Nonbank SIFI Designation

Cite

FSOC, Notice of Proposed Interpretive Guidance, Request for Public Comment; Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies

Recommended Distribution

Policy, Legal, Government Relations

Websites

https://home.treasury.gov/system/files/261/FSOC-2023-Proposed-Nonbanks-Guidance.pdf

Impact Assessment

- Nonbank asset managers, mortgage companies, payment providers, tech platforms, and other entities raising FSOC-targeted risks would again be at risk of SIFI designation, very costly Fed regulation.
- Some "shadow banks" would thus be brought within the regulatory perimeter, reducing the arbitrage risk and competitive challenges to GSIBs, other regulated entities.
- Availability and cost of targeted nonbank financial products could be significantly and adversely affected.

Overview

In concert with proposing a new systemic-risk methodology,[1] the Financial Stability Oversight Council sought comment on guidance that significantly rewrites the manner in which nonbanks are designated as systemically important financial institutions (SIFIs). The new approach retracts key aspects of the Trump FSOC's approach,[2] for example eliminating the necessity of determining if a possible designee is likely to fail and what the costs and benefits of new systemic standards are likely to be. Although the new approach retains numerous procedural opportunities for the possible designee to know of and protest action, these and other changes make designation more likely. Should it occur, the SIFI would then be regulated by the Federal Reserve at considerable cost to current business models but potential benefits to financial stability.

[1] See **SYSTEMIC95**, *Financial Services Management*, April 26, 2023.

[2] See **SIFI35**, *Financial Services Management*, December 18, 2019.

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Impact

FSOC's latest action in many ways returns the SIFI-designation process to the one established by rule along with interpretive guidance in 2012.[3] Although much in the 2019 revision would be retained when it comes to interactions with possible designees, the new approach significantly changes the criteria for designation and the process now requiring extensive consideration of alternative approaches with other state and federal regulators.

Among the most controversial changes proposed now is deletion of the 2019 requirements for cost-benefit analysis (CBA). A 2016 District Court decision overturned MetLife's designation on grounds that FSOC had failed to conduct a cost-benefit analysis,[4] but FSOC now believes that this ruling was based on an inaccurate read of the law as also requiring a finding of the likelihood of material financial distress. Since the proposal would not continue to require this, no cost-benefit assessment is deemed necessary.

FSOC also states that the Dodd-Frank Act expressly omits any requirement to assess cost if a company meets the statutory definition of a threat to financial stability.[5] The proposal concludes that financial crises can cost trillions and those related to designation depend on the specific prudential standards the Fed might impose which cannot be judged at the time of designation.

As noted, the Council also reverses a prior requirement of the likelihood of material distress. It does so in part because it believes that announcing any such finding could precipitate a run on a nonbank company or adversely affect its ability to do business, noting that this is the rationale for keeping CAMELs ratings confidential. Nonbanks have countered that designation is inappropriate if systemic risk is purely hypothetical, but this is also the approach adopted for designating U.S. GSIBs for additional prudential regulation.[6]

What's Next

The proposal describes why the Council does not believe this is a rulemaking, noting that – even though comment is requested – the Administrative Procedures Act does not apply; by inference, this reading also rejects the need to make this new approach express guidance. As with the systemic methodology, this new methodology was unanimously proposed by the FSOC on April 21. Comments are due June 27.

The designation proposal was more controversial upon issuance than the analytical framework likely because nonbanks fear the cost of SIFI designation. Republicans may well try to overturn the final guidance, but it is unclear if the Congressional Review Act applies to such interpretations. Even if it does, any

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[3] See **SYSTEMIC60**, *Financial Services Management*, April 16, 2012.

[4] See *Client Report*, **SIFI19**, April 18, 2016.

[5] See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

[6] See **GSIB10**, *Financial Services Management*, April 5, 2017.

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effort to reverse it will be blocked in the Senate and, were that not the case, vetoed by the President.

Analysis

A. New Framework

Key changes to the 2019 interpretive guidance would:

- remove what the Council now believes are inappropriate "hurdles" to systemic designation established in 2019 by eliminating initial deference to federal and state regulators to ameliorate any systemic risks identified by the Council using the activities-based option, using the analytical framework once finalized, and eliminating the necessity for cost-benefit analyses of systemic designation or those of the likelihood of material financial distress;
- revise the 2019 definition of a threat to the U.S. financial stability to delete a requirement that the economy must found to be "severely damaged" in favor of the current Council's view of Dodd-Franks standards for this determination with specific regard only to the financial system. Judgments about financial stability would as noted now be based on the new analytic framework;
- eliminate the requirement that the Council first consider an activities-based approach before advancing designations; and
- lay out the process by which the FSOC will advance a possible designation.

B. Request for Comment

Views are sought on matters such as:

- the interaction between the designation methodology and analytical framework;
- the proposed removal of activities designation as a requirement prior to advancing a firm-specific designation;
- the effectiveness of the initial staff-level identification process;
- the need for specific analytical metrics for nonbank sectors and, if this is recommended, what these metrics should be; and
- the statutory ramifications of removing the CBA and material-financial-distress conditions, the way material financial distress could be defined if retained, and what any such finding would do to a nonbank financial company.

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