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Treasury Issues Report on Financial Stability Oversight Council Processes for Designating Systemically Important Nonbank Financial Companies and Financial Market Utilities

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December 8, 2017 TO: ICI Members
Investment Company Directors
ICI Global Members SUBJECTS: Derivatives
Money Market Funds
Risk Oversight
Systemic Risk RE: Treasury Issues Report on Financial Stability Oversight Council Processes for Designating Systemically Important Nonbank Financial Companies and Financial Market Utilities

In response to an April 21, 2017 Presidential Memorandum (Presidential Memorandum),[1] the US Treasury Department recently issued a report entitled *Financial Stability Oversight Council Designations* (Report).[2] The Report evaluates and makes recommendations regarding two processes of the Financial Stability Oversight Council (FSOC or Council) under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act):

- the process for making determinations that nonbank financial companies shall be supervised by the Federal Reserve Board and subject to enhanced prudential standards (commonly referred to as the "SIFI designation process")[3]; and
- the process for designating financial market utilities (FMUs) as systemically important.

During Treasury's review of the SIFI designation process, ICI and several members provided input to Treasury on issues of concern to registered funds and their advisers.

The Report describes the scope of the Presidential Memorandum, which directed the Treasury Secretary to consider several specific questions in conducting its review (e.g., whether FSOC's designation processes are sufficiently transparent and provide entities with adequate due process). The Presidential Memorandum also required the Treasury Secretary to evaluate and report on whether FSOC's activities related to its designation processes are consistent with the Trump Administration's "core principles" for regulating the US financial system.[4]

After reviewing the purposes, composition, and authorities of the Council, the Report outlines five policy goals Treasury believes FSOC's processes should be designed to achieve:

- Leverage the expertise of primary financial regulatory agencies;
- Promote market discipline;
- Maintain a level playing field among firms;
- Appropriately tailor regulations to minimize burdens; and
- Ensure the Council's designation analyses are rigorous, clear, and transparent.

SIFI Designation Process

The Report discusses the effects and efficacy of nonbank financial company designations in achieving the Council's purposes. It highlights concerns and criticisms stakeholders have raised while also mentioning potential benefits some commentators have suggested. Broadly, the Report recommends that FSOC:

- Prioritize an activities-based or industry-wide approach to addressing risks to US financial stability;
- Increase the analytical rigor of designations analyses;
- Improve engagement and transparency in the designation process; and
- Provide a clear "off ramp" for designated nonbank financial companies.

Each of these reforms is discussed in more detail below.[5]

1) Prioritize an activities-based or industry-wide approach to addressing risks to US financial stability

Consistent with the suggestions of many stakeholders Treasury consulted, the Report recommends that FSOC take a new approach to mitigating risks to financial stability, using a three-step process:

Step One. The Council should prioritize its reviews of potential risks to financial stability from activities and products. The purpose of FSOC's analysis would be to identify financial activities, products, market behaviors, structural vulnerabilities, or other factors that could pose threats to US financial stability. The Report indicates that this analysis should take into account available historical data, research regarding the behavior of financial market participants, and potential emerging threats that could arise in evolving marketplaces.

Step Two. If the Council identifies a potential risk to financial stability, the Council should work with the relevant primary financial regulatory agencies to address the identified risks. The Report states that "[r]ather than designating individual firms, the Council would look to primary regulators to address the risks through regulation within and across industries. The primary regulator has the relevant knowledge and expertise, and should be given an opportunity to address the risk." The Report notes that if the primary regulator's actions are insufficient to mitigate identified potential risks to financial stability, FSOC can make formal recommendations to the regulator under Section 120 of the Dodd-Frank Act.[6]

Step Three. If, after consultation with the primary regulators, one or more companies may pose risks to financial stability, the Council should consider individual firms for designation. In this event, such consideration should occur under an enhanced SIFI designation process that incorporates the reforms discussed later in this memorandum.

The benefits of prioritizing an activities-based approach, according to the Report, are that it would: (a) enable FSOC to "identify the underlying sources of risks to financial stability, rather than addressing risks only at a particular nonbank financial company;" (b) "address some of the potential limitations that could arise from designations" (e.g., competitive disadvantages and unnecessarily burdensome regulatory requirements); and (c) "preserve the option to consider designation in the rare instance, such as the historical case of Fannie Mae and Freddie Mac, where it was clear that individual institutions could pose a threat to financial stability, but a primary regulator has not taken or cannot take adequate steps to address the risk."

2) Increase the analytical rigor of designations analyses

The Report discusses the statutory requirements for FSOC's analysis of nonbank financial companies for potential SIFI designation, as well as 2012 FSOC interpretive guidance setting forth FSOC's analytic approach.[7] It briefly describes the three channels FSOC has identified as most likely to facilitate transmission of the negative effects of a nonbank financial company's material financial distress to other financial firms and markets—the "exposure channel," the "asset liquidation channel," and the "critical function or service channel."

The Report notes that FSOC's guidance did not indicate with specificity how the Council would determine whether a particular firm's characteristics cause that firm to meet the statutory standards for designation. The Report states that there is "considerable and continuing uncertainty among market participants about how the Council makes its decisions, which factors the Council views as most relevant in identifying a company that could pose risks to financial stability, and how a company can take action to avoid designation." According to the Report, increased analytical rigor would promote certainty in the Council's conclusions and increase transparency to firms and the public.

In response to stakeholders' concerns that before designating a nonbank financial company, FSOC should more specifically identify the plausible scenarios in which the company could pose a threat to US financial stability, the Report recommends that the Council:

- *Consider Mitigants to Exposures*. FSOC should develop a framework for taking into account factors that would reduce the losses a nonbank financial company's counterparties and other market participants would experience in the event of the company's material financial distress. The framework should quantify the losses that each counterparty would experience.

- *Identify Plausible Asset Liquidation Risks.* FSOC should conduct more rigorous quantitative impact analysis in seeking to answer the three central questions around which its analyses of the asset liquidation transmission channel have been framed.[8]

- *Evaluate Likelihood of Distress as a Threshold Question.* FSOC should revise its interpretive guidance to "provide clearly for assessment of the likelihood of distress" as part of the analytic framework. The Report observes that "[m]aterial financial distress at a nonbank financial company does not pose a threat to U.S. financial stability if the company will not experience material financial distress." While acknowledging that FSOC already considers some factors relating to the likelihood of a firm’s distress, the Report states that “a distinct evaluation of the factors that may lead to a firm’s failure—and factors that mitigate those risks—will make the designation process more empirically grounded and focused on realizable risks.”

In addition, the Report recommends that FSOC use cost-benefit analysis to inform its designation decisions. The Report states that the “analytical discipline of weighing costs against benefits…improves the quality of administrative decision-making and ensures that agencies take account of the relevant trade-offs and alternatives.” It acknowledges the challenges of conducting cost-benefit analysis but observes that notwithstanding these challenges, “agency action is appropriate only if it does more good than harm, and there can be no confidence on that point unless the Council weighs the costs and benefits of its actions.”

The Report also recommends two changes to the preliminary stages[9] of the Council’s analysis to strengthen the Council’s analytical rigor: (1) amending the $50 billion total consolidated assets threshold it applies to nonbank financial companies in Stage 1 of its analysis if Congress amends the $50 billion threshold under the Dodd-Frank Act for subjecting bank holding companies to enhanced prudential standards; and (2) combining Stages 1 and 2 of its nonbank financial company designation process.

3) Improve engagement and transparency in the designation process

The Report analyzes FSOC’s engagement with companies and their regulators during the designation process and public transparency regarding designations. The Report recommends the improvements discussed below.

- *Engagement with nonbank financial companies under review.* Citing arguments that nonbank financial companies could better participate in the process if FSOC indicated earlier, more often, and more specifically its areas of focus, the Report recommends that during Stages 2 and 3, Council staff explain to the company the key risks that have been identified. The Report notes that “[i]f a company is aware of the potential risks the Council has identified during its preliminary review, the company can take action to mitigate those risks” prior to designation, thus helping achieve the goal of addressing potential risks to US financial stability.[10]

- *Engagement with primary regulators.* The Report enumerates the following benefits of deep engagement with a nonbank financial company’s primary financial regulator: (1) the regulator can provide unique insights into the company and its operations, activities, and risks; (2) the regulator can help FSOC understand the plausibility of theoretical risks at the company; and (3) a regulator with existing authority to address a company’s risks identified by FSOC can take action even without a designation. To achieve these benefits, the Report recommends that FSOC (i) actively solicit the regulator’s views regarding risks at the company and potential mitigants, (ii) share its preliminary views regarding potential risks at the company, and request that the regulator provide information regarding those risks and whether they are adequately mitigated, e.g., by existing regulation or the company’s business practices, and (iii) during the designation process, continue to encourage the regulator to use its existing authorities to address any risks to US financial stability.

- *Public transparency.* The Report reviews various existing mechanisms for public transparency, including under FSOC guidance and supplemental procedures, and discusses FSOC’s public transparency practices to date (e.g., the public bases it has published for designation decisions and the public minutes of Council meetings). The Report recommends that FSOC release publicly the full explanation of its basis for any future nonbank financial company designations or rescissions of designations (redacting confidential information), to give the public the greatest possible understanding of FSOC's reasons for its actions.

4) Provide a clear "off ramp" for nonbank financial companies designated as SIFIs

The Report discusses the statutory requirement for annual reevaluations of nonbank financial company designations, as well as relevant portions of FSOC guidance and supplemental procedures, and notes the lack of public information about the Council's analytic approach in annual reevaluations. The Report makes the following recommendations:

- FSOC's explanation of the final basis for any designation should highlight the key risks that led to the designation. It should include clear guidance regarding the factors that were most important to the Council's determination, which would make clear to the company the steps it could take to address the Council's concerns.

- The Council should adopt a more robust and transparent process for its annual reevaluations—one that makes clear how companies can engage with the Council and what information they should submit during a reevaluation. The process should enable engagement regarding the substance of the Council's analysis and changes to the company's risk profile over time.

- The Council should develop a process to enable a designated company to discuss changes it could make to address the risks it could pose to financial stability and to receive feedback regarding whether those changes may address the Council's concerns.

- The Council should clarify that the standard for annual reevaluations is the same as that for initial designations.[11] If the company no longer meets the standard due to changes at the company or in its markets, or based on changes in the Council's analysis, the Council should rescind its designation.

FMU Designation Process

The Report states that FMUs perform clearing, settlement, and transmission services that are vital to the US financial system, but notes that their function and interconnectedness concentrate a considerable amount of risk in the financial system.[12] It points to central clearing requirements under Title VII of the Dodd-Frank Act as an example of regulatory changes that have accelerated the growth of FMUs and further concentrated their risks in a small number of institutions.

The Report discusses the effects and efficacy of FMU designations, describing certain privileges afforded to designated FMUs in exchange for heightened regulatory and supervisory requirements imposed by the Federal Reserve, the Commodity Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC).[13] It notes that none of the designated FMUs contested its designation prior to final designation and that they generally do not express opposition to their continued designation.

The Report makes the following recommendations, several of which parallel recommendations above for the SIFI designation process:

- The agencies (Federal Reserve, CFTC, and SEC) should continue to work collaboratively to develop effective resolution strategies focused on ensuring the continuity of the critical services FMUs provide.

- The Council should consider incorporating cost-benefit analyses into its evaluations of FMUs for potential designation.

- The Council should enhance communication with FMUs during Stage 2,[14] notifying an FMU once it is under review in Stage 2 and communicating specific areas of focus. The firm should have an opportunity to respond to staff analysis.

- The expertise of the primary financial regulatory agencies should continue to be leveraged to inform any consideration of whether to designate an FMU, and to inform strategies for regulating and supervising designated FMUs.

- The Council should publicly release the explanation of the Council's basis for any future FMU designations (redacting confidential information).

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endnotes

[1] The Presidential Memorandum is *available at* https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-memorandum-secretary-treasury.

[2] The Report is *available at* https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf.

[3] The Dodd-Frank Act authorizes FSOC to make such a determination if it determines that a nonbank financial company's material financial distress, or the company's nature, scope, size, scale, concentration, interconnectedness, or mix of activities, could pose a threat to US financial stability.

[4] *See* Executive Order 13772, *available at* https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states. The Report explains how Treasury's recommendations would refocus FSOC's designation processes in line with the core principles.

[5] With one narrow exception, Treasury's recommendations do not call for statutory changes. *See infra* note 10.

[6] The Report explains that Section 120 authorizes FSOC to make recommendations to a primary financial regulatory agency to impose new or heightened standards or safeguards for a financial activity or practice. FSOC first must determine that the conduct, scope,

nature, size, scale, concentration, or interconnectedness of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, US financial markets, or low-income, minority, or underserved communities. Appendix C to the Report describes "non-designation examples of addressing potential financial stability risks"—specifically, FSOC's review of money market funds and its review of the asset management industry.

[7] Appendix B to the Report describes FSOC's framework for its analyses in detail; Appendix D provides highlights of the analyses that FSOC has completed regarding nonbank financial companies it has designated or considered for designation.

[8] These questions are: (1) To what extent does the company have liabilities that are, or could become, short-term in nature? (2) What assets does the company hold that if could rapidly liquidate, if necessary, to satisfy its obligations? (3) Could the resulting asset liquidation disrupt financial markets or impair other market participants?

[9] FSOC interpretive guidance establishes a three-stage process for identifying, evaluating, and communicating with nonbank financial companies. As indicated in the Report, Stage 1 involves the application of six uniform quantitative thresholds to identify firms for further review. In Stage 2, FSOC contacts the company and its regulators and conducts a preliminary analysis. Stage 3 comprises more in-depth review of the company, after which FSOC may vote on a proposed (and subsequently a final) designation. The Report describes the process in detail in Appendix B.

[10] The Report recommends that Congress amend Section 113 of the Dodd-Frank Act to increase from 30 to 60 days the time period for a company to request a hearing after a proposed designation and increase from 60 to 90 days the deadline for the Council to make a final designation. The Report explains that the additional time "would give the company a better opportunity to understand and respond to the Council's written analysis in the proposed designation, and would ensure that the Council has time fully to consider the company's submissions and arguments in any hearing.

[11] *See supra* note 3.

[12] The Report references a more detailed discussion of FMUs in the Treasury Department's October 2017 report, *A Financial System That Creates Economic Opportunities: Capital Markets, available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[13] Appendix E to the Report provides a detailed overview of FSOC's current approach to FMU designations and the applicable statutory standards and considerations. Appendix F assesses completed Council analyses of FMUs that have been designated.

[14] FSOC's process for analyzing FMUs has two stages. Stage 1 is largely based on quantitative metrics. In Stage 2, FMUs identified in Stage 1 are subject to a more in-depth review with more focus on qualitative factors and other institution- and market-specific considerations.