

MEMO# 32088

December 10, 2019

FSOC Adopts Final Guidance Reforming Nonbank SIFI Designation Process

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December 10, 2019 TO: ICI Members

Investment Company Directors SUBJECTS: Systemic Risk RE: FSOC Adopts Final Guidance Reforming Nonbank SIFI Designation Process

At an open meeting on December 4, the Financial Stability Oversight Council (FSOC or the Council) approved final interpretive guidance replacing its existing interpretive guidance on nonbank systemically important financial institution (SIFI) designations.[\[1\]](#) The final guidance largely tracks the Council's March 2019 proposal,[\[2\]](#) which ICI strongly supported in a comment letter filed in May 2019.[\[3\]](#)

Under the final guidance, FSOC will prioritize its efforts to identify, assess, and address potential risks and threats to U.S. financial stability beginning with an "activities-based approach"—a two-step process in which the Council first will monitor markets and market developments and then work with relevant financial regulatory agencies to address identified potential risks.

The final guidance specifies that FSOC will evaluate a nonbank financial company for possible SIFI designation only if (1) a potential risk or threat cannot be adequately addressed through an activities-based approach, and (2) the identified potential threat could be effectively addressed by SIFI designation.[\[4\]](#) Any such evaluation will be conducted under a more analytically rigorous and transparent process that involves, among other things, greater engagement with the company under review and its primary regulator.

A summary of the final guidance, highlighting certain changes from the proposal, follows below. The final guidance will be effective 30 days after publication in the Federal Register.

Activities-Based Approach

Under step one of the activities-based approach, FSOC, in consultation with relevant financial market regulators, intends to monitor diverse markets and market developments. Monitoring may include, among others, corporate and sovereign debt and loan markets, equity markets, and markets for other financial products, including structured products and derivatives. The final guidance explains how the Council will evaluate potential risks to US financial stability to determine whether they merit further review or action, including

assessing various characteristics that could amplify such risks and other factors that could exacerbate or mitigate risks. It sets forth four framing questions on which the Council's analyses generally will focus.[\[5\]](#)

In response to comments, the final guidance clarifies that in evaluating potential financial stability risks, FSOC will consult with relevant financial regulatory agencies and will take into account existing laws and regulations that may mitigate a potential risk to US financial stability. It further provides that FSOC will take into account the risk profiles and business models of market participants engaging in the products, activities, or practices under evaluation.

If the Council identifies a potential risk to US financial stability in step one, it will proceed to step two, working with relevant federal and state financial regulatory agencies to seek the implementation of appropriate actions by those regulators to address the identified risk. If FSOC believes regulators' actions are inadequate, it can make formal public recommendations to primary financial regulatory agencies under section 120 of the Dodd-Frank Act to apply new or heightened standards to a financial activity or practice.

In response to comments, the final guidance provides additional clarity on the process by which the Council may issue recommendations under section 120. For example, the final guidance indicates that in cases where the primary regulator would not be expected to perform a cost-benefit analysis of the actions it would take in response to a Council recommendation, the Council itself will conduct such an analysis prior to making a final recommendation, using empirical data to the extent available. In any such case, the Council will make a recommendation under section 120 only if it believes that the results of its assessment of benefits and costs supports the recommendation. The final guidance also states that prior to issuing a recommendation under section 120, the Council will consult with the relevant primary financial regulatory agency and provide notice to the public and opportunity for comment as required by section 120.

Analytic Framework for SIFI Designations

Like the proposal, the final guidance discusses the analytic framework FSOC will apply if it evaluates individual nonbank financial companies for potential SIFI designation, including how the Council will interpret certain terms not defined in the Dodd-Frank Act and how it will apply various statutory standards and considerations. In its analysis, FSOC will assess how the negative effects of a company's material financial distress, or of the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could be transmitted to or affect other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning.

The Council will focus on three transmission channels: (1) the exposure transmission channel; (2) the asset liquidation transmission channel; and (3) the critical function or service transmission channel. New language in the final guidance states that in its analyses under the transmission channels, the Council will consider applicable factors that may limit the transmission of risk.[\[6\]](#) In addition, as part of its analysis of the asset liquidation channel, the Council will consider the extent to which assets are managed rather than owned by the company.

The Council's analysis will include evaluation of a company's complexity and resolvability. New language added to the discussion of factors to be considered states that "[t]he opacity of a firm's structure—if the firm's structure and operations cannot readily or easily be determined—may present an obstacle to resolution." In addition, as required by statute,

the Council will take into account existing regulatory scrutiny of a company, focusing on the extent to which regulation of the company has mitigated the potential risks to financial stability identified by the Council.

The Council also will evaluate the expected benefits and costs of SIFI designation and will only make a designation if the expected benefits from Federal Reserve supervision and prudential standards justify the expected costs of designation. The final guidance provides greater specificity about FSOC's assessment of costs and benefits. For example, it states that when possible, FSOC will quantify reasonably estimable benefits and costs, using ranges, as appropriate, and based on empirical data when available. Furthermore, if such benefits and costs cannot be quantified in this manner, FSOC will explain why.

As was proposed, as part of its assessment of the overall impact of designating a company, the Council will assess the likelihood of the company's material financial distress. In response to comments, the final guidance contains a revised description of the process the Council will follow in conducting this assessment, which will be based on a company's vulnerability to a range of factors. The final guidance states that examples of these factors may include leverage (both on- and off-balance sheet), potential risks associated with asset reevaluations (whether such reevaluations arise from market disruptions or severe macroeconomic conditions), reliance on short-term funding or other fragile funding markets, maturity transformation, and risks from exposures to counterparties or other market participants. The Council's assessment may rely upon historical examples regarding the characteristics of financial companies that have experienced financial distress but may also consider other risks that do not have historical precedent. The analysis of the vulnerability of a nonbank financial company to material financial distress will be conducted taking into account a period of overall stress in the financial services industry and a weak macroeconomic environment.

SIFI Designation Process

As noted above, the Council will prioritize an activities-based approach for identifying, assessing, and addressing potential risks to financial stability and may consider a nonbank financial company for possible SIFI designation if a potential risk or threat cannot be adequately addressed through the activities-based approach. In a change from the proposal that ICI and other commenters recommended, the final guidance will require a vote of Council principals (rather than staff) to move from an activities-based review to potential designation.^[7] The Preamble notes that the Council agreed with this recommendation in light of the significance of SIFI designation. It observes that the Council's vote before considering a company for potential designation will help ensure that sufficient analysis has been conducted in the activities-based approach.

Like the proposal, the final guidance contemplates a two-stage process of evaluation and analysis: a preliminary evaluation in Stage 1 and a more in-depth evaluation in Stage 2.^[8] Consistent with ICI's comments, the Council has added to the description of engagement with the company in Stage 1 a statement that: "[t]hrough this engagement, the Council will seek to enable the company under review to understand the focus of the Council's analysis, which may enable the company to act to mitigate any risks to financial stability and thereby potentially avoid becoming subject to" a designation. As in the proposal, in addition to providing this potential pre-designation "off-ramp," the final guidance includes procedures designed to clarify the post-designation "off-ramp." The Preamble explains that "[b]y clarifying the 'off-ramp' to rescission, and taking other steps to promote designated nonbank financial companies' ability to reduce the threat they could pose to financial

stability, the Council seeks to both protect the U.S. financial system and reduce the regulatory burden on the companies.”

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endnotes

[1] See FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, RIN 4030-ZA00, available at <https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf> (Adopting Release). The Adopting Release consists of a preamble (Preamble) and an appendix (Appendix A) that sets forth the text of the final guidance.

[2] See ICI Memorandum No. 31676, dated March 25, 2019, available at https://www.ici.org/my_ici/memorandum/memo31676.

[3] See Letter from Paul Schott Stevens to FSOC, dated May 13, 2019, available at https://www.ici.org/pdf/19_ltr_fsoc.pdf.

[4] According to the final guidance, FSOC anticipates that it would consider a nonbank financial company for potential designation “only in rare instances” (e.g., if the company’s products, activities, or practices that pose a potential threat to US financial stability are outside the jurisdiction or authority of financial regulators).

[5] The questions are: (1) How could the potential risk be triggered? (2) How could the adverse effects of the potential risk be transmitted to financial markets or market participants? (3) What impact could the potential risk have on the financial system? (4) Could the adverse effects of the potential risk impair the financial system in a manner that could harm the non-financial sector of the US economy?

[6] Examples of such factors include existing regulatory requirements, collateralization, bankruptcy-remote structures, or guarantee funds that reduce counterparties’ exposures to the nonbank financial company or mitigate incentives for customers or counterparties to withdraw funding or assets.

[7] The Preamble includes a table summarizing key transition points under the final guidance, including whether a vote is required and the voting threshold.

[8] The final guidance eliminates the previous Stage 1 and the six-category framework for evaluating companies that were part of earlier guidance.

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