Financial Services Management

Nonbank SIFI Designation, Activity-and-Practice Standards

Cite

Financial Stability Oversight Council (FSOC), Final interpretive guidance; Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies

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https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf

Impact Assessment

- Nonbank SIFI designation will be rare absent an emergency.
- Activity-based standards are more likely but will be identified in a complex process complicating implementation.
- Activity-based consideration will be limited to financial-stability threats, not also to those to low-income households as permitted by DFA. As a result, high-cost lending or other practices with potentially adverse implications for vulnerable households will not be targeted.
- Firm-specific designation is possible when harm to vulnerable households is determined, but the designation process makes this unlikely.
- OLA resolution remains an option for any nonbank financial firm that poses systemic risk upon severe distress or failure, with taxpayer risk likely increased due to lack of advance planning and risk buffers.
- Near-term FSOC action is likely to focus on activity/practice designation for nonbank mortgage origination and servicing and certain BigTech infrastructure.

Overview

Acting unanimously to implement a key plank of President Trump's regulatory-relief agenda,[1] FSOC has approved final guidance to repeal the current standards determining which nonbanks are designated as systemically-important financial institutions (SIFIs) subject then to FRB supervision and regulation.[2] Although designations could still be made in rare or emergency circumstances, the new approach provides considerably more opportunities to contest it. It also creates an "activity-based" framework that relies on the willingness and authority of primary regulators to govern activities or practices FSOC identifies as financial-stability risks. The new framework, like the proposal,[3] reflects the findings of 2016 litigation in which the Obama-era FSOC designation of MetLife was rejected on procedural grounds[4] and the new global approach to activity-based regulation for non-bank, non-broker financial institutions. If designation proceeds only in emergencies, then it is unclear if subsequent Fed regulation would afford any protection, perhaps precipitating failure under the orderly liquidation authority established in the Dodd-Frank Act at potential taxpayer or financial-market cost.[5]

Impact

For all the furor over FSOC's decision to finalize this guidance, the record of designation under the Dodd-Frank Act's 2010 authority is problematic. Four nonbank SIFIs were eventually designated by Obama regulators and the Treasury: AIG, MetLife, GE Capital, and Prudential. GE Capital was the first to be de-designated,[6] but all four companies are now outside the scope of Fed systemic regulation, which thus covers only the nation's largest banks. During the period in which nonbanks were designated, the Fed imposed some restrictions on these SIFIs but failed to enact a formal regulatory framework.

Although differing structurally and philosophically from the Obama Administration, the FSOC guidance reiterates the systemic-risk responsibilities and powers granted to the Council by the Dodd-Frank Act.[7] The law includes both a lengthy designation process for certain nonbank financial companies and authority for FSOC to identify activities or practices that pose systemic risk or may harm low-income, minority, or underserved consumers. The new guidelines detail only systemic-risk considerations, wholly omitting consideration of vulnerable financial consumers. The designation criteria do mention this issue as a possible criterion, but the thrust of the discussion is also on systemic risk. It thus seems unlikely that any activity, practice, or firm that engages in predatory lending of or otherwise endangers underserved households would be sanctioned via this activity-based designation framework.

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1 See *Client Report* **ASSETMANAGEMENT7**, October 30, 2017.

2 See **SYSTEMIC60**, *Financial Services Management*, April 16, 2012.

3 See **SIFI32**, *Financial Services Management*, March 14, 2019.

4 See *Client Report* **SIFI19**, April 8, 2016.

5 See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

6 See **SIFI**, *Financial Services Management*, December 9, 2014.

7 See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

The Council intends its activity-based approach only to apply within narrow risk confines covered by existing federal or, perhaps, state law, stating that it will not cite any activity of concern absent the ability of a regulator to correct it under current law. As a result, emerging threats to systemic risk or vulnerable households may go unaddressed unless, as discussed below, the Council uses its designation authority over one or more companies to impose top-down prudential rules not now otherwise provided by federal law.

However, the guidance also stipulates that designation will be rare absent an emergency. As a result, activity-based proposals may also not address emerging systemic risks now outside the authority of the banking agencies, SEC, CFTC, state insurance regulators, or others to whom FSOC might turn following an activity-based conclusion. The Obama Administration began to confront this problem in an assessment of asset management in 2014.[8] It noted that single-firm designation of individual asset managers would create competitive challenges and a prudential patchwork, but also that the SEC's authority over asset managers was limited under current law. FSOC thus contemplated ways to contain the asset-management risks it feared by issuing new bank regulation. It remains to be seen if the FSOC activity-based approach would be forced to rely on such a "backdoor" approach if stability risks are spotted in this sector or with regard to insurance companies, where the state-based framework creates significant parent-company and resolution challenges.

Consistent with law, the guidance applies only to nonbank companies that are predominantly financial entities. It reiterates but does not clarify the standards established in Dodd-Frank. Thus, firm designation could apply to a company which derives the majority of revenue from financial activities within the confines of applicable Federal Reserve definitions. Giant platform companies would be unlikely to meet this standard even if financial activities were significantly ramped up. Certain activities might come under an activity-based approach, but how this might work would depend not only on the nature of any FSOC activity-based determinations, but then also on the reach of current law.

As a result, it is likely that BigTech activities would remain outside the reach of prudential and resolution regulation unless FSOC decides to use alternative systemic-designation authority expressly left untouched by this guidance. This authority permits FSOC designation of financial-market utilities (FMUs), subjecting firms or entities in the payment, settlement, or clearing sectors to Fed, SEC, or CFTC regulation based on the nature of the company's activity. It is not necessary for a firm to be wholly financial or regulated by one of these agencies to be designated an FMU, allowing this for giant-platform companies if FSOC determines that payment or similar activities permit it.[9]

What's Next

The FSOC adopted this guidance on December 4; it is effective thirty days after *Federal Register* publication. As guidance, the standards do not have the force of law but reflect FSOC's view of its authority pursuant to Dodd-Frank. It may rescind,

[8] See **SYSTEMIC75**, *Financial Services Management*, January 5, 2015.

[9] See **PAYMENT11**, *Financial Services Management*, July 23, 2010.

revise, or act differently without notice or a request for comment in an emergency or other circumstance. However, when this guidance was proposed in March, FSOC adopted a final rule to prevent it from formally amending or rescinding the guidance as a whole without seeking comment on any such changes.

In its most recent report of looming systemic risk,[10] FSOC continues to cite general concerns (e.g., cyber-security) challenging to address under either activity/practice or firm designations. However, it also added two new areas to its longstanding risk: nonbank mortgage origination and servicing and digital finance with particular attention to Libra. Activity/practice designation in mortgage finance could lead to new standards addressing issues such as contagion liquidity risk due to sudden servicer draws and mortgage-liquidity interruptions. Digital-finance regulation is likely in the near term to focus on new standards governing third-party vendor risk issued outside FSOC along with sanctions related to Libra if that stablecoin product advances in the U.S.

Analysis

The FSOC's guidance governs only nonbank SIFI regulation and does not change the process established elsewhere in the Dodd-Frank Act for designating financial-market utilities or their activities.

A. Activity-Based Approach

1. Framework

In the activity-based approach, the Council will work with "relevant financial regulatory agencies," also taking into account risk-mitigating law and rule along with market participant risk profiles and business models. This approach goes beyond the primary regulators clearly specified in Dodd-Frank for activity-based consultation. The guidance does not specify which agencies would be consulted, but appears to give FSOC considerably more discretion to consider the views of state regulators as well as the Federal Reserve or other federal agencies that lack direct authority over a particular activity. A strict interpretation of "primary regulator" could also have complicated deployment of activity-based standards for entities – e.g., financial-technology companies – without a primary federal regulator.

Even so, any FSOC activity-based options would need to be authorized under federal law to reach across a particular business line or product; in the absence of such authority (e.g., for tech-based finance), designation for firms or FMUs might remain the Council's only option.

2. Activities

Activities mentioned as coming under this approach include those related to the extension of credit, maturity and liquidity transformation, market making and trading, and other key functions critical to support financial markets. Products to be scrutinized include corporate and sovereign debt and loan markets; equity markets; new or evolving financial products, activities, and practices; and developments affecting the resiliency of financial-market participants.

[10] See *Client Report* **FSOC25**, December 9, 2019.

3. Process

The approach has two steps:

1. Monitoring of financial markets in consultation with relevant regulators to identify activities posing systemic risk. This encompasses risk of an event or development that could inflict significant damage on the broader economy by sufficiently impairing financial intermediation or financial-market function. Characteristics suggesting risk would include asset-valuation or -credit risk; leverage, including leverage arising from debt, derivatives, off-balance sheet obligations, and other arrangements; and financial-market transparency. "Framing" questions for analysis would include risk triggers (e.g., snapbacks), adverse-impact transmission, systemic impact, and scale and magnitude of these effects and how concentrated they might be. FSOC will also look to see how risks are mitigated or the extent to which they are correlated or otherwise amplified. FSOC members could raise risk concerns for monitoring should staff not already have them under review.

2. If risks appear to warrant intervention, then the Council would move on to working with relevant agencies to address them. Actions likely would just include information sharing, but the Council might formally ask relevant agencies to take specific risk-reduction action. These formal notices might be included in the Council's annual report or in specific statements. Recommendations will only be made where an agency has the statutory authority to take action.

If activity-and-practice designation is recommended, then the Council may issue recommendations that address statutory factors and its cost-benefit analysis.

B. Designation

1. Framework

SIFI designation will be considered only if the activity-based approach does not suffice (i.e., threats are outside the scope of a regulator's authority or the problem is specific to individual companies). In general, companies would only be designated if they pose a threat to financial stability, to credit availability for underserved communities, or to key-market liquidity if the firm's distress (i.e., imminent danger of insolvency or of default on financial obligations) would pose severe macroeconomic damage, not solely because the company is critical to any cited market or consideration. Successors to a designated SIFI will also be considered SIFIs.

Designation determinations will be based on contagion risk – i.e., the impact of a company's material financial distress or its characteristics (e.g., leverage, inter-connectedness) on the broader economy or financial system. In addition to a firm's complexity, opacity, and resolvability, the most significant transmission channels considered for designation would be:

- exposures (i.e., whether others are so exposed to the firm that its distress would jeopardize other entities);

- asset liquidation and/or sharp price decreases; and
- critical-functions or services (i.e., substitutability).

Additional considerations include the extent to which assets are managed, not owned, and the nature of a firm's regulation.

2. Cost-Benefit Analysis

In general, SIFI designations will occur only if FSOC determines that costs to the firm or its customers are outweighed by systemic benefits or those to the firm (e.g., lower cost of capital, higher credit rating). As detailed in the guidance, this analysis will also include an assessment of alternatives to designation. Risks will not only be considered in light of cost, but also likelihood of being realized (i.e., the likelihood that a firm would become distressed).

3. Determinations and De-Designation

As noted, designations will be considered only in "rare circumstances" and if there is an emergency or if the activity-based approach is unable to address FSOC-identified systemic risks. Revised from the current process, determinations will include:

- notice to a possible SIFI designee and its primary U.S. or home-country regulator (if any) to detail risks and determine if mitigation does not allay them. Proceeding to the following stage would require a Council vote; and
- after this step, in-depth evaluation of a more likely designation. Engagement would continue with the company and its regulator to provide another off-ramp from designation based on additional analytics and/or risk mitigation. As in phase one, the process will be transparent to the affected company, with an option provided for a meeting between the company and FSOC-agency head deputies. A proposed determination would also be subject to public and private notices as well as a hearing at which the company could present additional evidence to contest it. An off ramp is again provided ahead of or in response to designation.