

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

May 9, 2022

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: May 12, 2022, Full Hearing entitled, “The Annual Report of the Financial Stability Oversight Council”

The full Committee will hold a hybrid hearing entitled, “The Annual Report of the Financial Stability Oversight Council” on Thursday, May 12, 2022, at 10:00 a.m. E.T. in room 2128 of the Rayburn House Office Building and on Cisco Webex. There will be one panel with the following witness:

- **The Honorable Janet Yellen**, Secretary, U.S. Department of the Treasury, and Chairperson, Financial Stability Oversight Council (FSOC)

Overview

Pursuant to Section 112(a)(2)(N) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), Congress mandates the Financial Stability Oversight Council (FSOC) to submit an annual report to Congress on various issues, including: its activities; significant financial market and regulatory developments; and potential emerging threats to the financial stability of the United States. Pursuant to Section 112(c) of Dodd-Frank, the Chairperson of the FSOC is required to testify before the Committee to discuss the efforts, activities, objectives, and plans of FSOC and discuss and answer questions concerning FSOC’s annual report.¹

The Dodd-Frank Act established FSOC in the aftermath of the 2008 financial crisis to carry out three primary purposes, which are: “(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and (C) to respond to emerging threats to the stability of the United States financial system.”²

The FSOC comprises ten voting members – including the Secretary of the Treasury, who serves as FSOC’s Chairperson – and five nonvoting members.³ The Office of Financial Research (OFR) was established to conduct independent research and support FSOC’s work.⁴ While FSOC is empowered to designate nonbank financial companies for enhanced oversight by the Federal Reserve or designate

¹ Treasury, [Financial Stability Oversight Council Releases 2021 Annual Report](#) (Dec. 17, 2021); and FSOC, [2021 Annual Report](#) (Dec. 17, 2021). For previous FSOC annual reports, see FSOC, [Annual Reports](#) (accessed May 4, 2022). For other relevant U.S. and global financial stability reports, see Fed, [Financial Stability Report](#) (May 9, 2022); OFR, [Annual Report](#) (Nov. 17, 2021); and IMF, [Global Financial Stability Report](#) (Apr. 19, 2022).

² 12 U.S.C. § 5322.

³ Voting members include the chair of the FSOC (Treasury Secretary); the heads of the FDIC, OCC, Federal Reserve, NCUA, SEC, CFTC, FHFA, and CFPB; and an independent insurance expert appointed by the President. Nonvoting members include the directors of the OFR and Federal Insurance Office, as well as state regulatory representatives, one each for insurance, banking, and securities. See CRS, [Introduction to Financial Services: Systemic Risk](#) (Jan. 13, 2022), and CRS, [Financial Stability Oversight Council \(FSOC\): Structure and Activities](#) (Feb. 12, 2018).

⁴ 12 U.S.C. § 5344.

systemically important financial market utilities (SIFMUs),⁵ FSOC can generally only recommend—but not compel— member agencies to undertake regulatory changes.

A summary of FSOC’s 2021 annual report and recent activities are described below.⁶

Potential Threats to Financial Stability

According to FSOC’s 2021 annual report, “Regulatory reforms after the 2008 financial crisis strengthened the ability of the financial system to withstand a shock or an economic downturn. However, risks to U.S. financial stability today are elevated compared to before the pandemic... At the onset of the pandemic, the financial crisis in March 2020 has also made some vulnerabilities more salient.” The report identified the following areas of risks and vulnerabilities to financial stability:

Climate-related financial risk. In May 2021, President Biden issued Executive Order 14030, directing the Treasury Secretary to engage with FSOC members on climate-related financial risks and report on the FSOC’s activities.⁷ In October 2021, the FSOC issued a detailed report on climate-related financial risk, which found that “Climate change is an emerging threat to the financial stability of the United States.”⁸ The report described “physical risks” as economic and financial losses stemming from “harm to people and property arising from acute, climate-related disaster events such as hurricanes, wildfires, floods, and heatwaves as well as longer-term chronic phenomena such as higher average temperatures, changes in precipitation patterns, sea-level rise, and ocean acidification.”⁹ The report also described “transition risks,” or “stresses to certain institutions or sectors arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes necessary to limit climate change.”¹⁰ At its December 2021 meeting, the FSOC voted to establish a Climate-related Financial Risk Committee within the FSOC.¹¹

Corporate credit. FSOC noted that the average leverage of non-financial corporations is high relative to historical norms, particularly for the airline, hospitality and leisure, and restaurant sectors. FSOC recommended that member agencies monitor non-financial business leverage, asset valuations, and the financial sector’s ability to manage severe simultaneous losses.¹²

Short-term wholesale funding markets. FSOC highlighted how money market funds (MMFs) can liquidate assets in short-term funding markets to meet redemptions, amplifying stress in those markets. FSOC also noted recent episodes of stress in the repurchase agreement (repo) markets, specifically when there were large spikes in repo rates in September 2019 and March 2020. FSOC observed that reliance on repo funding by hedge funds and other leveraged investors can also amplify stress in these short-term funding markets in response to deleveraging pressure.¹³ Building on a December 2020 report on MMFs by the President’s Working Group on Financial Markets (PWG)¹⁴ and a request for comment by the Securities and Exchange Commission (SEC) in February 2021,¹⁵ FSOC recommended regulators continue to examine and address structural vulnerabilities in these short-term funding markets.¹⁶

⁵ FSOC, [Designations](#) (accessed May 4, 2022).

⁶ Treasury, [Financial Stability Oversight Council Releases 2021 Annual Report](#) (Dec. 17, 2021); and FSOC, [2021 Annual Report](#) (Dec. 17, 2021). Also see FSOC, [Annual Reports](#) (accessed May 4, 2022) for previous FSOC annual reports.

⁷ White House, [Executive Order on Climate-Related Financial Risk](#) (May 20, 2021).

⁸ FSOC, [FSOC Report on Climate-Related Financial Risk](#), (Oct. 2021).

⁹ *Id.*

¹⁰ *Id.*

¹¹ FSOC, [2021 Annual Report](#) pp. 137-140, 157 (Dec. 17, 2021).

¹² FSOC, [2021 Annual Report](#), pp. 23-30, 157-158 (Dec. 17, 2021).

¹³ FSOC, [2021 Annual Report](#), pp. 39-48, 158-160 (Dec. 17, 2021).

¹⁴ Treasury, [President’s Working Group on Financial Markets Releases Report on Money Market Funds](#) (Dec. 22, 2020).

¹⁵ SEC, [SEC Requests Comment on Potential MMF Reform Options Highlighted in President’s Working Group Report](#) (Feb. 4, 2021).

¹⁶ FSOC also issued a statement on MMF risks and potential reforms in June 2021. See FSOC, [Financial Stability Oversight Council Statement on Money Market Fund Reform](#) (Jun. 11, 2021).

Residential real estate market. FSOC described how nonbank mortgage companies increasingly play a significant role in the residential real estate market. However, many rely on short-term funding and are vulnerable to adverse market conditions, particularly given that many have limited loss-absorbing capacity. The Council recommended federal and state regulators should continue to coordinate to gather data, identify risks, and improve oversight of nonbank companies originating and servicing residential mortgages.¹⁷

Commercial real estate market. According to FSOC, commercial real estate (CRE) properties in central business districts have faced stress due to the pandemic. If acute stress materializes in CRE markets, asset sales could lead to a cycle of lower valuations, potentially resulting in defaults that would negatively affect banks, given that they hold a large portion of CRE loans. FSOC recommended regulators improve bank capital and liquidity buffers to account for their CRE exposure.¹⁸

Large bank holding companies. FSOC acknowledged how reforms following the 2008 financial crisis resulted in much stronger capital and liquidity positions at large, complex banks. However, they highlight a myriad of risks these firms face, including how the recent failure of Archegos underscored the importance of large banks having strong counterparty credit risk management practices.¹⁹ FSOC underscored the importance of regulators requiring large financial institutions to maintain sufficient capital and liquidity and the need to strengthen risk management practices by large banks.²⁰

Investment funds. The Council noted that open-end mutual funds holding primarily fixed-income instruments might be vulnerable to run risks. FSOC also identified a vulnerability on the use of leverage by investment funds, particularly hedge funds, in a period of stress when leverage can magnify losses or lead to margin calls, which can disrupt underlying markets in a liquidation. FSOC highlighted that it reconstituted its Hedge Fund Working Group and established an Open-end Fund Working Group to assess potential risks. FSOC also indicated its support of initiatives by the SEC and other agencies to address potential risks associated with investment funds, as well as data collection and other analysis to better identify these risks.²¹

Central counterparties (CCPs). FSOC's annual report finds that CCPs provide significant benefits for the functioning of the financial system, and there are several layers of protections in current rules to address situations of default, however, FSOC notes that severe losses or the default by one or more clearing members could put a strain on the financial system. FSOC recommends regulators evaluate the adequacy of current safeguards and consider the tradeoff between counterparty risk and liquidity risk. FSOC also stressed the importance of resolution planning and supervisory stress tests of CCPs designated as systemically important financial market utilities (SIFMUs) by FSOC.²²

Alternative reference rates. FSOC observed that the transition away from financial institutions utilizing the London Interbank Offered Rate (LIBOR) is entering a "critical stage" with multiple risks. One risk is if market participants do not transition to alternative rates with respect to legacy contracts in the event of LIBOR's cessation. FSOC noted that the Alternative Reference Rates Committee recommended the Secured Overnight Financing Rate (SOFR) as an alternative, and that regulators have issued guidance to help facilitate a smooth transition, but it urged market participants and regulators to

¹⁷ FSOC, [2021 Annual Report](#), pp. 64-74, 160-161 (Dec. 17, 2021).

¹⁸ FSOC, [2021 Annual Report](#), pp. 74-77, 161 (Dec. 17, 2021).

¹⁹ The Committee explored the lack of transparency with family offices, such as Archegos, in a hearing entitled, [Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III](#) (May 6, 2021). In July 2021, the Committee subsequently [marked up](#) and approved [H.R.4620](#), sponsored by Rep. Alexandria Ocasio-Cortez (D-NY), to narrow the family office exemption from SEC investment adviser regulations regarding those with less than \$750 million in managed assets.

²⁰ FSOC, [2021 Annual Report](#), pp. 77-93, 161-162 (Dec. 17, 2021).

²¹ FSOC, [2021 Annual Report](#), pp. 93-116, 162-163 (Dec. 17, 2021).

²² FSOC, [2021 Annual Report](#), pp. 116-120, 163-165 (Dec. 17, 2021).

remain vigilant.²³ Since FSOC’s annual report was issued, Congress enacted the Consolidated Appropriations Act of 2022 in March 2022, including the Adjustable Interest Rate (LIBOR) Act sponsored by Rep. Brad Sherman (D-CA). The law establishes a process to replace LIBOR in existing contracts with an alternative rate.²⁴

Financial market structure. FSOC discussed various risks, such as market volatility, that may arise from the structure of certain markets, including Treasuries, MBS, corporate bond markets, and short-term funding, as well as the interlinkages between these markets. FSOC noted an interagency staff progress report was issued in November 2021, examining recent disruptions and potential reforms in the U.S. Treasury market.²⁵ FSOC recommended regulators continue to evaluate market structure and ongoing changes that may have adverse impacts on market integrity and liquidity and consider increasing central clearing of Treasuries to improve market resilience while assessing the impact on liquidity.²⁶

Cybersecurity. Cybersecurity is an issue FSOC has consistently raised in its annual reports. In its 2021 report, FSOC highlighted new risks posed by the pandemic, ransomware incidents, and supply chain attacks, as well as the increased reliance on third-party service providers by financial institutions. However, FSOC identified regulatory gaps with respect to NCUA and FHFA that have limited authority with respect to overseeing such third-party service providers used by their regulated entities. FSOC also urged regulators to improve cybersecurity examinations of regulated entities.²⁷

Data gaps and challenges. FSOC explained that financial stress in 2008 and again in 2020 revealed data gaps with respect to “firm-level structure and ownership information, transaction data in certain important financial markets, and limitations in financial statement reporting for certain types of institutions,” where jurisdictional or other differences in reporting requirements limit the usefulness of data in monitoring the financial system. The Council urged member agencies to improve coordination to harmonize various data collection standards.²⁸

Financial innovation, digital assets, and the use of technology in financial services. FSOC noted that financial innovation can bring about a range of benefits, though it can also create new risks. FSOC noted that speculation is driving the majority of digital asset activity currently, and that the instruments may be highly volatile, while also posing risks relating to illicit financing, cybersecurity, and privacy, among other risks.²⁹ FSOC reviewed the PWG report on stablecoins,³⁰ which are cryptocurrencies backed by reserve assets, and urged regulators to consider the recommendations contained in that report. FSOC also noted that FSOC will consider taking steps to address risks posed by stablecoins in the event Congress does not enact stablecoin legislation outlined in the PWG report. Regarding the rapid adoption of technology in the financial services, FSOC noted this could increase operational risks, especially when financial institutions rely on third parties. FSOC also noted that technology can help increase the participation of retail investors in U.S. equity markets, but that risks of increased price volatility and market manipulation driven through social media may emerge. FSOC also encouraged agencies to collaborate and monitor the effects of new financial products and services on consumers, regulated entities, and financial stability, as well as identify and address potential risks from these new products and services.

²³ FSOC, [2021 Annual Report](#), pp. 120-123, 165-167 (Dec. 17, 2021).

²⁴ National Law Review, [Federal Enactment of Adjustable Interest Rate \(LIBOR\) Act](#) (Mar. 16, 2022).

²⁵ Treasury, Federal Reserve, Federal Reserve Bank of New York, SEC, and CFTC, [Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report](#) (Nov. 8, 2021).

²⁶ FSOC, [2021 Annual Report](#), pp. 31-39, 167-168 (Dec. 17, 2021).

²⁷ FSOC, [2021 Annual Report](#), pp. 125, 168-170 (Dec. 17, 2021).

²⁸ FSOC, [2021 Annual Report](#), pp. 154-156, 170-171 (Dec. 17, 2021).

²⁹ FSOC, [2021 Annual Report](#), pp. 123-125, 171-174 (Dec. 17, 2021).

³⁰ Treasury, [President’s Working Group on Financial Markets Releases Report and Recommendations on Stablecoins](#) (Nov. 1, 2021).

Managing vulnerabilities amid uneven and volatile global growth. FSOC’s annual report noted that “Risks include the possibility of higher-than-expected inflation leading to higher interest rates, causing losses at some financial institutions, higher borrowing costs, and the global economic recovery to lose momentum.”³¹ This echoed language from the Federal Reserve’s November 2021 financial stability report, which warned that “A steep rise in interest rates could lead to a large correction in prices of risky assets.”³² Since both of these reports were published, persistent inflation has caused the monetary policy environment and outlook to tighten substantially. On May 4, 2022, the Federal Open Market Committee (FOMC) announced that it would raise the federal funds rate by 50 basis points, the largest interest rate increase at a FOMC meeting in over 20 years.³³ Financial market participants now expect the federal funds rate to be roughly 3% at the end of 2022,³⁴ more than 2% above what monetary policy officials were projecting in December 2021.³⁵

Additional FSOC Activities and Background

FSOC and OFR Funding and Staffing. During the Trump Administration, the budget and staffing levels for FSOC as well as OFR were significantly reduced. One analysis noted FSOC’s budget was reduced by more than 25 percent and staffing was reduced by almost 60 percent, and OFR’s staffing levels were cut by more than half.³⁶ According to the Biden Administration’s budget proposal for fiscal year (FY) 2023, FSOC is expected to double its staffing to 27 full-time equivalent staff (FTEs) compared to 14 FTEs in FY 2021, whereas OFR is expected to increase its staffing to 163 FTEs in FY 2023 compared to 111 FTEs in FY 2021.³⁷

Guidance on FSOC Designations Process. In December 2019, FSOC, under the Trump Administration issued final guidance on nonbank designations by unanimous vote.³⁸ The guidance would require, among other things, for FSOC to pursue a SIFI designation if a systemic risk cannot be addressed through an activities-based approach, and require a cost-benefit analysis of any designation. The guidance garnered strong concerns. In a 2019 letter to Treasury Secretary Mnuchin and Fed Chair Powell from former Fed Chairs Yellen and Bernanke, along with former Treasury Secretaries Geithner and Lew, the group warned, “Though framed as procedural changes, these amendments amount to a substantial weakening of the post-crisis reforms. These 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.”³⁹ While several stakeholders have urged FSOC to repeal this guidance,⁴⁰ it remains in place.

FSOC Statement on Nonbank Financial Intermediation. On February 4, 2022, FSOC issued a statement discussing evolving financial stability risks posed by nonbank financial intermediation, particularly with respect to hedge funds, open-end funds, and money market funds. The statement identifies various regulatory work streams and recommendations to better identify and mitigate these risks.⁴¹

³¹ *Id.*

³² Federal Reserve, [Financial Stability Report](#), (Nov. 2021).

³³ Washington Post, [Fed raises rates by half a percentage point in fight against inflation](#), (May 4, 2022).

³⁴ CME Group, [Fed Watch Tool](#), (May 2022)

³⁵ Federal Open Market Committee, [Summary of Economic Projections](#), (Dec. 15, 2021).

³⁶ Gregg Gelzinsis, [5 Priorities for the Financial Stability Oversight Council](#), Center for American Progress (Mar. 2021).

³⁷ Treasury, [Budget Documents - Congressional Justification](#) (accessed May. 4, 2022).

³⁸ FSOC, [Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies](#), 84 FR 49, Mar. 13, 2019, p. 9028,

³⁹ See Alan Rappoport, [Former Top Financial Regulators Warn Against Move to Ease Oversight of Firms](#), New York Times, May 13, 2019, and [Letter from Timothy F. Geithner, Jacob J. Lew, Ben S. Bernanke, and Janet L. Yellen](#) to Steven L. Mnuchin and Jerome H. Powell, May 13, 2019.

⁴⁰ See FSC, [Waters Provides Recommendations to President-Elect Biden on Trump Actions to Reverse](#) (Dec. 4, 2020); and Americans for Financial Reform, [Letter to Secretary Yellen on Restoring FSOC’s Ability to Fully Execute its Authority Under Dodd Frank](#) (Jan. 24, 2022).

⁴¹ FSOC, [Financial Stability Oversight Council Statement on Nonbank Financial Intermediation](#) (Feb. 4, 2022).

Appendix - Legislation

- **H.R. 3571, “Climate Change Financial Risk Act of 2021” (Casten).** The bill requires FSOC to establish a committee to assist it in identifying risks and responding to threats to the financial system as a result of climate change. The Fed must develop financial risk analyses relating to climate change for certain large banks and nonbank financial companies, evaluating them every two years on whether they have the capital necessary to absorb financial losses that would arise under several different climate change risk scenarios. The bill also establishes the Climate Risk Scenario Technical Development Group to provide recommendations to the Fed regarding such climate change risk scenarios, and determine the financial and economic risks of these scenarios.⁴²
- **H.R. 5419, “Bank Merger Review Modernization Act of 2021” (C. García).** The bill would ensure bank mergers are in the public interest by clarifying and strengthening the public interest aspect of the merger review and require regulators to use a quantifiable metric to evaluate systemic risk.⁴³
- **H.R. 7022, “Strengthening Cybersecurity for the Financial Sector Act of 2022” (Foster).** The bill would reauthorize and make permanent authority NCUA had between 1998 and 2002 over credit union third-party vendors.⁴⁴ The bill would also provide the Federal Housing Finance Agency with similar authority over third-party vendors of their regulated entities.
- **H.R. ____, “Systemic Risk Mitigation Act” (C. García).** The bill would designate nonbank financial companies above a certain size and riskiness for enhanced regulation and oversight by the Federal Reserve, and provide a de-designation process for these firms. The bill would give FSOC rulemaking authority to address systemically risky activities. It would also enhance transparency of FSOC’s work, and increase their resources, along with OFRs, to better identify and mitigate systemic risks. The bill would establish a Climate Change Subcommittee of FSOC.
- **H.R. ____, “Treasury Market Transparency Act of 2022” (Quigley).** The bill would amend the Securities Exchange Act of 1934 to require real-time public reporting of secondary transactions in government securities.
- **H.R. ____, “Improving Prudential Standards for Nonbank Mortgage Servicers Act”.** The bill would give authority to the Federal Housing Finance Agency (FHFA) to establish minimum federal standards for the net worth, capital, liquidity, and other prudential standards for non-bank mortgage servicers.⁴⁵

⁴² Rep. Casten, [Casten, Schatz Reintroduce Legislation to Ensure U.S. Financial System is Prepared for Climate Change](#) (May 27, 2021).

⁴³ Sen. Warren, [Senator Warren and Rep. Chuy García Introduce the Bank Merger Review Modernization Act to End Rubber Stamping of Bank Merger Applications](#) (Sep. 30, 2021).

⁴⁴ NCUA, [Third-Party Vendor Authority](#) (March 2022).

⁴⁵ See Karan Kaul and Laurie Goodman, [Improving the Safety and Soundness of Nonbank Mortgage Servicers Will Require More Than Prudential Regulation](#), Urban Institute (Dec. 2020).