FSOC deliberately circumvented its procedures and expected that this deviation would never be discovered.

The Executive Director of the FSOC, Mr. Pinschmidt, was questioned about this discrepancy at his sworn Committee deposition. When asked if the FSOC's evaluation of this company that reached conclusions "in isolation" followed its own rules that required conclusions to be reached "in the context of a period of overall stress," Mr. Pinschmidt said the company's evaluation did not "seem in conflict with the guidance."[52]

Mr. Pinschmidt was then asked if the FSOC followed its own rules when conducting evaluations of nonbank financial companies, which he affirmed:

> Q: Now, we were speaking before about the Council's rule at 12 C.F.R. 1310. It states, "Council intends to assess the impact of the nonbank financial companies' material financial distress in the context of a period of overall distress in the financial services industry in a weak macroeconomic environment."
>
> And you've stated before, correct, that the Council follows its rules when it votes on whether to designate a company?
>
> A: Yes.[53]

Mr. Pinschmidt was also asked if a company could only be designated if it was advanced to Stage 3 of the evaluation process, which he confirmed. This means that when the FSOC votes to not advance a company from Stage 2 to Stage 3, it is formally declining to designate that company:

> Q: But a company can only be designated if it is advanced to stage 3, correct?
>
> A: That's correct.
>
> Q: So if the company's not advanced to stage 3, it is in effect not designating the company, correct?

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[52] Pinschmidt Deposition at 1:103-104.
[53] *Id.* at 1:102.

A: At that time, yes.[54]

Mr. Pinschmidt was then asked how the FSOC could decline to advance this company to Stage 3 when the FSOC's evaluation memo explicitly stated that material financial distress at the company in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment could lead to a "broader financial disruption" – the precise standard articulated in the FSOC's guidance. Even though Mr. Pinschmidt had been asked during the deposition to read aloud this exact passage of the memo, he stated that if the FSOC had determined the company could have caused a broader financial disruption in the context of a period of overall stress the Council would have advanced the company to Stage 3:

Q: It appears to me on page 12 that this memo is saying that if you had a stress in the broader economy and a failure of this company, that it could potentially lead to a broader financial disruption.

A: So I don't – I don't know if they're implying broader financial disruption, because I think it's talking about broader distress occurring and broader disruption in the market rather than the company leading to broader distress. I mean, again, you know, I haven't read this. . . . But I think what I'm saying is, like, had they concluded that this company, its failure could lead to broader distress, that would be an analysis that would be fully fleshed out as part of stage 3, not necessarily as part of stage 2. Stage 2 again is very preliminary, looking at the factors kind of consistent with the six-category framework, understanding if something went wrong, what that could be and how that could potentially play out, but not drilling down in terms of the transmission channels that happen in terms of the stage 3 levels.[55]

Q: So then you're saying for this company that the Council didn't – either didn't need any additional information or didn't believe that any more analysis needed to be done?

A: So, again, I don't want to comment specifically on this case because this was a long time ago, but I think because this company was not advanced to stage 3, I think it's safe to assume that the Council did not see – did not see sufficient cause for concern or – and thought they had enough information to arrive at that decision.[56]

[54] *Id.* at 1:103.
[55] Pinschmidt Deposition at 1:105-106.
[56] *Id.* at 1:107-108.

Mr. Pinschmidt's explanation for why the company was evaluated contrary to the FSOC's rule and guidance is unpersuasive. In fact, his attempted explanation of the glaring inconsistency is simply to deny its existence, against all the evidence.

IV. The FSOC evaluated similar aspects of different companies different ways, and its analysis is inconsistent

A. The FSOC performed a vulnerability analysis for companies that it declined to designate

An important question in the MetLife litigation against the FSOC is whether the FSOC was required under its guidance to conduct an assessment of a company's vulnerability to material financial distress before addressing the potential effect of that distress. The FSOC's evaluation of all nonbank financial companies to date, including MetLife, has been under the First Determination Standard, or whether "material financial distress at a nonbank financial company could pose a threat to the financial stability of the United States."[57] Under the First Determination Standard, whether a company is vulnerable to experiencing material financial distress could be significant for determining if that company could be a threat to the financial stability of the United States. If the company is unlikely to experience material financial distress, then it may be better evaluated under the FSOC's Second Determination Standard, or whether "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States."[58]

One of MetLife's claims in its lawsuit is that the FSOC was required to perform a vulnerability analysis if the company was evaluated under the First Determination Standard. The district court stated that the FSOC's response to MetLife's argument was that the "FSOC declared in the Final Determination—and maintains now—that the Guidance neither 'requires [n]or states that [FSOC] will evaluate the probability or likelihood of material financial distress at a nonbank financial company.'"[59] This carefully worded statement by the FSOC attempts to dismiss MetLife's argument, while at the same time not ruling out the possibility that the FSOC *could* evaluate the probability or likelihood of material financial distress in a SIFI designation. Nor does the FSOC represent to the court that the FSOC *has not* evaluated the probability or likelihood of material financial distress for other companies besides MetLife. In fact, FSOC documents reveal that the

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[57] Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc., July 8, 2013, at 4.
[58] *Id.*
[59] MetLife, Inc. v. Financial Stability Oversight Council, No. 15-0045, slip op. at 22 (D.D.C. Mar. 30, 2016).

FSOC evaluated the vulnerability of some companies to material financial distress – and then declined to designate those companies.

The district court summarized the FSOC's guidance on the issue:

> In its first notice of proposed rulemaking, FSOC reorganized the ten statutory factors into six "categories" of consideration: (1) Interconnectedness; (2) Substitutability; (3) Size; (4) Leverage; (5) Liquidity Risk and Maturity Mismatch; and (6) Existing Regulatory Scrutiny. 1st NPR at 4,560. According to FSOC, the first three categories "seek to assess the potential for spillovers from the firm's distress to the broader financial system or real economy." *Id.* The second three categories "seek to assess how vulnerable a company is to financial distress." *Id.* FSOC reasoned that companies "that are highly leveraged, that have a high degree of liquidity risk or maturity mismatch, and that are under little or no regulatory scrutiny are more vulnerable to financial distress." *Id.*
>
> This characterization of the second three factors remained in the Final Rule. *See* FR at 21,641 ("The remaining three categories . . . seek to assess the vulnerability of a nonbank financial company to financial distress.").[60]

The FSOC argued to the district court that, notwithstanding its plain language, the designation guidance required it to evaluate "whether, and how, the company's vulnerabilities, in a distress situation, could impact the broader financial system—not to assess whether distress could occur."[61] The FSOC also unveiled a new position at oral argument in the case, claiming that if the FSOC did change its position on conducting a vulnerability assessment, the change was justified and explained.[62] The district court found both of these arguments unconvincing; it stated the FSOC changed its policy on assessing vulnerability to material financial distress from the guidance to the Final Determination, while offering no explanation for this change.[63]

The FSOC appealed the district court's ruling to the Court of Appeals for the District of Columbia Circuit (DC Circuit), where the case is currently pending. Before the DC Circuit the FSOC has once again claimed that it is not required to assess a company's vulnerability to material financial distress, arguing that the

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[60] *Id.* at 7-8.
[61] *Id.* at 19 (citing Def. Mot. for Summ. J. at 34).
[62] *Id.* at 20.
[63] *Id.* at 21-24.

"guidance does not suggest, much less require, that the Council will consider the likelihood of a company's failure."[64]

Despite these statements from the FSOC, what is apparent from the Committee staff's evaluation of nonpublic FSOC documents is that the FSOC not only considered the vulnerability to material financial distress for certain companies, but the FSOC relied upon that vulnerability assessment as a reason to decline to designate those companies as SIFIs.

Every Stage 2 memorandum for companies that were evaluated by the FSOC for designation as a SIFI contains a section called "Vulnerability to Financial Distress," with subsections "Leverage," "Liquidity Risk and Maturity Mismatch," and "Existing Regulatory Scrutiny." These subsections match the FSOC's guidance that states it will organize the ten statutory factors under Section 113 of the Dodd-Frank Act into six "categories" of consideration, as those subsections are three of the six "categories."

The Committee staff reviewed the Stage 2 memos for all nine companies the FSOC evaluated, and found across all nine evaluated companies in the "Vulnerability to Financial Distress" sections of these memos that, for the most part, the FSOC merely recites financial facts about the specific company under evaluation. For many companies the FSOC does not say one way or the other whether the specific facts that are listed impact whether the company is vulnerable to material financial distress or not. What Committee staff found, however, was that for a number of companies, the FSOC conducted an analysis of "whether distress could occur" at that company – an analysis that the FSOC represented to the district court that it is not required to perform. The FSOC declined to designate any of the companies whose vulnerability to material financial distress it analyzed.

1. Consideration of Vulnerability in the Analysis of Company 1

For instance, in the Stage 2 memorandum for one company that the FSOC evaluated, the FSOC clearly conducts a vulnerability analysis. In the memo, directly under the heading "Risk of Financial Distress," the FSOC states:

> [COMPANY 1] encountered serious difficulties during the financial crisis of 2007-09, and some features of the company's funding/business model (e.g. significant dependence on [FINANCIAL ACTIVITY]) make it still vulnerable to disruptions in the broader financial markets. However, some of the factors at work during the financial crisis have been already addressed by the government and [COMPANY 1] itself.

[64] Brief for Defendant-Appellant at 13, MetLife, Inc. v. Financial Stability Oversight Council, No. 16-5086 (D.C. Cir. Jun. 16, 2016); *see also id.* at 26-29.

> In addition, [COMPANY 1] appears to be experiencing increasing net interest income, good control of expenses, and steady [FINANCIAL PRODUCT] investor appetite. For these reasons, the Nonbank Designations Committee believes that temporary market disruptions would be unlikely to threaten the imminent solvency of [COMPANY 1].[65]

In a similar vein, in the same section under the subheading "Liquidity Risk," the FSOC states about the same company:

> [COMPANY 1]'s heavy reliance on [FINANCIAL ACTIVITY] for funding makes it vulnerable to disruptions in [FINANCIAL ACTIVITY] markets and to distress in the broader financial markets. However, given its current liquidity position, [COMPANY 1] should be able to manage liquidity needs relatively well should severe strains arise.[66]

The FSOC declined to advance this company to Stage 3, which meant the company was not designated as a SIFI.

2. Consideration of Vulnerability in the Analysis of Company 2

The FSOC considered the vulnerability to material financial distress of a second company that was evaluated in Stage 2. In the Stage 2 memo, under the heading "Vulnerability to Financial Distress," under the subheading "Liquidity Risk and Maturity Mismatch," the FSOC states:

> [COMPANY 2] appears to have sufficient liquidity resources to offset the combination of risks associated with its reliance on [FUNDING SOURCE], capital calls from most credit downgrades, and possible mark-to-market losses on derivatives arising from interest rate shocks or foreign currency fluctuation. They include liquid assets, funds from operations, undrawn bank facilities, and credit support arrangements that make it less likely for liquidity concerns and maturity mismatches to translate into a viable source of systemic risk.[67]

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[65] Financial Stability Oversight Council, Consideration of [COMPANY 1] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at 9.
[66] *Id.* at 10.
[67] Financial Stability Oversight Council, Consideration of [COMPANY 2] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at 10.

Later in the same memo discussing this company, under the heading "Transmission Channels," the FSOC stated:

> The potential for financial distress to spread through the asset liquidation channel also appears to be low, although it is more difficult to assess this channel. … Moreover, given its access to [FUNDING SOURCE], liquidity facilities, and credit support arrangements from [REDACTED], it is not likely that [COMPANY 2] would be forced into an asset liquidation scenario.[68]

The FSOC declined to advance this second company to Stage 3, which meant the company was not designated as a SIFI.

3. Consideration of Vulnerability in the Analysis of Company 3

The FSOC considered the vulnerability to material financial distress of a third company that was evaluated in Stage 2. In the Stage 2 memo, under the heading "Interconnectedness," the FSOC states:

> [COMPANY 3]'s $[REDACTED] billion of debt, of which $[REDACTED] billion matures before the end of [REDACTED], affects both [COMPANY 3]'s vulnerability to financial distress and the impact that such distress might have on the broader U.S. financial system.[69]

Later in the same memo discussing this company, under the heading "Vulnerability to Financial Distress," under the subheading "Leverage," the FSOC states:

> [COMPANY 3]'s leverage ratio of [LESS THAN THE STAGE 1 THRESHOLD OF 15 TO 1] is above the 9 to 1 median leverage ratio for U.S. banks and nonbank financial companies with more than $50 billion in assets, and ranks [REDACTED] among the 77 firms in this group. The companies with higher leverage than [COMPANY 3] tend to be more diversified or have a focus on lower-risk prime residential mortgages, and many of these firms also have more stable funding sources, such as deposits or insurance premiums. [COMPANY 3]'s reliance on [FINANCIAL PRODUCT] combined with its higher-risk

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[68] *Id.* at 13.

[69] Financial Stability Oversight Council, Consideration of [COMPANY 3] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at 5.

> asset base indicates that its leverage could make [COMPANY 3] vulnerable to future economic and market stresses.[70]

Continuing under the heading "Vulnerability to Financial Distress," under the subheading "Liquidity Risk and Maturity Mismatch," the FSOC states:

> Recent improvements in [COMPANY 3]'s credit rating mitigate its liquidity risk and increase its access to the [FINANCIAL PRODUCT] market. … The return of [COMPANY 3] to the [FINANCIAL PRODUCT] market provides the company with an additional source of liquidity to meet the large amount of debt obligations coming due in the next 12 months. This reduces the risk of a liquidity crunch at [COMPANY 3] that could affect its creditors and counterparties.[71]

Under the heading "Transmission Channels," the FSOC states about this third company:

> The potential for financial distress to spread through the asset liquidation channel also appears to be low, although it is more difficult to assess this channel. … Moreover, given its access to [FUNDING SOURCE], liquidity facilities, it is not likely that [COMPANY 3] would be forced into an asset liquidation scenario.[72]

It is notable that the Transmission Channel Analysis for this third company is nearly identical in wording to the Transmission Channel Analysis for the second company, outlined above.

Under the heading "Additional Analysis," subheading "Interplay of Factors," the FSOC states about this third company:

> [COMPANY 3] has limited liquidity risk [IN A STABLE FINANCIAL ENVIRONMENT], but, as is the case for other financial companies, [COMPANY 3] is vulnerable to financial distress during an economic contraction. … However, this factor is tempered by the relationship [COMPANY 3] has with [REDACTED] and its ability to access [FUNDING SOURCE] in a period of limited access to unsecured credit. … [COMPANY 3] demonstrated its ability to manage through a difficult liquidity environment in the financial crisis by de-leveraging its balance sheet and replacing unsecured credit with [FUNDING SOURCE].[73]

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[70] *Id.* at 7.
[71] *Id.*at 10.
[72] *Id.*at 11.
[73] *Id.*at 12.

The FSOC declined to advance this third company to Stage 3, which meant the company was not designated as a SIFI.

4. Consideration of Vulnerability in the Analysis of Company 4

The FSOC considered the vulnerability to material financial distress of a fourth company that was evaluated in Stage 2. In the Stage 2 memo, under the heading "Potential impact of [COMPANY 4]'s financial distress on the broader economy: relevant considerations," subheading "Interconnectedness," the FSOC states:

> The relatively large number of counterparties and their geographic diversity suggests the company has attempted to minimize its exposure to any single counterparty as a way of limiting its funding risk. Given the diversity of its funding sources, the failure of a single counterparty is unlikely to cause material financial distress at [COMPANY 4].[74]

For this fourth company, the FSOC also determined that the company was vulnerable to material financial distress in certain situations, because it "faces significant liquidity risk and a maturity mismatch."[75] The FSOC also stated for this company that "[r]ising leverage would increase the vulnerability of [COMPANY 4] to unexpected liquidity needs, including margin calls."[76] Despite this finding of vulnerability to financial distress in this fourth company, the FSOC determined for other reasons that the failure of the company would not pose a threat to U.S. financial stability.[77]

The FSOC declined to advance this fourth company to Stage 3, which meant the company was not designated as a SIFI.

B. The FSOC treated the use of collateral differently for companies it declined to designate

A second way that the FSOC applied different standards to different companies in its evaluations was its treatment of collateral used to secure a

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[74] Financial Stability Oversight Council, Consideration of [COMPANY 4] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at 6-7.
[75] *Id.*at 2.
[76] *Id.*at 9.
[77] *Id.*at 11.

company's debt obligations. This differential treatment of certain companies by the FSOC is explicit in the context of securities lending and repurchase agreements. For two companies that were designated as SIFIs, the FSOC found that the securities lending and repurchase activities of those companies "could" cause losses to their counterparties, even though the securities lent or repurchased acted as collateral for the transaction. For two companies that were not designated as SIFIs, however, the FSOC found that the repurchase agreement activities of those companies were "unlikely to incur a material loss" for their counterparties in the event of the companies' material financial distress. The FSOC does not explain or justify in any of its documentation why the designated and non-designated companies are treated differently – even though the situations were broadly the same.

Securities lending and sales and repurchase agreements, or repos, are forms of short-term financing. The FSOC describes the process as follows:

> In the typical securities lending or reverse repo transaction, [COMPANY A] lends or reverse repos a security (borrowed securities) from its general account investment portfolio to a broker-dealer counterparty in exchange for cash financing of 100 percent (for reverse repo) or cash collateral (cash collateral) of 102 percent (for securities lending) of the value of the security.[78]

Essentially, in these transactions a company obtains short-term cash financing from a counterparty, and delivers a security to the counterparty in exchange for the cash, plus or minus a certain percentage. The companies typically reinvest the cash they receive in exchange for the lent security. The FSOC states in one company's basis for designation that this reinvestment of the cash is a potential danger:

> These transactions could pose a risk to the counterparties because, if [COMPANY A] were to become insolvent, the counterparties may suffer losses on liquidating their borrowed securities from the difference between the value of the borrowed securities and the cash collateral pledged to [COMPANY A].[79]

The FSOC repeats this assertion in the basis for designation of a second company:

[78] Financial Stability Oversight Council, Notice of Final Determination and Statement of the Basis for the Financial Stability Oversight Council's Final Determination Regarding [COMPANY A] at 66 [hereinafter COMPANY A Final Determination].
[79] *Id.* at 67.

> If [COMPANY B] could not return the cash collateral or some portion thereof, its counterparties may be forced to liquidate the borrowed securities, which could result in losses to the counterparty, although such losses would likely be much less in the case of U.S. government or similarly high-quality securities. Counterparty losses would be the difference between the liquidation value of the borrowed securities and the cash collateral pledged to [COMPANY B].[80]

For both of these designated companies, the FSOC states that the entire value of the securities lending program could lead to counterparty losses:

> [COMPANY A]'s potential insolvency could cause losses to the counterparties to [COMPANY A]'s $[REDACTED] in general account securities lending and reverse repurchase transactions (securities lending).[81]
>
> [COMPANY B]'s material financial distress could cause losses to the counterparties to [COMPANY B]'s approximately $[REDACTED] in securities lending transactions if [COMPANY B] has insufficient liquidity to repay the cash collateral.[82]

The FSOC makes this claim that the entire value of the securities lending programs at both of these companies could lead to counterparty losses even though for both companies over three-quarters of the securities lent were U.S. Treasury securities, or agency securities.[83] In the event of material financial distress at these two companies, the FSOC alleges that the counterparties could suffer losses from liquidating the borrowed securities:

> [S]ecurities lending counterparties would have strong incentives to close out transactions as quickly as possible in order to withdraw collateral if [COMPANY A] were to experience material financial distress. If [COMPANY A] were unable to find sufficient liquidity to repay its counterparties, the counterparties could in turn liquidate the borrowed securities while continuing to pursue claims for any remaining shortfall against [COMPANY A]. These securities being sold could fall in value in a volatile market, exacerbating the magnitude of potential losses suffered by the counterparties.[84]

[80] Financial Stability Oversight Council, Notice of Final Determination and Statement of the Basis for the Financial Stability Oversight Council's Final Determination Regarding [COMPANY B] at 130 [hereinafter COMPANY B Final Determination].
[81] COMPANY A Final Determination at 66.
[82] COMPANY B Final Determination at 126.
[83] COMPANY A Final Determination at 66; COMPANY B Final Determination at 82.
[84] COMPANY A Final Determination at 67.

For two companies that the FSOC did not designate, however, the FSOC treated similar government-backed collateral in a much different fashion. For these companies, the FSOC determined that the pledged collateral for short-term borrowing made it "unlikely" that their counterparties would suffer losses. For example, the following excerpt from a Stage 2 evaluation is the *entirety* of the FSOC's analysis of a third company's interconnectedness to the financial markets through the company's debt outstanding:

> The Council also uses total debt outstanding as a proxy for interconnectedness. [COMPANY C] has total debt outstanding of [REDACTED], of which [REDACTED] are repurchase agreements that are fully collateralized with U.S. Treasury securities or Agency MBS. Repurchase agreements are a source of interconnectedness between [COMPANY C] and other financial institutions. However, we believe repurchase agreements are not a likely channel through which financial distress would be spread to the broader financial system, because [COMPANY C]'s debt is fully collateralized with Agency MBS or U.S. Treasury securities. Thus, if [COMPANY C] defaults, its creditors are unlikely to incur a material loss.[85]

While the amount of debt outstanding and value of repurchase agreements are redacted in this excerpt to protect the identity of this company, for context the value of Company C's repurchase agreements is many multiples higher than the value of the securities lending and repurchase agreements for designated Companies A and B above.

The FSOC treats a fourth company, where the value of that company's repurchase agreements is also multiples higher than the value of the securities lending and repurchase agreements for designated companies A and B above, in the same manner as Company C. The FSOC explains its logic on collateral for non-designated companies more fully in this evaluation:

> The repos that [COMPANY D] uses to finance its assets involve the risk that the market value of the securities pledged or sold by [COMPANY D] to its repo counterparty may decline in value. If there is a decline in the value of collateral, lenders may require [COMPANY D] to post additional collateral or pay down borrowings to re-establish agreed-upon collateral requirements. Margin calls on repos could cause a rapid adverse change in [COMPANY D]'s liquidity position. Thus, [COMPANY D] could be forced to deleverage quickly by selling assets. If [COMPANY D] were otherwise unable to satisfy

[85] Financial Stability Oversight Council, Consideration of [COMPANY C] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act at 7-8.

> its obligations, [COMPANY D]'s repurchase counterparties would have to take [COMPANY D]'s collateral. If the counterparties, in turn, needed to liquidate the collateral quickly, concentrated selling pressure could force Agency MBS prices to drop sharply (though, potentially, only temporarily).[86]
>
> …
>
> It is not clear that [concentrated selling pressure could force Agency MBS prices to drop sharply] while Fannie Mae and Freddie Mac are in conservatorships and the principal and interest payments on Agency MBS are effectively guaranteed by the federal government, which has the effect of eliminating credit risk.[87]
>
> …
>
> [COMPANY D]'s creditors and counterparties have limited exposure to [COMPANY D] itself because its debt and derivative liabilities are collateralized with high-quality, liquid assets.[88]

Unsurprisingly, Companies C and D were not designated. From these explanations it is clear that the FSOC believes that for Companies C and D the use of U.S. Treasury or agency securities as collateral in short-term financing transactions substantially reduces risk. Why the FSOC did not extend this logic to companies that it designated – which used similar collateral as Companies C and D – is unclear.

In fact, for one designated company, collateral is not considered as a risk mitigant at all. In this company's nonpublic final designation document, in the 43-page analysis of the exposure channel there is a final subsection titled "Exposure Mitigating Factors."[89] This subsection is only two paragraphs long and discusses only two mitigating factors for the entire company. After discussing the first mitigating factor, the exposure channel analysis concludes:

> [C]apital markets exposures could be mitigated if the size of the individual exposures relative to counterparties' capital allows these losses to be absorbed without undermining the financial health of its counterparties or confidence more generally in market functioning.

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[86] Financial Stability Oversight Council, Consideration of [COMPANY D] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act at 9.
[87] *Id.* at 10.
[88] *Id.* at 11.
[89] COMPANY A Final Determination at 75.

> Notwithstanding these mitigants, the aggregate exposures are significant enough that material financial distress at [COMPANY A] could aggravate losses to large, leveraged financial firms, which could contribute to a material impairment in the functioning of key financial markets or the provision of financial services by [COMPANY A]'s counterparties.[90]

Notably, the FSOC does not calculate whether the size of each counterparty's individual exposure to Company A allows any potential losses to be absorbed without undermining the counterparty's financial health. The FSOC does not explain why it ignores collateral as a mitigating factor, or why the stated mitigating factors are insufficient to prevent aggravated losses at Company A's counterparties.

One conceivable reason that the FSOC treated the interconnectedness of the designated and non-designated companies differently with respect to their collateralized short-term financing could be the identities of the counterparties. For both designated companies, the FSOC identified their counterparties:

> [A] significant portion of [COMPANY B]'s securities lending counterparties are G-SIBs or top-25 U.S. BHCs whose interconnectedness with the broader financial system could amplify the effect of any losses.[91]

> Though the portfolio is small relative to portfolios of other participants in this market, most of [COMPANY A]'s general account securities lending counterparties are G-SIBs or top- 25 U.S. BHCs.[92]

The FSOC explicitly stated for one company in Stage 2 that the company should be advanced to Stage 3 in order to learn more about the company's securities lending counterparties:

> More information is needed to assess the exposures of [COMPANY B]'s securities lending and derivatives counterparties to the organization and the potential risks that [COMPANY B]'s material financial distress could pose to its counterparties.[93]

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[90] *Id.*
[91] COMPANY B Final Determination at 126-127.
[92] COMPANY A Final Determination at 66.
[93] Financial Stability Oversight Council, Consideration of [COMPANY B] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at 21.

In contrast, the FSOC did not even identify the collateralized short-term lending counterparties for companies C and D before deciding not to designate those companies. For instance, when discussing Company D's repo counterparties, the FSOC stated without any evidence that the "relatively large number of counterparties and their geographic diversity suggests the company has attempted to minimize its exposure to any single counterparty as a way of limiting its funding risk."[94] But the FSOC added as a footnote to that sentence that "Available information does not allow us to assess precisely the degree to which [COMPANY D]'s counterparties represent diversified funding sources. [COMPANY D] believes its current counterparty structure 'limits' its exposure to counterparty credit risk."[95]

Similarly, for Company C, the FSOC states, "[r]epurchase agreements are a source of interconnectedness between [COMPANY C] and other financial institutions."[96] As a footnote to that sentence, the FSOC concedes that it "do[es] not know the number of [COMPANY C]'s counterparties or the amount [COMPANY C] owes its largest creditor."[97] Thus the identity of the counterparties to these four companies evaluated by the FSOC cannot be the reason that their collateralized short-term funding arrangements are treated differently, because the FSOC did not see fit to even identify the counterparties of the companies that it did not designate. Without knowing the identity of those counterparties or how much of Company C and D's repos that the counterparties held, it is unclear how the FSOC would have been able to make any determination of the likelihood that Company C and D's repos could or could not be a threat to U.S. financial stability.

The importance the FSOC places on government-backed collateral for debt obligations in reducing the risks of a threat to financial stability is also reflected in the evaluation of a fifth company. In this evaluation the FSOC staff recommended not designating the company, and the basis for that recommendation was that "[COMPANY E]'s own risks are unlikely to be transmitted to broader financial markets and economic activity given that a large share of its assets have an explicit federal guarantee and it has a relatively small footprint in the overall financial market."[98] The FSOC followed the staff's recommendation and voted not to advance the company to Stage 3, which had the result of not designating the company.

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[94] Financial Stability Oversight Council, Consideration of [COMPANY D] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act at 6-7.
[95] *Id.* at 6-7 fn.18.
[96] Financial Stability Oversight Council, Consideration of [COMPANY C] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act at 7-8.
[97] *Id.* at 7-8 fn.20
[98] Financial Stability Oversight Council, Consideration of [COMPANY E] for Advancement from Stage 2 to Stage 3 of the Determination Process under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at 4-5.

For this fifth company, the FSOC staff's basis for concluding that the company "has a relatively small footprint in the overall financial market" is unclear, as this fifth company was easily large enough across multiple metrics to exceed the FSOC's Stage 1 numerical thresholds. But the FSOC was clear in this company's evaluation that the fact that a majority of debt issued by the company was collateralized by assets "guaranteed by the government, which would likely limit amplification of possible problems at [COMPANY E] to investors and debt issuers" in that market.[99] Of note for this fifth company is that the amount of its collateral guaranteed by the government was not equal to the entirety of its debt, but instead was an amount around 75%.[100] This percentage of government backed collateral is similar to that of the percentage of government backed collateral for Company A and B's securities lending and repurchase agreements. The type of collateralized debt issued by Company E is different from the securities lending and repurchase agreements of Company A and B, but the FSOC does not explain in any of its documentation why it treats government-backed collateral differently for companies that were designated and companies that were not designated.

V. Conclusion

The examples provided in this report demonstrate that the FSOC's evaluations of nonbank financial companies have been characterized by multiple inconsistencies and anomalies on key issues and significant departures from its own rules and guidance. These examples cast doubt on the fairness of the FSOC's designation process, and raise serious questions about its overall effectiveness.

VI. Acknowledgement

The Committee would like to express appreciation to the Congressional Research Service (CRS) for their invaluable assistance in the preparation of materials for, and drafting of, this report. CRS Specialists in Financial Economics Edward V. Murphy and Baird Webel provided countless hours of consultation, research, and review, and prepared a memorandum on issues of replicability in the FSOC nonbank designations process.

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[99] *Id.* at 2.
[100] *Id.* at 3.

VII. Appendices

A. Deposition of: Patrick Pinschmidt, May 11, 2016

ALDERSON REPORTING
HBA132090

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

DEPOSITION OF: PATRICK PINSCHMIDT

Wednesday, May 11, 2016

Washington, D.C.

The deposition in the above matter was held in Room 2219 of the Rayburn House Office Building commencing at 10:17 a.m.

Present: Representatives Fitzpatrick, Mulvaney, Hultgren, Pittenger, Wagner, Schweikert, and Tipton.

Appearances:

For the COMMITTEE ON FINANCIAL SERVICES:
UTTAM DHILLON, CHIEF OVERSIGHT COUNSEL
BRETT A. SISTO, MAJORITY COUNSEL
REBEKAH E. GOSHORN, MAJORITY COUNSEL
JOSEPH A. GAMMELLO, MAJORITY COUNSEL
ELIE S. GREENBAUM, MAJORITY COUNSEL
BRIAN R. ANDERSON, MAJORITY COUNSEL
JOSEPH R. CLARK, GENERAL COUNSEL AND PARLIAMENTARIAN
KELLY E. MCGRATH, MAJORITY STAFF ASSISTANT
MATT FISHLER, MAJORITY STAFF
DEANNE MILLISON, MINORITY LEGISLATIVE DIRECTOR AND COUNSEL
KATELYNN BRADLEY, MINORITY SENIOR COUNSEL
CHARLA OUERTATANI, MINORITY STAFF DIRECTOR
AMANDA FISCHER, MINORITY STAFF
OLA WILLIAMS, MINORITY STAFF
KRISTOFOR ERICKSON, MINORITY STAFF
DINO D. FALASCHETTI, PHD, MBA, CHIEF ECONOMIST

For the WITNESS:
SAMUEL B. DAVIDOFF, ESQ., WILLIAMS & CONNOLLY
MATTHEW DANZER, ESQ., WILLIAMS & CONNOLLY

[redacted]

Q So that impact that you're talking about, does the FSOC measure it?

A The impact -- you know, to the extent it's analyzed, that's part of the basis in terms of each designation.

Q Okay. But does the designation say that there could be an impact or does it measure that impact?

A It -- well, it draws direct links between certain markets, certain financial markets and potential impacts on the economy.

Q Okay. And then, you know, is there a threshold for this measurement where the FSOC determines that the -- this amount of losses would be significant damage for a particular thing happening at a company or that -- you know, what would happen in the failure of a particular company would not be significant damage to the economy? Is that analysis done?

A There's a very -- there's a very significant analysis done. There -- you know, there are no bright-line thresholds in terms of what's bad or what's good. I mean, certainly you look at the exposures, you look at the impact on market functioning, you look at the impact on the economy, and it's a qualitative assessment based on significant qualitative analysis.

Q Okay. So if there's no threshold on what is bad or what is good, then how does the FSOC determine what is bad or good?

A There -- there's clearly a threshold understanding among individual Council members as to what would be -- you know, what would be material and what would not be material. As part of the rule and guidance as you have in front of you, the thresholds that the Council evaluates are part of the -- sort of the -- the -- the narrowing exercises of which companies to prioritize for review. If you have X billion in assets outstanding, X billion in CDS exposure. There are thresholds there.

But in terms of understanding the impact of a company's failure and the impact on the market system and the impact on the economy, the analysis, as outlined in the basis, goes into a lot of detail looking at the specific exposures, the first order exposures, the second order exposures, and talking about how those could translate into financial market functioning issues, as well as broader impacts on the economy. And it's up to each voting member of the Council to decide for him or herself as to what constitutes a significant threshold for material financial distress.

Q Are they provided any guidance on what significant damage is or isn't?

A Certainly there's a lot of discussion about how -- how the company's failure could play out and what the implications are for the transmission channel. So there's a lot of discussion about that, there's a lot of analysis, and that's all outlined in the basis.

Q Okay. Sure. But, I mean, apart from the basis for an individual company, is there guidance generally to the members of the FSOC on what significant damage is or isn't? I mean, I would imagine that these designations need to be sort of fair and uniform across different companies. There's that -- there's some sort of threshold of significant damage and that it's not completely arbitrary.

Mr. Davidoff. Sorry. What's the -- I just lost the --

BY MR. SISTO:

Q So the question is is there -- is there guidance generally on what significant damage is apart from what's discussed in the basis for a designation of an individual company?

A Certainly, I mean, there's the rule that kind of outlines sort of the kind of -- the considerations and, you know, material financial distress, significant disruption in market functioning. And around that, I mean, there's the specific analysis that takes place for each company in understanding what are the factors at play here, what are the potential consequences, and that analysis is presented and shared with Council members.

Q Sure. So then I guess my question is how is that analysis for each individual company, how does the FSOC make sure that the analysis is consistent across companies?

A Well, there's the framework in the rule that, you know, applies a very clear kind of mechanism for evaluating each company. You know, that being said, you know, each company is different. I mean, there are different industries, there are different risk profiles, there are different types of businesses that are involved even within the same industry, and there are different funding profiles.

So to the extent like you have a highly levered company with a lot of securities on their balance sheet, that will have a different consequence to financial market stability, if that company were to fail than if you had a less levered company and that company was providing a critical service and that company went away.

So you have to tailor based on the company, based on the footprint, but there is a sort of core recognition that the rule and the guidance and the statute outlines the certain factors that are -- kind of frame that analysis.

Q Okay. And I had asked you earlier in the guidance here about the -- Council's definition for a threat to financial stability in the United States, which is an impairment to financial intermediation or market functioning. Are there any other definitions or ways that the FSOC understands a threat to the financial stability of the United States?

A I'm not aware of other definitions, which is not to say that there aren't.

[redacted]

[redacted]

Q Now, we were speaking before about the Council's rule at 12 C.F.R. 1310. It states, Council intends to assess the impact of the nonbank financial companies' material financial distress in the context of a period of overall distress in the financial services industry in a weak macroeconomic environment.

And you've stated before, correct, that the Council follows its rules when it votes on whether to designate a company?

A Yes.

Q In this memo, the Nonbank Designations Committee is recommending to the Council not to advance [redacted] to stage 3 of the validation process based on, quote, "The impact of the nonbank financial companies' material financial distress" -- I'm sorry. Start over there.

Is the Nonbank Designations Committee recommending to the Council not to advance [redacted] to stage 3 of the evaluation process based on the impact of the nonbank financial company's material financial distress in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment?

Mr. Davidoff. Are you reading? Are you reading from the document?

Mr. Sisto. I'm sorry, no. I'm reading from the Council's rule.

Mr. Davidoff. You're asking if the document follows the rule?

Mr. Sisto. Yes.

Mr. Davidoff. Okay.

Mr. Pinschmidt. So, yeah, as we talked about previously, I think there's a different level of analysis that happens at the stage 2 level versus the stage 3 level. You know, I'm not seeing anything inconsistent here.

BY MR. SISTO:

Q But a company can only be designated if it is advanced to stage 3, correct?

A That's correct.

Q So if the company's not advanced to stage 3, it is in effect not designating the company, correct?

A At that time, yes.

Q Right. So you're saying you believe that staff basing the recommendation of their belief based solely on the probability of disruption of failure in isolation is in accordance with the rule that says that it should be done in the context of a period of overall stress in the financial services industry?

A That's the designation standard. Here, as I noted before, sort of the stage 2 analysis is basically getting the information in front of the Council and in front of staff trying to understand if there's a there there. Because, you know, a company qualifies for stage 2 based on just quantitative metrics. So there's no analysis that a company is a company being in stage 2. And so the stage 2 analysis is kind of surveying the landscape, understanding the factors. Ultimately if a company is advance today stage 3 and there's a decision regarding something designation, then some of this language really is forcing a decision point.

But I think here I don't see anything really in conflict in terms of kind of what's in the guidance and the analytical team is -- you know, they -- again, I haven't read this memo in years, but, you know, unhighlighted portions of this memo seem to cite to different factors and different considerations and I don't want to speculate as to what their primary conclusion was based on -- based on this. But I think it doesn't seem in conflict with the guidance.

Q Okay. But, you know, on page 12 you read a section that says certain scenarios could expose vulnerabilities of [redacted] that could magnify negative effects on the [redacted], and in turn, potentially lead to broader financial disruption.

You said that the memo found that there's no there there. Do you sort of agree that there's -- there's no possibility of significant damage to the economy when this memo says that it potentially could lead to broader financial disruption?

A I think, you know, again, I'm sort of doing this on the fly here. I haven't read the memo, but, you know, the paragraph above acknowledges that obviously sort of -- some of the -- you know, if something bad were to happen to this particular company, that would probably be factors that would impact all other companies in the same industry.

So I think there's a recognition that, you know, this would be symptomatic of broader issues in the marketplace impacting [redacted]. Again, I haven't read this in a while, so I -- this is -- doesn't strike me as being in conflict.

Q But wouldn't broader issues in the [redacted] fit the definition of what's in the rule that you need a -- I'm sorry, definition is -- yeah, a context of a period of overall stress?

A Yeah, but is the question then -- so if you have the broader issues in [redacted] --

Q Right. And then this company experiences material financial distress, it appears to me on page 12 that this memo is saying that if you had a stress in the broader economy and a failure of this company, that it could potentially lead to a broader financial disruption.

A So I don't -- I don't know if they're implying broader financial disruption, because I think it's talking about broader distress occurring and broader disruption in the market rather than the company leading to broader distress. I mean, again, you know, I haven't read this.

Q Sure. Sure.

A But I think what I'm saying is, like, had they included that this company, its failure could lead to broader distress, that would be an analysis that would be fully fleshed out as part of stage 3, not necessarily as part of stage 2. Stage 2 again is very preliminary, looking at the factors kind of consistent with the six-category framework, understanding if something went wrong, what that could be and how that could potentially play out, but not drilling down in terms of the transmission channels that happen in terms of the stage 3 levels.

Q Sure. Perhaps you haven't drilled down at the stage 3 level, but is the Council advancing any companies to stage 3 that it thinks are not likely to cause damage to the broader economy?

A I -- so I -- I mean, I think there's a recognition that, based on the analysis that is done in stage 2, that there are either outstanding questions that deserve to be answered -- because previously for this company and for other companies that were considered in stage 2 that were advance today stage 3, there was no engagement with the company in stage 2. So you could not [redacted] and ask them questions in stage 2.

So a lot of what happens at stage 2 is aggregating the publicly available information, aggregating what's available through the regulatory channels, painting a picture as to kind of, well, this is the profile, these are the things that sort of, you know, raise questions or concerns and are worthy of additional analysis. Or even if they are worthy of additional analysis, we're not that worried about it and therefore we don't need to advance them to stage 3.

So that's kind of an assessment that happened at stage 2. Just kind of understanding of the company, understanding how -- you know, what's the Council's potentially worried about and, you know, recognizing that if there's more work that needs to be done, if there's questions that need to be answered that have a material impact on sort of the analysis that was done on stage 2, then it makes sense to advance to stage 3.

Q So then you're saying for this company that the

Council didn't -- either didn't need any additional information or didn't believe that any more analysis needed to be done?

A So, again, I don't want to comment specifically on this case because this was a long time ago, but I think because this company was not advanced to stage 3, I think it's safe to assume that the Council did not see -- did not see sufficient cause for concern or -- and thought they had enough information to arrive at that decision.

[redacted]

B. Deposition of: Patrick Pinschmidt, May 18, 2016

COMMITTEE ON FINANCIAL SERVICES,

U.S. HOUSE OF REPRESENTATIVES,

WASHINGTON, D.C.

DEPOSITION OF: PATRICK PINSCHMIDT

Wednesday, May 18, 2016

Washington, D.C.

The deposition in the above matter was held in Room 2220, Rayburn House Office Building, commencing at 10:17 a.m.

Present: Representatives King, Fitzpatrick, Huizenga, Duffy, Ross, Schweikert, and Hill.

Appearances:

For the COMMITTEE ON FINANCIAL SERVICES:

UTTAM DHILLON, CHIEF OVERSIGHT COUNSEL

BRETT A. SISTO, MAJORITY COUNSEL

REBEKAH E. GOSHORN, MAJORITY COUNSEL

KELLY E. MCGRATH, MAJORITY STAFF ASSISTANT

DEANNE MILLISON, MINORITY LEGISLATIVE DIRECTOR AND COUNSEL

LISA PETO, MINORITY DIRECTOR OF LEGISLATIVE OPERATIONS

OLA WILLIAMS, MINORITY STAFF

For the WITNESS:

SAMUEL B. DAVIDOFF, ESQ., WILLIAMS & CONNOLLY

MATTHEW DANZER, ESQ., WILLIAMS & CONNOLLY

[redacted]

Q Okay. I believe you said before that the decision to form an analytical team for a company at stage 2 was done by a vote of the Deputies Committee. Is that correct?

A So based on the new supplemental procedures in February of 2015, you know, the Deputies Committee forms an analytical team to do a review. Based on the -- you know, prior to that, there wasn't a vote by the Deputies Committee on forming an analytical team.

Q Okay. So now there is a formal vote?

A Yes.

Q Okay. Are there minutes of the Deputies Committee meetings?

A There aren't.

Q Are there minutes kept internally at FSOC?

A I'm not aware of any, no.

Q Okay. Why is that?

A You know, I mean, I think there's a clear agenda. There are topics to be discussed. And, you know, there are 30 people in the room, so I think there's a clear recognition of what was discussed. And, you know, often it's multiple meetings on the same topics.

Q Okay. So there are agendas for these meetings?

A Yes.

Q Okay. Are those made public?

A They aren't.

Q Are there any other records of these meetings besides the agendas?

A I mean, if there were materials presented, documents discussed.

Q Okay. Are there records of the meetings of any of the other committees of the FSOC?

A There's a -- I'm not aware of any formal records in terms of something that's distributed but --

[redacted]

[redacted]

Q Who are the members of the Nonbank Financial Companies Designations Committee?

A That's a staff agency, interagency staff agency that reports into the Deputies Committee, and, you know, generally speaking, you know, staff members from the various agencies --

Q Who choose --

A -- who have expertise and -- relevant in the nonbank designations process.

Q How many people on that committee?

A I'm -- I don't know the precise number. It's probably about 40.

Q Is the number fixed? Assuming it's 40, which I'm not holding you to, if somebody leaves, are they immediately replaced or can the number of people on this committee vary?

A So, unlike the Deputies Committee, which is, you know, generally fixed in terms of its membership, you know, the practice has been with these staff-level committees, you know, some agencies bring more to the table than other agencies in terms of level of expertise in particular areas that are under focus. And, you know, I think if there are, you know, for example, five members from one agency, you know, that would not be uncommon for the Nonbank Designations Committee. So there isn't a fixed allotment.

Q Okay. And who determines who is on this committee?

A Generally the deputies -- the agencies -- the deputies from each of the agencies are the ones who serve as kind of the point person for individual member agencies, all of them at the staff-level committees. I don't know -- you know, I can't speak to how those decisions are made within individual agencies, but that's generally been the practice.

Q So how -- how is it determined how many persons from each agency gets to be on the designations committee?

A Well, there's deference to the individual member agencies to the extent that, you know, they -- they have a strong interest and they have an expertise to contribute. You know, the practice has been to allow people to participate.

Q Okay. Is every member of the Council represented on the committee?

A I would -- you know, I would believe so, yes. I can't say precisely, though.

Q Okay. Is there a roster kept of the people on this committee?

A I don't believe there's an official roster. I mean, there is an email distribution list.

Q So then how --

A There is -- actually, there's a -- I mean, I think it's base -- you know, that email distribution list is informed by kind of, you know, these are the representatives of each of the agencies. So, you know, we periodically ask the deputies as to, you know, who are the representatives.

[redacted]