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Submitted via electronic mail

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

The undersigned group of captive finance[1] companies[2] is pleased to provide comments to the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO") regarding the Consultative Document ("Consultative Document") entitled, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, Proposed High-Level Framework and Specific Methodologies."[3]

We applaud the FSB's efforts to reduce systemic risk in the worldwide financial system by identifying those non-bank non-insurer entities that are so large, complex and/or interconnected that their distress or failure could disrupt worldwide economic and financial stability. No one wants a repeat of the financial crisis. We further support the creation of a formal, objective methodology for identifying and designating such entities as non-bank non-insurer global systemically important financial institutions ("NBNI G-SIFIs").

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[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] Ford Motor Credit Company LLC, American Honda Finance Corporation, Hyundai Capital America, and Toyota Motor Credit Corporation.
[3]. 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/publications/r_140108.pdf

However, because captive finance companies have unique characteristics that differentiate them from other finance companies, for the reasons described in more detail below, we believe that captive finance companies should be expressly excluded from NBNI G-SIFI designation. If, however, captive finance companies are not excluded, the assessment methodology for captive finance companies should be modified in the manner discussed below. At the very least, the assessment methodology should be revised to use a risk-based approach (and de-emphasize size as a standalone criteria) that would more appropriately identify those entities that truly present systemic risks.

This letter is organized to: (1) discuss the business of captive finance companies and the relatively low-risk nature of this business model, (2) describe why captive finance companies should be excluded from the assessment process, (3) recommend changes to the proposed assessment (a) process to provide formal opportunities for participation by NBNI entities and (b) methodology to incorporate a risk-based approach.

I. <u>The Simplicity and Low-Risk Nature of Captive Finance Companies</u>

Captive finance companies are a specific type of finance company whose purpose is to provide financings that promote and facilitate the sale or lease of products manufactured by their parent and/or affiliate companies. A captive finance company plays an important role in supporting the manufacturing, distribution and sales activities of its parent and/or affiliates. Although there are many examples of captive finance companies, the most well-known are those captive finance companies associated with motor vehicle and equipment manufacturers.

Captive finance companies are not complex financial institutions, a fact which is apparent when captive finance companies are considered alongside global systemically important banks and insurers. Typically, a captive finance company is structured as a direct or indirect subsidiary of a parent manufacturing company, and some captive finance companies may themselves have multiple subsidiaries (e.g., separate legal entities that operate in different jurisdictions). Although other financial institutions may provide similar products, captive finance companies, by definition, maintain a narrower business focus than other financial institutions, who are engaged in a wide range of consumer and commercial credit markets.

Because of their unique role as support institutions to their group companies, captive finance companies and their affiliates differ significantly in their risk profile from other types of financial institutions. For example, captive finance companies have relatively low credit exposures, as most of their assets are secured by the products manufactured by their related companies. To the extent that captive finance companies engage in derivatives transactions, such transactions are risk-mitigating hedging and not speculative in nature. Further, many captive finance companies have credit support arrangements with their parent, reducing the possibility of a captive finance company's failure and mitigating the impact of a captive finance company's financial distress. Depending on the nature of parental support, captives also maintain relatively low leverage compared to other G-SIFIs.

Although captive finance companies, collectively, are an important source of credit for businesses and consumers, the credit markets in which captive finance companies operate are populated by numerous types of financial institutions that are in competition to provide similar, if not identical, short duration credit products.

II. Captive Finance Companies Do Not Have the Characteristics of Systemically Important Institutions and Should be Excluded from the Assessment Process

The relative simplicity and low-risk nature of captive finance companies, as discussed above, show that captive finance companies do not present systemic risks based on the three transmission channels identified in the Consultative Document. Consequently, the FSB's framework should be revised to be more risk-based and to exclude captive finance companies from the NBNI G-SIFI assessment process.

Section 1 of the Consultative Document identifies three channels whereby financial distress of a NBNI financial entity is most likely to be transmitted to other financial institutions and markets, and thereby pose a threat to global financial stability. None of these three channels applies to captive finance companies.

Counterparty Channel Risk

Captive finance companies do not have concentrated exposures to other financial institutions or any particular group of market participants, and therefore, the failure of a captive finance company does not present a risk of causing a "cascading" effect in the broader financial system.

Captive finance companies' connections to other financial institutions occur primarily through funding and hedging activities, and these activities are necessarily diversified. For example, banks that provide loans to captive finance companies are subject to lending limits that restrict exposures to any single party. The derivatives activities undertaken by captive finance companies as a part of their finance business also present minimal counterparty risk, as these activities are undertaken to hedge commercial risks, usually interest rate and foreign currency exposures, and not for speculative purposes. In addition, some derivatives entered into by captive finance companies are collateralized, which further reduces counterparty exposure.

Asset Liquidation Channel Risk

A fire sale of assets by a captive finance company would be unlikely to cause a negative price impact or disrupt funding in key markets. As discussed above, the assets of a captive finance company are almost exclusively short duration loans and leases secured by group company products, and each such asset therefore has a relatively stable value supported by the underlying payment streams and collateral. Due to their relatively simple business purpose and capital structure, coupled with short duration assets, captives could be liquidated very efficiently.

Substitutability Channel Risk

Captive finance companies often operate in a highly competitive market (for example, the consumer auto finance market) with low barriers to entry. Most captive finance companies compete with a wide range of bank and nonbank lenders, and as a result, the market share held by a failed finance company in most cases could be quickly distributed among other lenders in the marketplace. These lenders already have or could quickly acquire the knowledge and skills necessary to step in and replace the services offered by a failed captive finance company, as they are active in the lending markets today.

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

We believe that the NBNI G-SIFI designation process should be revised to be more risk-based. An effective risk-based approach would focus on the relative complexity and opacity of an entity's business. As the financial crisis demonstrated, it is more difficult for regulators and market participants to effectively manage risks presented by complex and non-transparent companies. For the reasons discussed above, captive finance companies are relatively simple and transparent and should thus be excluded from the assessment process. Nevertheless, if such companies were to be subject to the assessment methodology, NBNI entities should be provided formal opportunities to participate in the process. Such participation would facilitate a better understanding of both the G-SIFI determination process by NBNI entities as well as NBNI business models by the relevant national authorities. NBNI entities would have the opportunity to share data regarding their business model, risks and risk management practices, and as a result, national authorities would be able to make more informed judgments regarding the actual risks that any particular entity presents to the financial system.

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

The Proposed Materiality Threshold Should Be Increased

The Consultative Document states that for finance companies, the threshold for inclusion in the assessment pool for potential NBNI G-SIFI designation is USD 100 billion in balance sheet total assets. While we appreciate FSB's attempt to articulate a specific quantitative threshold, we are concerned that this threshold is arbitrary and too low.

The materiality threshold should be revised to ensure that captured NBNI entities are roughly comparable to current G-SIFIs. To this end, we believe that a materiality threshold of EUR 200 billion is generally appropriate. This would align the materiality threshold for NBNI entities with the reporting thresholds required by the assessment methodology used by the FSB to identify global systemically important banks.

In addition, different thresholds should be used for different categories of NBNI institutions. In the case of captive finance companies, we believe that EUR 200 billion is too

low because, relative to other finance companies and NBNI institutions, captive finance companies present far fewer systemic risks for the reasons discussed above. Rather, we recommend a materiality threshold for captive finance companies higher than EUR 200 billion, given the smaller risk profile of these institutions.

By the inherent nature of their business models, captive finance companies maintain a narrow scope of business, primarily supporting the sale of products from the manufacturing parent and/or affiliate companies. As such, captives are inherently conservative and run a low-risk business model in order to provide support through economic cycles to their group companies. As a result, the size of the balance sheet is generally not dependent on changes in risk appetite, but rather based on growth or decline in sales in the underlying industry and/or group companies. Moreover, the balance sheets of captive finance companies will naturally contract during times of economic stress as sales in the underlying industry contract, generating additional liquidity to mitigate disruption.

Regardless of the final materiality threshold, the threshold should take into account the specific risk-characteristics of the NBNI institutions' assets by weighting them accordingly. For example, unsecured assets should not be weighted equally to fully secured assets in the calculation of the materiality threshold.

In Assessing Size, the Characteristics of Assets and Liabilities Should Be Considered

As discussed above, we believe that the risk characteristics of assets and liabilities should be considered and weighted appropriately. For example, assets that are secured by collateral that maintains a steady and readily ascertainable value present a significantly lower risk profile than unsecured assets. This lower risk profile should be reflected in the assessment methodology's consideration of size.

Further, given that only "financial entities" are subject to NBNI G-SIFI designation, we believe that only those assets determined to be related to a company's activities that are financial in nature should be considered for assessing the systemic importance of the entity. It is inconsistent to include activities, operations and assets of nonbank financial companies that are independent of the financial markets or financial functions of the company. 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.

Finally, size should be given a relatively low weight in the overall assessment methodology, as it is a poor stand-alone indicator of systemic risk when compared to other factors, such as interconnectedness and complexity.

In Assessing Interconnectedness, FSB Should Consider Risk-Mitigating Factors

An analysis of interconnectedness should focus on the greatest potential threats to financial stability. For example, in calculating the intra-financial system assets and

liabilities of an NBNI entity, the assessment methodology includes net mark-to-market OTC derivatives with financial institutions.[4] This is overly broad and fails to distinguish between OTC derivatives that are entered into for speculative purposes – which can increase systemic risk – and OTC derivatives that are entered into to hedge against legitimate business risk.[5] We strongly believe that the net mark-to-market OTC derivatives calculation should be exclusive of derivatives used to hedge underlying commercial risk of a parent and non-captive affiliated companies. Along similar lines, the assessment methodology should recognize the risk-mitigating benefits of collateralized derivatives.

In Assessing Substitutability, the FSB Should Appropriately Consider the Full Competitive Markets in Which Captive Finance Companies Operate

In our discussion of the lack of systemic risk posed by captive finance companies, we noted that captive finance companies operate in highly competitive markets and are easily substitutable. In assessing the substitutability of a captive finance company, the assessment methodology should accurately describe and consider the full range of the captive finance company's competitors. Additionally, the methodology should account for the low barrier to entry into the markets in which captive finance companies operate.

In Assessing Complexity, the Assessment Methodology Should Be Calibrated to Compare Finance Companies with G-SIFIs

The proposed indicators of complexity should be calibrated to ensure that any analysis of the complexity of finance companies is conducted relative to other financial institutions that have already been designated as G-SIFIs.

In addition, as noted above, the assessment methodology should take into account, when considering an NBNI institution's notional amount of OTC derivatives transactions, that derivatives transactions entered into for legitimate hedging purposes pose far less risk than speculative transactions. Finally, due to their relatively simple business purpose and capital structure and short duration assets, captives could be dissolved very efficiently as compared with other G-SIFIs.

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[4] Id., p. 17.

[5] In the United States, captive finance companies that use interest rate or currency swaps to hedge underlying commercial risk do not need to centrally clear their swaps, even though nearly all of these transactions are with financial counterparties (swap dealers or derivatives dealers). In order to qualify for this exemption from the mandatory clearing requirement, captive finance companies have to meet the stringent "90/90 test." The "90/90 test" defines a captive finance company, for the purposes of the mandatory clearing exemption, as "an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company." We believe that OTC derivatives that qualify for such an exemption from the central clearing requirement should not be included in the calculation of an NBNI's interconnectedness under the assessment methodology.

In Assessing a Captive Finance Company's Global Activities, the Assessment Methodology Should Focus on the Potential for Activities and Risks to Spread Across Jurisdictions

The proposed indicators for cross-jurisdictional activities do not capture cross-border risks but simply international business activities. The assessment methodology should be revised to ensure that cross-jurisdictional activities that actually pose systemic risks are duly weighted. For example, as noted above in our discussion of captive finance companies, such companies typically operate in many jurisdictions through self-funded businesses that are confined to that jurisdiction. The assessment methodology should recognize that, although such a captive finance company may conduct operations in many jurisdictions in this manner, the actual risk posed to the global financial system by the company's distress or failure in any one market would be minimal and unlikely to spread across jurisdictions.

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 the FSB to exempt captive companies from designation as NBNI G-SIFIs.

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

Sincerely,

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