Davis Polk

FSOC 2023 Annual Report: Takeaways and observations

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Key takeaways

- At the end of last year, the Financial Stability Oversight Council (**FSOC**) released its 2023 Annual Report, highlighting its 2023 activities, significant financial market and regulatory developments and potential emerging threats to U.S. financial stability.
- Compared to the 2022 Annual Report, the 2023 Annual Report identifies slightly different vulnerabilities in the U.S. financial system. Key changes to identified vulnerabilities are indicated for additions and removals, respectively:

Financial Risks	Financial Institutions	Financial Market Infrastructure, Operational Risk and Technological Risk
– Commercial Real Estate – Residential Real Estate – Corporate Credit – Short-Term Funding Markets – Digital Assets – Climate-Related Financial Risks	– G-SIBs and Large Non-G-SIBs* – Regional Banks* – Investment Funds – Central Counterparties – Insurance Sector	– Treasury Markets – Cybersecurity – The Use of Artificial Intelligence (**AI**) in Financial Services – Third-Party Service Providers – ~~Alternative Reference Rates~~ – ~~Provision of Financial Services by Nonbank Financial Institutions~~

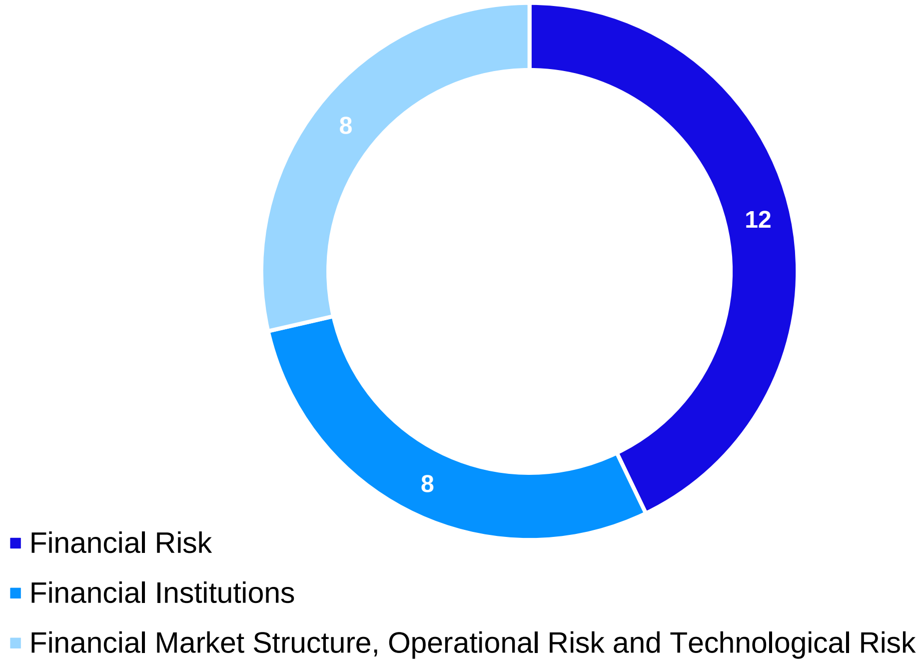
* In 2022, discussion of G-SIBs, large non-G-SIBs and regional banks was included in a single discussion entitled "Large Bank Holding Companies." In 2023, the banking sector is segmented differently, as discussed on slide 6.

Key takeaways

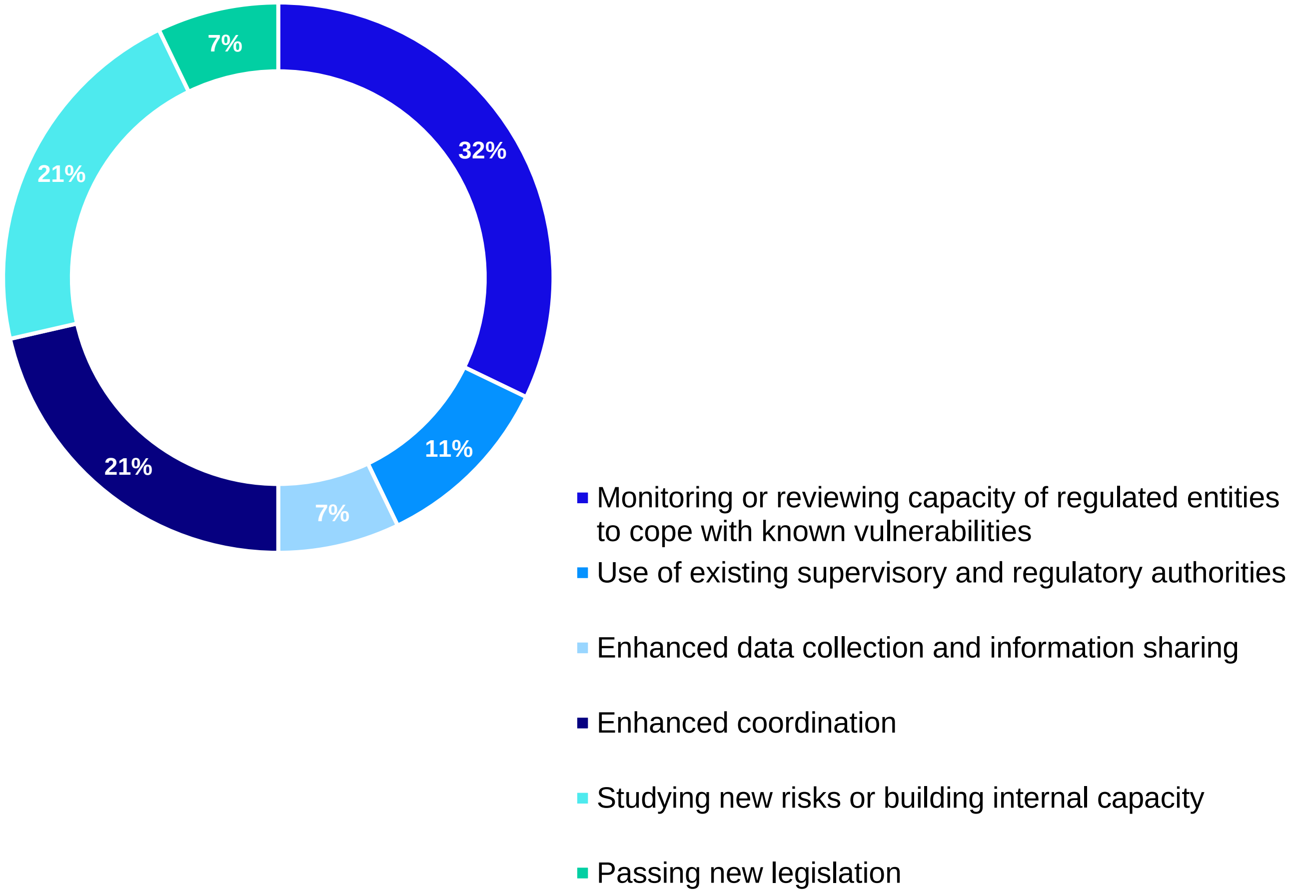
- Although FSOC removed "Provision of Financial Services by Nonbank Financial Institutions" as an identified vulnerability, related discussion, including with respect to private credit and nonbank mortgage originators and servicers, remains prevalent throughout the 2023 Annual Report. For example, the 2023 Annual Report states that the "level of opacity in private credit markets can make it challenging for regulators to assess the buildup of risks in the sector" and that the "Council also supports enhanced data collection on nonbank lending to nonfinancial businesses to provide additional insight into the potential risks associated with the rapid increase in private credit."
- FSOC member agencies already have taken steps to address some of FSOC's concerns about nonbank financial intermediation. For instance, at the end of 2023, the banking agencies proposed new reporting requirements (available here) that would provide the agencies with more information about bank exposures to private funds and private credit providers.

Summary of FSOC recommendations to address key vulnerabilities

Number of recommendations mapped to vulnerabilities



Types of recommendations*



Source: [FSOC 2023 Annual Report]
* Reflects Davis Polk's discretion in allocating recommendations to each category.

Key changes from 2022: The use of AI in financial services

- FSOC identified the use of artificial intelligence in financial services as a vulnerability in the U.S. financial system. In particular, FSOC noted the use of:
  - Internal models that leverage AI to detect and prevent fraud, provide customer service, review documents and extend credit; and
  - Generative AI to identify patterns in large datasets and develop new content, such as responding to queries.
- FSOC noted that:
  - Financial institutions' reliance on internal models that leverage AI on large data sets heightened the importance implementing of proper data controls and, moreover, that these models may not apply well to conditions outside of the data on which they are trained.
  - Generative AI may create results which are not correct or consistent but nevertheless persuasive, concluding generative AI may create risks and undermine proper data governance.
  - Where complex modeling may create or mask biases or inaccurate results and therefore consumer compliance risks, financial institutions and regulators must monitor the quality of AI model outputs.
- FSOC concluded that existing requirements and guidance may already apply to AI and recommended that financial institutions, market participants and regulatory and supervisory authorities should continue to monitor developments in AI and build expertise in the technology.

Key changes from 2022: The use of AI in financial services

- Several members of FSOC, in their capacities as heads of their agencies, have indicated an interest in further research and potential application of their individual agencies' authorities to AI; for example:
  - Director of the Consumer Financial Protection Bureau (**CFPB**) Rohit Chopra stated that:
    - The CFPB would scrutinize use of AI in consumer finance contexts, including bias in lending and algorithmic advertising (available here); and
    - "[E]xtremely opaque AI" and "mimicry of human communication" may create or magnify disruptions in financial markets (available here).
  - Chair of the Securities and Exchange Commission (**SEC**) Gary Gensler stated that:
    - Securities laws and SEC authority "may be implicated depending upon how AI technology is used" (available here).
    - AI "may heighten financial fragility, as it could promote herding[,] encourage monocultures [and] exacerbate the inherent network interconnectedness of the global financial system. Thus, AI may play a central role in the after-action reports of a future financial crisis" (available here).

Key changes from 2022: Segmentation of banking sector and expanded discussion of regional banks

- In the 2022 Annual Report, FSOC identified a single group of large bank holding companies, those with over $10 billion in assets, in its discussion of vulnerabilities emanating from the banking sector.
- In the 2023 Annual Report, FSOC identified vulnerabilities in the U.S. banking system arising from interest rate conditions and the effects of those conditions on banks' securities portfolios, reliance on uninsured deposits and concentrations of commercial real estate.
- In a change from last year, the discussion of identified vulnerabilities in the U.S. banking system in the 2023 Annual Report is divided in two categories.
  - The section on "G-SIBs and Large Non-GSIBs" reviews the U.S. financial stability risks arising from bank holding companies with $250 billion or more in assets. FSOC reviewed bank capital and profitability, credit quality and lending standards and liquidity and funding, concluding they are each generally healthy, although notes ongoing risks associated with commercial real estate portfolios.
  - The section on "Regional Banks" reviews the U.S. financial stability risks arising from bank holding companies with between $100 billion and $250 billion in assets. FSOC reviewed bank capital and profitability, liquidity and funding and credit risks, concluding that increases in funding costs, deposit outflows and declines in lending volumes could affect bank profitability, and commercial real estate portfolios in regional banks may be sources of financial stability risk.
  - This new segmentation between large "systemically important" banks and other regional banks likely reflects how the banking agencies think about the banking sector more generally from a financial stability perspective.

Key changes from 2022: Insurance sector

- FSOC identified insurance as a vulnerability in the U.S. financial system, a sector which previously was the focus of FSOC's activities in its first years.
- FSOC noted that:
  - Macroeconomic developments since COVID-19 began, including higher interest rates, increased credit risk and lower commercial real estate occupancy rates, have adversely affected the investment portfolios of insurers.
  - The accounting rules would not generally require insurers to recognize unrealized losses on most fixed-income securities, and that statutory accounting generally does not penalize unrealized losses on most fixed-income securities or negatively affect an insurer's statutory capital position.
  - Rising interest rates create competition for insurance products, but in-force insurance includes contractual and economic considerations which may slow customer attrition in higher interest rate environments.
  - Insurers have shifted away from traditional investments in favor of less liquid assets such as bank loans, private-label securities and asset-backed securities, concluding these changes could adversely affect an insurer's liquidity and capital position.

Key changes from 2022: Insurance sector

- FSOC also noted that:
  - Growing concentration of private debt, which offers favorable returns as compensation for liquidity and complexity risk, on the balance sheets of insurers may pose heightened risks and raise questions about the quality of underlying assets.
  - Increasing popularity of cross-border reinsurance transactions have increased insurers' dependency on offshore capital and increased the complexity of insurers' structures. These developments, in turn, raise concerns that such transactions reduce the U.S. insurer's reserves, increase opacity and may not be arm's-length transactions.
  - The private equity-owned life and health insurance market encompasses some of the largest providers of fixed annuities and pension risk transfers in the sector.
- In light of these developments, FSOC supported:
  - Ongoing monitoring of the National Association of Insurance Commissioners' Macroprudential Initiative and its implementation in each state in order to ensure the adequacy and effectiveness of regulatory and supervisory tools.
  - Strengthening supervisory, credit analysis, risk management and capital frameworks to ensure rapidly changing economic conditions or the failure of one or more offshore insurers would not create financial stability risks.

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