November 9, 2023

Financial Stability Oversight Council Finalizes Revised Guidance on Nonbank SIFI Designations

Guidance Could Facilitate New Nonbank SIFI Designations, But Timing and Potential Targets Remain Unclear

SUMMARY

On November 3, 2023, the 10 voting members of the Financial Stability Oversight Council ("*FSOC*" or "*Council*")[1] voted unanimously to finalize (1) amendments to its existing interpretive guidance ("*2019 Interpretive Guidance*")[2] governing the designation of nonbank financial companies for supervision by the Federal Reserve Board and application of prudential standards ("*Interpretive Guidance*")[3] and (2) an "analytic framework" for identifying, assessing, and responding to financial stability risks ("*Analytic Framework*").[4] The Council finalized the Interpretive Guidance and Analytic Framework substantively as proposed in April 2023 (described in our publication dated April 26, 2023),[5] with minor modifications in response to public comments. The Interpretive Guidance and Analytic Framework replace the 2019 Interpretive Guidance and include both procedural and substantive modifications that could facilitate new nonbank financial company designations ("*SIFI designations*").

The Interpretive Guidance reverts, in several significant respects, to the approach embodied in the FSOC's initial 2012 designation guidance ("*2012 Interpretive Guidance*"),[6] including by removing the prioritization of an activities-based approach to address risks to financial stability. The Council also was not persuaded by comments that it was required by the court decision in *MetLife*[7] to conduct a cost-benefit analysis or an assessment of the likelihood of a company's material financial distress prior to making a designation.[8] The Interpretive Guidance will become effective 60 days following its publication in the *Federal Register* and the Analytic Framework will become effective upon its publication.

In a statement explaining the rationale for the Council's revised approach, Treasury Secretary Janet Yellen, who chairs the FSOC, argued that the Interpretive Guidance "eliminates several prerequisites to designation in place under the [2019 Interpretive Guidance] that were not contemplated by the Dodd-Frank Act and that are based on a flawed view of how financial risks develop and spread."[9] Although Secretary Yellen recognized that risks often "emanate from widely conducted activities and can be addressed through action by an existing regulator or interagency coordination," she argued that, in other instances, risks are "instead concentrated in one or more specific nonbank financial companies."[10] She noted, however, that SIFI designation is "only one of the Council's tools and is not being prioritized over other approaches to addressing financial stability risks."[11]

KEY CLARIFICATIONS AND DETAILS

The Interpretive Guidance and the Analytic Framework track the April 2023 proposals, but include a small number of targeted revisions made in response to public comment.

A. INTERPRETIVE GUIDANCE

The Interpretive Guidance is substantively identical to the proposal and, according to the Council, "removes three significant but inappropriate prerequisites"[12] that were embodied in the 2019 Interpretive Guidance: (1) the prioritization of industry-wide, activity-based regulations over the designation of specific entities (*i.e.*, an "activities-based approach") to address risks to financial stability; (2) the commitment to conduct a cost-benefit analysis prior to designating a nonbank financial company; and (3) the commitment to assess the likelihood of a company's "material financial distress" prior to designation (the latter two of which were included in response to shortcomings identified in the MetLife decision).[13] The Council determined that these prerequisites to designation "are not legally required, are not useful or appropriate, and would unduly hamper the Council's ability to use the statutory designation authority in relevant circumstances."[14] Also as proposed, the Interpretive Guidance replaces the analytic approach to evaluating nonbank financial companies under consideration for designation that was embodied in the 2019 Interpretive Guidance with the standalone Analytic Framework. In doing so, the FSOC indicated that the Analytic Framework is designed to apply to the Council's systemic risk analyses not only in respect of potential nonbank financial company designations, but also in respect of payment, clearing, and settlement ("*PCS*") activity and financial market utility ("*FMU*") designations under Title VIII of the Dodd-Frank Act[15] and the Council's activities-based analyses and recommendations under section 120 of the Dodd-Frank Act.[16]

Consistent with the proposal, the Interpretive Guidance significantly modifies the definition of the term "threat to the financial stability of the United States," which is not defined by statute, from a threat that "*would* be sufficient to *inflict severe damage* on the broader economy" to a threat that "*could* substantially *impair* the financial system's ability to support economic activity," a much more speculative standard.[17]

Although the prioritization of an activities-based approach has been removed, the preamble to the Interpretive Guidance clarifies that the revised approach "does not make designation the Council's default method of addressing risks to financial stability" nor does it eliminate the Council's use of an activities-based approach to address risks to financial stability "when the Council finds it to be appropriate."[18] Instead, the Interpretive Guidance "puts the Council's designation authority on equal footing with other powers."[19] The Interpretive Guidance states that the Council expects to "continue addressing most risks through its collaboration with primary financial regulators" and will base any nonbank financial company designation on "data-driven analysis that reflects the distinctive aspects of the company, its market, and its existing regulation."[20]

B. ANALYTIC FRAMEWORK

Similarly, the Analytic Framework generally closely hews to the proposal. However, the final Analytic Framework, which "describes the approach the Council expects to take in identifying, assessing, and responding to certain potential risks to U.S. financial stability,"[21] includes additional details on the FSOC's approach that were not included in the proposal.

1. Identifying Potential Risks

Consistent with the proposal, the Analytic Framework notes that the FSOC's monitoring for potential risks to financial stability may cover an "expansive range of asset classes, institutions, and activities."[22] The Analytic Framework retains the non-exhaustive list of asset classes, institutions, and activities included in the proposal, but adds "private funds" to the list in response to "comments suggesting the addition of further examples."[23]

2. Assessing Potential Risks

The Analytic Framework retains the eight proposed "vulnerabilities that most commonly contribute" to financial stability risks.[24] Relative to the proposal, the Analytic Framework includes additional examples of the types of "quantitative metrics" the Council may consider under certain vulnerabilities:

Vulnerability	Sample Metrics – Proposal	Additional Metrics – Final
Leverage	• Ratios of assets, risk-weighted assets, debt, derivatives liabilities or exposures, and off-balance-sheet obligations to equity	• N/A
Liquidity risk and maturity mismatch	• Ratio of short-term debt to unencumbered short-term high-quality liquid assets • Amounts of funding available to meet unexpected reductions in available short-term funding	• Scale of financial obligations that are short-term or can become due in a short period • Amounts of transactions that may require the posting of additional margin or collateral

Vulnerability	Sample Metrics – Proposal	Additional Metrics – Final
Interconnections	• Total assets, off-balance-sheet assets or liabilities, total debt, derivatives exposures, values of securities financing transactions, and the size of potential requirements to post margin or collateral • Concentration of holdings of a class of financial assets	• N/A
Operational risks	• Statistics on cybersecurity incidents or the scale of critical infrastructure	• N/A
Complexity or opacity	• Number of jurisdictions in which activities are conducted • Number of affiliates	• Extent of intercompany or interaffiliate dependencies for liquidity, funding, operations, and risk management
Inadequate risk management	• Amounts of capital and liquidity	• Levels of exposures to particular types of financial instruments or asset classes
Concentration	• Market shares in segments of applicable financial markets	• N/A
Destabilizing activities	• Trading practices that substantially increase volatility in one or more financial markets • Activities that involve moral hazard or conflicts of interest	• N/A

The Analytic Framework also retains the four proposed "transmission channels that are most likely to facilitate the transmission of the negative effects of a risk to financial stability."[25]

In addition to the items set forth in the proposal, the Analytic Framework "identifies vulnerabilities that may be particularly relevant to each of the four listed transmission channels and includes more detailed discussions of examples and analyses relevant to the transmission channels."[26] Notably, the Analytic Framework was modified from the proposal to distinguish between risks arising from exposures to assets managed for third parties and exposures to assets owned by a company itself.[27]

Transmission Channel	Description – Proposal	Additional Details – Final	Relevant Vulnerabilities Identified in Final
Exposures	• Direct and indirect exposures of creditors, counterparties, investors, and other market participants	• Exposures to equity, debt, derivatives, or securities financing transactions • Risks arising from exposures to assets managed by a company on behalf of third parties distinct from exposures to assets owned by, or liabilities issued by, the company itself	• Leverage • Interconnections • Concentration

Transmission Channel	Description – Proposal	Additional Details – Final	Relevant Vulnerabilities Identified in Final
Asset liquidation	• Rapid liquidation of financial assets	• Takes into account amounts and types of liabilities that are or could become short-term in nature, amounts of assets that could be rapidly liquidated to satisfy obligations, and the potential effects of a rapid asset liquidation on markets and market participants • Possible that actions by market participants or financial regulators to impose stays on counterparty terminations or withdrawals may reduce the risks of rapid asset liquidations, but such actions may increase risks through the exposures transmission channel if they result in potential losses or delayed payments or through the contagion transmission channel if there is a loss of market confidence	• Leverage • Liquidity risk and maturity mismatch
Critical function or service	• Disruption of a critical function or service that is relied upon by market participants and for which there are no ready substitutes that could provide the function or service at a similar price and quantity	• Possible that risks arise in situations where a small number of entities are the primary or dominant providers of critical services in a market that the Council determines to be essential to U.S. financial stability • Concern about a potential lack of substitutability possibly greater if providers of a critical function or service are likely to experience stress at the same time because they are exposed to the same risks	• Interconnections • Operational risks • Concentration
Contagion	• Perception of common vulnerabilities or exposures, such as business models or asset holdings that are similar or highly concentrated	• N/A	• Interconnections • Complexity or opacity

The Analytic Framework does not describe how these considerations would be analyzed in practice, which may create uncertainty in understanding and evaluating specific designation determinations. For example, the Analytic Framework observes that actions to impose stays on counterparty terminations or withdrawals may reduce the risks of rapid asset liquidations, but could potentially increase risks if such stays result in potential losses or delayed payments or if there is a loss of market confidence.[28] It is unclear how the FSOC would weigh these countervailing factors, either in general or in specific cases.

OBSERVATIONS AND IMPLICATIONS

Although the Interpretive Guidance and Analytic Framework could potentially facilitate new nonbank SIFI designations (both procedurally and substantively), there is no clear indication as to which, if any, nonbank financial companies may be under consideration for designation by the FSOC, or when any such designation process may begin. In particular, it is not clear whether the various revisions or the "de-prioritization" of an activities-based approach is designed to signal actual action.

As under the 2019 Interpretive Guidance, the FSOC would follow a two-stage process when determining whether to designate a nonbank financial company.[29] This process reflects the fact that many of the procedures governing nonbank financial company designation are required by statute.[30] The FSOC declined to modify the stages or notice periods set forth in the proposals (which largely follow the 2019 Interpretive Guidance), but, in response to certain comments, restored language from the 2019 Interpretive Guidance clarifying that its engagement with a nonbank financial company under consideration "may enable the company to act to mitigate any risks to financial stability and thereby potentially avoid becoming subject to a Council determination."[31] Nonbank financial companies should continue to monitor actions by the FSOC, including the work of its staff-level committees and working groups, for further indications as to the FSOC's priorities.[32]

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ENDNOTES

1 The voting members of the Council are the Secretary, the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection, the Chairman of the Securities and Exchange Commission, the Chairperson of the Federal Deposit Insurance Corporation, the Chairperson of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board, and an independent member with insurance expertise who is appointed by the President and confirmed by the Senate. There are also five non-voting members representing the Federal Insurance Office, the Office of Financial Research and state banking, insurance, and securities regulators. *See* 12 U.S.C. 5321(b).

2 *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 84 Fed. Reg. 71,740 (Dec. 30, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-12-30/pdf/2019-27108.pdf. For further information, see our publication, Financial Stability Oversight Council: FSOC Finalizes Changes to Nonbank SIFI Designation Guidance, dated January 2, 2020, *available at* https://www.sullcrom.com/files/upload/SC-Publication-FSOC-Finalizes-Nonbank-SIFI-Designation-Guidance.pdf.

3 *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, *available at* https://home.treasury.gov/system/files/261/Interpretive-Guidance-Regarding-Authority-to-Require-Supervision-and-Regulation-of-Certain-Nonbank-Financial-Companies.pdf.

4 *Analytic Framework for Financial Stability Risk Identification, Assessment, and Response*, *available at* https://home.treasury.gov/system/files/261/Analytic-Framework-for-Financial%20Stability-Risk-Identification-Assessment-and-Response.pdf.

5 *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 88 Fed. Reg. 26,234 (Apr. 28, 2023), *available at* https://www.govinfo.gov/content/pkg/FR-2023-04-28/pdf/2023-08964.pdf; Analytic Framework for Financial Stability Risk Identification, Assessment, and Response (Apr. 28, 2023), *available at* https://www.govinfo.gov/content/pkg/FR-2023-04-28/pdf/2023-08969.pdf.

6 *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21,637 (Apr. 11, 2012), *available at* https://www.govinfo.gov/content/pkg/FR-2012-04-11/pdf/2012-8627.pdf.

7 *MetLife, Inc.* v. *Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016). For further information, see our publication, D.C. District Court Rescinds FSOC's Designation of MetLife as Systemically Important: Decision Cites "Fundamental Violations of Established Administrative Law," Including a Failure to Consider the Costs of Regulation and Unexplained Deviations From Prior Regulatory Guidance, dated April 7, 2016, *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_D.C._District_Court_Rescinds_FSOCs_Designation_of_MetLife_as_Systemically_Important.pdf.

8 The Interpretive Guidance notes that, although the *MetLife* court viewed costs as a "risk-related factor," the court "failed to take into account that the Council did not 'deem' the cost of designation an appropriate risk-related factor to consider," as required by statute. Interpretive Guidance, at 47-48. In addition, the Interpretive Guidance notes that the *MetLife* court held that the 2012 Interpretive Guidance required an assessment of the likelihood of a company's material financial distress, notwithstanding the Council's arguments to the contrary, and that the FSOC is "now clarifying that it does not interpret the Dodd-Frank Act, the [Interpretive] Guidance, or the Analytic Framework to contemplate an assessment of the likelihood of a company's material financial distress." *Id*. at 50-51, n.85.

ENDNOTES (CONTINUED)

9 Remarks by Secretary of the Treasury Janet L. Yellen at the Open Session of the meeting of the Financial Stability Oversight Council (Nov. 3, 2023), *available at* https://home.treasury.gov/news/press-releases/jy1875.

10 *Id*.

11 *Id*.

12 Interpretive Guidance, at 6.

13 *See id*.

14 *Id*. at 7.

15 Among other things, the PCS and FMU designation authorities could be used to designate certain activities conducted within stablecoin arrangements. *See* President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, *Report on Stablecoins* 18 (Nov. 2021), *available at* https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf ("In the absence of Congressional action, the agencies recommend that the Council consider steps available to it to address the risks outlined in this report. Such steps may include the designation of certain activities conducted within stablecoin arrangements as, or as likely to become, systemically important [PCS] activities . . . In addition, the Council potentially could address stablecoin arrangements using its authority to designate systemically important [FMUs], subjecting those arrangements to consolidated supervision.").

16 *See id*. The Council takes the position that the notice and comment requirements of the Administrative Procedure Act do not apply to the Analytic Framework and that the Analytic Framework has no binding effect. *See* Analytic Framework, at 3 and 23; *see also* Interpretive Guidance, at 62. Although the Council takes a similar position with respect to the Interpretive Guidance, the Council "voluntarily committed that it would not amend or rescind" the Interpretive Guidance without providing the public with notice and comment opportunities, as required under 12 C.F.R. 1310.3 (codified in March 2019). Interpretive Guidance, at 62. The Council asserts that the Analytic Framework is not subject to the requirements under 12 C.F.R. 1310.3, which may, in the Council's view, allow it to deviate from the Analytic Framework without having to follow the notice and comment requirements to which it would otherwise be subject if the substantive risk analytic framework remained part of the Interpretive Guidance.

17 Interpretive Guidance, at 30-31 (emphasis added); *see also* Analytic Framework, at 24. The new definition in the Interpretive Guidance is also more speculative than the original definition in the 2012 Interpretive Guidance, which defined a "threat to the financial stability of the United States" as one that "*would* be sufficiently severe to inflict significant damage on the broader economy." 2012 Interpretive Guidance, at 21,657 (emphasis added). The April 2023 proposals provided no definition of "threat to the financial stability of the United States."

18 Interpretive Guidance, at 6.

19 *Id*.

20 *Id*.

21 Analytic Framework, at 2.

22 *Id*. at 27.

23 *Id*. at 9. Because neither the Interpretive Guidance nor the Analytic Framework elaborates on the addition of private funds to the non-exhaustive list, it is difficult to assess the significance of this change.

24 *Id*. at 28.

ENDNOTES (CONTINUED)

[25] *Id*. at 31.

[26] *Id*. at 5.

[27] *See id*. at 32.

[28] *See id*. at 10.

[29] *See* Interpretive Guidance, at 66-76.

[30] *See* 12 U.S.C. § 5323(d)-(e).

[31] Interpretive Guidance, at 70.

[32] *See* FSOC, Readouts, *available at* https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/council-meetings/readouts; *see also* FSOC, Meeting Minutes, *available at* https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/council-meetings/meeting-minutes.

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