FDIC Chair Highlights Risks Of Nonbank Financial Institutions

By **Daniel Meade** (November 9, 2023)

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This September, Federal Deposit Insurance Corporation Chairman Martin Gruenberg gave remarks to the Exchequer Club of Washington, D.C., on the financial stability risks of nonbank financial institutions, and floated the idea that one way to deal with their risks is to be less binary regarding the use of the Financial Stability Oversight Council.[1]

While Gruenberg is a voting member of FSOC and could propose changes to the FSOC process, his remarks may be more rightly categorized as food for thought.

Gruenberg stated that nonbank financial institutions are critical financial intermediaries in the U.S. and global financial system, noting that assets in insured depository institutions are only slightly higher than U.S. nonbank financial assets, but that nonbank financial institutions often are not subject to the same prudential safety and soundness requirements that banks are subject to, and that poses risk that should be addressed.

He particularly focused on so-called shadow banks — which he said included open-ended mutual funds and money market funds, leveraged investment vehicles such as hedge funds, and nonbank lenders, some fintech firms, securitization vehicles, and insurance companies.

Gruenberg noted that nonbank financial institutions contributed to both the 2008 global financial crisis and the 2020 COVID-19 crisis, and required Federal Reserve funding or assistance.

Gruenberg stated that "[t]he experience with nonbank financial institutions through these two crises underscores the financial stability risks they can pose, the resulting claim they have on public support, and the urgent need to give careful consideration to how to address those risks."

Implicit in Gruenberg's remarks seemed to be the notion that, although some efforts have been made, we still are not adequately addressing those risks.

Gruenberg noted that financial regulatory agencies have taken some actions to address, or at least study, these risks.

In 2022, FSOC reestablished its Hedge Fund Working Group, established a new Open-end Fund Working Group, and expressed encouragement for the U.S. Securities and Exchange Commission's efforts regarding reform of money market funds.[2]

Gruenberg also noted that FSOC had published for comment this year a new analytical framework for financial stability risk identification, assessment and response.[3]

Gruenberg proffered that FSOC could be useful in addressing these nonbank financial institution risks, not only in its ability to designate systemically important nonbanks to be regulated by the Fed, but also through its ability to direct the Office of Financial Research to collect information from nonbanks to lend more transparency to their impact.

Gruenberg went on to note that "[i]t is worth keeping in mind that nonbank financial institutions are not banks" and that "one of the impediments to the FSOC's nonbank designation process has been the perception of its binary nature."

He called for development of "a more tailored process that reduces undue financial system risk while applying prudential regulation and resolution planning requirements that are fit-for-purpose in the context of a particular nonbank financial institution's risks" rather than the binary all-on or all-off prudential regulation for designated firms.

If a more tailored approach were to be followed by FSOC and its member agencies, it could possibly address the risks that nonbank financial companies can cause that call for use of some aspects of the federal financial safety net on occasion, but not have full bank holding company-like regulation for the relevant firms. Nevertheless, even if clothed in softer, gentler clothing, Gruenberg is calling for additional supervision or regulation of shadow banks.

Gruenberg did not go into further detail about a more tailored FSOC designation, but it does offer an interesting proposition.

As mentioned above, nonbank financial institutions are often viewed as not regulated or lightly regulated, notwithstanding the clear risks they bring to the financial system.

As Gruenberg points out, these nonbank institutions are not banks, and so it may not be appropriate to regulate them as if they are bank holding companies, but it may be appropriate to place them under some regulation given the public support they have needed on at least two occasions in the past 15 years.

That history of needed support may suggest that a tailored approach to FSOC designations of nonbank financial institutions, or Fed supervision, once designated should focus particularly on management of liquidity risk.

The first glimpse of this type of tailored approach might be found in the Fed's Framework for the Supervision of Insurance Organizations it issued over a year ago,[4] but many would probably suggest that the framework is more or less a binary approach.

Gruenberg also noted that he has already heard some criticism of the Basel III endgame proposal,[5] and arguments that it would push more activities to the "more lightly regulated 'shadow banks' and cause greater risk to the system."

He concluded that "[t]he obvious response to that is there should be appropriately strong capital requirements for those activities in the banks, complemented by greater transparency, stronger oversight and appropriate prudential requirements for nonbanks. That would be the most effective and balanced way to enhance the stability of the entire financial system."

It is interesting that despite Gruenberg's invitation for FSOC and its member agencies to consider a more tailored approach to what happens once a nonbank financial institution is designated as systemically important, he concluded with remarks on the Basel III endgame proposal, which some have criticized as lacking the tailoring that federal law suggests should occur.

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[1] Remarks by FDIC Chairman Martin J. Gruenberg at the Exchequer Club (https://exchequerclub.com/) on the Financial Stability Risks of Nonbank Financial Institutions, available at https://www.fdic.gov/news/speeches/2023/spsept2023.html.

[2] See FSOC Press Release, February 4, 2022 available at https://home.treasury.gov/news/press-releases/jy0587.

[3] Analytic Framework for Financial Stability Risk Identification, Assessment and Response, 88 Fed. Reg. 26,305 (April 28, 2023), available at https://home.treasury.gov/system/files/261/FSOC-2023-Risk-Framework.pdf.

[4] Framework for the Supervision of Insurance Organizations 87 Fed. Reg. 60,160 (Oct. 4, 2022), available at https://www.federalregister.gov/documents/2022/10/04/2022-21414/framework-for-the-supervision-of-insurance-organizations.

[5] See Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity 88 Fed. Reg. 64,028 (Sep. 18, 2023) available at https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant.