Dear Secretary Yellen:

I am writing to you in your capacity as Chair of the Financial Stability Oversight Council (FSOC) ahead of its meeting on November 3, 2023, to urge the Council to finalize its proposed interpretive guidance on nonbank financial company designations, and to use those authorities to designate and subject nonbank entities to heightened regulation to mitigate their risks on the stability of the financial system. Nonbank financial institutions (nonbanks) were “major contributors” to the 2008 financial crisis and also posed evident risks to the financial system during the 2020 COVID-19 pandemic. The rapid growth of these entities – hedge funds, insurance companies, asset managers, money market funds, and more – and their aggressive lending calls for an “urgent need” to address their growing threats to U.S. financial stability.

The 2008 financial crisis demonstrated how the failure of large financial firms that are not regulated depository institutions but which “serve as intermediaries to channel savings into investment” – or so-called “shadow banks” – could threaten the safety and soundness of the financial system. In response, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA) authorized FSOC to designate certain nonbank financial companies and financial market utilities as a “systemically important financial institution” (SIFI) and subject those entities to “heightened prudential regulation” by the Federal Reserve if their failure would harm U.S.


5 Id.
financial stability. As experts have noted, “[m]aking systemically significant banks and nonbanks subject to a similar regulatory regime was intended to end the misaligned incentives and opportunities for regulatory arbitrage as heightened regulation forces those entities to internalize the costs of their high-risk behavior.” In other words, SIFI designations allow regulators to apply a standard set of rules to large and important financial institutions of all kinds, helping ensure that threats to the financial system don’t accumulate in its most under-regulated pockets.

During the Obama administration, FSOC used its authorities to designate four nonbanks as systemically important: American International Group (AIG) – which received roughly $182 billion in bailout funds from the U.S. government during the financial crisis – Prudential, MetLife, and GE Capital.

Under the Trump administration, however, FSOC irresponsibly dropped SIFI designations for these risky institutions and weakened its own oversight power. At the time, your predecessors at FSOC wrote in a letter to former Secretary Mnuchin and Fed Chair Powell that “[t]hese changes would make it impossible to prevent the build-up of risk in financial institutions whose failure would threaten the stability of the system as a whole.” I applauded FSOC for taking important steps under the Biden administration to strengthen its designation process to protect the stability of the financial system. FSOC has proposed changes to (1) eliminate a statement from the 2019 Interpretative Guidance that calls for the Council to rely on federal and state regulators to address risks before the Council considers potential designations, (2) implement an analytic framework that increases public transparency into how the Council evaluates risks to financial stability, and

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(3) drop language from the 2019 Interpretive Guidance that requires the Council to perform a cost-benefit analysis that considers a firm’s material financial distress.\textsuperscript{13}

Now, the Council must finalize this proposed guidance to remove previous interpretations that “unduly hamper[s] the Council’s ability to use the statutory authority Congress provided to it,” and fully exercise its designation authority. If the Council continues to only use this authority “sparingly,”\textsuperscript{14} nonbanks will continue to take advantage of the lack of regulatory scrutiny and rely on “excessive leverage and volatile funding sources” that make themselves vulnerable to collapse.\textsuperscript{15}

FSOC must act now given that nonbanks have expanded rapidly and now provide almost 60 percent of all consumer and business credit.\textsuperscript{16} I am especially concerned by how their inherent vulnerabilities are amplified in light of the current risks caused by rising interest rates: the losses in commercial real estate and the leveraged lending market are among those growing risks.\textsuperscript{17} Nonbank mortgage lenders wrote at least 7 out of every 10 home loans last year.\textsuperscript{18} Yet, FSOC noted in its annual report that nonbank mortgage originators were loosening their underwriting standards, relying on short-term wholesale funding, and operating with limited capital and loss-absorbing capacity, potentially exposing themselves to extreme strains in the event of widespread mortgage delinquency.\textsuperscript{19} By taking on these risks with no oversight or accountability, nonbanks have spread these vulnerabilities across the financial system. Any shocks to a nonbank lender, such as rising defaults given high interest rates,\textsuperscript{20} could ripple out and overwhelm the entire economy’s financial stability.

\footnotesize\textsuperscript{14} Id.
FSOC must quickly finalize its proposed guidance interpretations to “enhance [its] ability to address financial stability risks.” But finalizing the proposed interpretive guidance is not enough. FSOC must also exercise its designation authority to effectively carry out its responsibility of addressing potential risks to the U.S. financial system before they destabilize the system. Past financial crises have demonstrated how nonbanks could be catalysts of future financial crises. FSOC has the opportunity to act now to protect the U.S. financial system, and I urge the Council to make a swift decision to do so at its upcoming meeting.

Sincerely,

Elizabeth Warren
United States Senator