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April 28, 2023

FSOC Proposes Changes to Nonbank SIFI Designation Process, New Analytic Framework for Financial Stability Risks

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TO: ICI Members

Investment Company Directors

SEC Rules Committee SUBJECTS: Financial Stability

Investment Advisers

Money Market Funds RE: FSOC Proposes Changes to Nonbank SIFI Designation Process, New Analytic Framework for Financial Stability Risks

On April 21, the Financial Stability Oversight Council (FSOC or Council) voted to issue two proposals: (i) revised guidance on the Council's process for potential designation of a nonbank financial company as a systemically important financial institution (SIFI);[\[1\]](#) and (ii) a new analytic framework outlining how the Council expects to identify, assess, and address potential risks to financial stability, regardless of whether those risks arise from activities, individual firms, or otherwise.[\[2\]](#) Background information and a brief summary of each proposal are provided below. Comments are due 60 days following publication of the proposals in the Federal Register.

Background

In 2012, roughly two years after its establishment, the Council adopted a rule setting forth its SIFI designation authority pursuant to Section 113 of the Dodd-Frank Act. Appendix A to that rule, which the Council adopted as nonbinding interpretive guidance, detailed a three-stage process by which the Council would consider whether a nonbank financial company should be subject to SIFI designation and, thereby, subject to heightened prudential standards and supervision by the Federal Reserve Board. Appendix A set forth quantitative thresholds used to identify individual companies for further evaluation and a six-category analytical framework to guide such evaluations. In 2015, FSOC adopted supplemental procedures relating to the SIFI designation process.

Through a notice and comment rulemaking in 2019, the Council replaced Appendix A with revised guidance that: (i) adopts a two-step process by which FSOC would monitor markets and work with primary regulators, such as the Securities and Exchange Commission, to

address potential risks to financial stability; (ii) provides that the Council will consider a nonbank financial company for possible SIFI designation only if the potential risks posed by the company cannot be addressed through activities-based regulation; and (iii) requires FSOC to consider the possible designation of any such company under a more robust process, including greater engagement with the company and its primary regulator.^[3] As with original Appendix A, the revised version adopted in 2019 discusses both the procedural processes and substantive analytic framework to be used by the Council in considering a nonbank financial company for potential designation.

Proposed Guidance on SIFI Designation Process

The Council is proposing a third iteration of Appendix A. The release states that the 2012 guidance "provided a crucial framework for the Council's analyses" but that it "could not reflect lessons learned from engaging in...designations [of nonbank financial companies]." The release further states that the 2019 guidance provided "additional clarity" regarding the procedures for SIFI designation but "created inappropriate hurdles to the Council's ability to use this authority." The Council is proposing three key changes to the 2019 guidance:

- The new guidance would focus exclusively on the procedures that FSOC would apply in any initial review of a nonbank financial company for potential designation and any annual reevaluation of a designated company. The release characterizes as "minor" the proposed changes to these procedures. Unlike the 2012 and 2019 iterations of Appendix A, the new guidance would not address the Council's substantive analyses. Such guidance would be included in the proposed analytic framework (discussed in the next section of this memorandum). The release explains that the Council may consider the same risk factors (e.g., leverage, liquidity risk, operational risk) and transmission mechanisms (e.g., common exposures, asset liquidation) in "activities-based reviews, entity-specific analyses, or other work" and, for that reason, "describing these substantive analytic approaches broadly, rather than in a context limited to nonbank financial company designations, is most appropriate."
- The new guidance would eliminate the statement in the 2019 guidance that the Council would use an activities-based approach before considering the designation of a nonbank financial company. The release explains that removing this prioritization is intended to clarify that the Council may use any of its statutory authorities, as appropriate, to address risks and threats to US financial stability. It further states that "the Council considers dozens of potential risks to financial stability every year, as described in its annual reports, and the Council expects that most potential risks to financial stability will continue to be addressed by existing regulators rather than by use of the Council's nonbank financial company designation authority."
- Unlike the 2019 guidance, the new guidance would not commit FSOC to conducting a cost-benefit analysis or assessment of the likelihood of a nonbank financial company's material financial distress prior to making a determination under section 113 of the Dodd-Frank Act. The release asserts that neither step is required by statute and that such steps "are not useful or appropriate, and unduly hamper the Council's ability to use the statutory authority Congress provided to it." The release further states that its SIFI designation authority is "preventative" and that the regulatory tools associated with designation (i.e., heightened prudential standards and Federal Reserve Board supervision) "must be in place well before material financial distress [at the company] appears to be likely."

The Council's [fact sheet](#) provides this overview of the proposed processes that the Council

"would generally expect to follow" for any initial review of a nonbank financial company for potential designation^[4] and any annual reevaluation of a designated company:

- Stage 1. During the first stage of the process, a nonbank financial company identified for review will be subject to a preliminary analysis, based on quantitative and qualitative information available to the Council primarily through public and regulatory sources. During Stage 1, the Council will notify the firm of the review and permit, but not require, the company to submit relevant information and will consult with the company's primary financial regulatory agency, as appropriate.
- Stage 2. Following Stage 1, any nonbank financial company that is selected for additional review will receive notice that it is being considered for a proposed designation that the company will be supervised by the Federal Reserve and be subject to prudential standards and that the company will be subject to in-depth evaluation during the second stage of review. Stage 2 will also involve the evaluation of additional information collected directly from the nonbank financial company.
- Proposed and final designations. At the end of Stage 2, the Council may consider whether to make a proposed designation of the nonbank financial company. If the Council makes a proposed designation, the nonbank financial company may request a hearing. After making a proposed designation and holding any written or oral hearing if requested, the Council may vote to make a final designation.
- Annual reevaluations of previous designations. For any company designated by the Council, the proposed guidance specifies that the Council would encourage the company or its regulators to take steps to mitigate the identified risks. The Council will reevaluate the designation at least annually and rescind the designation if the Council determines that the company no longer meets the statutory standards for a designation. During the Council's annual reevaluations, the company will have an opportunity to meet with representatives of the Council to discuss the review and present information. The company may also submit written information. If the company explains changes it could make to its business to address the identified risks, Council representatives will endeavor to provide feedback on the extent to which the changes would mitigate the identified risks. Further, if the Council votes not to rescind a designation, the Council will provide the company with a written explanation addressing the material factors in the analysis.

Proposed Analytic Framework

The Council is proposing a new analytic framework outlining how it expects to identify, assess, and address potential risks to financial stability—regardless of whether those risks arise from activities, individual firms, or otherwise—using its range of authorities granted in the Dodd-Frank Act. The release explains that the proposed framework is not a binding rule and does not establish rights or obligations applicable to any person or entity, and it states that the Council has authority to promulgate interpretive guidance and issue policy statements. The release further indicates that the framework "is intended to help market participants, stakeholders, and other members of the public better understand how the Council expects to perform certain of its duties."

An introduction to the proposed framework briefly discusses how risks to financial stability may arise and evolve, as well as the Council's objectives and authorities. The introduction explains:

The actions the Council may take depend on the nature of the vulnerability; for example, vulnerabilities originating from activities that may be widely conducted in a particular sector or market over which a regulator has adequate existing authority may be addressed

through an activity-based or industry-wide response; in contrast, in cases where the financial system relies on the ongoing financial activities of a small number of entities, such that the impairment of one of the entities could threaten financial stability, or where a particular financial company's material financial distress or activities could pose a threat to financial stability, an entity-based action may be appropriate.

It characterizes the Council's authorities as "complementary" and indicates that FSOC "may select one or more of those authorities to address a particular risk."

Identifying Potential Risks. The proposed framework indicates that the Council's monitoring "may cover an expansive range of asset classes, institutions, and activities" in keeping with its broad statutory mandate. Among the examples cited are: various markets and financial entities (including asset managers and investment companies); payment, clearance, and settlement activities; new or evolving financial products and practices; and developments affecting the resiliency of the financial system (e.g., cybersecurity, climate-related financial risks).

Assessing Potential Risks. The proposed framework discusses vulnerabilities that the Council believes most commonly contribute to risks to financial stability, including: leverage; liquidity risk and maturity mismatch; interconnections; operational risks; complexity or opacity; inadequate risk management; concentration; and "destabilizing activities" (e.g., trading practices that substantially increase volatility in one or more financial markets). The proposed framework identifies quantitative metrics that are "commonly used" measurements in each area. For example, with respect to liquidity risk and maturity mismatch, the proposed framework states that "[r]elevant metrics may include the ratio of short-term debt to unencumbered short-term high-quality liquid assets and amounts of funding available to meet unexpected reductions in available short-term funding."

The proposed framework also discusses four "transmission channels" by which the adverse effects of potential risks could be transmitted to financial markets or market participants: exposures; asset liquidation; critical function or service; and contagion. It observes that contagion can arise from the perception of common vulnerabilities or exposures, as well as "when there is a loss of confidence in financial instruments that are treated as substitutes for money."[\[5\]](#)

Addressing Potential Risks. The proposed framework discusses various approaches the Council may take to address a potential risk to financial stability, including: interagency coordination and information sharing; recommendations to primary regulators or Congress pursuant to section 120 of the Dodd-Frank Act; SIFI designation; designation of systemically important payment, clearing, and settlement activities; and financial market utility designations. The proposed framework indicates that the Council's Deputies Committee generally will direct staff-level committees or working groups to consider potential policy approaches or actions, including but not limited to those identified in the framework, for consideration by the Council.

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Notes

[1] See [Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies](#) and associated [fact sheet](#).

[2] See [Analytic Framework for Financial Stability Risk Identification, Assessment and Response](#) and associated [fact sheet](#).

[3] For more detail, see [ICI Memorandum 32088](#) (Dec. 10, 2019).

[4] A footnote in the proposed guidance explains that FSOC "may waive or modify [the designation process] in its discretion if it determines that emergency circumstances exist, including if necessary or appropriate to prevent or mitigate threats posed by a nonbank financial company to US financial stability in accordance with section 113(f) of the Dodd-Frank Act."

[5] The 2019 guidance, which discusses transmission channels solely in the context of potential SIFI designations, considers contagion to be part of evaluating risk under the exposure transmission channel.