

Regulatory Alert

Regulatory Insights for Financial Services

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Financial Stability, Nonbank Supervision: FSOC Final Guidance

KPMG Insights:

- **Expanding Regulatory Perimeter:** *The supervisory authority of the FRB will expand to cover designated nonbank financial companies.*
- **Risk Management Focus.** *Continued regulatory focus on heightened risk management standards - through both issuances of cross-agency frameworks and guidance.*
- **Harmonize Supervision.** *Recognizes the growth of nonbank financial entities (e.g., private funds, asset managers, money market funds, insurance companies) and the commitment of the regulators to harmonize supervision and regulation of financial stability risks posed by banks and nonbanks.*

The Financial Stability Oversight Council (FSOC) issues:

- An [analytic framework](#) for financial stability risks.
- [Guidance](#) for determining whether to subject nonbank financial companies to supervision and regulation by the FRB.

Analytic Framework for Financial Stability Risks

The Analytic Framework outlines how the FSOC “expects to” 1) identify, 2) assess, and 3) respond to potential financial stability risks (independent of whether those risks arise from activities, firms, or otherwise), and is intended to decrease 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.

Key changes from proposal. The framework is adopted largely as proposed, with several key changes based on comments received, including:

- *“Threat to financial stability”* – Building on the proposed interpretation of “financial stability,” the framework interprets the term “threat to financial

stability” to mean events or conditions that could “substantially impair” the financial system’s ability to support economic activity.

- *Metrics to assess vulnerabilities* – Adding more examples of the types of quantitative metrics the FSOC may consider in its assessment of vulnerabilities that contribute to risks to financial stability.
- *Transmission channels* – Clarifying and adding detail on FSOC’s consideration of channels of risk transmission, including identification of vulnerabilities for each of the four channels FSOC has listed as most likely to transmit risk through the financial system.
- *Regulatory engagement* – Emphasizing FSOC’s “extensive” engagement with federal and state regulators regarding potential risks and the extent to which existing regulation may mitigate those risks.

Final Analytic Framework.**1) Identify.** Risk monitoring under the Analytic Framework would include:

- Markets for debt, loans, short-term funding, 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, private funds (added in the final framework), 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 a non-exhaustive, non-exclusive list of vulnerabilities and related quantitative metrics that it states most commonly contribute to potential stability risks, including:

- Leverage ratios
- Liquidity risk and maturity “mismatch”
- Direct or indirect financial interconnections
- Operational risks
- Complexity or “opacity”
- “Inadequate” risk management
- Concentration risks
- “Destabilizing activities”

Transmission Channels. 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, as well as specific vulnerabilities in each channel and areas that the framework analyzes:

- *Exposures.* The framework evaluates direct and indirect exposures of creditors, counterparties, investors, and other market participants, particularly exposures to a particular financial instrument or asset class, such as equity, debt,

derivatives, or securities financing transactions and potential impairment of those market participants if there is a default on or other reduction in the value of the instrument or assets. Potential vulnerabilities that could exacerbate risks to financial stability include instances where:

- Exposures are “larger”.
 - Transaction terms provide “less protection” for counterparties.
 - Exposures are correlated, concentrated, or interconnected with other instruments or asset classes.
 - Entities with significant exposures include large financial institutions.
- *Asset liquidation.* Rapid liquidations of financial assets can pose risks to financial stability when they cause significant asset prices to fall, disrupt trading or funding in key markets, or funding problems for market participants. The framework considers account amounts and types of liabilities that are or could become short-term in nature, amounts of assets that could be rapidly liquidated to satisfy obligations, and the potential effects of a rapid asset liquidation on markets and market participants. The potential risk to financial stability increases if:
 - Leverage or reliance on short-term funding is “higher”.
 - Assets are “riskier” and may experience a reduction in market liquidity in times of broader market stress.
 - Asset price volatility could lead to significant margin calls.
 - *Critical functions or services.* Disruptions of critical functions or services that are relied upon by market participants and for which there are no ready substitutes can pose financial stability risks. These “substitutability” risks can be greater if:
 - Providers of critical functions or services are likely to experience stress at the same time because they are exposed to the same risks.
 - The critical functions or services are interconnected or large.
 - Operations are opaque.

- The functions or services use or rely on leverage to support its activities.
 - Risk management practices related to operational risks are “insufficient”.
- *Contagion.* Even without exposures, contagion can arise from the perception of common vulnerabilities or exposures (e.g., similar or correlated business models or asset holdings) and spread stress rapidly and unpredictably, particularly when there is:
- Limited transparency into investment risks, correlated markets, or operational risks.
 - A loss of confidence in financial instruments that are treated as substitutes for money.

(Note: The framework acknowledges that FSOC’s analyses consider market participants’ varying risk profiles and business models, but that the framework is not intended to address sector-specific distinctions but rather to address FSOC’s “overarching approach to financial stability risks regardless of their origin.”

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.

Effective Date. The Analytic Framework is effective as of the date of publication in the Federal Register.

Determination of Nonbank Financial Companies for FRB Regulation and Supervision

As proposed, the FSOC’s final 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. 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.
3. 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 finalized and outlined above).

In addition, the final guidelines incorporate the definition of a “threat to the financial stability” adopted in the FSOC’s Analytic Framework. As such, “events or conditions that could substantially impair the financial system’s ability to support economic activity would constitute a threat to financial stability.”

Process for nonbank financial company determinations.

Under the final guidance, the process for nonbank financial company determinations will include:

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| <p>Evaluation: Stage 1 - “Preliminary Evaluation”</p> <p><i>As identified through the Analytic Framework processes and using quantitative and qualitative information from public and regulatory sources</i></p> | <p>The company would be notified of the review and may, but would not be required, to provide information. The company and its subsidiaries may be evaluated separately or together.</p> <p>The company’s primary financial regulator will be consulted as part of the preliminary evaluation.</p> <p>The company will be notified of the review (at least sixty (60) days in advance of an FSOC vote to proceed to Evaluation Stage 2.</p> <p>The FSOC will vote on whether to advance the company to a more significant Stage 2 review, but notes that even Stage 2 review does not constitute a final decision on designation. A decision not to advance the company to Stage 2 does not preclude the FSOC from reinitiating a review.</p> |
| <p>Evaluation: Stage 2 – “In-depth Evaluation”</p> <p><i>Using information collected directly from the company as well as from public and regulatory information.</i></p> | <p>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.”</p> <p>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.</p> |
| <p>Determination: Proposed</p> <p><i>Based on findings during Stage 2, the FSOC may vote to Propose Determination.</i></p> | <p>Requires a two-thirds vote of the FSOC members then serving, including an affirmative vote of the FSOC Chair.</p> <p>The FSOC will provide written notice, including an explanation of the basis for the Proposed Determination, to the company and its primary financial regulator.</p> <p>The company will be permitted to request a hearing to contest the Proposed Determination.</p> |
| <p>Determination: Final</p> <p><i>Following any requested hearing, the FSOC may vote to make a Final Determination.</i></p> | <p>Requires a two-thirds vote of the FSOC members then serving, including an affirmative vote of the FSOC Chair.</p> <p>The FSOC will publicly announced the Final Determination at least one day after providing written notice to the company and its primary financial regulator. The notice would highlight key risk that led to the Final Determination and guidance regarding important factors to the Council.</p> <p>The company may bring an action in U.S. District Court for an order to rescind the Final Determination.</p> <p>Upon designation, the company would be subject to supervision by the FRB and prudential standards.</p> |
| <p>Reevaluation</p> <p><i>At least annual reevaluation to assess material changes using the same standards of review applied during the initial determination.</i></p> | <p>The company will have opportunities to meet with the FSOC and to provide additional information. If a company contests the determination during the annual evaluation, the FSOC will vote on whether to rescind.</p> <p>Moreover, every five (5) years, each company can request an oral hearing to contest their designation.</p> <p>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.</p> |

Effective Date. The final interpretive guidance on nonbank designations will become effective sixty (60) days after the date of publication in the Federal Register.

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