Essential Reforms to FSOC's Nonbank Guidance

Both Congress and the Financial Stability Oversight Council (FSOC) must act to make essential reforms that bring stability, predictability, and transparency to FSOC's guidance governing the designation of nonbank companies[1] as a Systemically Important Financial Institution (SIFI).[2]

- Congress can ensure stability by enacting legislation to codify the activities-based approach to systemic risk.[3]
- FSOC can provide predictability and transparency by restoring the 2019 Guidance that prioritized the activities-based approach and ensured due process.

Effective systemic risk[4] regulation should address activities across markets and be based on rigorous analysis of data. Individual designations should not be a metric for achieving FSOC's mandate as they could make the financial system less competitive and more vulnerable to economic shock.

Objective 1:

The Chamber supports the FSOC Improvement Act (H.R. 3682), bipartisan legislation requiring the Financial Stability Oversight Council (FSOC) to consider alternative approaches before determining that a U.S. nonbank financial company should be supervised by the Federal Reserve.

Why Congress should act in the 119th Congress

1) The bill would bring needed procedural stability and predictability to FSOC guidance.
   - Since Dodd-Frank was enacted, three administrations have adopted three different approaches to nonbank guidance in 2012, 2019, and 2023.
   - Regulatory whiplash has undermined FSOC's stability objective by creating uncertainty and discouraging innovation.

2) FSOC's 2023 guidance and analytic framework eliminated critical due process safeguards for nonbank firms under consideration for SIFI designation without proper justification.
   - Demoted the activities-based approach to systemic risk as its priority tool.
   - Eliminated earlier procedural protections to conduct a cost-benefit analysis and to assess the likelihood of a nonbank's distress or failure before making a designation, which ensured the potential decision to designate a nonbank was based on data and used only as a last resort.
     - This change ignored the 2016 MetLife court decision, which criticized FSOC's flawed approach to designating nonbank companies.
   - Broadened the definition of "threat to the financial stability of the U.S.," so that FSOC now has the authority to investigate any entity over mere speculative risks.
   - FSOC's mission is to reduce systemic risks to the financial system – not to prioritize and strengthen SIFI designation authority.

3) An activities-based approach is an effective method to address systemic risks.
   - It prioritizes identifying potential risks on a system-wide basis (rather than one institution) and working with the relevant federal and state financial regulatory agencies to address the risks.
   - A nonbank's primary regulator is in the best position to identify specific gaps in regulation across an industry and take the lead in developing consistent and predictable rules that reduce risk for all entities, unlike SIFI designation which focuses on one company.

4) Designation of a nonbank as a SIFI should be a tool of last resort.

- The Federal Reserve doesn't have the expertise to oversee nonbanks or their perceived risks.
- Federal Reserve bank capital requirements are designed for large, complex banking organizations, not nonbank financial institutions.
- Designation is a blunt instrument that will have permanent ramifications for a nonbank.

5) Unintended consequences of nonbank SIFI designation.

- Distorts the competitive landscape and creates an uneven playing field.
  - Undesignated companies in the same industry can offer the same or similar products and services without the costs and constraints of Federal Reserve regulation.
- Increased costs to the nonbank could make them more vulnerable to financial distress.
- May exacerbate threats to financial stability by causing unnecessary panic in the financial markets or a run on the company.
- Customers of nonbanks would face higher fees from designated nonbanks.

6) FSOC retains emergency power to act.

- Even by prioritizing the activities-based approach, FSOC can address emergency risks to the financial stability of the U.S. with 2/3 of voting FSOC members.

Endnotes

[1] **Nonbank financial companies** represent a wide range of entities, including asset manager, insurance, fintech, digital assets, and real estate.

[2] **Systemically Important Financial Institution (SIFI)** is a financial institution deemed by the Federal Reserve to pose serious risk to the U.S. economy if it fails.

[3] **Activities-based approach** focuses on regulating specific financial activities on a system-wide basis.

[4] **Systemic risk** is financial market risk that poses a threat to financial stability.

Objective 2:

The Chamber encourages FSOC to restore the 2019 Guidance governing the designation of nonbank financial institutions as systemically important.

Why FSOC should restore the 2019 nonbank guidance

The 2019 Guidance was adopted following lessons learned earlier in the decade when four nonbanks had been designated as SIFIs by FSOC. It created balance between FSOC's authority to evaluate financial stability of nonbanks, while nonbanks would receive essential due process if under consideration for heightened supervision.

The 2019 Guidance (1) prioritized an activities-based approach to systemic risk, (2) emphasized coordination with primary regulators, and (3) required a cost-benefit analysis and assessment of the likelihood of a nonbank's financial distress or failure before making a designation.

What is FSOC?

FSOC was established by the Dodd–Frank Wall Street Reform and Consumer Protection Act (2010). It is comprised of the heads of the federal financial regulators and state regulator advisory members.

- Congress charged FSOC, acting in coordination with other financial regulators, with identifying and addressing risks to U.S. financial stability.

FSOC has several tools at its disposal:

- It can make recommendations to Congress or to a primary regulator to act on financial activities that it deems a risk to financial stability.
- It can engage directly with nonbanks to address a perceived risk.
- It can designate nonbank financial companies as a SIFI, which would subject them to Federal Reserve supervision and enhanced prudential standards.