Nonbanks Face Tougher Road Under New FSOC Plan

The U.S. Treasury Department's interagency regulatory body, the Financial Stability Oversight Council (FSOC), recently announced it is resurrecting its authority to impose sweeping regulation on nonbank financial institutions.[1] On the surface, the threat is nothing new. But unlike its last attempt to regulate nonbank financials, which ended in a court battle that FSOC lost in 2018,[2] this time the financial services industry will have a tougher time playing defense.

The new proposal,[3] announced April 21, would beef up FSOC's authority to designate nonbank companies as systemically important financial institutions, or "SIFIs," an authority that dates back to the 2010 Dodd-Frank Act. In announcing the proposal, U.S. Treasury Secretary Janet Yellen said,[4] "The designation tool serves as an important part of our post-Global Financial Crisis defense," and highlighted risks in money market funds, open-end funds and crypto-assets. Yellen has also previously raised concern over risks of hedge funds.[5] Both Federal Reserve Vice Chair for Supervision Michael Barr and Consumer Financial Protection Bureau Chair Rohit Chopra have argued that FSOC's process for designating systemically important financial institutions is in need of overhaul.[6]

Born out of the 2008 financial crisis, FSOC is an interagency body led by the U.S. Treasury Department and made up of 10 financial regulators whose mission is to coordinate, spot and mitigate systemic risk to the economy. Its focus has shifted regularly since its inception, over time moving away from targeting individual companies toward one that is activities-based. The new proposal, however, appears to put renewed attention on individual company designations.[7]

As part of the proposal, FSOC put forward a two-step process for comment to more easily designate non-bank institutions as systemically important, subjecting them to Federal Reserve supervision. The new guidance removes some "inappropriate hurdles," including the cost-benefit analysis process required to designate nonbank firms, which FSOC said could take up to six years. It also drops a Trump-era requirement that FSOC consider a firm's distress and apply an "activities-based approach" and replaces it with a quantitative and qualitative process to determine whether "a particular financial company's material financial distress or activities could pose a threat to financial stability."[8]

The proposal has the financial services industry on edge, for good reason. Designating a company as a SIFI has enormous consequences for any company. The designation subjects a firm to substantially increased supervision from the Federal Reserve, similar to that of large banks. Alternatively, the designation would empower the designated entity's primary regulator (SEC, CFTC, OCC, etc.) to enhance its existing regulation of the entity. In the case of digital assets, that carries with it a whole set of complicating factors, given the lack regulatory clarity governing the industry.

> *Asset managers and digital asset companies are paying particularly close attention.*

Considerations for Asset Managers and Digital Asset Companies

Asset Managers

The proposed changes have the potential to upend regulatory oversight of asset managers, who have until now been successful in warding off the prying eyes of FSOC. During the Obama administration, FSOC designated insurance companies as SIFIs and attempted to target asset managers.[9] A united campaign from the industry convinced the U.S. Treasury and other regulators that the industry was not a systemic risk.

The industry's lobbying efforts will likely prove more difficult this time. For one, the industry is far more splintered than it was a decade ago, making a united campaign more challenging. What's more, the asset management industry is now in the midst of a high-profile, national political fight over ESG and its role in investment decisions. Unlike past industry-wide battles, the asset managers are not coordinating their lobbying and advocacy against these pressures and lack trade association support in the ESG fight.[10] Further, political support among Republicans in Washington has plummeted, with many GOP leaders now charging asset managers with claims of "woke" investing.[11]

Digital Assets

The digital assets industry, which didn't exist when FSOC was created nearly 15 years ago, now finds itself in the crosshairs of the regulatory body, particularly given the lack of a regulatory framework governing crypto.

While legislation on digital assets is stalled, regulation through FSOC may be an easier back-door path to formal industry oversight. In fact, the Biden administration essentially foreshadowed such a move in the President's Working Group report on stablecoins[12] over a year ago. While the industry is eager for regulatory clarity, Federal Reserve bank-like rules are not the industry's preferred approach.

Difficult to Stop this Train

As disliked as the proposal may be among industry participants, stopping it will prove challenging. Congress may be able to use its oversight power to scrutinize FSOC, but it doesn't have the authority to thwart the Biden administration's proposal. And unlike during the early days of FSOC, impacted industries have fewer friends on Capitol Hill.

While the risk for the industry is high, the slow pace of Washington all but guarantees that the process will take a long time. The upcoming general election campaign may also slow the Biden administration's roll, with the prospect of the normally apolitical FSOC becoming a topic of debate on the campaign trail. All of that suggests that the industry has time to shift the narrative. Asset managers, crypto firms and other potentially affected industries have an opportunity to launch coordinated public affairs campaigns and education efforts to thwart claims of systemic risk, remind policymakers of the importance of a proper cost-benefit analysis, and show the potential economic harm if these firms suddenly become subject to crippling regulatory oversight. The moment won't last long.

Endnotes

[1] "FSOC Issues for Public Comment Proposed Analytic Framework for Financial Stability Risks and Proposed Guidance on Nonbank Financial Company Determinations," U.S Department of the Treasury (April 21, 2023), https://home.treasury.gov/news/press-releases/jy1432.

[2] MetLife, Inc. v. Financial Stability Oversight Council, 177 F. Supp. 3d 219 (D.D.C. 2018),

[3] Id. at 1.

[4] "Remarks by Secretary of the Treasury Janet L. Yellen at Financial Stability Oversight Council Meeting," U.S. Department of the Treasury (April 21, 2023), https://home.treasury.gov/news/press-releases/jy1431.

[5] "Remarks by Secretary of the Treasury Janet L. Yellen at the National Association for Business Economics 39th Annual Economic Policy Conference," U.S. Department of the Treasury (March 30, 2023), https://home.treasury.gov/news/press-releases/jy1376.

[6] "Making the Financial System Safer and Fairer," Federal Reserve Vice Chair for Supervision Michael Barr at the Brookings Institution (September 7, 2022), https://www.federalreserve.gov/newsevents/speech/barr20220907a.htm, and "Statement of CFPB Director Rohit Chopra on the 2022 Annual Report of the Financial Stability Oversight Council," Consumer Financial Protection Bureau (December 16, 2022), https://www.consumerfinance.gov/about-us/newsroom/statement-of-cfpb-director-rohit-chopra-on-the-2022-annual-report-of-the-financial-stability-oversight-council/.

[7] U.S. Department of the Treasury, Financial Stability Oversight Council, at https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc.

[8] "Analytic Framework for Financial Stability Risk Identification, Assessment, and Response," Financial Stability Oversight Council, (April 21, 2023), available at https://home.treasury.gov/system/files/261/FSOC-2023-Risk-Framework.pdf.

[9] "Designations," Financial Stability Oversight Council, U.S. Department of Treasury, available at https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/designations.

[10] "Executive Order on Climate-Related Financial Risk," White House, (May 20, 2021), available at https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk/.

[11] "Republicans Plan Surge of Attacks on 'Woke' Investing after the Midterms," Politico, (November 1, 2022), available at https://www.politico.com/news/2022/11/01/republicans-sustainable-investing-midterms-00064326.

[12] "Report on Stablecoins," President's Working Group on Financial Markets, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, (November 2021), available at https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.

CHEYENNE HOPKINS
Managing Director
cheyenne.hopkins@fticonsulting.com

MEGHAN MILLOY
Managing Director
meghan.milloy@fticonsulting.com

CAROLINE SAYERS
Senior Consultant
caroline.sayers@fticonsulting.com