Systemic-Risk Determinations

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Impact Assessment

- The new systemic methodology expands many criteria for systemic intervention that could lead to Council recommendations or designations beyond the banks and FMUs now subject to systemic standards.
- A new focus also on transmission channels could lead primary federal regulators to cut key risk-transfer nodes when market sectors or key players are outside the federal regulatory perimeter. This would largely be done by standards limiting nonbank access to regulated institutions and/or payment, settlement, or clearing systems.
- FSOC's systemic criteria differ from those leading the Fed to designate GSIBs, creating the possibility of SIFI designation for smaller banks if the Fed concurs.
- One systemic vulnerability is said to be market concentration as evidenced in part by market share. As a result, the systemic-designation process could achieve competition objectives in addition to those more traditionally thought of as key to financial stability.
- Emerging products could be deemed systemic even if not yet at scale of demonstrably systemic proportions. This could bring digital assets, AI, or other financial products or technologies under direct or indirect regulation.
- Threats to minority or other under-served communities are not a significant systemic consideration despite statutory authority in this area.

Overview

Rejecting the Trump Administration's hands-off approach to designating systemically-important nonbank financial institutions or activities and practices,[1] the Biden Administration's FSOC has finalized its bifurcated proposals to designate systemic entities[2] and another laying out an analytical approach to identifying systemic risk that would then guide firm and activity designation as well as Council

[1] See **SIFI32**, *Financial Services Management,* March 14, 2019.

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

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staff coordination with primary federal regulators. This is likely to lead to new additional systemic entity-based designations, rules, product or service prohibitions/restrictions, and/or firm-specific supervisory action.[3] The final framework is as comprehensive as the proposal, meaning that U.S. systemic standards could extend far more widely than is now the case even if firm-specific nonbank designations are few and far between.

Impact

FSOC's goal with this new methodology is to craft a transparent framework that informs public understanding of when the Council may use its authority to designate or de-designate a firm, activity, or some other feature of the U.S. financial system. The reach of these new risk-identification criteria is sweeping. Indeed, FSOC's readout of the meeting at which this proposal was approved notes that systemic consideration was already under way for nonbank mortgage companies and hedge funds. It is thus possible that FSOC-led intervention in these sectors may now quickly follow in concert with action on issues that have taken on new prominence such as AI in the wake of the President's executive order focusing on systemic risk among other concerns.[4]

The manner in which systemic standards are imposed could then vary widely and come with or without advance public notice. The Council could for example ask primary regulators of entities it believes either are exposed to risk or enable it to reduce ties to targeted firms and/or sectors. However, if the Council pursues systemic activity- or-practice designation for these two sectors or any others, then it would first need to seek public notice and comment. However, even if public comment is favorable, FSOC is limited in applying direct systemic regulation upon any such finding in some cases because the Dodd-Frank Act allows the Council only to commend a designated activity or practice to a primary federal regulator for additional regulation.[5] Neither nonbank mortgage companies nor hedge funds have a primary federal prudential regulator, giving the Council few direct options should it make a systemic determination under this methodology other than selecting large providers for possible designation.

However, because FSOC is likely to believe that sectors with few dominant providers are challenging to contain via designation, the Council in such an instance could instead turn to limiting the ability of regulated entities to do business with sectors or entities deemed systemic. "Proxy" regulation was proposed in the Obama Administration's Council, which considered it in 2015 for asset management. This never advanced in the Trump Council, but could do so now.[6]

In addition to using bank or similar regulation as a way to reduce systemic- risk transmission, the new FSOC methodology could lead to additional, direct bank regulation. Perhaps most striking is the list of vulnerabilities that differs markedly from those used by the Federal Reserve to designate global systemically-important banks (GSIBs).[7] The Council could thus press the FRB, FDIC, and/or OCC to

3 See **SYSTEMIC95**, *Financial Services Management*, April 26, 2023.

4 See Client Report **AI3**, October 31, 2023.

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

6 See **SYSTEMIC75**, *Financial Services Management*, January 5, 2015.

7 See **GSIB7**, *Financial Services Management*, July 23, 2015.

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introduce new risk constraints, remediation, resolution, or other standards on banks with particular activities, practices, or characteristics it believes stoke systemic risk. As detailed in the methodology, one or more agency could then follow through with specific standards, broader rules, or supervisory restrictions for one or more banks or even groups of institutions that share certain characteristics the agencies believe warrant revisions to the tailoring rules or other action.[8]

As discussed below, systemic risk is said to be found not only in institutions of scale or that provide essential services as has generally been the case so far. Emerging products or technologies could also be deemed systemic even if not yet a scale, a provision likely included because of recent FSOC and PWG findings that digital and crypto assets could quickly pose systemic risk.[9] Market power could also be a criterion for systemic designation based on findings that it resulted in vulnerabilities also defined in this guidance such as asset or pricing correlations. However, while mentioning the statutory requirement that activity-and-practice designation consider risks to minority or under-served communities, the methodology has no concrete steps by which FSOC will do so.

As with the Trump Administration's policy, nothing in this rewrite alters the manner in which financial-market utilities (FMUs) are identified for subsequent systemic designation.[10] However, the new risk-identification methodology takes a sweeping view of risk across CCPs and other payment, settlement, or clearing firms. Here, primary regulators – the Fed, SEC, and CFTC – have express statutory authority to govern any entity deemed an FMU even if it is otherwise outside the scope of federal regulation. The FSOC has long pressed for greater attention to CCP resolvability and has also focused on margin practices since the 2020 crisis. The extent to which FSOC now moves to intervene in these or other areas remains unclear, but the methodology provides an express platform for doing so that could not only impose new standards on designated FMUs, but also increase the number of entities so designated.

Although commenters urged the Council to add climate change to its risk of identified vulnerabilities, FSOC declined to do so on grounds that its methodology captures climate financial risk without the need for segregated standards. This approach differs sharply from the new inter-agency climate-risk guidance,[11] where the banking agencies decided that existing risk-management and prudential standards do not suffice.

What's Next

The Council unanimously approved this final guidance on November 3.

[8] See **SIFI34**, *Financial Services Management*, October 23, 2019.

[9] See Client Report **CRYPTO32**, September 21, 2022.

[10] See Client Report **FMU14**, March 18, 2019.

[11] See **CLIMATE17**, *Financial Services Management*, November 1, 2023.

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Analysis

FSOC is at pains to make clear that this methodology is not a binding rule even though it sought public comment. The Council retains the right to make systemic designations on a case-by-case basis.

A. Definitions

Systemic risk is said to be possible in:

- markets for debt, loans, short-term funds, equities, commodities, digital assets, derivatives, and others;
- CCPs and FMUs;
- financial entities such as banks, broker-dealers, asset managers, investment companies, insurance companies, mortgage originators and servicers, and specialty finance companies;
- new or evolving financial products or services; and
- cyber, climate, or other risks to systemic resilience.

The analytic framework interprets "financial stability" as the financial system being resilient to events or conditions that could impair its ability to support economic activity, such as by intermediating financial transactions, facilitating payments, allocating resources, and managing risks. The final guidance goes beyond the proposal also to define threat to financial stability as events or conditions that could "substantially impair" the financial system's ability to support economic activity.

Each annual FSOC report will detail the Council's findings on systemic risk along these varying dimensions.[12]

B. Risk Identification

To determine which risks warrant discussion in the annual report or more immediate action, the Council will continue to gather data and coordinate with member and other agencies, including global bodies. A non-exhaustive list of vulnerabilities and metrics the Council expects to consider include:

- leverage evident at individual institutions or across markets measured by factors such as capital to risk-based assets;
- liquidity risk or maturity mismatches, measured by metrics such as the ratio of short-term debt to unencumbered, high-quality assets;
- inter-connections such as concentrated exposures or margin requirements. FSOC also here considers asset-class correlation risk across the financial sector;
- operational risk judged by metrics such as cyber-security breaches, and critical- infrastructure scale;
- complexity or opacity judged by scale, legal or organizational complexity and complex funding structures;
- inadequate risk management due to entity practice or inapplicable regulation in areas such as capital and liquidity;

[12] See Client Report **FSOC28**, December 19, 2022.

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- concentration where a small number of entities controls key markets or perform essential functions. This will be measured by market share; and
- "destabilizing activity" such as those that increase volatility even where this is permitted by applicable regulation. Activities that involve moral hazard or conflicts of interest also fall into this category.

The Council may take action – e.g., activity, practice, entity, or FMU designation – based on its conclusions about vulnerabilities on the dimensions described above, but designation of FMUs and non-bank SIFIs will proceed under the newly-finalized designation standards and other applicable rules.

C. Risk Transmission

Transmission channels are:

- correlated, concentrated, inter-connected, or acute losses related to exposures managed by a company on behalf of others or on its own balance sheet;
- asset liquidation due to a loss of asset value or market function that results in fire sales;
- critical-service disruption; and
- contagion, the risk of which rises with opaque markets, market correlation, or operational risk. It may also occur when money-equivalent assets suffer a loss of confidence.

D. FSOC Action

The statement details the internal process which FSOC will generally follow when systemic risks are identified via the methodology outlined above. Steps thereafter include:

- inter-agency coordination and information-sharing, a step that could lead to regulatory intervention to reduce identified risks;
- formal recommendations to regulators and/or Congress;
- systemic activity-or-practice designation;
- nonbank SIFI designation (an issue addressed in more detail in the companion guidance noted above); and
- FMU designation.

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