GSE Activity Report

Thursday, April 27, 2023

How To Say It's Systemic

Summary

FSOC's newly-proposed analytical methodology for systemic risk identification is most immediately important for nonbank mortgage companies and the regulated institutions that love them. It may look as if a U.S. systemic framework is months away, but FSOC has signaled that, in some cases, systemic interventions could well come sooner.

Impact

Our new in-depth analysis of FSOC's methodology lays out how the Council plans to identify systemic risk by vulnerabilities evident at financial institutions, asset classes, financial infrastructure products, services, technologies, and other risk categories. Importantly, FSOC is not only monitoring targeted entities or activities, but also "transmission channels" through which risk migrates from manageable to cataclysmic across the financial system and then into the macroeconomy. The methodology will apply not only to how systemic the Council finds a nonbank subject to the new designation procedure proposed at the same time the methodology was unanimously approved last Friday. It will also govern how activities and practices or entire sectors are judged and then addressed by designation, rule, or even requests for new law.

In the readout accompanying the new standards, FSOC expressly mentions nonbank mortgage companies along with hedge funds as sectors under the systemic gun. This isn't news – each of the last few FSOC annual reports figures nonbank mortgage companies as systemic worries. What's been holding FSOC back from taking action is not only press of other business – and that's been a crush – but the problem that bedeviled the Obama Administration's like kind worries about nonbank financial companies: whether an activity-or-practice designation would have any purpose in the absence of a primary federal regulator with the authority to respond to it.

Under the Dodd-Frank Act, FSOC can designate any activity or practice systemic, but all it gets to do when it does so is then ask a primary federal regulator to do something about it. If there's no federal regulator, FSOC could ask the states, but neither the primary federal regulator nor a state agency need do anything but acknowledge receipt if it's feeling polite. When there's no federal regulator, there's still less likelihood of an answering edict.

Towards the end of its term, the Obama Administration FSOC thought of a way around this roadblock for the asset-management sector on which it focused: conditioning many of the links between the sector and the big banks on which asset managers relied. Forcing banks to institute risk controls on how they dealt with asset managers was, FSOC thought, a way to force banks to demand better controls from asset-management customers as well as to limit the interconnections through which systemic risk could quickly metastasize. FSOC proposed standards to do so, but nothing more came of them because the

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Trump Administration took over FSOC shortly thereafter.

As noted, the new methodology focuses in part on transmission channels, laying out how these move liquidity and other risks through the financial system and establishing a methodology to spot the channels. But, how to stop risk migrations?

Because of the limits on activities-and-practice designations, the only way to do this is through regulated companies because FSOC cannot force what it deems good behavior on nonbanks. Still, using this tool could well have a powerful impact on targeted nonbank sectors by working through bank regulators willing to tell their charges to deprive a targeted nonbank sector of liquidity facilities via the banking sector, limiting asset purchases of relevant obligations, and even conditioning access to payment, settlement, or clearing systems.

And, of course, banks aren't the only entities with systemic interconnections to nonbank mortgage companies. The GSEs rely on them for far more than banks. FHFA has already taken steps to address FSOC concerns with nonbank counterparty-eligibility standards, but an express systemic designation would surely lead it to demand more from the GSEs to force additional resilience on the nonbank sector.

Outlook

When might this happen? Not any time soon, we would think. Comment on the methodology will be due sixty days after *Federal Register* publication, the same deadline also set for the nonbank-designation standards. FSOC won't read fast and it's still got lots else to do, so we do not expect final protocols until year-end. That said, FSOC is careful to say in the methodology that nothing in it constrains the Council from doing anything it wants anytime it wants nor must it propose anything other than a formal activity-and-practice designation. Thus, while near-term nonbanks standards are unlikely, they're not impossible.

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