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Submitted via electronic mail

Re: Financial Stability Board Consultative Document (2nd) Regarding Assessment Methodologies for Identifying Non-Bank Non-Insurer Globally Systemically Important Financial Institutions (NBNI G-SIFIs)

The undersigned group of captive finance¹ companies² is pleased to provide comments to the Financial Stability Board (“FSB”) and the International Organization of Securities Commissions (“IOSCO”) regarding the Consultative Document 2nd (“Second Consultative Document” or “Document”) entitled, “Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, Proposed High-Level Framework and Specific Methodologies.”³

This letter expands upon, and incorporates by reference, the information provided in our April, 2014 comment letter (“Initial Comment Letter”)⁴ to FSB’s and IOSCO’s January 2014, Consultative Document (“Initial Consultative Document”)⁵ on this issue.

¹ A “captive finance” company refers to an entity whose primary mission is to provide financial products that promote and facilitate the sale or lease of products manufactured by its parent companies. In almost all respects the funding, hedging and other activities of a captive finance company are analogous to the treasury division or department of a manufacturing company that is a non-financial, commercial end-user.

² American Honda Finance Corporation, Caterpillar Financial Services Corporation, Ford Motor Credit Company, LLC, GM Financial, and Volvo Financial Services Region the Americas.

³ Financial Stability Board. “Consultative Document (2nd) Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, Proposed High-Level Framework and Specific Methodologies” (March 4, 2015). *See*, <http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf>.

⁴ *See*, http://www.financialstabilityboard.org/wp-content/uploads/r_140423m.pdf.

⁵ Financial Stability Board. “Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, Proposed High-Level Framework and Specific Methodologies” (January 8, 2014). *See*: http://www.financialstabilityboard.org/wp-content/uploads/r_140423m.pdf.

The Initial Comment Letter describes, in detail, the simple and low-risk nature of captive finance companies and, we believe, presents a compelling case for why captives would not be considered non-bank non-insurer global systemically important financial institutions (“NBNI G-SIFIs”).

While we support FSB’s and IOSCO’s efforts to reduce systemic risk in the worldwide financial system, we are troubled by inconsistencies between the Document and policies developed by other regulatory bodies, including the framework created by BCBS and IOSCO for margin requirements on uncleared swaps. The Document is inconsistent with these swap margin policies and other rulemakings from legislative and regulatory bodies which expressly acknowledge that captive finance companies do not pose systemic risk.

The crucial differences between captive finance companies and traditional financial entities deserve further attention. We reiterate our belief that, for the reasons described in the Initial Comment Letter, captive finance companies do not have the same risk profile as financial entities and should therefore not be considered NBNI G-SIFIs.

We are also concerned that the Document does not give entities being considered for NBNI G-SIFI designation sufficient opportunity to participate in the assessment process, particularly in light of recent changes made by other similar regulatory bodies. We strongly feel that transparency and due process should exist within any such process. Finally, we once again stress the importance of having the assessment be more risk-based as opposed to size-based.

I. The Second Consultative Document is Inconsistent with Rulemakings by Other Regulatory Bodies

The Second Consultative Document is at odds with rulemakings by other regulatory bodies, which have consistently recognized that, due to their unique and low-risk nature, captive finance companies should not be considered financial entities.

Particularly noteworthy are the inconsistencies between the Document and the approach adopted by BCBS and IOSCO in determining whether non-financial end-users of derivatives should be required to post margin on non-centrally cleared swaps. In July 2012, BCBS and IOSCO published their Second Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives.”⁶ (“Margin Consultative Document”). This document noted:

“There was broad consensus within the BCBS and IOSCO that the margin requirements need not apply to non-centrally-cleared derivatives to which non-financial entities that are not systemically-important are a party, given that (i) such transactions are viewed as *posing little or no systemic risk* and

⁶ Bank for International Settlements. “Margin Requirements for Non-Centrally Cleared Derivatives” (February 2013), ISBN web: 92-9197-267-3. See, <http://www.bis.org/publ/bcbs242.pdf>.

(ii) such transactions are *exempt from central clearing mandates under most national regimes.*⁷

BCBS and IOSCO determined that it should be up to the appropriate national regulators to make the determination as to whether an entity is “financial” or “non-financial.” Specifically, the Margin Consultative Document stated:

“The precise definition of financial firms, non-financial firms and systemically important non-financial firms *will be determined by appropriate national regulation.* Only non-centrally cleared derivative transactions between two covered entities are governed by the requirements of this paper (emphasis added).”⁸

Many of the undersigned companies provided written comments⁹ to BCBS and IOSCO on the Margin Consultative Document. These comments supported the position adopted by BCBS and IOSCO, noting that “U.S. Congress and federal regulators have repeatedly recognized that captive finance companies are not financial entities for the purposes of clearing and do not pose systemic risk to world financial markets.” The comments described in detail actions taken by the U.S. Congress to exclude captive finance companies from (i) the definition of a “financial entity” for purposes of the mandatory clearing requirement; and (ii) the definition of a “major swap participant” with respect to their swap hedging activities, in both instances due the recognition that captive finance companies do not pose systemic risk.¹⁰

In its September 2013, Final Policy Framework (“Final Margin Framework”), BCBS and IOSCO confirmed the principle that national regulators were best-equipped to distinguish between “financial” and “non-financial entities” – a decision ensuring that in the United States and other jurisdictions captive finance companies should not be treated as financial entities for purposes of margin.

Since that time, regulators have reaffirmed that captive finance companies should not be treated as financial entities for regulatory purposes. For example:

- In 2011, the United States banking regulators¹¹ initially proposed rules on margin and capital requirements for covered swap entities that would have required banks to collect both initial and variation margin from its swap counterparties, including

⁷ Id., page 9.

⁸ Id., page 9.

⁹ See, <http://www.bis.org/publ/bcbs242/captivefinanceec.pdf>.

¹⁰ See, 7 U.S.C. 2(h)(7)(C)(iii) and 7 U.S.C. 1a(33)(D), respectively. In a joint rulemaking interpreting these exclusions, the U.S. Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) determined to interpret the statutory language “in a broad sense,” consistent with the intention of Congress. See, SEC and CFTC Final “Further Definitions” Rule,” 77 *Federal Register* 30596 at 30693 (May 23, 2012).

¹¹ The banking regulators consist of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the “Agencies” or “Prudential Regulators”).

end users, in nearly all circumstances.¹² Late last year, the regulators issued a re-proposal¹³ with significant changes designed to harmonize the rules with the BCBS/IOSCO Final Margin Framework. Under the re-proposal, captives are not considered “financial end users,” and banks are therefore required to collect margin from captives only “at such times and in such forms and such amounts (if any) that the [bank] determines [is] appropriate. . . .”¹⁴; and

- Earlier this year, Canadian regulators recognized captive finance companies as non-financial entities by excluding companies “that lend to customers to finance the purchase of its non-financial goods or services” in their proposed clearing mandate.¹⁵

While many other regulators are moving towards recognizing the low risk nature of captives, FSB and IOSCO continue to treat captives as financial entities for potential NBNI G-SIFI designation.

II. The Document Fails to Address Key Points Raised In The Initial Letter

The Initial Comment Letter (i) describes the simplicity and low-risk nature of captive finance companies relative to other financial entities; (ii) explains why this should exclude captive finance companies from NBNI G-SIFI designation; (iii) points out that the NBNI G-SIFI designation process does not give entities sufficient opportunity to participate in the assessment process; and (iv) urges FSB/IOSCO to adopt a risk-based as opposed to size-based approach to the NBNI G-SIFI assessment process, taking into account assets that may already be part of the regulated banking sector.

We strongly urge further consideration of the points raised in the Initial Comment Letter regarding the many unique characteristics of captive finance companies. The Second Consultative Document discusses only a single aspect of captives – the fact that captives enjoy the explicit and implicit financial support of their parent company. However, rather than acknowledge this support as a positive attribute, the Document unduly discounts this differentiating characteristic of captives by stating that, during severe economic conditions, “financial difficulties may . . . transmit stress to the industrial parent and its liability holders, and the likelihood of parent support may deteriorate.”¹⁶

In fact, a captive exists solely or primarily to support the sales of the industrial parent. Its financial operations are countercyclical to the parent. Thus, a captive’s liabilities shrink in

¹² A sixth agency, the Commodity Futures Trading Commission, initially proposed rules that would not have required captives and other end-users to post margin in connection with uncleared swaps.

¹³ “Margin and Capital Requirements for Covered Swap Entities,” 79 Fed. Reg. 57348 (Sept. 24, 2014).

¹⁴ *Id.*, at 57358. The re-proposal further notes “it is expected that nonfinancial end users would not be required to post margin to [banks] unless the [bank] is unwilling to take uncollateralized credit exposure to that counterparty, consistent with existing market practices.”

¹⁵ Canadian Securities Administrators, *Proposed National Instrument 94-101 Mandatory Central Counterparty Clearing of Derivatives*, 38 OSCB 1413, https://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20150212_92-101_roc-derivatives.htm

¹⁶ Second Consultative Document, p. 17.

response to a decrease in the parent's production or an economic downturn. This, in turn, results in less reliance on the parent for support and reduces the already low risk of systemic contagion from captive to parent.

We want to once again bring to your attention the many ways, all of which contribute to a low risk profile, in which captives differ from finance companies - a distinction recognized by many national regulators. Captive finance companies, among other things:

- Have a relatively simple business model and corporate structure;
- Have relatively low credit exposures compared with financial entities;
- Transact derivatives that are risk-mitigating hedges of underlying business risk, and are not speculative in nature;
- Have diversified funding sources and use simple funding strategies, often based on the underlying assets;
- Have a positive maturity profile in which short duration assets mature before liabilities are due;
- Have no concentrated exposures to other financial institutions or market participants; and
- Compete in a highly competitive market in which there are low barriers to entry and many easily-accessible substitutes.

Again, the Initial Comment Letter describes in detail the many differences between captives and financial entities, and we encourage FSB/IOSCO to consider the information contained therein prior to finalizing its NBNI G-SIFI assessment methodology.

III. The Process for NBNI G-SIFI Designation Does Not Give Entities Sufficient Opportunity to Participate in the Assessment Process

As noted in the Initial Comment Letter, the process for NBNI G-SIFI designation is ambiguous and does not give entities being considered for assessment sufficient (i) notice that they are under consideration, or (ii) opportunity to participate in the assessment process. The Second Consultative Document does reference the possibility of "interviews"¹⁷ between regulators and the entity, but no mention is made of allowing the entity to have any real participation in the process.

This is at odds with similar proceedings in other jurisdictions, where the trend is towards greater transparency and more active participation. Earlier this year, the U.S. Financial Stability Oversight Council ("FSOC") altered its procedures ("FSOC Supplemental Procedures") for designating entities as systemically important in order to increase transparency and allow greater input by the potentially designated entity. The FSOC Supplemental Procedures include:

¹⁷ Second Consultative Document, p. 14.

- Moving up the time an entity is first notified of its potential designation, so entities now receive notice soon after an analytical review by FSOC has commenced;
- Requiring FSOC to explain the evaluation process to an entity being considered for designation, as well as inform the entity of specific areas FSOC is focusing on in its review;
- Confirming that an entity may, upon written request, meet with the FSOC team analyzing it and present to FSOC any information that it deems relevant;
- Confirming that upon request, FSOC will provide the entity with the primary public sources of information FSOC is using in its analysis, to ensure the entity understands the information that FSOC is relying upon; and
- Notifying an entity when it is no longer being actively considered for FSOC designation

These changes were made in recognition of the fact that the initial designation process was inadequate in several key respects. At a minimum, FSB and IOSCO should incorporate procedural changes similar to those described in the FSOC Supplemental Procedures in order to provide a more transparent, robust designation process for entities being considered for NBNI G-SIFI assessment.

IV. The Indicators for Assessing the Systemic Importance of Finance Companies Should be Modified to be More Risk-Based

In the Initial Comment Letter,¹⁸ we explained why and how the indicators for assessing the systemic importance of finance companies should be modified to become more risk-based. We suggested that, among other things:

- The proposed materiality threshold should be increased;
- In assessing size, FSB/IOSCO should consider the characteristics of assets and liabilities;
- In assessing interconnectedness, FSB/IOSCO should consider risk-mitigating factors;
- In assessing substitutability, FSB/IOSCO should consider the full, robust, competitive markets in which captive finance companies operate;
- In assessing complexity, FSB/IOSCO should calibrate the assessment methodology to compare finance companies with G-SIFIs; and
- The assessment methodology should focus on the potential for activities and risks to spread across jurisdictions

Because only “financial entities” are subject to NBNI G-SIFI assessment, we urge FSB and IOSCO to only consider assets that are financial in nature in the assessment process. It is unfair and inconsistent to include activities, operations and/or assets that are independent of the financial markets or financial functions of the company in this determination. Additionally, it is unclear how the assessment will view assets that are already subject to

¹⁸ Initial Comment Letter, pp. 4-7.

prudential supervision outside the home jurisdiction and if these assets would be regulated by a banking regulator in foreign jurisdictions as well as the “home regulator.” Finally, financial companies should not be evaluated based on “total consolidated balance sheet assets,” but rather on the total consolidated balance sheet assets that are financial in nature.

V. Conclusion

Captive finance companies are a small, narrowly defined group of companies that provide vital financing to support the sales and leasing activities of their parent and affiliated manufacturers. We urge FSB/IOSCO to bring its regulatory framework in line with those adopted by other regulatory bodies and exempt captive companies from designation as NBNI G-SIFIs. In addition, more transparency and engagement by the entity being considered for assessment is required. Finally, we reiterate our request that the assessment methodology should adopt a risk-based rather than size-based approach.

We thank you again for the opportunity to provide you with comments.

Sincerely,

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