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July 27, 2023

Mr. Eric Froman
Assistant General Counsel, Banking & Finance
Financial Stability Oversight Council
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Room 2308
Washington, DC 20220
(Submitted electronically)

Re: IIF Public Comment on the Financial Stability Oversight Council's Notification of Proposed Interpretive Guidance and Analytic Framework for Financial Stability Risk Identification, Assessment, and Response (88 Fed. Reg. 26234 (April 28, 2023) and 88 Fed. Reg. 26305 (April 28, 2023), respectively)

Dear Mr. Froman:

The Institute of International Finance (IIF)[1] and its member firms welcome the opportunity to comment on the Financial Stability Oversight Council's (FSOC) Notification of Proposed Interpretive Guidance on Nonbank Financial Company Determinations ("the Proposed Guidance").[2] and its proposed Analytic Framework for Financial Stability Risk Identification, Assessment, and Response ("the Analytic Framework") (collectively, the Proposals).[3] The IIF appreciates the important role that FSOC plays in identifying potential risks to the financial stability of the United States, responding to emerging threats to U.S. financial stability, promoting market discipline, and addressing financial stability risks that may arise from the activities of nonbank financial companies.

Nonbank and market-based finance, conducted by non-bank financial companies (NBFCs), have experienced spectacular growth since the global financial crisis, and NBFCs play a critical role in

[1] The Institute of International Finance is the global association of the financial industry, with around 400 members from over 65 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial, and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks, and development banks.
[2] FSOC 2023 – Proposed Guidance. "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies" (April 28, 2023).
[3] FSOC 2023 – Analytic Framework. "Analytic Framework for Financial Stability Risk Identification, Assessment, and Response" (April 28, 2023).

serving the global economy, "enhancing access to credit, and supporting economic growth."[4] The universe of NBFCs is very broad with different types of intermediaries, including asset managers, investment funds, pension funds, and insurance companies, engaged in a range of traditional and new and innovative financial activities. Many NBFCs and their activities are substantively regulated and supervised, most notably the insurance and reinsurance industry.

We recognize that the FSOC guidance and the analytic framework for identifying, assessing, and responding to risks to the financial stability of the United States may occasionally require updates in light of significant market or regulatory developments. However, any change to current guidance should balance the likelihood and anticipated impact of financial stability risks with the risk of unintended detrimental consequences to financial markets, those they serve, and U.S. and global economic growth.

The IIF appreciates the opportunity to respond to FSOC's Proposed Guidance and Analytic Framework. Given their interconnection, the IIF is providing feedback on both proposals through this letter.

The Proposals should reflect current Global Activities-based Approaches

The IIF and its members strongly encourage FSOC to reflect in its approach to non-bank risk the activities-based approach (ABA) currently being developed by the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO), and the Holistic Framework for the Assessment and Mitigation of Systemic Risk in the Insurance Sector (Holistic Framework) [5] that has been developed by the International Association of Insurance Supervisors (IAIS). The Holistic Framework was developed after several years of work, which involved experimenting with alternative approaches, including an entity-based approach (EBA). Notably, the Holistic Framework was endorsed by the FSB in 2022 as a superior approach to the EBA that designated global systemically important insurers. [6] This framework has demonstrated how an ABA can be effective and it provides an overarching foundation that jurisdictional insurance regulators are implementing, including the National Association of Insurance Commissioners (NAIC) and state insurance regulators in the U.S.

FSOC should suspend any changes to the current FSOC guidance until the global standard-setting processes, in which the U.S. actively participates, are finalized. Aligning FSOC's guidance and analytic framework to the global ABA would be a substantial contribution to avoiding market fragmentation.

A key consideration in revising FSOC's guidance and in adopting an analytic framework is how the Proposed Guidance and Analytic Framework would balance the ABA and the EBA in a manner that reflects global approaches to systemic risks. The long-standing approach of the FSB, IOSCO and IAIS has been a focus on structural vulnerabilities arising from the *activities* of NBFCs. The FSB focuses on a company's high-level economic functions, rather than on the company's legal form, in order to assess financial stability risks in a consistent and forward-looking manner.

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[4] IMF 2023. "The Global Financial Stability Report (GFSR)" (April 11, 2023).
[5] IAIS 2019. "Holistic Framework for Systemic Risk in the Insurance Sector" (November 14, 2019).
[6] FSB press release (December 9, 2022).

Broadly consistent with this global approach, in 2019, FSOC prioritized the ABA, a positive step that was welcomed by the IIF. In FSOC's current review of the guidance, while FSOC may determine a need to provide for a degree of flexibility to use an EBA in exceptional cases where a clear and present risk to U.S. financial stability is evident, and it has been determined that an ABA would not be effective, the guidance should not reverse the existing presumption that an ABA is the most appropriate tool or give rise to a presumption that the most suitable tool is entity designation.

The prioritization of the ABA should be maintained

IIF supports the need to ensure that regulators apply the principle of 'same activity, same risks, same regulatory outcome' among market participants both within and outside the current regulatory perimeter. Well-regulated financial activities, such as those conducted by asset managers and (re)insurers, are well addressed through the ABA, which better promotes the key principle of 'same activity, same risks, same regulatory outcome'.

An ABA has several advantages when compared to an EBA, as described in the IIF's 2019 response letter[7] to FSOC. The ABA is a more durable approach as it permits the consistent treatment of activities across sectors, reducing fragmentation, providing a level playing field, and promoting financial stability. The ABA avoids the EBA's overly narrow focus on an individual company and its promotion of a single regulatory solution to systemic risk. The broader view of financial markets and their interconnectedness[8] on a system-wide basis under the ABA also serves to minimize the potential for competitive distortions that is present in the EBA and addresses other acknowledged flaws of the EBA, such as its lack of sensitivity to timing and economic conditions. We believe that, overall, the ABA is working well globally and has been tested by a number of recent market stresses as well as by a global pandemic. An ABA is more consistent with the fundamental principle of 'same activity, same risks, same regulatory outcome.' It provides FSOC with flexibility to identify risks not just from NBFCs but also risks that may arise from the rapidly evolving and increasingly complex financial services ecosystem that includes the provision of traditional and novel financial products and services by a wide range of commercial companies that are not commonly considered to be NBFCs.

When regulation is applied to only a subset of the companies that are conducting a particular activity, the activity and its associated risks often shift to firms that are unregulated or less actively regulated. FSOC should heed calls by regulators concerned about the shifting of risk outside of the regulatory perimeter.[9] The management of risks to financial stability arising from nonbank

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[7] The IIF's response letter to the proposed interpretive guidance on the supervision and regulation of certain nonbank financial companies can be found here (May 10, 2019).

[8] However, when considering interconnectedness through the Analytic Framework, FSOC should recognize the risk mitigation and diversification benefits of interconnectedness, including through the appropriate use of hedging through the use of derivatives or reinsurance.

[9] https://www.occ.gov/news-issuances/speeches/2021/pub-speech-2021-117.pdf, "Modernizing the Financial Regulatory Perimeter."

entities through an EBA should not be seen as the primary solution to the issue of risk migrating from regulators' view and scope of authority.

The consistent treatment of activities without regard to the type of entity conducting a particular activity promotes a consistent and less arbitrary approach and a level playing field for market participants. It also recognizes that systemically risky activities may be conducted by firms not subject to financial services regulation and supervision or by smaller companies that are subject to more proportionate supervision.

If an EBA remains an option for FSOC, the Proposed Guidance should clarify the types of nonbank financial firms that could be in scope of designation

FSOC should continue to prioritize the ABA over the EBA. In instances where the EBA may remain an option for FSOC (e.g., entities conducting activities that are not well-regulated), we recommend the following improvements to the EBA. First, the Proposed Guidance should specify the types of NBFCs that could be in scope of designation, based on FSOC's current views of structural vulnerabilities. The lack of clarity and transparency in the Proposed Guidance and the Analytical Framework has led to significant uncertainty among the NBFC ecosystem as to the financial entities and activities that might be in scope of designation. Continued uncertainty could lead to certain NBFCs taking proactive defensive measures that may be suboptimal from a business perspective or that may not be consistent with the needs of the markets they serve. For example, a company may discontinue a line of business or the provision of a product that customers need and demand.

An EBA should not focus simply on company size, market share or related proxies in determining those companies in scope for potential designation. The cumulative impact of a shock on multiple companies (both large and small) conducting similar activities or engaged in similar business models can pose significant risk, as seen in recent market events in the banking industry. Furthermore, as recognized in the Basel Committee on Banking Supervision's 2023 consultative document on Core Principles for Effective Banking Supervision[10], there are NBFCs that engage in some bank-like activities, which may constitute a significant portion of the total financial system. These NBFCs may be largely unsupervised and their activities can also affect the stability of the financial system. The Analytic Framework should provide an approach for assessing a wide range of potential risks to financial stability across the financial system, including interconnectedness, rather than providing for a narrow focus on specific larger entities. FSOC is well placed to focus on the shortcomings in the oversight of activities that could present a vulnerability that increases risks to financial stability.[11]

Relatedly, the Proposed Guidance and Analytical Framework would not provide a tangible 'roadmap' to companies to avoid designation, unlike the 2019 guidance, which is designed to make companies under consideration for designation aware of the potential risks that FSOC has identified in order to provide an 'off-ramp' from designation. The current proposals do not provide

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[10] https://www.bis.org/publ/bcbs230.htm

[11] See e.g., https://www.consumerfinance.gov/about-us/newsroom/cfpb-finds-billions-of-dollars-stored-on-popular-payment-apps-may-lack-federal-insurance/

adequate guidance to NBFCs regarding the circumstances that could lead to designation or what the company could do to avoid designation.

The Proposed Guidance should include an assessment of the likelihood of a firm's material financial distress prior to making a determination under Section 113 of the Dodd-Frank Act.[12]

The designation of a NBFC necessarily requires a finding by FSOC of a likelihood of material financial distress, as it is a prerequisite to that company posing a threat to U.S. financial stability. Under Section 113(a) of the Dodd-Frank Act, FSOC is authorized to designate a NBFC if it determines that material financial distress at the company or the existence of certain company-specific vulnerabilities could pose a threat to U.S. financial stability. Congress clearly intended for the analysis under Section 113 to be two-pronged: first, is the company vulnerable to material financial distress and secondly, could that distress pose a threat to U.S. financial stability. If a determination of the company's vulnerability to material financial distress was not necessary under the statute and could simply be presumed by FSOC without any analysis, then we question why Congress included in the statute a comprehensive list of factors indicative of such vulnerability, along with a catch-all category of other risk-related factors. If the company is not vulnerable to material financial distress, then it could not pose a threat to U.S. financial stability. Therefore, the vulnerability analysis must precede the analysis of a potential threat to U.S. financial stability.

Consideration of the likelihood of material financial distress would not prevent FSOC from taking preventive action to respond to threats to U.S. financial stability, but it would help to avoid actions that could be counterproductive to economic growth and stability by requiring a thorough analysis before interfering in the activities of a company and impacting the rights of the owners of that company, except in emergency situations. In emergency situations, FSOC may, by two-thirds vote, take action to waive or modify the statutory procedures. We also find without merit the argument that consideration of the likelihood of material financial distress could lead to runs on the company by its creditors and counterparties, because FSOC conducts its analyses and discussions under protocols that protect confidential and sensitive information from disclosure.

Unlike the 2012 and 2019 guidance, the Proposed Guidance fails to provide a clear standard for designation that FSOC would apply

Under the 2012 guidance, a threat to the financial stability of the United States was defined to exist "if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy.[13] Similarly, under the 2019 guidance, a threat to the financial stability of the United States is defined as "an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict severe damage on the broader economy."[14] In the Proposed Guidance, FSOC would merely incorporate the definition of financial stability proposed to be included in the non-binding Analytical Framework: "financial stability can be defined as the financial system being resilient to events or

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[12] The Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5321) (Dodd-Frank Act).
[13] Cite to 2012 guidance at 21657.
[14] Cite to 2019 guidance at 71763.

conditions that could impair its ability to support economic activity, such as by intermediating financial transactions, facilitating payments, allocating resources, and managing risks”.[15]

By eliminating from the Proposed Guidance the 2019 definition of a threat to financial stability, a definition that has been in place since 2012, and referencing the definition in the Analytical Framework, FSOC would render its process less transparent to firms under review and would inject into the process additional subjectivity that could heighten the risks that designation decisions would be less rigorous.

FSOC justifies this proposed change to a long-standing definition by claiming that the existing definition in the 2019 guidance contrasts sharply with the statutory standard under the Dodd-Frank Act. However, the statutory standard relates to a determination that an entity or activity *could* pose a threat to U.S. financial stability, whereas the 2019 guidance retains the statutory standard and, similar to the 2012 guidance, defines a threat to U.S. financial stability as an impairment that *would* inflict severe damage on the broader economy. Consequently, the definition in the 2019 guidance does not run afoul of the statutory standard, provides more clarity to firms on how FSOC will apply the standard, and, indeed, is also consistent with FSOC’s obligation to consider the likelihood of material financial distress and the cost implications prior to making a determination to designate a nonbank financial company.

The cost-benefit analysis (CBA) should be restored in the Proposed Guidance

Even though undertaking a CBA is not mandated explicitly by the Dodd-Frank Act, previous court rulings have found that regulators cannot disregard such an analysis. Moreover, a consideration of cost is implicit in Section 113(a)(2)(K) of the Dodd-Frank Act, which requires consideration of any other risk-related factors that FSOC deems “appropriate” in designating a nonbank for Federal Reserve supervision.

In Michigan v. EPA, the Supreme Court explained that “appropriate” is an all-encompassing term that includes consideration of all relevant factors. In the case before the Court, those factors clearly included cost.

Building on Michigan v. EPA, the 2016 MetLife case found:

> “*FSOC also focused exclusively on the presumed benefits of its designation and ignored the attendant costs, which is itself unreasonable under the teachings of Michigan v. Environmental Protection Agency, — U.S. -, 135 S.Ct. 2699, 192 L.Ed.2d 674 (2015). While MetLife advances many other arguments against its designation, FSOC’s unacknowledged departure from its guidance and express refusal to consider cost require the Court to rescind the Final Determination.”*[16]

Eliminating the CBA from the final guidance adopted by FSOC could give rise to significant legal uncertainty for the financial stability monitoring process.

Moreover, eliminating the consideration of cost may result in FSOC taking action that would not only impose costs on the company under consideration for designation should it be designated,

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[15] 88 Fed. Reg. at 26306.
[16] U.S. District Court 2016. [“MetLife vs. Financial Stability Oversight Council”] (March 30, 2016).

but could also result in action that would impose costs on the financial system or a particular financial sector to the detriment of U.S. financial stability. These costs to the financial system or to a particular sector could be monetary or non-monetary in nature. For example, as a result of the designation of one of its peers, companies in a particular financial sector may determine that it would be prudent to discontinue providing a particular product or service in order to avoid designation. The discontinuation of products and services would involve direct costs to the company, indirect 'costs' through foregone profits and potential costs to the broader economy if the discontinued product or service is one that customers need and demand (e.g., the provision of certain types of insurance coverage).

Finally, FSOC acknowledges that the Proposed Guidance is subject to Executive Order 12866, which directs the consideration of costs and benefits of available regulatory alternatives and the selection of regulatory approaches that maximize net benefits. FSOC cannot at the same time argue that cost is not a relevant factor in making a determination as to whether to designate a nonbank financial company.

Eliminating the reliance on federal and state regulators in the Proposed Guidance is suboptimal from a financial stability point of view

Eliminating from the Proposed Guidance the reliance in the first instance on federal and state regulators that perform ongoing supervision for safety and soundness as well as address financial stability risks is suboptimal from a financial stability viewpoint and inappropriately shifts authority and responsibility from the primary regulators that best know and understand the risk profile of the nonbank.

For example, (re)insurers and asset management firms are subject to stringent regulations and robust supervision of their activities by authorities with deep knowledge of these industries and companies. The Proposed Guidance should acknowledge and leverage the strong regulatory and supervisory regimes in place for these and other well-regulated and supervised firms and should not seek to supplant these authorities.

The regulatory and supervisory outcomes of designation are not transparent in the course of the designation process

A shortcoming of both the current and proposed designation processes is the lack of clarity as to the scope of prudential standards and supervisory activities that would be applied to a designated company by the Federal Reserve. A designated company does not have visibility into the consequences of a designation and the impact of the designation on its business strategies and operations until after the designation has been finalized. This lack of transparency into the consequences of designation negatively impacts the ability of the company to pursue an 'off-ramp' to designation. Moreover, by the time that the designation process has been finalized and the Federal Reserve has determined the standards and supervisory activities that should be applied to the company, the activities and risk profile of the company and the broader macroeconomic environment may have changed significantly.

The process for NBFC designations should better incorporate due process protections

We strongly encourage FSOC to consider changes to language in the Proposed Guidance that would help preserve the due process rights of companies under consideration for designation, and those that have been designated.[17]

During Stage 1 of the designation process, FSOC should be **required** to indicate to the company under consideration for designation the potential risks that FSOC has identified. The current language, "*the Council **intends** for representatives of the Council to indicate to the company potential risks that have been identified in the analysis,"* leaves open the possibility that FSOC could eliminate this important step, which provides the company with the information needed to present to FSOC its view as to how those risks are mitigated or no longer present. Moreover, FSOC principals should conduct a substantive review of any potential risks that have been identified by staff in order to determine whether FSOC should proceed with Stage 1. The company should be invited to submit any information that it believes relevant to consideration of whether to designate the company throughout the process.

Similarly, during Stage 1, *"if the Council believes that regulators' or the company's actions have adequately addressed the potential risks to U.S. financial stability the Council has identified, the Council **may** discontinue its consideration…"* In this case the word **"shall"** would be more appropriate than "*may*." If the risks that have led to the consideration of designation have been addressed, the case should be closed. FSOC retains the option to reopen the case if risks to U.S. financial stability arise anew.

During Stage 2, the text currently states, *"In addition, the Council **expects** that its Deputies Committee will grant a request to meet with a company in Stage 2 to allow the company to present any information or arguments it deems relevant to the Council's evaluation."* In this case, the words "**will require**" would be more appropriate than "*expects*." FSOC should commit to dialogue with the company under consideration for designation throughout the designation review process and that dialogue should be conducted by FSOC principals assisted by staff.

Finally, during the Annual Reevaluation, if the company explains in detail and in a timely manner potential changes it could make to its business to address the potential risks previously identified by FSOC, then FSOC representatives should be **required** to provide their feedback on the extent to which those changes may address the potential risks and should be **required** to provide their views on any potential risks that may remain unaddressed.

The Analytic Framework should not be applied in a manner that would commingle the need to address distinct risks to the financial stability of the United States with other public policy objectives

The Analytic Framework and FSOC's tools should be designed and applied in a manner that does not commingle the need to address distinct risks to the financial stability of the United States with other important broader public policy objectives, such as the need to close financial services protection gaps. The potential risks addressed through the Analytic Framework should be clearly linked to systemic risk transmission channels and potential systemic risks should be analyzed

[17] FSOC 2023 Proposed Guidance – Page 26242

based on the materiality of the impact of the potential risk to U.S. financial stability should it eventuate.

Thank you for your consideration of these comments. On behalf of the IIF membership, we hope that these global industry perspectives will contribute constructively to your efforts.

We thank the FSOC for its consideration of our comments and welcome any additional stakeholder engagement around this topic to help the FSOC in its efforts to identify potential financial stability risks that may arise from the activities of nonbank financial companies. If you have any questions, please do not hesitate to contact Martin Boer at mboer@iif.com or Mary Frances Monroe at mmonroe@iif.com.

Sincerely yours,

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