To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: September 19, 2016

Subject: September 22, 2016, 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 Thursday, September 22, 2016 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

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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).

subjected to heightened prudential 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]

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; designations of non-bank financial institutions for heightened prudential supervision by the Federal Reserve; 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.[6] 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.[7]

The FSOC's 2016 Annual Report

On June 21, 2016, the FSOC submitted its sixth 2016 annual report to Congress.[8] The report's findings and recommendations are organized around what the FSOC identifies as "key potential emerging threats and vulnerabilities":

- **Cybersecurity:** The potential of a destructive cyberattack incident that could significantly disrupt the workings of the financial system (pp. 4, 7-9, 113);
- **Asset Management Products and Activities:** Risks associated with asset management liquidity and redemption, leverage, operational functions, securities lending, and resolvability and transition planning (pp. 4, 9-12);
- **Large, Complex, Interconnected Financial Institutions:** Risks to the equity valuations and profitability of bank holding companies from the flat yield curve, rising credit risk, litigation expenses, and other factors (pp. 4, 12-13, 109-110);

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[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 §112(a)(2)(N), *codified at* 12 U.S.C. 5322(a)(2)(N).
[7] Dodd-Frank Act §§ 112(c), *codified at* 12 U.S.C. 5322(c). The Financial Services Committee held hearings to consider the first four annual FSOC reports on October 6, 2011, July 25, 2012, May 22, 2013, and June 24, 2014.
[8] https://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2016-Annual-Report.aspx

- **Central Counterparties:** Heightened concentration of risk at central counterparties (CCPs) that could transmit credit and liquidity problems among financial institutions and markets during periods of market stress (pp. 5, 13, 110-111);
- **Short-Term Wholesale Funding:** Risks from fire sales of collateral deployed in repo transactions (pp. 5, 14, 111-112);
- **Reliance on Reference Rates:** Risks to reference rates such as LIBOR due to decline in volume of unsecured wholesale lending, where with further volume declines it increases the possibility that it will no longer be possible to publish the benchmark rate (pp. 5, 14-15, 112);
- **Data Gaps and Data Sharing:** Critical gaps remain in the scope and quality of available data on financial markets and institutions. In addition, challenges remain among regulators in the sharing of data that may enhance risk identification and monitoring efforts (pp. 5, 15-16, 112-113)
- **Housing Finance Reform:** Core challenges to housing finance reform persist. Legislation addressing the conservatorship of Fannie Mae and Freddie Mac and clarifying the future role of the federal and state governments in mortgage markets would help reduce uncertainty in the mortgage market and better enable market participants to make long-term investment decisions (pp. 6-7, 16-17);
- **Risk Taking in a Low-Yield Environment:** Risk of excessive asset valuations from the current low interest rate environment, leading market participants to take on risk to gain higher yields by increasing risk, shifting towards less liquid assets, or assets that embed greater market or credit risk (pp. 6, 17, 120);
- **Changes in Financial Market Structure:** Vulnerabilities that could arise from the expansion of electronic trading beyond equities and futures markets (pp. 6, 17-18, 121-122);
- **Financial Innovation:** Risks that could arise from the development of new financial products or services (including peer-to-peer lending) and the migration of activities to less-regulated or unregulated sectors (including leveraged lending and mortgage servicing) (pp. 6, 18, 126-127).