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FSOC's 2023 Annual Report and Recent Revisions to Nonbank Guidance

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The Financial Stability Oversight Council ("FSOC") was active in the final quarter of 2023. It unanimously-approved its 2023 Annual Report,[1] which, among other things, describes potential emerging threats to financial stability, identifies various vulnerabilities in the financial system and issues recommendations on how such threats and vulnerabilities may be mitigated. Approximately one month prior, FSOC issued a new analytic framework for financial stability risks (the "Final Analytic Framework")[2] and final guidance on its nonbank financial company determinations process (the "Final Guidance"),[3] which, combined, simplify the process by which FSOC may designate nonbank financial companies as systemically important financial institutions ("SIFIs").

HIGHLIGHTS FROM THE ANNUAL REPORT

The 2023 Annual Report highlighted areas of risk and stress that FSOC believes deserve to be monitored and addressed in the near future. FSOC identifies 14 financial stability vulnerabilities in 2023, grouped into three broad categories.

Financial risks: vulnerabilities related to commercial real estate, residential real estate, corporate credit, short-term funding markets, digital assets and climate-related risk.

Financial institutions: vulnerabilities related to the banking systems, investment funds, central counterparties and the insurance sector.

Financial market structure, operational risk and technological risk: vulnerabilities related to the treasury market, cybersecurity, the use of artificial intelligence ("AI") in financial services and third-party service providers.

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[1] FINANCIAL STABILITY OVERSIGHT COUNCIL, ANNUAL REPORT 2023 (2023), *available* here [hereinafter "2023 Annual Report"].

[2] Analytic Framework for Financial Stability Risk Identification, Assessment, and Response, 88 Fed. Reg. 78026 (Nov. 14, 2023).

[3] Guidance on Nonbank Financial Company Determinations, 88 Fed. Reg. 80131 (Nov. 17, 2023).

Among other areas of focus, FSOC discusses:

Spring 2023 Bank Failures

FSOC characterizes the U.S. banking system as "resilient overall, despite the Spring 2023 turmoil," but highlights potential areas of systemic weakness related to financial institutions, such as interest rate risk, business concentrations and potential overreliance on uninsured deposits for funding.[4] FSOC "supports banking agencies' efforts to improve the agility of supervision to be more responsive to institution-specific risks," including the ongoing review of regulatory capital requirements, long-term debt requirements and resolution plans by the relevant agencies.[5] Reflecting "lessons learned" from the spring 2023 bank failures, FSOC recommends that banking agencies monitor uninsured deposit levels, depositor composition and banks' reliance on uninsured deposits or other credit sensitive deposits.

Commercial Real Estate Lending

FSOC identifies several market vulnerabilities related to commercial real estate ("CRE") lending, including a rise in vacancy rates and declines in value for certain property types, elevated interest rates, heightened CRE loan maturities, inflation in property operating costs and an increase in CRE loan delinquencies.[6] The report cautions that losses from a CRE loan portfolio has the potential to accumulate and spill over into the broader financial system.[7] Further, FSOC identifies the significant concentrations in CRE for many regional and community banks as a risk to the banking system, noting that such banks are potentially "vulnerable to negative trends in the office market and an erosion in high multifamily property valuations."[8]

Funds and Insurance

FSOC identifies a number of risks associated with various types of pooled investment vehicles, including hedge funds and money market mutual funds. To this end, FSOC expresses its support for reforms being advanced by the Securities and Exchange

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[4] 2023 Annual Report, *supra* note 1, at 50. *See also*, Martin J. Gruenberg, *Statement on the Approval of the FSOC Annual Report*, FDIC (Dec. 15, 2023), *available* here. ("While the banking industry has proven to be quite resilient, in light of the large bank failures earlier this year, I am particularly appreciative of the Annual Report's discussion of interest rate risk and its impact on underlying vulnerabilities in the banking system related to unrealized losses on securities and loans on bank balance sheets, concentrations of uninsured deposits, and commercial real estate, particularly in the office building sector.")

[5] 2023 Annual Report, *supra* note 1, at 12, 59.

[6] *Id.* at 18.

[7] *See id* ("Sales of financially distressed properties can reduce market values of nearby properties, lead to a broader downward CRE evaluation spiral, and even reduce municipalities' property tax revenues. In addition, wide-spread CRE distress can contribute to tightening credit availability.")

[8] *Id.* at 50.

Commission to address these risks.[9] FSOC also notes the "structural changes" occurring in the life and health insurance sector, including the involvement of large asset management and private equity firms in the sector and life insurers' increased use of offshore reinsurance. FSOC believes these changes may raise concerns, such as growth risk appetites, and recommends continued evaluation of the trends and their "potential impact … on systemic risk."[10]

Climate-Related Risk

Since first identifying climate change as an emerging threat to U.S. financial stability two years ago, FSOC has sustained its efforts to integrate climate risk into prudential regulatory policy. FSOC's Climate-related Financial Risk Committee is currently working to develop a preliminary set of risk indicators for banking, insurance and financial markets.[11] Among other vulnerabilities, the report calls attention to the effects of physical risk (e.g., severe weather events) on residential and commercial real estate, which have already decreased the availability of property and casualty insurance in various states such as California, Florida and Louisiana this past year. FSOC recommends that agencies and regulators continue to coordinate on developing a framework to identify and assess climate risk and promoting disclosures that would allow investors and financial institutions to incorporate climate-related risk into investment and lending decisions.[12]

Digital Assets

The report also mentioned recent high-profile cases brought against crypto-asset firms this year.[13] According to FSOC, crypto-assets and related services continue to pose investor protection and market integrity concerns, as well as pose a risk for contagion within the crypto-asset market. Citing the knock-on effects of the collapse of the crypto-asset trading platform FTX on Silvergate Bank (which reported almost substantially all of its deposits as being derived from crypto-asset customers) in advance of the other spring 2023 bank failures, FSOC further warns of contagion risk to traditional financial systems to the extent they are connected to the crypto-asset ecosystem.[14]

Artificial Intelligence

For the first time, the annual report features AI as a potential area of vulnerability. FSOC noted the rise of AI use in financial services and emphasized certain areas of

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[9] *Id.* at 59–68.

[10] *Id.* at 73–78.

[11] *Id.* at 99.

[12] *Id.* at 11.

[13] *Id.* at 43, n.74, 76.

[14] *Id.* at 43.

concern, such difficulty in verifying the AI's processes, methodology or quality of output, potential introduction of bias and challenges with respect to data privacy and controls.[15] Secretary Yellen emphasized that "[s]upporting responsible innovation in this area can allow the financial system to reap benefits like increased efficiency, but there are also existing principles for rules and risk management that should be applied."[16]

KEY TAKEAWAYS FROM NONBANK GUIDANCE

Prior interpretive guidance on FSOC's designation authority issued in 2019 (the "2019 Guidance") imposed roadblocks for FSOC's designation authority. Indeed, in a comment letter to the proposed version of the 2019 Guidance, Janet Yellen (current Treasury Secretary and former Chair of the Federal Reserve) joined two former Treasury Secretaries and another former Federal Reserve Chair in suggesting that the changes would "neuter the designation authority."[17] Yellen and the other authors stressed the importance of timing when it comes to FSOC's designation authority, citing examples from the 2008 financial crisis and referring back to the 2010 Dodd-Frank Act, which was enacted in response to the crisis.[18]

Although FSOC does not signal that it anticipates any immediate SIFI designations, FSOC's Final Guidance removes the existing roadblocks and makes it easier for FSOC to designate nonbanks as SIFIs and, in fact, echoes many of the themes set forth in the comment letter, including (as discussed further below) the removal of certain pre-requisites in designating nonbank SIFIs.[19] Below, we discuss this and other key takeaways from the Final Guidance.

Rejection of Certain Aspects of the 2019 Guidance

Consistent with the Proposal and as noted above, the Final Guidance removes three requirements that were prerequisites for potential designation of a nonbank financial company under section 113 of the Dodd-Frank Act that had been imposed by the 2019 Guidance.

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15 *Id.* at 92.

16 Janet L. Yellen, *Remarks at the Open Session of the Meeting of the Financial Stability Oversight Council*, U.S. DEP'T TREASURY (Dec. 14, 2023), *available* here.

17 Timothy F. Geithner, Former Sec'y Treasury, Jacob J. Lew, Former Sec'y Treasury, Ben S. Bernanke, Former Chair, Bd. Gov. Fed. Rsrv. Sys., and Janet L. Yellen, Former Chair, Bd. Gov. Fed. Rsrv. Sys., Comment Letter on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (May 13, 2019), *available* here.

18 *Id.*

19 *Id.* at 7–9.

- Removal of the Activities-Based Approach. In issuing the Final Guidance, FSOC noted that the requirement to exhaust all available alternatives before making a designation by prioritizing an "activities-based approach" would "obstruct[]" FSOC from responding to risks to financial stability in a timely fashion by requiring a multi-step process under which "[FSOC] would wait for existing regulators to address identified risks to financial stability."[20]

- Removal of Cost-Benefit Analysis. In the Final Guidance, FSOC pushed back on including the requirement of performing a cost-benefit analysis before making a designation on the grounds that (1) Congress did not specifically require FSOC to consider such analysis in a designation, and (2) such analysis "is not reasonably estimable, useful, or warranted" in the designation context.[21]

- Removal of Assessment of Likelihood of Material Financial Distress. FSOC explained in the Final Guidance that "[a]ssessing a nonbank financial company's likelihood of material financial distress [before making a designation] is not among the tasks Congress `set for [FSOC] and could undermine financial stability by spurring a run on a company that is designated or under review for potential designation."[22]

The Final Guidance also lowers the threshold for determining a "threat to the financial stability of the [U.S.]" by removing the requirement that a nonbank financial institution impose "severe damage on the broader economy," finding the requirement "overly restrictive and in conflict with the Council's statutory purpose."[23] Instead, the Final Guidance (via the Final Analytic Framework) notes that "events or conditions that could substantially impair the financial system's ability to support economic activity would constitute a threat to financial stability."[24]

Departure from *MetLife v. FSOC*

The preamble to the Final Guidance responds to comments that the *MetLife* court decision was not sufficiently acknowledged by FSOC in the Proposal. The *MetLife* decision[25] focused on whether MetLife, a nonbank financial company, was vulnerable to material financial distress and FSOC's failure to consider the costs to MetLife. Although *MetLife* is discussed at length in the preamble, FSOC does not change its views about the implications for *MetLife* on the Final Analytic Framework or the Final Guidance.

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20 88 Fed. Reg. at 80111.

21 *Id.*

22 *Id.*

23 *Id.*; *see also* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 71740, 71763 (Dec. 30, 2019).

24 88 Fed. Reg. at 80111.

25 177 F. Supp. 3d 219 (D.D.C. 2016).

FSOC noted that the *MetLife* court seemed to rely on the guidance in place at the time and represents a single district court ruling.[26]

Areas of Consistency with 2019 Guidance

In some respects, the Final Guidance maintains and solidifies certain changes that were set forth in the 2019 Guidance. For example, although the Final Guidance does not prioritize the activities-based approach to the extent it was required under the 2019 Guidance, it maintains that FSOC may still use an activities-based approach among its other authorities. Additionally, the Final Guidance maintains: (1) the two-stage designation process (as opposed to the prior three-stage process included in pre-2019 interpretive guidance); (2) an emphasis on engagement by FSOC and staff with companies under review and their primary financial regulators; (3) FSOC's annual re-evaluations of previous designations; and (4) the movement away from the strict, uniform stage 1 quantitative financial thresholds of the 2012 and 2015 interpretive guidelines.[27] Finally, FSOC argues that the Final Guidelines maintain the transparency of the approach set forth in the 2019 Guidelines.

Broad Implications for the Large and Growing Nonbank Sector

Since FSOC's inception, the nonbank sector has changed significantly both as financial assets have steadily migrated out of banks and as new entrants, such as cryptocurrency companies, have grown and become the center of the public eye. According to data collected by the Financial Stability Board, in 2008, nonbanks owned or controlled roughly 42 percent of global financial assets. By 2021 (which is the latest reporting year available), that proportion had grown to roughly 49 percent.[28]

Given this migration of financial assets out of banks and into nonbank financial entities, FSOC has enhanced its focus in certain nonbank-dominated areas. For example, in its 2023 Annual Report, as discussed above, FSOC identified digital assets as an area of priority.[29] Back in October 2022, FSOC released a report on digital asset financial stability risks and regulation in which it found that crypto-asset activities may pose a danger to the stability of the U.S. financial system, in part due to the interconnectivity

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[26] 88 Fed. Reg. at 80122–23.

[27] For example, under the 2012 framework, a company would need to have $50 billion in assets and meet another threshold, such as a 15 to 1 leverage ratio to be evaluated in stage 2. *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637, 21661 (Apr. 11, 2012). FSOC notes in the preamble to the Final Guidance the incongruency between uniform quantitative thresholds and the range of risks that nonbank financial companies' material financial distress or activities could pose, highlighting specifically the potential for uniform quantitative thresholds to become "obsolete or less relevant to specific risks" as the activities of nonbank financial companies continuously evolve. 88 Fed. Reg. at 80115.

[28] Anna Cooban, *Banks Are in Turmoil But a Bigger Financial Crisis May Be Brewing Elsewhere*, CNN BUSINESS (Apr. 6, 2023), *available* here.

[29] 2023 Annual Report, *supra* note 1, at 15.

between such activities and the traditional financial system and within the crypto-asset ecosystem.[30] In addition to its focus on digital assets, FSOC remains focused on mitigating potential systemic risks posed by open-end mutual funds, hedge funds and money market funds.[31]

Broader Interest in Nonbank Financial Risks

The focus on risks posed by nonbank financial participants has not been limited to FSOC, and how to calibrate bank regulatory policies in light of the migration of activity to nonbanks has been a topic of discussion. For example, Federal Reserve Governor Christopher Waller noted concerns the currently-proposed regulatory capital rule would "push more activities to the unregulated nonbank sector" and cautioned that "as we saw during the pandemic, a lot of problems can emerge from nonbanks that operate outside of our view."[32] Federal Reserve Chair Powell cautioned that the increase in the market risk requirements in the currently-proposed capital rule for banking organizations would risk "a movement of some of these activities into the shadow banking sector."[33]

Notably, Governor Michelle Bowman has specifically expressed the view that nonbank activities that are equivalent to regulated bank activities should be regulated. Governor Bowman opined that if the same products are being provided outside of a regulated entity and are presenting the same risks, they should be subject to the same regulation, noting that "[i]t really shouldn't matter where that activity is taking place; if it's the same activity that a bank is participating in or providing, it has to have the same oversight."[34]

It will be worth watching how, in 2024, policymakers seek to address the regulatory playing fields for both banks and nonbanks.

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Please do not hesitate to contact us with any questions.

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[30] FIN. STABILITY OVERSIGHT COUNCIL, REPORT ON DIGITAL ASSET FINANCIAL STABILITY RISKS AND REGULATION 75 (2022), *available* here.

[31] 2023 Annual Report, *supra* note 1, at 59.

[32] *Statement by Governor Christopher J. Waller*, Joint Press Release, BD. GOV. FED. RSRV. SYS. (Jul. 27, 2023), *available* here.

[33] *Statement by Chair Jerome H. Powell*, Joint Press Release, BD. GOV. FED. RSRV. SYS. (Jul. 27, 2023), *available* here.

[34] *See* Kyle Campbell, *The Need for Nonbank Regulation is a Consensus Issue for the Fed*, AM. BANKER (Dec. 7, 2022), *available* here; *see also* Kyle Campbell, *Fed's Bowman: Regulations Shouldn't Push Banks Out of Traditional Activities*, AM. BANKER (Dec. 1, 2022), *available* here.

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