

The Honorable Jacob J. Lew
U.S. Department of the Treasury
Hearing on the Financial Stability Oversight Council Annual Report to Congress
House Committee on Financial Services
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Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify today regarding the 2014 annual report of the Financial Stability Oversight Council.

Nearly four years ago, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the most comprehensive set of reforms to our financial regulatory system since the Great Depression. As a result of the implementation of these new rules, consumers have access to better information about financial products and are benefiting from new protections. Financial markets and companies have become more resilient. Regulators have become better equipped to monitor, mitigate, and respond to threats to financial stability. And today, our financial system is better capitalized, more transparent, and better prepared to withstand shocks.

As many of you know, one of the important reforms in the Dodd-Frank Act was the creation of the Financial Stability Oversight Council (Council). Before the Council, no single authority was accountable for monitoring and addressing risks to financial stability, and each regulator focused on the institutions, functions, or markets under its purview. As we learned, without a mechanism to look at the entire financial system, risks to financial stability can spread quickly across

institutions and markets. This siloed approach allowed certain risks to fall through the cracks of the regulatory system and failed to protect us in the lead-up to the crisis.

Congress changed that. With the establishment of the Council, senior regulators from across the system now meet regularly to facilitate a more coordinated approach to monitoring, identifying, and responding to potential threats to financial stability. Today, the Council provides a forum to foster regular and close collaboration among its members at both the federal and state levels.

This collaboration features frequent meetings between senior officials, as well as dedicated and ongoing engagement among staff on a near-daily basis.

Independent regulators continue to be responsible for regulating the markets and institutions they oversee. But they are now also part of a process that enables them to look across markets and institutions to monitor the entire financial system and identify potential risks to U.S. financial stability. Some now suggest that this function should be curtailed, but hindering the Council's ability to analyze information regarding particular sectors, firms, or activities runs the risk of missing the next threat to our financial system and the U.S. economy. This is an important responsibility that the Council must fulfill.

Today, there are even some who challenge the notion that the Council should ask questions about whether certain activities or companies might pose risks to the stability of the U.S. financial system. But asking questions does not equal regulatory action. We learned from the financial crisis that regulators should have asked more, not fewer, questions about the institutions and

activities that they oversaw. And today we should ask these questions equally prepared to find a reason to take action or not. But if we avoid or are discouraged from asking questions all together, our financial system will be more exposed to unseen risks, potentially leading to large scale problems.

There are many possible outcomes to the Council examining a particular risk. If the Council determines there is a risk that requires action, Congress provided the Council with a broad range of authorities and potential remedies. But the Council may conclude that it does not need to act, that it needs to examine and issue further, or that it must gather additional data. What the Council should not do is cordon off any sector or activity without even considering it. That would be a dereliction of Council responsibilities and a complete disregard for the very purpose of the Council.

Some also claim that the Council's processes are opaque and its outcomes are predetermined, but that is simply wrong. The Council has voluntarily adopted a robust transparency policy and put in place a comprehensive, deliberative approach to its evaluation of risks, and it solicits public input and carefully considers all points of view. Its report, which I will be discussing today as the subject of this hearing, describes the work of the Council.

As the distance in time since the financial crisis grows, we must not forget the financial and emotional pain endured by millions of American families who lost their homes, their retirement savings, or their jobs. We cannot return to a regulatory environment that failed to detect risks to

financial stability and was unequipped to mitigate those risks and prevent the damage to our financial system and economy.

In this context, the Council's annual report stands as a testament to how the Council is executing on its statutory duty to identify and respond to potential threats to financial stability. The report reflects the collective judgment of Council members regarding the key risks to financial stability and provides an important example of how the Council shares information about its work with Congress and the public in a clear and transparent manner. Each annual report is the product of a highly collaborative analysis conducted by the Council's member agencies to document for the public the Council's sense of the risks present in all corners of the market, its assessment of how those risks might be transmitted to the broader financial system, and its recommendations for specific actions to mitigate those risks.

The Council's annual report also provides a roadmap for the Council's agenda for the upcoming year – what areas it will focus on, what areas will likely require additional attention, and how it expects to address them. The 2014 annual report focuses on nine areas that warrant continued attention and possibly further action from the Council's members:

- First, regulatory agencies and market participants should continue to take action to reduce vulnerabilities in wholesale funding markets, including tri-party repo and money market mutual funds, that can lead to destabilizing fire sales.

- Second, regulators should continue to work with policymakers to implement the significant structural reforms that are needed to reduce the taxpayers' exposure to risk in the housing market.
- Third, cybersecurity threats, infrastructure vulnerabilities, and other operational risks remain a top priority for the Council, and regulators should continue to take steps to prevent operational failures and improve resiliency.
- Fourth, as the financial system evolves in response to technological, competitive, and regulatory changes, regulators should remain attentive to financial innovations and the migration of certain activities outside of traditional financial intermediaries that could create financial stability risks.
- Fifth, U.S. regulators should continue to cooperate with foreign counterparts to address concerns about benchmark reference rates such as LIBOR.
- Sixth, regulators and institutions should remain vigilant in monitoring and assessing risks related to interest rate volatility, particularly as investors seek higher yields in a low interest rate environment.
- Seventh, Council member agencies should continue to work with the Office of Financial Research (OFR) to fill financial data gaps and address related issues of data quality and comprehensiveness.
- Eighth, regulators should continue implementation of Dodd-Frank reforms to reduce risk-taking incentives of large, complex, interconnected financial institutions.
- And finally, there is a need for continued monitoring of adverse financial developments abroad and their potential impact on the U.S. financial system.

Activities of the Council

Since its 2013 annual report, the Council has continued to fulfill its statutory responsibilities to identify risks to U.S. financial stability, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. The Council regularly examines significant market developments and structural issues within the financial system. For example, over the past year, the Council considered issues such as market volatility, the government shutdown and debt ceiling impasse, interest rate risk, economic developments in Europe and emerging economies, housing finance reform proposals, the NASDAQ trading halt in August 2013, and risks to financial stability arising from cybersecurity threats. Recognizing the need to be vigilant in responding to new and emerging challenges, the Council will continue to monitor potential threats to financial stability and to facilitate coordination among its member agencies.

In addition, last year, the Council made its first designations of nonbank financial companies. The Council's designations authority addresses a key weakness brought to light by the financial crisis: the existing regulatory structure allowed some large, complex nonbank firms to pose risks to financial stability that were not subject to adequate supervision. As a result, the Dodd-Frank Act allows the Council to designate nonbanks whose distress or activities could pose a threat to U.S. financial stability, and subject them to supervision by the Federal Reserve and enhanced prudential standards. The Council has used a thorough and transparent process when considering

these companies for designation, giving each company numerous and extensive opportunities to engage with the Council and its staff and to understand the detailed reasons for any designation.

The Council voted in July 2013 to make final determinations regarding American International Group (AIG) and General Electric Capital Corporation. In September 2013, the Council voted to make a final determination regarding Prudential Financial. The Council had notified those companies in the fall of 2012 that they were under review for potential designation, and the companies submitted information for the Council to consider in its evaluations. The lengthy and careful analyses conducted by the Council included frequent and substantive interactions with the companies under consideration.

Let me give you an example. For one of the companies that has been designated, Council staff spent over a year conducting an analysis that considered more than 200 data submissions from the company that totaled over 6,000 pages. The Council or its staff met with the company 20 times. Prior to a final determination the Council prepared and shared with the company an approximately 200-page document outlining the Council's analysis and rationale for a proposed determination. The company responded to this document and discussed it with all the members of the Council before the Council made a final decision. This determination – and any others made by the Council regarding nonbank financial companies – are based on the standards set forth by Congress in the Dodd-Frank Act and follow the process laid out in the Council's public rule and guidance.

One final point I would like to make here is that given the global nature of the financial system, the United States has made strong commitments to international efforts to institute financial regulatory reforms comparable to and consistent with ours. Such efforts are important to safeguarding the U.S. financial system from threats resulting from weaker regulation abroad, as well as to promoting a level playing field for U.S. firms that operate internationally.

The Council's Governance and Transparency

The Council is committed to conducting its work publically. Indeed, as I noted publicly at our May meeting, the Council's annual reports will continue to serve as a key tool for communicating our activities to the public and Congress.

However, much of the Council's work – particularly in regards to companies under consideration for potential designation – relies on sensitive company and industry data and information that would not be shared by firms or regulators without an expectation of confidentiality.

Accordingly, the Council is committed to conducting its meetings in public whenever possible and to releasing minutes for all its meetings. Though no statute requires the Council to do so, we believe taking these steps helps provide the public with insight into the Council's work. We have kept those commitments over the past three and a half years, including holding twelve open meetings and releasing minutes for forty meetings.

The Council also understands that it can always improve upon its commitments. To that end, the Council has undertaken a review of its governance and transparency policies, beginning in 2013, to determine whether it can even better enhance its openness and accountability to the public while still protecting sensitive information. This review included consideration of the practices of other organizations with similar structures, memberships, or responsibilities as the Council. For example, during a public session in May, the Council revised its transparency policy to incorporate several enhancements to improve communication with the public. Additionally, the Council adopted bylaws for its Deputies Committee that will provide further visibility into some of its staff work.

The Council understands that its analysis is enhanced by the perspective of the public. Accordingly, it actively seeks input from outside parties to inform its work. For example, in December 2013, a representative from the banking sector joined a public meeting of the Council to discuss cybersecurity. And in May, the Council hosted a public conference on asset management to hear directly from industry representatives, academics, and other stakeholders on topics related to asset management. The Council continues to work with state and foreign regulators in the course of its analysis on nonbank financial companies. The Council continues to benefit from this type of engagement with external stakeholders and expects to continue to be informed by outside experts on its work going forward.

Progress on Financial Regulatory Reform

The 2014 annual report discusses the significant progress that Council member agencies, both individually and collectively, have made implementing Dodd-Frank Act reforms. As a result of the implementation of these reforms, consumers have access to better information about financial products and are benefiting from new protections. Financial markets and companies have become more resilient and transparent. And regulators have become better equipped to monitor, mitigate, and respond to threats to the financial system.

Over the past year, the regulators reached a number of key milestones in financial reform implementation, including:

- finalization of the Volcker Rule, bank capital rules, a supplementary leverage ratio for the largest banks and bank holding companies, enhanced prudential standards for the U.S. operations of large foreign banks, and the development of clearing, trading, and registration requirements for certain swaps markets;
- proposed rulemakings on money market mutual fund (MMF) reform, risk retention for securitizations, and requirements for short-term liquidity coverage for large banking organizations; and
- significant reductions in intraday credit exposures in the tri-party repo market and significant progress on the strategy for financial institution resolution under the orderly liquidation authority.

On a related note, there has been continued progress towards achieving an international minimum standard that would allow national authorities in the majority of the world's largest economies to wind down failing global banks without the use of taxpayer money. We also anticipate progress on a framework for cross-border cooperation in the future resolutions of global banks.

Now let me provide greater detail about the nine areas of focus covered in the report.

Areas of Focus of the Council's 2014 Annual Report

Wholesale Funding Markets

The Council has highlighted run risks associated with MMFs and the tri-party repo market since our first annual report in 2010. Regarding MMFs, in June 2013 the SEC proposed rules to reform the structure of MMFs in order to make them less susceptible to runs. This proposal includes a number of the same principles and concepts, such as requiring a floating NAV, that were part of the proposed recommendations for reform issued by the Council in November 2012. The Council recommends that the SEC move forward and adopt meaningful structural reforms designed to address MMF run risk. The Council also recommends that its member agencies examine the nature and impact of any structural reform of MMFs that the SEC implements to

determine whether the same or similar reforms are appropriate for other cash-management vehicles.

In the tri-party repo market, there has been significant progress in reducing market participants' reliance on intraday credit from the clearing banks. The share of tri-party repo volume funded intraday by the clearing banks fell from 92 percent in December 2012 to under 20 percent in December 2013. But vulnerabilities to fire sales remain, particularly with respect to borrowers, such as broker-dealers, that rely heavily on these markets for financing. The Council acknowledges the work that has been done in the past year to reduce the reliance on discretionary intraday credit, which is forecasted to be less than 10 percent by the end of 2014. Yet, a default of a broker-dealer remains a key vulnerability that could lead to fire sales of repo collateral, and may lead to the disruption of certain asset and financing markets. The Council recognizes that regulatory reforms implemented since the crisis, such as increases in the amount of capital, liquidity, and margin changes for U.S. broker-dealers, may help to mitigate the risk of default. However, the Council advises all U.S. regulators of firms that rely on this market for funding to assess whether additional steps may need to be taken to protect borrowers from funding runs.

Housing Finance Reform

The housing finance system continues to require significant reform to enhance financial stability. The residential mortgage market relies heavily on government guarantees, while private mortgage activity remains muted. Increasing the presence of private capital and reducing risk to

taxpayers in housing finance remains a priority. Fannie Mae and Freddie Mac achieved their targets for risk-sharing transactions and reductions in their mortgage investment portfolios. Member agencies also made progress on the risk-retention rule, and infrastructure reforms such as the development of the Common Securitization Platform are moving forward. The annual report outlines the ongoing need for market participants, regulators, and Congress to work together to create structural reforms that will help reduce uncertainty in the housing finance market, provide access for creditworthy borrowers, and protect taxpayers. In the past year, progress was made towards establishing a new framework for housing policy, but ultimately Congress must pass legislation to achieve comprehensive housing finance reform.

Operational Risks

Cybersecurity remains a top priority for the Council, as deliberate attempts to disrupt institutions, markets, and commerce continue, as seen in the high-profile cyber-attack on Target that resulted in the theft of bank card and customer information. While companies and financial markets become more dependent on complex technologies and networks, the frequency, severity, and sophistication of such incidents are likely to rise. The Council recommends that financial regulators continue their efforts to assess cyber-related vulnerabilities facing their regulated entities and identify gaps in oversight that need to be addressed. In addition, the Council recognizes the importance of removing legal barriers to information sharing between public and private sector partners to enhance overall awareness of cyber threats, vulnerabilities, and attacks

in a manner that continues to protect privacy and civil liberties, including the passage of comprehensive cybersecurity legislation by Congress.

Market continuity and confidence were also challenged this past year with an increase in outages and failures resulting from technological and infrastructure vulnerabilities. Some of these incidents led to the temporary suspension of trading. Other incidents involved software failures that sent involuntary orders through automated trading systems, leading to large losses. The vulnerabilities that are associated with such incidents may be heightened, particularly in fragmented markets, by high-frequency or low-latency automated trading activities. The Council recognizes that alternative trading venues and methods may present operational and other risks by magnifying system-wide complexity. As such, the Council recommends that regulators focus not only on centrally traded products, but also on a broader set of financial products and trading methods off exchanges.

Financial Innovation and Migration of Activity

The financial system is constantly evolving, with the development of new products, services, and business practices. These changes can provide a number of benefits to the financial system, but they may also present new risks. While new products or services are often developed as a result of technological and competitive forces, sometimes they are created to circumvent regulation. In other instances, the migration of some activities may move a regulated activity outside of the regulatory perimeter. The changing landscape of the post-financial crisis world has fostered

many innovations which should be monitored for the potential to create risks to financial stability.

Reference Rates

Beginning in the second half of 2012, investigations uncovered multiple instances of systematic false reporting and manipulation of widely used survey-based benchmark interest rates, such as LIBOR and EURIBOR, by reporting banks. More recently, concerns have been raised about the integrity of certain foreign exchange (FX) rate benchmarks. One important insight from the recent allegations in FX markets is that transactions-based benchmarks can also be subject to manipulation and adversely impact related markets.

While some progress has been made to find viable alternative interest-rate benchmarks, more work is needed. The Council recommends U.S. regulators continue to cooperate with foreign regulators and international bodies to identify alternative interest rate benchmarks anchored in observable transactions and supported by appropriate governance structures, and to assess market practices and benchmarks in the FX markets. The Council also recommends development of a plan to implement a smooth and orderly transition to any new benchmarks.

Resilience to Interest Rate Volatility

The prolonged period of low interest rates and low volatility has provided incentives for investors and financial institutions to search for yield by extending the duration of their portfolios, investing in lower-quality credit, increasing leverage, or easing underwriting standards. Such strategies may increase short-term profits, but at the risk of potentially large losses in the event of a sudden yield curve steepening or a large rise in rates.

Despite the relatively benign impact on financial stability of last year's sharp rise in interest rates, volatility remains a potential threat to financial stability. For this reason the Council recommends that supervisors, regulators, and financial firm management continue to monitor and assess the growing risks resulting from search-for-yield behaviors as well as the potential risk of severe interest rate shocks.

Data Quality and Comprehensiveness

High quality and readily available access to financial data is critical for regulators, supervisors, and financial firms, but access to comprehensive data is limited. For example, regulators lack sufficient data to thoroughly analyze all repo markets, and they are still unable to effectively monitor securities lending transactions and the reinvestment of cash collateral. In addition, some regulators still face difficulties in accessing data stored at swap data repositories. However, regulators have made significant progress in addressing financial data gaps in recent years. They

now collect real-time data from various markets and institutions. There has also been progress in improving the standardization of certain financial data, including the legal entity identifier (LEI), which will help to identify parties to financial transactions. The widespread adoption of LEI both domestically and globally, together with the work to enhance the consistency and availability of swaps data reported by swaps data repositories, would improve the ability of regulators to monitor emerging risks in the financial system. The Council supports these efforts and recommends that member agencies and the OFR continue to work together to promote high-quality data standards and fill data gaps where they exist.

Risk-taking Incentives of Large, Complex, Interconnected Financial Institutions

Historically, when large, complex, interconnected financial institutions became distressed, official authorities often intervened to maintain financial stability. The Dodd-Frank Act addresses the incentives and abilities of large, complex, interconnected financial institutions to engage in excessive risk-taking that could result from implicit expectations of future official sector intervention. Financial regulatory reforms have created much stronger financial institutions, with capital levels doubling compared to pre-crisis levels, significantly reducing the likelihood of failure. Reforms have also been designed to minimize the damage that any single firm's failure would have on the broader financial system.

During 2013, the largest U.S. financial institutions continued to reduce their complexity in some dimensions. Additionally, credit rating agency assessments of potential government support to

U.S. bank holding companies reflect declining expectations of the likelihood of government support. However, rating agency opinions continue to explicitly factor in the possibility that the government will provide support to the largest banks if they become financially distressed. The full implementation of the orderly liquidation authority, and the phasing in of enhanced prudential standards in coming years, should help reduce remaining perceptions of government support for large, complex, interconnected financial institutions.

Foreign Markets Risks

In 2013, domestic market participants remained concerned about the adverse consequences of financial developments abroad. However, the areas from which these risks emanate have changed considerably. In previous years, stability in peripheral Europe was a key area of concern for global financial markets. Over the past year, economic and financial conditions in the euro area have stabilized. At the same time, potential risks emanating from emerging markets have become more prominent. Beginning in the late spring of 2013, emerging market economy exchange rates and asset prices became much more volatile, and economic growth subsequently slowed in some of these economies. The potential spillover effects on the United States from emerging markets' stresses appears limited, but a substantial worsening of these stresses is a risk.

Conclusion

In summary, the Council plays a critical role in our financial regulatory system by bringing together federal and state financial regulators to identify potential risks across the system and prevent problems from falling through the cracks. The annual report is a reflection of the collaboration and collective judgment of these officials. And its findings and recommendations are a critical statement that guides action, promotes transparency, and creates accountability.

Indeed, I strongly believe that the actions of the Council and its member agencies have made the financial system more stable and less vulnerable to future economic and financial stress. Yet, the Council must continue to remain vigilant to new risks while focusing on the risks highlighted in the annual report.

I want to thank the other members of the Council, as well as their staffs, for their work over the last year and their efforts in preparing the 2014 annual report, as well as their ongoing contributions to the important work of the Council. We look forward to working with this Committee, and with Congress as a whole, to continue to make progress in creating a more resilient and stable financial system.