FSOC Proposes New Guidance on Nonbank "SIFI" Designation Process

On April 21, 2023, the Financial Stability Oversight Council ("FSOC") voted unanimously to release for public comment two related proposals: (1) revised interpretive guidance concerning FSOC's procedures for designating nonbank financial companies as "systemically important financial institutions" ("nonbank SIFIs") (the "Proposed Guidance")[1] and (2) a new analytic framework for assessing financial stability risks (the "Proposed Analytic Framework").[2] Comments on the proposals are due June 27, 2023.

EXECUTIVE SUMMARY AND KEY TAKEAWAYS

- The Proposed Guidance would replace the interpretive guidance that FSOC issued in 2019, which prioritized an "activities-based approach" to monitoring and addressing systemic risk and relegated nonbank SIFI designation to a tool of last resort (the "2019 Guidance").[3]
- Almost all of the current members of FSOC are different than those on the FSOC that approved the 2019 Guidance. The current FSOC explained that the Proposed Guidance is designed to provide FSOC with "flexibility" to use the "most appropriate tool" for addressing a given risk to U.S. financial stability—including nonbank SIFI designations. The current FSOC also stated that the 2019 Guidance "created inappropriate hurdles" to FSOC's ability to use the nonbank designation authority.
- The Proposed Analytic Framework is broadly consistent with the approach articulated in the 2019 Guidance, but would be moved to a separate stand-alone document. The Proposed Analytic Framework outlines FSOC's proposed approach to identifying, assessing and responding to potential risks to U.S. financial stability, including by highlighting the vulnerabilities, metrics and transmission channels FSOC would use as part of its evaluation of potential risks.
- The Proposed Guidance would make it significantly easier for FSOC to designate companies as nonbank SIFIs.
- That said, finalizing the Proposed Guidance would not necessarily mean that FSOC will begin the designation process for specific companies. As the Proposed Analytic Framework highlights, FSOC may consider a variety of tools other than nonbank financial company designations to address systemic risks.
- Speaking more broadly than nonbank SIFI designations, Treasury Secretary Yellen in March 2023 stated that she "inherited a financial stability apparatus at Treasury that had been decimated" and that Treasury has "recommitted to our partnership with regulators to make progress on our financial stability agenda."[4]
- Over the years, FSOC has shown significant interest in and focus on the asset management industry generally. Secretary Yellen, in her March 2023 remarks, noted that money market funds, open-end funds and hedge funds are among the current focus areas for FSOC.

FSOC: BACKGROUND AND CONTEXT

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") created FSOC to identify risks to U.S. financial stability, promote market discipline and respond to emerging threats to the stability of the U.S. financial system. By statute, FSOC is chaired by the Secretary of the Treasury and consists of 10 voting members (generally, the heads of the federal financial regulatory agencies) and five nonvoting members. The Dodd-Frank Act assigned FSOC specific duties, including (1) monitoring the financial services marketplace for potential threats to U.S. financial stability; (2) monitoring global financial regulatory proposals; (3) facilitating sharing and coordination among financial regulators; and (4) identifying gaps in regulation that could pose risks to U.S. financial stability, among others.

FSOC also has the authority to designate a nonbank financial company for Federal Reserve supervision and prudential standards, if FSOC 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 U.S. financial stability. FSOC also has the authority to issue formal public (but not binding) recommendations to primary financial regulatory agencies concerning new or heightened standards and safeguards.

FSOC's approach to and use of its nonbank SIFI designation authority has not been without controversy. In 2012, FSOC issued a final rule and interpretive guidance describing its procedures and approach to nonbank SIFI designations. FSOC then designated four nonbank SIFIs in 2013 and 2014: American International Group, Inc. ("AIG"), GE Capital Global Holdings, LLC ("GE Capital"), Prudential Financial, Inc. ("Prudential") and MetLife, Inc. ("MetLife"). In March 2016, a federal district court rescinded MetLife's designation. Following the change in Presidential administration, the U.S. government dropped its appeal of that decision. FSOC rescinded the designations of GE Capital, AIG and Prudential in 2016, 2017 and 2018, respectively. No companies are currently designated as nonbank SIFIs.

The **Appendix** highlights key dates and events in the history of FSOC's nonbank SIFI designation authority.

FSOC'S 2019 GUIDANCE

Prior to 2019, there were criticisms levied at FSOC's nonbank SIFI designation process and analytical approach—including by the U.S. Government Accountability Office in a 2014 report, the MetLife court and members of Congress, among others. In April 2017, President Trump directed the Treasury Department to review the SIFI designation process and develop recommendations to improve it, culminating in the Treasury Department's publication of a formal report later that year.

In 2019, FSOC—then chaired by Treasury Secretary Mnuchin—adopted the 2019 Guidance. The guidance states that FSOC will prioritize its efforts to identify, assess and address potential risks and threats to U.S. financial stability through an "activities-based approach." The 2019 Guidance explains that FSOC expects to use entity designations as a last resort: "only if a potential risk or threat cannot be adequately addressed through an activities-based approach."[5] The activities-based approach generally describes FSOC's approach of examining a range of financial products, activities, or practices that could pose risks to U.S. financial stability. If a potential risk to U.S. financial stability is identified, FSOC would work with federal and state financial regulators to seek the implementation of appropriate actions to address the identified potential risk.[6]

The 2019 Guidance also introduced other changes, including to FSOC's nonbank SIFI designation process, such as:

- *Cost-benefit requirement for designation authority*. Requires FSOC to conduct a cost-benefit analysis and then confirm—before making any nonbank SIFI designation—that the expected benefits to financial stability from an entity-based designation would justify any expected costs resulting from the designation.
- *Likelihood of material financial distress*. Requires FSOC to consider the *likelihood* of a nonbank financial company's material financial distress when making a designation determination—as opposed to merely assessing whether such distress *could* threaten financial stability.

- *Meaning of "threat to the financial stability of the United States."* Interprets this phrase, which is central to FSOC's designation authority, as meaning: the threat of an impairment of financial intermediation or of financial market functioning that *would* (not *could*) be sufficient to inflict severe damage on the broader economy.

In 2019, FSOC also adopted a final rule stating that it would not amend or rescind its interpretive guidance on nonbank SIFI designations without first providing the public with notice and opportunity to comment.

2023 PROPOSED GUIDANCE

The Proposed Guidance may not come as a surprise to many who have been following FSOC. In 2019, in a comment letter to FSOC regarding what ultimately became the 2019 Guidance, Janet Yellen and other former senior government officials raised concerns regarding the "activities-based approach," including that it would "neuter the designation authority."[7]

The Proposed Guidance states that while the 2019 Guidance "provided additional clarity regarding the Council's procedures" it created "inappropriate hurdles" to FSOC's ability to use its nonbank SIFI designation authority. The Proposed Guidance states that FSOC has used its nonbank SIFI designation authority "sparingly"— but in order "to mitigate the risks of future financial crises, the Council must be able to use each of its statutory authorities as appropriate to address potential threats to U.S. financial stability."

If finalized (as proposed), the Proposed Guidance would replace the 2019 Guidance and differ in the following key ways:

- *Removes "last resort" approach to entity designation.* It would remove the prioritization scheme articulated in the 2019 Guidance—namely, FSOC's focus on only an "activities-based approach" and relegation of nonbank SIFI designation to a tool of last resort. Instead, FSOC would have "flexibility to use the most appropriate tool for addressing potential risks" in a given context.
- *Removes cost-benefit requirement for designations.* It would eliminate the requirements that FSOC conduct a cost-benefit analysis and consider the likelihood of a firm's material financial distress before making a nonbank SIFI designation.
- *Meaning of "threat to the financial stability of the United States."* It states that FSOC would expect to evaluate such threats "with reference to" the Proposed Analytic Framework's description of financial stability—and not based on the interpretation provided in the 2019 Guidance.

2023 PROPOSED ANALYTIC FRAMEWORK

The Proposed Analytic Framework is broadly consistent with the approach articulated in the 2019 Guidance. The Proposed Analytic Framework provides the substantive analysis underlying FSOC's approach to fulfilling certain of its statutory duties, namely identifying, assessing and responding to various potential risks to U.S. financial stability. It provides an illustrative list of the "expansive range" of asset classes, institutions and activities that FSOC's monitoring activities cover and identifies eight vulnerabilities it considers to most commonly contribute to financial stability risks. These vulnerabilities are leverage, liquidity risk and maturity mismatch, interconnections, operational risks, complexity or opacity, inadequate risk management, concentration and destabilizing activities. The proposal also describes certain sample quantitative metrics frequently used to measure the identified vulnerabilities.

The Proposed Analytic Framework also identifies four transmission channels that FSOC views as being most likely to facilitate the transmission of the negative effects of financial stability risks: exposures, asset liquidation, critical function/service and contagion.

1 *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 88 Fed. Reg. 26234 (Apr. 28, 2023), *available at* https://www.govinfo.gov/content/pkg/FR-2023-04-28/pdf/2023-08964.pdf.

2 *See* Analytic Framework for Financial Stability Risk Identification, Assessment, and Response, 88 Fed. Reg. 26305 (Apr. 28, 2023), *available at* https://www.govinfo.gov/content/pkg/FR-2023-04-28/pdf/2023-08969.pdf.

3 *See* Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 71740 (Dec. 30, 2019) ("2019 Release").

4 Department of the Treasury, "Remarks by Secretary of the Treasury Janet L. Yellen at the National Association for Business Economics 39th Annual Economic Policy Conference" (Mar. 30, 2023) ("March 30, 2023 Remarks"), *available at* https://home.treasury.gov/news/press-releases/jy1376.

5 2019 Release at 71742.

6 The 2019 Guidance requires FSOC, before using its recommendation authority, to ascertain whether the relevant financial regulatory agency would be expected to perform a cost-benefit analysis of the actions it would take in response to a contemplated FSOC recommendation. If such analysis is not expected, then FSOC would itself perform the cost-benefit analysis prior to making the recommendation.

7 Comment from former Chairs of the FSOC and two previous Chairs of the Federal Reserve Board, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (RIN 4030-ZA00)" (May 13, 2019), *available at* https://www.regulations.gov/comment/FSOC-2019-0001-0010.

Appendix

Timeline of Relevant Key FSOC Developments

JULY 21, 2010
FSOC established by the Dodd-Frank Act

APRIL 11, 2012
FSOC publishes rules and guidance on process for reviewing nonbank financial companies for potential designation

JULY 8, 2013
FSOC designates AIG and GE Capital as nonbank SIFIs

SEPTEMBER 19, 2013
FSOC designates Prudential as a nonbank SIFI

DECEMBER 18, 2014
FSOC designates MetLife as a nonbank SIFI

FEBRUARY 4, 2015
FSOC releases supplemental procedures for reviewing nonbank financial companies for potential nonbank SIFI designation

JUNE 8, 2015
FSOC staff releases guidance explaining how nonbank financial company determination stage 1 thresholds are calculated

MARCH 30, 2016
U.S. District Court rescinds MetLife's nonbank SIFI designation

JUNE 28, 2016
FSOC rescinds GE Capital's nonbank SIFI designation

APRIL 21, 2017
President Trump directs Treasury Department to review FSOC's SIFI designation process and develop recommendations for improvement

SEPTEMBER 29, 2017
FSOC rescinds AIG's nonbank SIFI designation

NOVEMBER 17, 2017
Treasury Department issues report recommending changes to FSOC's SIFI designation process

JANUARY 18, 2018
U.S. government and MetLife file joint motion to dismiss U.S. government's ongoing appeal of U.S. District Court decision that rescinded MetLife's nonbank SIFI designation

JANUARY 23, 2018
U.S. Court of Appeals dismisses U.S. government's appeal of MetLife U.S. District Court decision

OCTOBER 17, 2018

FSOC rescinds Prudential's nonbank SIFI designation

MARCH 6, 2019

FSOC proposes for comment interpretive guidance on nonbank SIFI determinations

FSOC adopts final rule stating it will not amend or rescind its interpretive guidance on nonbank SIFI designations without soliciting public notice and comment

DECEMBER 4, 2019

FSOC finalizes the 2019 Guidance

APRIL 21, 2023

FSOC approves Proposed Guidance and Proposed Analytic Framework for public notice and comment

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