The Honorable Janet L. Yellen  
U.S. Department of Treasury  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

July 19, 2023

Re: FSOC-2023-0002

Comments on Proposals:

1) 12 CFR Part 1310 - Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, and


From: CFA Institute Systemic Risk Council

Submitted electronically: https://www.regulations.gov

Dear Chair Yellen and Members of the Financial Stability Oversight Council:

➢ Executive Summary

The Financial Stability Oversight Council (FSOC or the Council) recently voted to issue the referenced proposals for public comment. These actions cover a new analytic framework for determining and measuring financial stability risks posed by nonbank financial companies and new procedural steps when considering designation of a nonbank financial company for Federal Reserve supervision (the Proposals). The Proposals are intended to provide greater transparency to the public about how the FSOC identifies, assesses, and addresses potential risks to financial stability, regardless of whether such risk stems from financial activities across firms or from the size and complexity of an individual firm itself. The CFA Institute Systemic Risk Council (SRC) appreciates the opportunity to comment on these important new Proposals and their potential to improve systemic risk protections and economic stability.

SRC Summary Comments:

- The SRC supports the new Proposals and the removal of various impediments to the designation process introduced in the FSOC’s 2019 Guidance.
▪ The SRC supports further refinements and reflections on the Proposal design for nonbank designations to better meet the urgency of the systemic risks and dangers to economic stability represented by a burgeoning NBFI sector.
▪ The SRC questions whether the new Risk Review Process combined with the Proposed and Final Designation process can proceed timely and efficiently enough to meet the need to monitor growing NBFI vulnerabilities.
▪ A designation process that simply encourages a designated NBFI, in consultation with its primary regulator, to take corrective action in order to rescind the systemic designation misses the point. Corrective action should be required to mitigate an NBFI designate’s risk to economic stability.

➢ **History of the FSOC Designation Authority.**

We have followed closely the developments and progress of the FSOC since being created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or DFA) in 2010. The original statute sets out key FSOC responsibilities as follows: (1) identifying risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies or that could arise outside the financial services marketplace; (2) promoting market discipline by eliminating shareholder, creditor, and counterparty expectations that some institutions are “too big to fail”; and (3) responding to emerging threats to the stability of the U.S. financial system. Considerable progress has been made since FSOC inception, but it is fair to say that the important powers to designate systemically important nonbank financial institutions for supervision by the Federal Reserve remains a work-in-progress.

The FSOC adopted the first set of guidelines in 2012 under Title I of Dodd-Frank for designation of nonbank financial companies for Federal Reserve supervision (the 2012 Guidance). Pursuant to this adoption, FSOC designated four nonbank financial institutions in the period 2013-2014, as systemically important amid great controversy and push back from the financial industry. They were: American International Group, Inc.; General Electric Capital Corporation; Prudential Financial, Inc.; and MetLife, Inc. Since then, all four of those designations have been terminated and the focus and approach to a high-quality and transparent designation process has had its fits and starts. No FSOC designations of nonbank companies have occurred since the initial four firms.

In 2019, FSOC replaced the 2012 Guidance, which resulted in a new focus for assessing potential systemic risks associated with nonbank financial institutions. Simply put, the 2019 Guidance would henceforth focus on systemic risks posed by investment products and financial business activities at firms rather than the individual nonbank companies themselves. Under this products/activities-based approach, FSOC members began to focus on regulating risky activities conducted by companies, rather than designating companies themselves for Federal Reserve supervision.
In our **SRC comment** letter regarding this 2019 Guidance, we were highly critical of the proposals and encouraged the FSOC to abandon efforts that the SRC felt would “marginalize” the designation process.

> “The Systemic Risk Council urges the US Treasury, and the other members of the Financial Stability Oversight Council, to abandon their proposal to marginalize the designation of non-bank financial intermediaries as systemically significant. It is an important and useful power that can be used to protect the American people from financial instability and should be utilized when warranted by the threat to stability that would be caused by an intermediary’s failure or distress.”

In sum, the FSOC designation process for nonbank financial companies has been sidelined since its initial designations in 2013, regardless of whether various rounds of FSOC guidance featured a systemically important firm approach or a products/activities approach. Now comes the next round of guidance via the Proposals, seeking to reverse 2019 Guidance and revive the designation process focused on nonbank financial companies. The FSOC seeks to provide greater transparency and due process around how such companies are initially identified for systemic designation review, how the assessment of a firm’s systemic importance will be conducted, what due process steps a target company is entitled to in challenging a designation and procedural clarity/refinements around the entire designation process.

➢ **Summary of the Proposals.**

**Main purpose:** According to the FSOC’s press release, the Proposals enhance the Council’s ability to address financial stability risks. The financial system continues to evolve, and past crises have shown the importance of being able to act decisively to address risks to financial stability before they destabilize the system. The new proposed guidance would help ensure that the Council can use all of its statutory authorities as appropriate to address risks to U.S. financial stability, regardless of the source of those risks.

**Key Provisions:** First, the Proposals would remove the 2019 requirement that FSOC must first consider whether an activities-based designation would suffice before allowing individual companies to be designated as systemically important nonbank financial companies.

Second, a new analytic framework and process would make it explicit that FSOC need not engage in a cost-benefit analysis as part of its decision to designate a nonbank financial company as systemically important. This means that FSOC designations will not necessarily consider the financial impact of a designation on the company being designated (or the broader market in which the company participates). This waiver of cost-benefit analysis is permitted, says FSOC, pursuant to rules that have determined that the Proposed Analytic Framework (PAF) is not a “significant regulatory action.”

Third, the Proposals eliminate a 2019 requirement that FSOC consider the likelihood of a company’s material financial distress before designating that company as a systemically important nonbank financial company. This removes a subjective and imprecise factor as a condition to making systemic designations. The SRC is of the view that predicting the
likelihood, timing and magnitude of material financial distress is extremely challenging. Similarly, the odds of whether the knock-on effects of such an incident will result in material distress or failure of a nonbank financial company are unknowable. To that end we see the more objective factors identified in the Proposals for determining systemic importance and potential designation as key.

**Designation Process Specifics.**

1. **Systemic Risk Review Stages.** The Proposals frame a two-step process that includes a preliminary and additional review stage when determining whether a nonbank financial company should be subject to Federal Reserve supervision and prudential standards.

   **Stage 1. Preliminary Identification.** Nonbank financial companies identified as potentially systemic will be notified and subject to a preliminary analysis, based on quantitative and qualitative information available to the FSOC, primarily through public and regulatory sources. The company may submit other information they deem relevant to the FSOC analysis. Both FSOC and the company may consult with the company’s primary financial regulatory agency, as appropriate.

   **Stage 2. Additional Review.** Any nonbank financial company that is selected for additional review will receive notice that it is being considered for a proposed designation that the company will be supervised by the Federal Reserve and be subject to prudential standards and that the company will be subject to in-depth evaluation during the second stage of review. Stage 2 will also involve the evaluation of additional information collected directly from the nonbank financial company.

   **SRC Comment:** FSOC should ensure time periods expected for these stages and reviews can happen quickly or comprehensively enough to fully gauge the size, complexity, and interconnectedness of NBFI risks. Please clarify the role of the primary regulator in the FSOC decision to designate a NBFI as systemic and the scope of non-public information to be collected. It is also unclear whether the authority and process for collecting the non-public information contemplated by Stage 2, is a new and more expansive authority, or simply a reassertion that such authority is already vested with FSOC members?

2. **Systemic Designation Stage (Proposed and Final designations).** At the end of Stage 2, the FSOC may consider whether to make a proposed designation of the nonbank financial company. If the Council makes a proposed designation, the nonbank financial company may request a hearing. After making a proposed designation and holding any written or oral hearing if requested, the Council may vote to make a final designation.

   **SRC Comment:** Like the Risk Review Process, the FSOC should ensure the proposed and final designation stages can proceed timely and efficiently enough to meet the need to monitor growing NBFI vulnerabilities. The length of these Review and Designation stages together may frustrate the objective of obtaining timely and actionable information to mitigate systemic fault
lines. The need for timely, actionable information must not be entirely subservient to procedural safeguards.

3. Annual Reevaluations and Recission Rights. For any company designated by the Council, the proposed guidance specifies that the Council would encourage the company or its regulators to take steps to mitigate the identified risks. The Council will reevaluate the designation at least annually and rescind the designation if the Council determines that the company no longer meets the statutory standards for a designation. During the Council’s annual reevaluations, the company will have an opportunity to meet with representatives of the Council to discuss the review and present information on mitigation efforts. If the Council votes not to rescind a designation, the Council will provide the company with a written explanation addressing the material factors in the analysis.

**SRC Comment:** In the creation of a better system to detect and mitigate growing systemic vulnerabilities, FSOC and primary regulators should require corrective steps when actions and activities put financial stability at risk via the transmission channels identified in the Proposals. A designation process that simply encourages an NBFI, in consultation with its primary regulator, to take corrective action in order to rescind the systemic designation undermines the fundamental importance of systemic risk prevention. In our view, remediating systemic risk vulnerabilities at the company level, which threaten economic stability, should be more than encouraged.

In the original DFA debates around creating robust systemic risk protections, the design of the FSOC was criticized for not providing a specific process that would identify systemic risks early, move quickly and act with authority to minimize the threat to economic stability. This was sometimes referred to as having the resources and authority to remove the speculative “punch bowl” from the party and to do so at the appropriate time. What is proposed— encouragement to fix things if a company wishes to remove its systemic designation—is subject to similar criticism. Dealing with the growing NFBI vulnerabilities requires efficient detection, designation and authoritative steps to mitigate destabilizing activities.

➢ **Statutory Authority.**

With respect to the Council’s procedures for designations and annual reevaluations of designations described, the nonbank financial company under review will interact fully with such company’s primary regulator. This new, proposed guidance is intended to enable the FSOC, along with the relevant primary regulator, to use its statutory authorities already in place as part of the Dodd Frank Act and to ensure rigorous procedural protections for nonbank financial companies being considered for potential designation.

**SRC Comment:** It is clearly important to ensure that the Proposals offer strong procedural protections for those companies facing a potential designation and at the same time ensure coordination and collaboration among FSOC members. Making the process trusted, transparent and orderly is key. However, given that NBFI systemic risk vulnerabilities are already looming, the FSOC, OFR and member agencies should use existing statutory authorities where appropriate to reduce such vulnerabilities. This includes the authority to designate Payment, clearing, and
settlement activities and/or Financial market utility businesses that the Council determines are, or are likely to become, systemically important”. This will enhance the ability of the FSOC and member agencies to identify and address new and emerging threats.

➢ **Additional SRC Comments.**

The SRC has the following general and supplemental comments on the various aspects of the two Proposals.

**SRC Comment:**

**Execution Risk - Can the PAF Be Implemented?** The SRC believes the PAF represents an improvement in the clarity and transparency of the designation process and will enhance FSOC’s ability to meet its objective of maintaining financial stability in terms of intermediating financial transactions, facilitating payments, allocating resources, and managing risks. We agree that this must pertain to a wide range of asset classes, institutions, and activities that are adequately enumerated in the PAF. The Proposals would benefit from more detail around so-called execution risk, and whether and how the FSOC and the Office of Financial Research (OFR) can manage the process. Since its formation, there have been mixed views on whether the OFR is fit for purpose and whether proper staffing, skills and adequate resources are in place to operationalize an initiative as complex as the PAF, which must digest vast pools of public and confidential data. Without the staffing to manage the data requests and the skills and technology to analyze and do complex risk modeling, PAF implementation would stall.

**Dynamic Vulnerabilities.** The PAF provides a lengthy list of vulnerabilities that consistently challenge economic stability; namely, hidden and excess leverage; liquidity risk and maturity mismatch; transparency around NBFI interconnectedness; complexity and opacity, and so on. While it is important the Council has the correct list and definitions, we expect these items will come as no surprise. They have been examined consistently over the last decade. Refining and clarifying the list is only half the job. After a decade of FSOC existence, it is clear the list is dynamic and can shift quickly with modern technologies and virtual markets.

**Consider More Streamlined Proposals.** We noted that the FSOC should consider whether the design of the Proposals is calibrated properly to include the breadth of NBFI information needed, the time necessary to complete the designation process and the need for urgency in mitigating systemic vulnerabilities. For example, Stage 1 of the designation process involves scrubbing publicly available information and regulatory filings to determine designation targets. This information is reported with a lag and needs to be updated to reflect current conditions, much less indicate how risks are evolving. This means the PAF process is likely to be chronically late in identifying and addressing systemic vulnerabilities. Moreover, assuming the FSOC already has the authority to require access to nonpublic information identified in the Stage 2 process, we recommend combining these two stages to speed up the systemic assessment, designation determination, appeals process etc., to get to the systemic mitigation matters promptly. Clearly, the systemic vulnerabilities listed in the Proposals can manifest and transmit quickly.
Fixing Too Big to Fail. PAF identifies four “channels” that enable or facilitate the broader transmission of the systemic vulnerabilities that ultimately impact financial stability: exposures; asset liquidation; critical functions or services; and contagion. We agree with these categories and how they are defined in the PAF. Based on our consultations with numerous experts, we would emphasize that enhanced visibility around concentrated and interconnected counterparty exposures of NBFI s should be a primary concern. Likewise, recent events have confirmed that transmission risk posed by runs on illiquid assets, whether at regulated banks or NBFI s, can pose a significant threat to stability. Moreover, these events have shown that the government’s predisposition to support critical short-term funding markets remains strong. This suggests we have made little progress in quelling expectations that some markets and institutions are too big to fail.

Financial Apps and Social Media Runs. We close with a specific mention of the new vulnerabilities arising from the rapid advancement of financial app technology and social media communication channels. As stated in the Introduction to the PAF, risks to financial stability can arise from widely conducted activities or from the activities of individual entities, and from long-term vulnerabilities or from sources that are new or evolving. Recent bank failures in the U.S. should prompt the FSOC to reimagine how bank supervisors and other regulators might design countermeasures to help modulate the speed of runs accelerated by app technology and social media. The SRC has heard consistently that banks and NBFI regulators must have the tools and time to address and correct imbalances in this new, fast-moving environment.

➢ Conclusion

We believe that NBFI s and their activities represent a growing and unaddressed vulnerability to financial stability in the U.S. and beyond. We support the FSOC as it recalibrates the designation process and upgrades its capabilities to gather necessary data and improve its line-of-sight on nonbank leverage, interconnectedness, liquidity and risk management gaps. We believe that the measure of success for these Proposals will be a process that is calibrated for prompt, corrective action and where the OFR will have appropriate resources for staffing, monitoring capabilities, and data analysis to implement the PAF.

Thank you for the opportunity to comment. We provide these views on behalf of the CFA Institute Systemic Risk Council.

Respectfully submitted,

Simon Johnson, Co-Chair
Erkki Liikanen, Co-Chair

Note: The views expressed herein represent the collective views of the SRC and not all members agree with all aspects of this comment letter.

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