Davis Polk

FSOC revisits its nonbank “systemically important financial institution” designation framework

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Key takeaways from the proposals

- On April 21, 2023, the Financial Stability Oversight Council (**FSOC**) unanimously approved two proposals (the **Proposals**) for public comment regarding FSOC's authority to designate nonbank financial companies for Federal Reserve supervision and regulation, which had previously been used during the Obama administration to designate insurers and a savings and loan holding company as "systemically important financial institutions" (**SIFIs**).
  - (1) the Proposed Interpretive Guidance on the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (the **Nonbank Designation Guidance Proposal**) (available **here**, together with a summary fact sheet **here**); and
  - (2) the Analytic Framework for Financial Stability Risk Identification, Assessment and Response (the **Proposed Risk Analytic Framework**) (available **here**, together with a summary fact sheet **here**).
- Through the Proposals, FSOC has proposed to reverse key aspects of the changes made during the Trump administration to the nonbank financial company designation framework and procedures. See slides **4-7** for a comparison of the existing guidance finalized in December 2019 (the **2019 Nonbank Designation Guidance**) and the Proposals. See **here** for our prior client memo on the 2019 Nonbank Designation Guidance.
- Some of the changes reflected in the Proposals would seek to eliminate elements of the 2019 Nonbank Designation Guidance that incorporated and addressed certain holdings of the *MetLife v. FSOC* decision, under which the federal District Court in D.C. ruled to invalidate the FSOC's designation of MetLife.

Key takeaways from the proposals

- In remarks accompanying the Proposals (here), Treasury Secretary Yellen stated that the changes reflected in the Nonbank Designation Guidance Proposal are needed because "[t]he existing [2019] guidance created inappropriate hurdles as part of the designation process. . . . It has been estimated that a designation process with these steps could take six years to complete. That is an unrealistic timeline that could prevent [FSOC] from acting to address an emerging risk to financial stability before it's too late."
- The Proposals are intended to provide the SIFI designation authority co-equal footing with FSOC's other authorities, and make it available to FSOC to use as a practical matter out of a recognition that an "entity-focused approach may be [ ] appropriate" in certain circumstances.
  - For example, in her remarks, Treasury Secretary Yellen suggested that designation may be appropriate where systemic risks emanate from a "particular entity – one that might not be within the jurisdiction of a regulator with adequate prudential or supervisory authorities."
- The Proposals do not reintroduce the concept of screening criteria reflected in the guidance issued by the Obama-era FSOC in 2012 that established a pool of potential candidates for SIFI designation. See the Appendix for a summary of the screening quantitative metrics used in the 2012 nonbank financial company guidance (the **2012 Nonbank Designation Guidance**).
  - The 2019 Nonbank Designation Guidance did not retain the quantitative metrics on the basis that these metrics "generate confusion among firms and members of the public and [are] not compatible with the prioritization of an activities-based approach."

Select aspects of the 2019 Nonbank Designation Guidance

Topic	2019 Nonbank Designation Guidance
Prioritization of an activities-based approach	– FSOC “**prioritize[s]** its efforts to identify, assess and address potential risks and threats to U.S. financial stability through . . . an activities-based approach” and expects to consider nonbank designations “only if a potential risk or threat cannot be adequately addressed through an activities-based approach.”
Cost-benefit analysis	– **Designation Authority.** The 2019 Nonbank Designation Guidance requires FSOC to determine, prior to any designation, that the expected benefits to financial stability from the entity-based designation justify the expected costs that the designation would impose. – **Recommendation Authority.** The 2019 Nonbank Designation Guidance provides that before making a recommendation to a federal regulatory agency pursuant to Section 120 of the Dodd-Frank Act for new or heightened standards and safeguards, FSOC will ascertain whether the primary financial regulatory agency would be expected to perform a cost-benefit analysis of the actions it would take in response to FSOC’s contemplated recommendation. If no such analysis is expected, then FSOC performs the cost-benefit analysis itself prior to making a final recommendation. When FSOC conducts its own analysis, it makes a recommendation under Section 120 of the Dodd-Frank Act only if it believes that the results of its assessment of benefits and costs support the recommendation.
Interpretation of “threat to U.S. Financial stability”	– The 2019 Nonbank Designation Guidance Proposal interprets the term “threat to the financial stability of the United States” (a statutory standard under Section 113 of the Dodd-Frank Act used to designate a nonbank financial company as a SIFI) to mean a “threat of an impairment of financial intermediation or of financial market functioning that *would* be sufficient to inflict severe damage on the broader economy” (emphasis added).

Select aspects of the 2019 Nonbank Designation Guidance

Topic	2019 Nonbank Designation Guidance
SIFI designation procedures	– The existing SIFI designation process as set forth in the 2019 Nonbank Designation Guidance includes the following attributes: ▪ **Two Stage Process:** – **Stage 1** involves a preliminary analysis of the nonbank financial company based primarily on public or regulatory quantitative and qualitative information, and provides opportunities for the nonbank financial company to engage with FSOC staff; and – **Stage 2** involves (1) an in-depth examination of the basis for the designation of a nonbank financial company that moved through Stage 1, in which the company is involved; (2) a vote of the FSOC members on the proposed designation of the nonbank financial company; (3) a hearing in the case the nonbank financial company requests one following the proposed designation; and (4) a vote of the FSOC members on the final designation of the nonbank financial company. ▪ **Removal of Threshold Criteria.** The streamlined approach set forth in the 2019 Nonbank Designation Guidance eliminated a threshold stage under guidance issued in 2012 (the **2012 Nonbank Designation Guidance**) pursuant to which FSOC used a set of uniform, quantitative metrics to identify nonbank financial companies to be subjected to the more qualitative, company-specific evaluations in subsequent stages, as discussed in more detail in the Appendix. ▪ **Likelihood of Financial Distress.** FSOC assesses the likelihood of a nonbank financial company's material financial distress when evaluating the entity for a potential designation. ▪ **Transparency and Engagement.** The 2019 Nonbank Designation Guidance includes procedural elements intended to facilitate additional engagement with entities under consideration and transparency into FSOC's processes, including providing entities with greater visibility into the aspects of their business that may pose risks to U.S. financial stability. ▪ **De-designation Processes.** FSOC further defined procedures for an "off ramp" from designation, including annual reevaluations, in which FSOC may rescind its SIFI designation if an entity or its regulators take steps to mitigate the potential risks identified in FSOC's written explanation of the basis for its designation.

Summary of the proposals

Topic	Changes reflected in the proposals
Prioritization of an activities-based approach	– The Proposals together clarify that FSOC's nonbank designation authority would not be de-prioritized as compared to an activities-based approach. – While elements of the basic framework (i.e., the identification, assessment and addressing of financial stability risk) and certain other considerations, such as manner of risk transmission, would be retained as part of the Proposals, the Proposed Risk Analytic Framework would put designation authority on a co-equal footing with the other authorities available to the FSOC. See slide 8-10 for a description of the Risk Analytic Framework. – In addition, the Nonbank Designation Guidance Proposal would eliminate guidance that prioritizes an activities-based approach.
Cost benefit analysis	– **Designation Authority.** FSOC would **not** be required to analyze whether the expected benefits to financial stability from the entity-based designation justify the expected costs. – **Recommendation Authority.** FSOC **would no longer be** required to conduct a cost-benefit analysis in instances where an existing financial regulatory agency is not required to make a cost-benefit analysis, before issuing a recommendation pursuant to Section 120 of the Dodd-Frank Act.
Interpretation of "threat to U.S. Financial stability"	– The Nonbank Designation Guidance Proposal would remove the definition of "threat to U.S. financial stability" set forth in the 2019 Nonbank Designation Guidance (see slide 4 above), stating that the definition "contrasts sharply with the statutory standard under section 113 of the Dodd-Frank Act, which calls on [FSOC] to determine whether there 'could' be a threat to financial stability." – FSOC specifies that it "would expect to evaluate a 'threat to the financial stability of the United States' with reference to the description of financial stability provided in" the Proposed Risk Analytic Framework. See slides 8-10 for a description of the Proposed Risk Analytic Framework.

Summary of the proposals

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<tr><th>Topic</th><th>Changes reflected in the proposals</th></tr>
<tr><td>SIFI designation procedures</td><td>
– The Nonbank Designation Guidance Proposal retains certain procedural aspects of the 2019 Nonbank Designation Guidance, including the following:

The Nonbank Designation Guidance Proposal has the same structure of a two-stage nonbank financial company designation process.
As in the 2019 Nonbank Designation Guidance, the Nonbank Designation Guidance Proposal does not reintroduce a threshold stage included in the 2012 Nonbank Designation Guidance in which a set of uniform, quantitative metrics were used to identify nonbank financial companies to be subjected to additional review by FSOC. See <u>Appendix</u> for the quantitative metrics set forth in the 2012 Nonbank Designation Guidance.
The procedural aspects to facilitate engagement with and transparency from FSOC throughout the designation process stayed largely the same. The Nonbank Designation Guidance Proposal would add some additional engagement and transparency mechanisms, such as clarifying the period in which the FSOC must provide notice to a company under review of the vote to proceed from Stage 1 to Stage 2 of the designation process.
The Nonbank Designation Guidance Proposal retains the process for annual reevaluation and potential de-designation of a designated nonbank financial company in the case that an entity or its regulators take steps to mitigate the potential risks identified in FSOC’s written explanation of the basis for its designation.

– The Nonbank Designation Guidance Proposal would no longer require FSOC to assess the likelihood of a nonbank financial company’s material financial distress.
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Proposed risk analytic framework

- The Proposed Risk Analytic Framework is intended to provide “new public transparency” about how FSOC **identifies, assesses** and **responds to** potential risks to financial stability, regardless of whether the risk stems from specific activities, firms or otherwise.
- By separating the Proposed Risk Analytic Framework from the Nonbank Designation Guidance Proposal, the Proposed Risk Analytic Framework may be changed without being subject to the public comment requirement set forth in 12 CFR § 1310.3.
- With respect to the **identification of risks**, the Proposed Risk Analytic Framework sets forth certain categories within which FSOC, in coordination with relevant financial regulators, would monitor financial stability risks, including:
  - certain financial markets;
  - central counterparties and payment;
  - clearing and settlement activities;
  - financial entities;
  - new or evolving financial products and practices;
  - and developments affecting the resiliency of the financial system.

Proposed risk analytic framework

- While the manner of **assessing identified risks** is often highly fact specific, the proposed framework specifies that FSOC generally would consider certain common vulnerabilities and the manner in which the adverse effects of potential risks would be transmitted throughout the financial markets, as part of its assessment process. The list of vulnerabilities and transmission channels are not exhaustive, but instead indicative of what FSOC would expect to consider.
  - **Vulnerabilities.** The Risk Analytic Framework specifies certain vulnerabilities that FSOC expects to consider in evaluating potential risks to financial stability, including: leverage; liquidity risk and maturity mismatch; interconnections; operational risks; complexity or opacity; inadequate risk management; concentration; and destabilizing activities.
  - **Transmission Channels.** FSOC considers how the adverse effects of potential risks could be transmitted to financial markets or market participants and what impact the potential risk could have on the financial system. While the transmission of risk can occur through various mechanisms or channels, the Risk Analytic Framework identifies those which FSOC considers the **four most common**: (1) exposures; (2) asset liquidation; (3) critical function or service; and (4) contagion.

Proposed risk analytic framework

- In **addressing risks**, the Proposed Risk Analytic Framework stresses that FSOC may use “different approaches” or “multiple tools to mitigate” an identified risk depending on the circumstance once the risk has been identified and assessed in accordance with the framework, and that “the actions [FSOC] takes may depend on the circumstances.”
  - When a potential risk to financial stability is identified, FSOC may consider using any of FSOC’s authorities to respond to risks to U.S. financial stability, including:
    - **Facilitating interagency coordination and information sharing.** FSOC has the authority to work with relevant federal and state financial regulatory agencies to seek the implementation of appropriate actions to ensure a potential risk is adequately addressed.
    - **Making recommendations to agencies or Congress** to apply new or heightened standards and safeguards for a financial activity or practice as provided for under Section 120 of the Dodd-Frank Act.
    - **Designating a nonbank financial company** as subject to Federal Reserve regulation and supervision, in accordance with the procedures set forth in the Nonbank Designation Guidance Proposal.
    - **Designating a financial market utility or payment, clearing or settlement activity** as systemically important under Title VIII of the Dodd-Frank Act.

Appendix: Threshold criteria to SIFI designation process

- **Absence of Threshold Criteria in the Proposals.** As in the 2019 Nonbank Designation Guidance, the Nonbank Designation Guidance Proposal does not include any quantitative metrics to apply during an initial stage to determine which nonbank financial companies should be a focus in subsequent evaluation stages.
- **Threshold Criteria under the 2012 Guidance.** The 2012 Nonbank Designation Guidance included a three stage designation process (rather than a two-stage process as set forth in the 2019 Nonbank Designation Guidance and Nonbank Designation Guidance Proposal). During the threshold stage, FSOC determined which nonbank financial companies should be a focus for subsequent evaluations through the application of uniform, quantitative metrics.
  - To advance beyond the initial stage, a nonbank financial company was required to satisfy the "**total consolidated assets size**" **threshold of ≥ $50 billion** and, in addition, **one of five factors:**
    1. **Total Debt Outstanding.** ≥ $20 billion of total debt outstanding.
    2. **Credit Default Swaps.** ≥ $30 billion in gross notional credit default swaps outstanding for which the financial company is the reference entity.
    3. **Derivatives Liabilities.** ≥ $3.5 billion of derivative liabilities.
    4. **Leverage Ratio.** Leverage ratio of total consolidated assets to total equity ≥ 15:1.
    5. **Short-Term Debt Ratio.** Short-term debt to total consolidated assets (excluding, as above, separate accounts for insurers) of ≥ ten percent.

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