BETTER MARKETS

FSOC

FACT SHEET

Key Topics for FSOC Annual Report to Congress

February 5, 2024

The Financial Stability Oversight Council (FSOC) was one of the most important reforms created in the Dodd-Frank Act to address several of the key drivers of the 2008 crash and financial instability generally. The FSOC was designed to reduce the threats from the unregulated shadow banking system, level the playing field between systemically significant banks and nonbanks, minimize regulatory arbitrage, identify and address new emerging financial risks, and help prevent financial crashes. While the Obama administration took some initial actions to implement the FSOC's authorities, the Trump administration crippled it and effectively killed it by adopting regulations inconsistent with the mandates of the Dodd-Frank Act.

The FSOC has been AWOL since then and the Biden administration has been far too slow in reversing the unlawful actions of the Trump administration. **In November 2023 the FSOC finally updated guidance that reinstated its authority to require supervision and regulation of systemically important nonbank financial companies.** At the same time, it established an analytic framework to guide the process and allow for more flexibility to make de minimis changes as needed in the future, without having to reopen the entire rule.

Better Markets applauded both decisions because the Trump administration's previous actions interfered with the FSOC fulfilling its mission as required by the Dodd-Frank Act. This resulted in an unlevel and unfair playing field where systemically important banks and nonbanks were not similarly regulated. Because of the grave threat that they pose, as evidenced in 2008 and 2020, systemically important nonbanks must be properly regulated and the new designation guidance and analytic framework will facilitate that work.

- For more information, please read Better Markets' comment letters on the proposal found here and here.

The November 2023 decision made several key changes:

- **Implementing an entity-based approach in tandem with the activities-based approach.** Designation should not be limited to one or the other – both should be options based on the facts and circumstances in each case. This flexibility provides the FSOC with the authority necessary to identify risks and properly tailor a regulatory response to those risks.
- **Eliminating the requirement for cost-benefit analysis (CBA).** CBA has been a key weapon of the financial industry to defeat not just rules, but the intent of Congress to reduce the threats posed by the financial industry to the country. Congress determined that, like other financial regulatory agencies, the FSOC should not have to conduct CBA, which most often understates the threats and benefits to the public while exaggerating the costs to

the industry. The November 2023 action makes the FSOC's procedures consistent with Congressional intent and removes an unnecessary and dangerous barrier to properly protecting the American people.

- **Modifying the interpretation of "threat to the financial stability of the United States" to mean the potential for a systemic threat.** The Trump administration distorted this statutory mandate to require the FSOC to wait for an already empirically proven threat to materialize, by which time, of course, it would be too late to prevent disaster. Those changes, again inconsistent with the law, virtually guaranteed systemic threats becoming crises, causing crashes, and resulting in bailouts. The changes make the procedures consistent with the statute, align with the FSOC's mission, and enable it to identify and prevent threats from endangering the country.

While approval of the final rule was an important first step, it is only a first step.

- The FSOC must immediately ***take action*** to resume reviewing nonbanks to determine those that are systemically important and designate them for the appropriate level of regulation. It is a dereliction of duty for not one single nonbank in the U.S. to be designated as systemically significant today. As proved in 2008 and 2020, that will inevitably lead to systemic risks materializing unexpectedly, and, like AIG and other shadow banks, result in crashes and bailouts.

The 2023 FSOC Annual Report outlines some of the types of nonbanks that it is evaluating for systemic vulnerability, but it must do much more much faster.

- **Hedge Funds:** The FSOC's Hedge Fund Working Group (HFWG) has developed a risk-monitoring system to assess hedge fund–related risks to U.S. financial stability.
- **Nonbank Mortgage Servicing:** The FSOC's Nonbank Mortgage Servicing Task Force is facilitating interagency coordination and additional market monitoring of the risks that nonbank mortgage servicers pose to U.S. financial stability.

HEDGE FUNDS

- The hedge fund industry has grown from $7.5 trillion as of the first quarter of 2018 to $9.5 trillion as of the first quarter of 2023.
- Hedge funds' use of on- and off-balance sheet leverage to enhance returns can increase systemic risks by magnifying losses in a market downturn.
  - The effects of such loss magnification can contribute to market dislocations if a distressed fund liquidates its positions in a disorderly manner.
  - Volatility can also be transmitted to the fund's counterparties if the distressed fund is unable or unwilling to meet margin or collateral calls.
- Leveraged funds are highly interconnected with the broader financial system, and typically obtain funding from U.S. and foreign G-SIBs, as was evident in Archegos' failure in March 2021, which caused $10 billion in losses for losses for several large banks and more than $100 billion in lost shareholder value. While this prompted the Fed to subsequently issue a cautionary letter to banks with derivatives portfolios and that have relationships with investment funds, that is grossly insufficient action.
  - In the first quarter of 2023, hedge fund borrowing totaled $3.8 trillion, up from $2.6 trillion five years prior.

NONBANK MORTGAGE SERVICERS

- Nonbank mortgage originators and servicers continued to gain market share from banks over the last 10 years, with the share of nonbank originations and servicing at record highs.
    - Nonbanks now service over half of all mortgages: 54 percent as of the second quarter of 2023, compared with 20 percent in 2013.
    - The concentration of nonbank mortgage servicers as a percentage of top servicers grew from 6 nonbanks in the top 20 in 2013 to 12 in 2023.
- Servicer financial strength concerns may arise if a high percentage government loans become delinquent because of the uncapped advance obligation of the servicer for these loans. In some cases, servicers must make payments to the investor, regardless of whether the borrower makes a mortgage payment, and they must repurchase the mortgage out of its mortgage-backed security (MBS) pool at par.
    - During this period, the mortgage servicer must also continue making insurance payments while paying taxes and occasionally homeowners' association fees.
    - During a crisis, widespread delinquencies could threaten the viability of nonbank mortgage servicers, due to the length of time25 that nonbank mortgage servicers must forward these payments on behalf of nonpaying borrowers before the relevant mortgage guarantor reimburses them.

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Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside, and protect investors and consumers.

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