June 27, 2023

Financial Stability Oversight Council
Attn: Eric Froman, Assistant General Counsel for Banking and Finance
1500 Pennsylvania Avenue NW
Room 2308
Washington, DC 20220

Re: Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, RIN 4030–[XXXX]

Dear Mr. Froman:

Introduction

The Center for American Progress ("CAP") welcomes the opportunity to submit comments to the Financial Stability Oversight Council’s ("FSOC" or "the Council") notice and request for comment titled, Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies ("the proposal" or "proposed interpretive guidance").1 CAP is an independent, nonpartisan policy institute dedicated to improving the lives of all Americans, through bold, progressive ideas, strong leadership, and concerted action.

Since the 2007-2008 financial crisis, the nonbank sector has grown dramatically, now accounting for nearly 50 percent of global financial assets, per the Financial Stability Board.2 Even though nonbank financial companies often perform bank-like activities and are key players in the U.S. financial system and economy, they are largely under- or un-regulated.3 Lessons from the financial crisis have also demonstrated that nonbanks can pose systemic risk that threatens financial stability4 and can necessitate too-big-to-fail

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government bailouts. In the aftermath of the financial crisis, under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Congress established the Financial Stability Oversight Council, charged it with monitoring such risks, and provided it with the means to address them. The authority to designate a nonbank financial firm as systemically important and subject it to enhanced supervision and regulation by the Federal Reserve is among the FSOC’s most powerful tools in maintaining the health of the financial system.

The FSOC has employed its designation authority sparingly since its inception over a decade ago, identifying four nonbank financial companies as systemically important – American International Group Inc. (AIG), Prudential, MetLife, and GE Capital. GE Capital's subsequent divestitures and other efforts to reduce its systemic footprint are a testament to the efficacy of post-crisis laws and regulations, and led to its eventual de-designation by the FSOC under the Obama administration. Despite evidence that remaining firms were still creating risks to stability, the FSOC under the Trump administration took steps to allow for their de-designation. And, in 2019, the FSOC under the Trump administration sought to further undermine the Council’s designation authority, setting up inappropriate hurdles to fulfilling its statutory purpose, as the proposal acknowledges.

CAP commends the FSOC for now taking this critical step toward removing the barriers in exercising its authority to designate certain nonbank financial companies as

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6 12 U.S. Code § 5321
7 12 U.S. Code § 5322
systemically important that were imposed under the Trump Administration. As financial actors endure economic shocks like those from climate disasters, the COVID-19 pandemic, and the war in Ukraine, it is clear that the financial system must be more resilient than ever, and the FSOC must have access to its full set of tools, as authorized by statute, to maintain financial stability. Below, please find considerations in response to the questions posed by the proposal.

**Key Changes**

CAP supports the FSOC’s decision to design a separate framework that describes the Council’s analytic approach to monitoring risk, regardless of its origin or which of the Council’s authorities is used to address such risks. The FSOC’s authority to monitor nonbank financial companies and designate firms is critical, but it is only part of its mandate. The proposed analytic framework, on which CAP has separately provided comments, provides important transparency regarding the FSOC’s holistic and deliberative process for identifying, assessing, and addressing risks. It accurately considers the varied avenues in which financial stability risks may proliferate and lays out the actions the Council may employ to address such risks.

Additionally, the proposal correctly eliminates the 2019 guidance’s interpretation of “threat to the financial stability of the United States” as meaning “the threat of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict severe damage on the broader economy.” This language is in direct conflict with the mandate set forth under Dodd-Frank, which makes clear the FSOC’s preventive role in risk mitigation and management. Specifically, the statute allows the FSOC to, “require supervision by the Board of Governors for nonbank financial companies that may pose risks to the financial stability” as well as “to respond to emerging threats” to financial stability. This change in the proposed interpretive guidance makes clear that the FSOC may exercise its authority precautionally.

**Activities-Based Approach**

Removing the prioritization of the activities-based approach from the interpretive guidance is critical to enabling the Council to achieve its statutory purpose. The activities-based approach under the 2019 interpretive guidance is misguided and ineffective by design. The FSOC lacks the statutory authority to directly regulate activities and can only make nonbinding policy recommendations to the company’s primary regulator, where one exists. Moreover, individual regulators lack both the ability to regulate important

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13 12 U.S. Code § 5322

14 Ibid.
activities (such as collectively important trading strategies of hedge funds\textsuperscript{15}) and the enhanced stability-related authority exercised by the Federal Reserve with respect to FSOC-designated nonbank financial firms. \textsuperscript{16} In the case of insurance companies, which are regulated at the state level, there is no federal regulator to which recommendations can be made. While activities-based recommendations in some cases may be appropriate, they should not act as a substitute or impediment to designation. The 2-stage approach described in the proposal establishes a deliberative, straightforward path to designation.

Further, prioritizing an activities-based approach fails to paint a complete picture of a firms’ risk profile, which should take into consideration factors such as size, leverage, and interconnectedness, among others. The newly proposed interpretive guidance acknowledges the shortcomings of prioritizing an activities-based approach and makes the important clarification that the FSOC may use any of its statutory authorities, as appropriate, in addressing risks.

\textit{Cost-Benefit Analysis and Likelihood of Material Financial Distress}

The proposed interpretive guidance rightly removes the cost-benefit analysis (“CBA”) provision, which was added by the 2019 interpretive guidance but is not required by statute and has limited usefulness. The costs associated with designation, such as building out compliance capacity to adhere to a new regulatory regime, may be more straightforward to determine. However, the benefits of robust prudential oversight that keeps the financial system healthy are much more difficult to quantify.\textsuperscript{17} CBAs are also sensitive to discount rate assumptions,\textsuperscript{18} as “benefits that occur in the future are to be discounted to present value to compare with costs that may be incurred upfront.”\textsuperscript{19} The imposition of a CBA, which tends to overstate the costs of regulation relative to the benefits, would likely discourage the FSOC from pursuing designation under the current guidance.

Similarly, using a measure of the current likelihood of a company’s financial distress as a prerequisite to designation frustrates the purpose of the FSOC, which is to limit the sources of financial instability. This is particularly important with respect to the lightly

regulated nonbank sector. For instance, the collapse of Bear Stearns and Lehman Brothers, and the near failure of AIG, were not deemed likely before they delivered large shocks to the financial system in the Great Financial Crisis.\textsuperscript{20}

\textit{Conclusion}

CAP commends the FSOC for undertaking this proposal. Ensuring that the Council may make full use of its designation authority is central to achieving its statutory purpose and a critical tool in maintaining the stability of the financial system. If you have questions related to the considerations outlined above, please contact Lilith Fellowes-Granda, Senior Policy Analyst for Financial Regulation and Corporate Governance, at lfellowesgranda@americanprogress.org.

Sincerely,
Center for American Progress