

November 15, 2023

FSOC Finalizes Guidance on Nonbank Systemically Important Financial Institution Designations

1. Executive Summary

On November 3, 2023, members of the Financial Stability Oversight Council (“FSOC” or “Council”)¹ voted unanimously to issue final interpretive guidance on the FSOC’s nonbank financial company designations process (the “Final Guidance”),² which is set to replace the existing 2019 guidance (“2019 Interpretive Guidance”) 60 days after publication,³ and a new analytic framework for financial stability risk identification, assessment and response (the “Analytic Framework”).⁴ In April of this year, the FSOC and the U.S. Treasury Department issued proposed versions of the analytic framework and guidance, signaling regulators’ intention to adopt a new approach to systemic risk designations.

The Final Guidance outlines the FSOC’s procedures for determining whether a nonbank should be subject to Federal Reserve supervision and introduces key changes not otherwise covered by the 2019 Interpretive Guidance. The Analytic Framework introduces a data-driven means of assessing systemic risk and highlights specific vulnerabilities that are likely to impact negatively on financial stability. It also offers an elaborate explanation of the FSOC’s approach towards risk assessment and potential risk management as well as the range of interagency resources at its disposal in addressing potential risks.

At the meeting of the Council on November 3, U.S. Secretary of the Treasury Janet Yellen described these regulatory actions as a step towards fulfilling the Council’s mission of providing comprehensive monitoring of the stability of the U.S. financial system. For Yellen, “recent stresses in some financial sectors arising from the onset of the pandemic and the sudden failures of some regional banks underscore the continuing need to remain vigilant to threats to ensure the resilience of the financial system and our economic strength.”⁵

¹ Section 111 of the Dodd-Frank Act established the FSOC and charged it with the duty, broadly, to identify risks to the financial stability of the U.S. financial system, promote market discipline and respond to emerging threats to the stability of the U.S. financial system. The FSOC is chaired by Secretary of the Treasury and comprises 10 voting members and 5 non-voting members. Members consist of the heads of federal financial regulators (such as the Chairman of the Board of Governors of the Federal Reserve System (“Federal Reserve”) and the Chairman of the Securities and Exchange Commission (“SEC”)), state regulators and an independent insurance expert appointed by the President.

² Access the full Final Guidance here: <https://home.treasury.gov/system/files/261/Interpretive-Guidance-Regarding-Authority-to-Require-Supervision-and-Regulation-of-Certain-Nonbank-Financial-Companies.pdf>

³ See Final Guidance at page 2.

⁴ Access the full Analytic Framework here: <https://home.treasury.gov/system/files/261/Analytic-Framework-for-Financial%20Stability-Risk-Identification-Assessment-and-Response.pdf>

⁵ See full statement of the Secretary of the U.S. Treasury Department here: <https://home.treasury.gov/news/press-releases/jy1875>

The Final Guidance and Analytic Framework mark a significant evolution in the regulatory landscape of the financial services sector, particularly in relation to nonbank entities. Historically, financial regulatory and supervisory efforts have been aimed at traditional banks and broker-dealers. However, increased regulatory costs on traditional banking activities have led to “debanking” in the financial sector with nonbank entities filling the void left by banks who have exited certain businesses. Now the Analytic Framework removes obstacles to the designation of nonbank financial companies as systemically important financial institutions (“SIFIs”), paving the way for potentially more stringent regulation of nonbank companies designated as “systemically important.”

2. The Nonbank Designation Guidance

(a) Overview

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) mandates that the FSOC may designate certain nonbank financial companies as SIFIs for supervision by the Federal Reserve. A nonbank financial company is defined under the Dodd-Frank Act as a company that is predominantly engaged in financial activities⁶ and may be designated as a SIFI if the following two determination standards are met: (1) when “material financial distress” at the company “could pose a threat to the financial stability of the United States” or (2) when the “nature, scope, size, scale, concentration, interconnectedness, or mix of the company’s activities” could pose the same threat.⁷

Before releasing the Final Guidance, the FSOC had initially issued a series of rules, guidance and public statements with respect to its process for evaluating nonbank financial companies for potential designation as SIFIs, the most recent being the 2019 Interpretive Guidance. However, with the Final Guidance, the FSOC has established more rigorous and elaborate procedures for nonbank financial companies, including the process for designation as SIFIs. Secretary Yellen argues that the Final Guidance eliminates “several prerequisites to designation in place under the 2019 Interpretive Guidance that were not contemplated by the Dodd-Frank Act and that are based on a flawed view of how financial risks develop and spread. And, again, designation is only one of the Council’s tools and is not being prioritized over other approaches to addressing financial stability risks.”⁸ The Final Guidance mandates the FSOC to be more data-driven in its designation process in a manner that “reflects the distinctive aspects of the company, its market, and its existing regulation.”⁹

(b) The Final Guidance vs. the 2019 Interpretive Guidance

The most material differences between the Final Guidance and the 2019 Interpretive Guidance are as follows:

- (i) The 2019 Interpretive Guidance requirements for the FSOC to exhaust all available alternatives, perform a cost-benefit analysis of its approach, and assess the company’s material financial distress before a SIFI designation can occur have been removed.¹⁰

⁶ See 12 U.S.C. Section 5311(4). “Predominant engagement” as used here is said to exist if (1) the company’s annual gross revenues derived from activities that are financial in nature (as defined by 12 U.S.C. § 1843(k)) represent 85 percent or more of its consolidated annual gross revenues or (2) its consolidated assets related to activities that are financial in nature represent 85 percent or more of its consolidated assets. See 12 U.S.C. § 1843(k).

⁷ See 12 U.S.C. Section 5323.

⁸ See full statement of the Secretary of the U.S. Treasury Department here: <https://home.treasury.gov/news/press-releases/jy1875>

⁹ See Final Guidance at page 8.

¹⁰ See Final Guidance at page 7.

- (ii) The Final Guidance omits the 2019 Interpretive Guidance’s definition of “threat to the financial stability of the United States” as requiring “severe damage on the broader economy,” as the FSOC’s current position is that this definition unduly restricts it and is seen as being in conflict with the statutory purpose.¹¹
- (iii) Analytic approach to the FSOC’s assessment of what constitutes a “threat to the financial stability of the United States” has been moved to the Analytic Framework.¹² Previously, the 2019 Interpretive Guidance defined a “threat to the financial stability of the United States.”¹³ However, the FSOC has provided a reinterpretation of that definition in the Analytic Framework, leaving the Final Guidance to focus solely on the FSOC’s procedure for nonbank designations. Under the Analytic Framework, the FSOC will evaluate a “threat to the financial stability of the United States” based on the Analytic Framework’s description of “financial stability.”¹⁴

(c) Process for Nonbank Designation

The Final Guidance sets out a two-stage process to be observed by the FSOC in determining whether a nonbank should be designated as a SIFI. This process is designed to allow the FSOC and companies under review to have extensive communications and engagements with the primary financial regulator, if any, of the company’s business or sector.

- (i) Stage 1. Initial identification and investigation of the company’s business. Stage 1 is initiated by a notification from the FSOC to the company at least 60 days before the FSOC would hold a vote on whether to recommend that the company move to Stage 2, during which time the company may submit relevant information to the FSOC.¹⁵ This stage involves a review of both quantitative and qualitative data about the company as made available to the FSOC through public outlets and consultations with the primary financial regulator of the company, if any.¹⁶ This stage is only preliminary and may be followed up by subsequent opportunities for hearings and reevaluations. The Final Guidance provides that companies under this preliminary phase of assessment are not axiomatically expected to get to Stage 2 and will have ample opportunity to engage with the FSOC to rebut a systemic risk determination.¹⁷
- (ii) Stage 2. In-depth evaluation: Stage 2 involves a deeper evaluation of the company’s operations. Following a notice by the FSOC indicating its decision to evaluate the company further, the company will be required to provide additional information that the FSOC deems relevant.¹⁸ The FSOC will also rely on information obtained by the FSOC’s Office of Financial Research which is mandated to coordinate with and obtain public and regulatory

¹¹ *Id.*

¹² *Id.*

¹³ Defined as a “threat of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict severe damage on the broader economy.” *See* 84 Fed. Reg. at 71,763.

¹⁴ “Financial stability” is defined as a condition of the “financial system being resilient to events or conditions that could impair its ability to support economic activity, such as by intermediating financial transactions, facilitating payments, allocating resources and managing risks.” *See* Analytic Framework at page 6.

¹⁵ *See* Final Guidance at page 10.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *See* Final Guidance at page 11.

information from other relevant agencies including the primary regulator of the company, if any.¹⁹ The FSOC would make staff available to meet with representatives of any company that enters Stage 2.²⁰

- (iii) FSOC’s Decision. The outcome of Stage 2 will determine whether FSOC should make a proposed determination with respect to the company under assessment.
- (iv) Opportunity for Review. If the FSOC votes to make a proposed determination that a nonbank financial company is a SIFI and as such should be supervised by the Federal Reserve and subject to prudential standards (“Proposed Determination”), the company may request a nonpublic hearing to contest the Proposed Determination, following which the FSOC may make a final determination that the nonbank financial company is a SIFI.²¹

3. The Analytic Framework

(a) Overview

While the FSOC has authority to evaluate systemic risks in the financial sector and issue guidance clarifying its approach,²² the level of transparency introduced by the Analytic Framework is comparatively novel. In this regard, the most striking significance of the Analytic Framework is that it offers clarity and 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.”²³

Allowing for a firm-specific approach, the Analytic Framework is not designed to broadly apply to all market participants or firms with the same parameters. However, the Analytic Framework is only guidance—it does not have the force of law and therefore is not binding on either market participants or the FSOC, nor does it impose specific rights and obligations on any person.²⁴

(b) The FSOC’s Analytic Process

The Analytic Framework breaks down the FSOC’s approach to risks affecting financial stability into three methodological phases: (a) risk identification; (b) risk assessment; and (c) the process of addressing potential risks. As a starting point, the Analytic Framework clarifies the meaning of “financial stability” and defines it as a state of “the financial system being resilient to events or conditions that could impair its ability to support economic activity, such as by intermediating financial transactions, facilitating payments, allocating resources, and managing risks. Events or conditions that could substantially impair such ability would constitute a threat to financial stability.”²⁵ The Analytic Framework notes that the FSOC will not use a broad brush to

¹⁹ *Id.*

²⁰ *Id.*

²¹ As with a Proposed Determination, a Final Determination requires a vote of two-thirds of the voting members of the Council then serving, including an affirmative vote by the Chairperson of the Council, and cannot be delegated by the Council. See Final Guidance at page 12.

²² The judicial attitude toward government agencies exercising their inherent powers to issue interpretive rules has been consistently positive. See *U.S. v. Mead*, 533 U.S. 218, 227 (2001).

²³ See Analytic Framework at page 2.

²⁴ Pursuant to section 3(f) of Executive Order 12866, as amended by Executive Order 14094, the Office of Information and Regulatory Affairs within the Office of Management and Budget has determined that the Analytic Framework is not a “significant regulatory action.” Additionally, the Administrative Procedure Act which entails the requirements for issuance of legislative rules that carry the force and effect of law, exempts interpretive rules and general statements of policy. See 5 U.S.C. § 553(b)(A).

²⁵ See Analytic Framework at page 2.

paint all market participants when assessing potential risks; rather, it will consider factors relevant to the assessment of a potential risk or threat to U.S. financial stability on a case-by-case basis.²⁶

(i) Identifying Potential Risks

In identifying potential risks, the FSOC’s focus is to monitor the financial markets from time to time, underpin developments thereon and consult with other financial regulatory agencies²⁷ to determine whether a risk—apparent or foreseeable—exists. In line with the Dodd-Frank Act, the FSOC will rely on relevant data research and analysis in making its findings.²⁸ The range of businesses targeted covers “an expansive range of asset classes, institutions and activities”—from market-for-debts, loans, digital assets, derivatives, institutional and consumer financial products, payments, clearings, asset management, private funds, insurance, originations, specialty finance businesses, evolving financial products and climate-related risks, to “developments affecting the resiliency of the financial system.”²⁹

(ii) Assessing Potential Risks

The Analytic Framework specifies that risk assessment will be highly fact-specific. This will require the FSOC to consult with its mentee agencies and other financial regulatory bodies in the assessment process given the wide range of factors to consider. These factors are technically referred to as “vulnerabilities,” all of which the FSOC will measure by reference to “sample quantitative metrics.”³⁰ These vulnerabilities are conditions that commonly contribute to financial risks, and the Analytic Framework contains a non-exhaustive list, including:

- a. leverage;
- b. liquidity risks and maturity mismatch;
- c. interconnections;
- d. operational risks;
- e. complexity or opacity;
- f. inadequate risk management;
- g. concentration; and
- h. destabilizing activities.

The Analytic Framework acknowledges that these vulnerabilities may arise from broadly conducted activities or from a small number of entities, so nothing suggests that only a certain kind of business may be targeted based on market value or revenue streams. The FSOC also outlines a number of transmission channels that are likely to facilitate the negative effects of these

²⁶ See Analytic Framework at page 3.

²⁷ It is noteworthy that references in the Analytic Framework to “financial regulatory agencies” may encompass a broader range of regulators than those included in the statutory definition of “primary financial regulatory agency” under section 2(12) of the Dodd-Frank Act, 12 U.S.C. 5301(12).

²⁸ See Dodd-Frank Act section 112(d), 12 U.S.C. 5322(d).

²⁹ See Analytic Framework at page 4.

³⁰ See Analytic Framework at page 5.

vulnerabilities, consequently impacting financial stability. These transmission channels include: (a) exposures; (b) asset liquidation; (c) contagion; and (d) critical function or service.³¹

(iii) Addressing Potential Risks

Addressing potential risks would take different forms. The FSOC will decide internally what method is most appropriate in a given circumstance. More broadly, however, addressing risks will take the form of:

- a. interagency coordination and information sharing, which is basically the FSOC working with other financial regulatory agencies at federal and state levels;³² and/or
- b. recommendations to other agencies or the U.S. Congress.³³

Under the Analytic Framework, the FSOC also restates its authority to designate certain payment, clearing and settlement activities that it determines are, or are likely to become, systemically important under Title VIII of the Dodd-Frank Act.³⁴

4. Conclusion

The ultimate impact of the Final Guidance and Analytic Framework on the financial services industry will remain to be seen. The prior administration paid less attention to targeting nonbanks for SIFI designations. However, with the Final Guidance and Analytic Framework, the threat of SIFI designations has been re-introduced as a powerful tool for policymakers. A key aspect will be how the revised guidance is applied in practice in any assessment of any nonbank SIFI designations. Market participants and stakeholders should consider these changes to the regulatory framework and potential impact on the financial industry and its businesses.

* * *

³¹ See Analytic Framework at pages 6-10.

³² See Dodd-Frank Act sections 112(a)(2)(A), (D), (E) and (F), 12 U.S.C. 5322(a)(2)(a)(b)(c)(d)(e)(f).

³³ Dodd-Frank Act section 120(d)(3), 12 U.S.C. 5330(d)(3). The Council also has authority to issue recommendations to the Board of Governors of the Federal Reserve System (Federal Reserve Board) regarding the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to nonbank financial companies subject to Federal Reserve Board supervision and large, interconnected bank holding companies (Dodd-Frank Act section 115, 12 U.S.C. 5325); recommendations to regulators, Congress or firms in its annual reports (Dodd-Frank Act section 112(a)(2)(N), 12 U.S.C. 5322(a)(2)(N)); and other recommendations to Congress or Council member agencies (Dodd-Frank Act sections 112(a)(2)(D) and (F), 12 U.S.C. 5322(a)(2)(D) and (F)).

³⁴ See Dodd-Frank Act section 804(a)(1), 12 U.S.C. 5463(a)(1).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Jarryd E. Anderson
+1-202-223-7489
janderson@paulweiss.com

H. Christopher Boehning
+1-212-373-3061
cboehning@paulweiss.com

Susanna M. Buerger
+1-212-373-3553
sbuerger@paulweiss.com

Jessica S. Carey
+1-212-373-3566
name.name@paulweiss.com

John P. Carlin
+1-202-223-7372
jcarlin@paulweiss.com

Roberto J. Gonzalez
+1-202-223-7316
rgonzalez@paulweiss.com

Brad S. Karp
+1-212-373-3316
bkarp@paulweiss.com

Loretta E. Lynch
+1-212-373-3000

Anastasia Peterson
+1-212-373-3779
avpeterson@paulweiss.com

Aaron J. Schlaphoff
+1-212-373-3555
aschlaphoff@paulweiss.com

Jennifer Songer
+1-202-223-7467
jsonger@paulweiss.com