KPMG

Regulatory Alert

Regulatory Insights

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Financial Stability, Nonbank Supervision: FSOC Proposals

The Financial Stability Oversight Council (FSOC) proposes:

— An analytic framework for financial stability risks.

— Guidance for determining regulation and supervision of nonbank financial companies.

Analytic Framework for Financial Stability Risks

The proposed Analytic Framework outlines how the FSOC would 1) identify, 2) assess, and 3) respond to potential financial stability risks (independent of whether those risks arise from activities, firms, or otherwise), with the goal of reducing the risk of “shocks” arising from within the financial system, improving resilience against shocks that could affect the financial system, and mitigating financial vulnerabilities that may increase risks to financial stability.

1. **Identify.** Risk monitoring under the FSOC’s proposed Analytic Framework would include:
   - Markets for debt, loans, short-term funds, equity securities, commodities, digital assets, derivatives, and other institutional and consumer financial products and services.
   - Central counterparties and payment, clearing, and settlement activities.
   - Financial entities, including banking organizations, broker-dealers, asset managers, investment companies, insurance companies, mortgage originators and servicers, and specialty finance companies.
   - “New or evolving” financial products and practices.
   - Developments that may affect the resiliency of the financial system, such as cybersecurity and climate-related financial risks.

2. **Assess.** The FSOC identifies certain vulnerabilities that it states most commonly contribute to potential stability risks, including, but not limited to:
   - Leverage ratios
   - Considerations about liquidity risk and maturity
   - Interconnections
   - Operational risks
   - Complexity or “opacity”
   - “Inadequate” risk management
   - Concentration risks
   - “Destabilizing activities”

   Additionally, the FSOC identifies four channels that may facilitate the transmission of “negative effects” of a financial stability risk to financial markets or market participants:
   - Exposures.
   - Asset liquidation.
   - Critical function or service.
   - Contagion.

   (*Note*: FSOC acknowledges that these risks can arise from widely conducted activities or from the activities of a smaller number of entities, and the type and scope of evaluations and actions will depend on the nature of the vulnerabilities and/or transmission channels and not on the origin of a particular risk.)

3. **Respond.** Following identification and assessment, the FSOC’s Deputies Committee will direct one or more of the FSOC’s staff-level committees or working groups to consider potential policy approaches or actions to

address the potential risk (as appropriate), including but not limited to:

- Interagency coordination and information sharing.
- Recommendations to agencies or Congress.
- Nonbank financial company "determinations".
- Payment, clearing, and settlement activity designations.
- Financial market utility designations.

Determination of Nonbank Financial Companies for Regulation and Supervision

The FSOC's proposed interpretive guidance sets forth three changes to the FSOC's 2019 Interpretive Guidance, the process by which the FSOC determines (or "designates") whether to subject a nonbank financial company to supervision and prudential standards by the Federal Reserve Board (FRB).

These changes include:

1. Eliminating the statement that the FSOC would first use an "activities-based approach", which includes relying on federal and state regulators to address identified potential financial stability risks through actions under their respective jurisdictions before considering an "entity-specific determination" (i.e., a nonbank financial company for potential designation).
2. Rescinding the description of the FSOC's analytic approach to evaluating nonbank financial companies under consideration for designation and instead referencing the Analytic Framework (as concurrently proposed and outlined above).
3. Removing language stating that the FSOC would conduct a cost-benefit analysis and assessment of the likelihood of a company's "material financial distress" prior to making a determination.

Under the proposed guidance, the process for nonbank financial company determinations would include:

Evaluation: Stage 1 : **"Preliminary Evaluation"** *As identified through the Analytic Framework processes and using quantitative and qualitative information from public and regulatory sources*	The company would be notified of the review and may, but would not be required, to provide information. The company's primary financial regulator would also be contacted. The FSOC would vote on whether to advance the company to a more significant Stage 2 review
Evaluation: Stage 2: **"In-depth Evaluation"** *Using information collected directly from the company as well as from public and regulatory information.*	To consider whether "material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to U.S financial stability." The FSOC may discontinue its consideration of the company for a potential determination if the FSOC believes actions taken by the company's regulator (using its existing authorities) or by the company "adequately" address the potential financial stability risk identified by the FSOC.
Determination: Proposed *Based on findings during Stage 2, the FSOC may vote to Propose Determination.*	Requires a two-thirds vote of the FSOC members, including an affirmative vote of the FSOC Chair. The company would be permitted to request a hearing to contest the Proposed Determination.
Determination: Final *Following the hearing, the FSOC may vote to make a Final Determination.*	Requires a two-thirds vote of the FSOC members, including an affirmative vote of the FSOC Chair. The FSOC will publicly announced the Final Determination after providing written notice to the company. The company would be subject to supervision by the FRB and prudential standards.
Reevaluation *At least annual reevaluation using the same standards of review applied during the initial determination.*	The company would have opportunity to meet with the FSOC and to provide additional information. The FSOC would vote to rescind the determination if the potential risks that existed at the time of the Final Determination – based on steps to mitigate the risk taken by the company or its regulator – no longer exist and the FSOC determines the company no longer meets the statutory standards for designation.

Comment Period

Comments on the proposed "Analytic Framework for Financial Stability Risk Identification, Assessment, and Response" as well as the proposed interpretive guidance on the FSOC's "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies" will be accepted for a period of sixty (60) days following publication in the Federal Register.

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