

# The Banking Law Journal

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**Editor's Note: The Regulators Are Regulating**  
Victoria Prussen Spears

**The Consumer Financial Protection Bureau's Abusive Policy Statement**  
Eric J. Mogilnicki

**From FDICIA to Silicon Valley Bank: The Evolution of the Systemic Risk Exception**  
Andrew Olm

**Revival of the Financial Stability Oversight Council: FSOC Proposes Two Key Guidance Documents**  
Michael D. Lewis and Matthew S. Katz

**Ensuring Insurability of Management Liability Claims**  
Geoffrey B. Fehling and Jae Lynn Huckaba

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<b>Editor's Note: The Regulators Are Regulating</b> Victoria Prussen Spears	375
<b>The Consumer Financial Protection Bureau's Abusive Policy Statement</b> Eric J. Mogilnicki	377
<b>From FDICIA to Silicon Valley Bank: The Evolution of the Systemic Risk Exception</b> Andrew Olmem	397
<b>Revival of the Financial Stability Oversight Council: FSOB Proposes Two Key Guidance Documents</b> Michael D. Lewis and Matthew S. Katz	411
<b>Ensuring Insurability of Management Liability Claims</b> Geoffrey B. Fehling and Jae Lynn Huckaba	415
<b>Financial Competition and Coexistence in a Bipolar World: Building an Effective U.S. Strategy for Engagement with China – Part II</b> Connie M. Friesen	425

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# Revival of the Financial Stability Oversight Council: FSOC Proposes Two Key Guidance Documents

*By Michael D. Lewis and Matthew S. Katz\**

*In this article, the authors discuss two proposals from the U.S. Financial Stability Oversight Council (FSOC) suggesting that the FSOC intends to take a more active role in reviewing and assessing the systemic risks posed by nonbank financial companies.*

The U.S. Financial Stability Oversight Council (FSOC) has issued a proposed analytic framework for financial stability risks and proposed interpretive guidance regarding FSOC's procedures for designating nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System (Federal Reserve) and imposition of enhanced prudential standards (collectively, the 2023 Guidance). These proposals suggest that FSOC intends to take a more active role in reviewing and assessing the systemic risks posed by nonbank financial companies.

Accordingly, institutions in financial services – including insurance companies, asset managers, private equity funds, hedge funds, nonbank lenders, nonbank payment service providers, and cryptoasset companies, among others – may face additional regulatory scrutiny from FSOC with respect to the financial stability risks that they are perceived to pose. Should FSOC determine that the material distress or failure of such a business could pose a risk to the financial stability of the United States, such businesses may be designated as systemically important and subjected to supervision by the Federal Reserve as well as enhanced prudential standards (such as capital and liquidity requirements).

## HISTORY

FSOC – a multiregulator body, the voting members of which are the heads of major U.S. federal financial services regulators – was created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The statute identifies three purposes for FSOC:

- (1) Identifying risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies or that could arise outside the financial

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services marketplace;

- (2) Promoting market discipline by eliminating shareholder, creditor, and counterparty expectations that some institutions are “too big to fail”; and
- (3) Responding to emerging threats to the stability of the U.S. financial system.<sup>1</sup>

Under Dodd-Frank, FSOC generally acts as a research, advisory, and interagency coordination body. However, it is also afforded certain significant powers, including the aforementioned power to designate systemically important nonbank financial institutions for supervision by the Federal Reserve.<sup>2</sup>

In 2012, FSOC adopted guidance establishing the procedures for designating nonbank financial companies for Federal Reserve supervision and describing the standards that FSOC would apply to make such designations (the 2012 Guidance).<sup>3</sup> This framework was adopted under Title I of Dodd-Frank. Under this framework, FSOC designated four nonbank financial institutions as systemically important: American International Group, Inc.; General Electric Capital Corporation; Prudential Financial, Inc.; and MetLife, Inc. (MetLife). MetLife subsequently sued over its designation, and by 2018, FSOC had rescinded or terminated all four of these designations.

In 2019, FSOC adopted changes to its designation procedures replacing the 2012 Guidance, which resulted in an approach to assessing potential risks to U.S. financial stability that was primarily focused on the business activities that posed risk rather than the individual nonbank companies (the 2019 Guidance).<sup>4</sup> Under this activities-based approach, FSOC focused on working with other regulators to regulate risky activities conducted by companies, with designating companies for supervision by the Federal Reserve only as a fallback position. At the time, FSOC characterized this approach as creating more consistent and predictable rules that would apply to all market participants engaged in an activity. The 2019 Guidance also committed FSOC to including a cost-benefit analysis as part of its decision whether to designate an entity for Federal Reserve supervision and to making such determinations based on the likelihood that the entity would actually experience material financial distress (rather than strictly looking at the risk posed if an entity did experience material financial distress).

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<sup>1</sup> 12 U.S.C. § 5322(a)(1).

<sup>2</sup> 12 U.S.C. §§ 5322(a)(2)(H), (I), (J).

<sup>3</sup> 12 C.F.R. Part 1310; 77 Fed. Reg. 21637 (Apr. 11, 2012).

<sup>4</sup> 84 Fed. Reg. 71740 (Dec. 30, 2019).

## 2023 GUIDANCE

The 2023 Guidance, if adopted as proposed, would rescind many of the changes made as part of the 2019 Guidance. From the perspective of a nonbank financial company, however, the 2023 Guidance would make three key changes.

First, it would move away from the activities-based model adopted by the 2019 Guidance, allowing individual designation of companies as systemically important nonbank financial companies as a first step rather than as a last resort. Whether or not a company is designated for Federal Reserve supervision is determined using the analytic framework and process described below.

Second, responding to one of the issues raised by the MetLife lawsuit over its designation, the 2023 Guidance would make explicit that FSOC need not engage in a cost-benefit analysis as part of its decision to designate a nonbank financial company as systemically important. This means that FSOC designations will not necessarily consider the financial impact of a designation on the company being designated (or the broader market in which the company participates).

Third, the 2023 Guidance eliminates the requirement that FSOC consider the likelihood of a company's material financial distress before designating that company as a systemically important nonbank financial company. As such, in deciding to designate a company, FSOC will presuppose that the company is experiencing distress and evaluate based on that scenario rather than including its assessment the likelihood of that risk being realized.

The analytic framework proposed as part of the 2023 Guidance indicates that FSOC will monitor a broad range of asset classes, entities, and activities for the risks posed to financial stability. As described earlier, this suggests that FSOC will be considering the risks posed by multiple types of nonbank financial companies, payment systems, and financial market utilities and may consider designating types of firms not previously designated under the respective authorities available to do so (certain payment systems and financial market utilities are or may be subject to a different designation process under Title VIII of Dodd-Frank).

The 2023 Guidance also identifies a variety of vulnerabilities that FSOC may look at when assessing risks to financial stability, including:

- (1) Leverage;
- (2) Liquidity risk and maturity mismatch;
- (3) Interconnection between entities (such as exposures of creditors, counterparties, investors, and borrowers);
- (4) Operational risks (generally stemming from financial market infra-



- structure, processes, or systems);
- (5) Complexity or opacity of markets, activities, or firms;
  - (6) Inadequacy of risk management;
  - (7) Concentration in industries or activities; and
  - (8) Destabilizing activities (such as trading practices that increase volatility).

## **DESIGNATION PROCESS**

Under the proposed guidance, FSOC generally expects to follow a two-stage process when determining whether to designate a nonbank financial institution as systemically important pursuant to Title I of Dodd-Frank.

In the first stage, FSOC will notify a company selected for review and perform a preliminary analysis. As part of this analysis, the company will be permitted (but not required) to submit information to FSOC, and FSOC will contact the company's primary regulatory agency. If a company is thereafter selected for additional review, FSOC will notify the company that it is being reviewed for designation. This second stage consists of an in-depth evaluation, including collection of information directly from the company. If FSOC proposes to designate the company, the company may request a hearing, after which FSOC will make a final decision whether to designate the company. Thereafter, companies will be reevaluated annually to determine whether the designation should remain in place.

## **CONCLUSION**

It is possible that a final rule will be promulgated by year-end, though any new designations of nonbank financial institutions as systemically important are likely to take additional time thereafter. As such, nonbank financial companies should begin thinking about their risk profile under the factors established by FSOC, and considering how they might adjust relative risk in light of the consequences associated with potential designation as systemically important.