M E M O R A N D U M

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: June 19, 2014

Subject: June 24, 2014 Full Committee Hearing on "The Annual Report of the Financial Stability Oversight Council"

The Committee on Financial Services will hold a hearing at 10:00 a.m. on Tuesday, June 24 22, 2014 in Room 2128 of the Rayburn House Office Building to receive the "Annual Report of the Financial Stability Oversight Council" and the Secretary of the Treasury's testimony on the report. Treasury Secretary Jacob J. "Jack" Lew will be the only witness.

Background

Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.l. 111-203) established the Financial Stability Oversight Council (FSOC). The FSOC is charged with three statutory mandates: (1) to identify risks to the financial stability of the United States; (2) to promote market discipline by eliminating the expectation of government bailouts; and (3) to respond to emerging threats to the U.S. financial system.[1] The FSOC consists of ten voting members and five nonvoting members.[2] The ten voting members are the heads of nine federal financial regulatory agencies[3] and an independent member with insurance expertise; the five nonvoting members are the directors of the Office of Financial Research (OFR) and the Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner. The FSOC meets at least quarterly, subject to the call of the Chairperson, who is the Secretary of the Treasury, or to the call of a majority of the members then serving.

The Dodd-Frank Act grants the FSOC numerous authorities and tools to carry out its statutory purposes. Section 113 of the Dodd-Frank Act vests the FSOC with the authority to determine whether nonbank financial companies should be subjected to heightened prudential

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[1] Dodd-Frank Act § 112(a)(1), *codified at* 12 U.S.C. 5322(a)(1).
[2] Dodd-Frank Act § 111(b), *codified at* 12 U.S.C. 5321(b).
[3] These agencies are the Department of the Treasury; the Board of Governors of the Federal Reserve System (Fed); the Office of the Comptroller of the Currency (OCC); the Consumer Financial Protection Bureau (CFPB); the Securities and Exchange Commission (SEC); the Federal Deposit Insurance Corporation (FDIC); the Commodity Futures Trading Commission (CFTC); the Federal Housing Finance Agency (FHFA); and the National Credit Union Administration (NCUA).

standards and supervision by the Federal Reserve.[4] Such a designation may be made where two-thirds of the voting members of the FSOC, with the concurrence of the Chairman, determine that a nonbank financial company's "material financial distress"—or the "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities"—could pose a threat to U.S. financial stability.[5] Although the term does not appear in the Dodd-Frank Act, companies designated for Fed supervision by the FSOC are commonly referred to as "systemically important financial institutions," or "SIFIs."

The FSOC may also recommend that certain financial activities or practices undertaken by SIFIs be subjected to heightened prudential standards and safeguards where the activities or practices could create significant credit, liquidity, or contagion risks.[6] If the Federal Reserve determines that a SIFI poses a grave threat to the financial stability of the U.S., the FSOC may, by a two-thirds vote of its voting members, authorize the Fed to restrict the company's ability to engage in mergers or acquisitions, to refrain from conducting certain financial activities, or even to require the company to liquidate its assets.[7] Additionally, the FSOC may designate financial market utilities (FMUs) and payment, clearing, and settlement activities as systemically important, which would subject the FMU to heightened risk management standards, additional examinations and reporting requirements, as well as potential enforcement actions.[8] Finally, the Dodd-Frank Act created the OFR, whose mandate is to collect data on the financial system and provide information and technical expertise to the FSOC.[9] The OFR has broad authority to compel financial institutions and market participants to provide data, and will be permanently funded by assessments on SIFIs.[10]

The FSOC's Annual Reporting and Testimonial Requirements

The Dodd-Frank Act requires the FSOC to submit an annual report to Congress detailing the FSOC's activities; significant financial market and regulatory developments; potential emerging threats to U.S. financial stability; SIFI designations made by the FSOC; recommendations for resolving jurisdictional disputes among the FSOC's member agencies; and recommendations to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets, to promote market discipline, and to maintain investor confidence.[11] In addition, the Dodd-Frank Act requires the Secretary of the Treasury to appear before the Financial Services Committee and the Senate Banking Committee at annual hearings to discuss the FSOC's efforts, activities, objectives, and plans, and to answer questions concerning the annual report.[12]

[4] Dodd-Frank Act § 113, *codified at* 12 U.S.C. 5323. Bank holding companies with assets in excess of $50 billion are automatically subject to the heightened supervision and prudential regulation by the Federal Reserve pursuant to Dodd-Frank Act § 165.
[5] Id.
[6] Dodd-Frank Act § 120, *codified at* 12 U.S.C. 5330.
[7] Dodd-Frank Act § 121, *codified at* 12 U.S.C. 5331.
[8] Dodd-Frank Act § 804, *codified at* 12 U.S.C. 5463.
[9] Dodd-Frank Act §§ 152 and 153, *codified at* 12 U.S.C. 5342 and 5343.
[10] Dodd-Frank Act § 155(d), *codified at* 12 U.S.C. 5345(d).
[11] Dodd-Frank Act §112(a)(2)(N), *codified at* 12 U.S.C. 5322(a)(2)(N).
[12] Dodd-Frank Act §§ 112(c), *codified at* 12 U.S.C. 5322(c). The Financial Services Committee held hearings to consider the first three annual FSOC reports on October 6, 2011, July 25, 2012, and May 22, 2013.

The FSOC's 2014 Annual Report

The FSOC issued its fourth annual report on May 7, 2014.[13] The report's findings and recommendations are organized around what the FSOC identifies as several "key potential emerging threats" to financial stability:

- The vulnerability to runs in wholesale funding markets, including tri-party repo and money market funds, that can lead to destabilizing fire sales;
- Developments in financial products, services, and business practices that may result in previously regulated activity shifting "outside the regulatory perimeter;"
- "Risk-taking incentives of large, complex, interconnected financial institutions" arising out of market expectations that government support will be available in the event such firms becomes financially distressed;
- Systematic false reporting and manipulation of widely used benchmark reference rates, including the London Interbank Offered Rate (LIBOR);
- Financial system vulnerability to interest rate volatility, arising out of the extended period of low interest rates that "has led investors to extend maturities, purchase lower quality credit, and increase leverage in a search for yield;"
- Operational risks – including "outages and failures resulting from technological and infrastructure vulnerabilities" – that can threaten market continuity and confidence;
- The potential for spill-over effects in the U.S. from "financial developments abroad," including increased volatility and a slow-down in economic growth in emerging markets;
- Gaps in the comprehensiveness and availability of financial data needed to monitor emerging risks to the financial system; and
- Remaining challenges in a housing finance system that continues to rely heavily on government and agency guarantees.

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[13] Financial Stability Oversight Council: 2014 Annual Report, *available at* *http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf*