Nonbank SIFI Designation

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

Recommended Distribution
Policy, Legal, Government Relations

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

Impact Assessment

- Nonbank asset managers, mortgage companies, payment providers, tech platforms, insurers, and other entities posing identified risks are again at risk of SIFI designation and thus costly Fed regulation.
- Some "shadow banks" would thus be brought within the regulatory perimeter, reducing arbitrage risk and competitive challenges to GSIBs and other regulated entities but sharply increasing a SIFI's regulatory cost and operational burden.
- Availability and cost of targeted nonbank financial products could be adversely affected based on how many companies are designated and/or the concentrated market power a designee holds.

Overview

In concert with finalizing a new systemic-risk methodology,[1] the Financial Stability Oversight Council issued guidance that significantly rewrites the manner in which nonbanks are designated as systemically important financial institutions (SIFIs), largely retaining its initial proposal.[2] The new approach retracts the Trump FSOC's approach via an entirely new framework,[3] now eliminating the necessity of determining if a possible designee is likely to fail and what the costs and benefits of designation is likely to be. Although the new approach retains numerous procedural opportunities for the possible designee to know of and protest action, the new protocol still makes designation more likely. Should it occur, the SIFI would then generally be regulated by the Federal Reserve at a

1 See **SYSTEMIC60**, *Financial Services Management*, April 16, 2012.
2 See **SIFI36**, *Financial Services Management*, May 3, 2023.
3 See **SIFI35**, *Financial Services Management*, December 18, 2019.

considerable cost to current business models but with potential benefits to financial stability.

Impact

FSOC's latest action in many ways returns the SIFI-designation process to the one established in 2012.[4] Although much in the 2019 revision is retained when it comes to interactions with possible designees, the new approach significantly changes the criteria for designation and eliminates the requirement for extensive consideration of alternative approaches.

The most controversial change 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,[5] but FSOC believes that this ruling was based on an inaccurate reading of the law as also requiring a finding of the likelihood of material financial distress. Since FSOC will 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 find a company meets the statutory definition of a threat to financial stability.[6] Even so, the new guidance on systemic analytics defines this term to mean a threat to financial stability as events or conditions that could "substantially impair" the financial system's ability to support economic activity. This provides some additional clarity, but creates far less of a hurdle to designation than the 2019's requirement of finding a "severe" threat to financial stability. The point of this change in part is to ensure that the designation process, like the analytical framework, also responds to emerging risks.

As noted, the Council also reversed the prior requirement of finding the likelihood of material distress. It did 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 rating confidential. Nonbanks have countered that designation is inappropriate as systemic risk is purely hypothetical, but this is also the approach adopted for designating U.S. GSIBs for additional prudential regulation.[7]

MetLife, P&C, and re-insurance companies all argued that entity-based designation is inappropriate in their sectors, as did asset managers, mutual and bond funds, fintechs, private funds, nonbank mortgage companies, and securitizers. As with the 2019 guidance, the FSOC here declines to immunize any sector from scrutiny, because its analysis will reflect sector-specific considerations. Further, activity-and-practice designation for a sector as a whole remains an option where entity-specific designation does not apply. However, the new FSOC approach no longer prioritizes activity-and-practice designation over entity-based designation as in the 2019 standards. As a result, no nonbank

[4] See **SYSTEMIC60**, *Financial Services Management*, April 16, 2012.
[5] See *Client Report*, **SIFI19**, April 18, 2016.
[6] See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.
[7] See **GSIB22**, *Financial Services Management,* August 22, 2023.

sector won the exemption from FSOC consideration and potentially-costly rules many had fervently sought.

The new FSOC approach also largely retains the Trump Administration's designation and de-designation process. As a result, there would be extensive discussion with a possible designee and its primary federal regulator. Unlike the 2019 standards, state regulators would not necessarily be consulted, a blow to insurance companies and nonbanks – e.g., payment-service providers, certain cryptoasset companies, and nonbank mortgage originators – who believe state regulation suffices.

The effect of these and other provisions restored to the non-bank designation process or instituted for the first time is to increase the likelihood that FSOC will begin again to designate nonbank financial companies, likely doing so in sectors where direct federal regulation is not permitted and the Council deems that direct or indirect sector-wide activity/practice standards do not suffice.

What's Next

The final standards were adopted on November 3 by unanimous FSOC vote. As noted, the new guidance rejects findings in prior litigation reversing one SIFI designation and reverses Trump Administration designation requirements such as a cost-benefit analysis. FSOC is at pains to lay out its legal reasoning in doing so, rejecting also suggestions that its approach could be deemed arbitrary and capricious. It nonetheless seems likely that any firm ultimately designated as a SIFI following the new, more deliberative process might litigate the designation rather than face its significant costs.

Analysis

The final standards emphasize that FSOC continues to prefer to address issues through primary federal regulators, not via designation.

A. New Framework

As noted, systemic risk will be determined under the new analytical methodology. This interpretive statement thus deals only with how these determinations will be applied to potential designees.

B. Designation/De-Designation Process

Designation will depend on the analytical methodology as well as the framework outlined above which refines consideration to the specific factors dictated in the

Dodd-Frank Act for entity designation. The council rejected comments seeking further refinement of designation criteria, such as weightings for different factors or standards for specific sectors on grounds that each company may present different concerns.

The new process, like its predecessor, includes notice to a possible designee following initial FSOC deliberations and a step-by-step process for consultation with the entity and a hearing if requested. Although the process expressly requires only consultation with federal regulators, these may also occur with state regulators. Proposed designation would occur under a detailed two-stage process premised on the analytical methodology, requiring a two-thirds Council vote, including that of the Treasury Secretary. A nonbank company may request a hearing to object, with the same two-thirds vote and that of the Secretary necessary to designate a company and subject it to FRB regulation. Designation would then be made public, with FSOC emphasizing that the firm and its primary regulator will be encouraged to address identified problems, and mitigate them to permit de-designation.

De-designation could then occur under an annual review process also detailed in the final standards.