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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 Bachus, Ranking Member Frank, and members of the Committee, thank you for the opportunity to testify today regarding the Financial Stability Oversight Council's (the "Council") annual report.

Each year, the Council is required to prepare a public report reviewing financial market and regulatory developments, potential threats to financial stability, and recommendations to strengthen the financial system. My testimony today reviews the conclusions and recommendations made by the Council in its second annual report, which is being submitted in full alongside this testimony.

Measures of Strength in the Financial System

The strategy adopted by the United States to repair and reform the financial system after the crisis has helped produce a stronger and more resilient system.

- We have forced banks to substantially increase the amount of capital they hold, so that they are able to provide credit to the economy and absorb losses in the future. Tier 1 common capital levels at our country's banks are up by $420 billion, or 70 percent, from three years ago. The ratio of tier 1 common equity to risk-weighted assets at these institutions increased from 6 percent to over 11 percent during this period.
- We have forced a significant reduction in overall leverage in the financial system. Financial sector debt has dropped by more than $3 trillion since the crisis, and household debt is down $900 billion.
- Banks are funding themselves more conservatively, relying less on riskier short-term funding.
- The size of the "shadow banking system"—which had been a key source of financial stress during the crisis—has fallen substantially, by several trillion dollars.
- The government has closed most of the emergency programs put in place during the crisis and recovered most of the investments made into the financial system, which were originally expected to result in a loss to taxpayers of several hundred billion dollars. The TARP bank investments have already produced a profit for the taxpayer of over $19.5 billion, and on current estimates will generate an overall profit of approximately $22 billion.

- Credit is expanding, and the cost of credit has fallen significantly from the peaks of the crisis. Commercial and industrial lending at commercial banks increased 10 percent in 2011 and increased at an annual rate of 11 percent in the first five months of 2012.

The overall impact of these changes is very important. They have made the financial system safer, less vulnerable to future economic and financial stress, more likely to help rather than hurt future economic growth, and better able to absorb the impact of failures of individual financial institutions.

Threats to Financial Stability

The Council's report identifies a number of potential threats to the stability of the financial system. Among the most important of these is the fact that the financial system still confronts a challenging and uncertain overall economic environment.

The ongoing European crisis presents the biggest risk to our economy. The economic recession in Europe is hurting economic growth around the world, and the ongoing financial stress is causing a general tightening of financial conditions, exacerbating the global slowdown.

Over the past two years, U.S. financial institutions have significantly reduced their exposure to the most vulnerable economies of Europe, and they hold substantial levels of capital against the remaining exposures. The combined economies of the euro area constitute the second largest economy in the world and are home to many of the world's largest and most interconnected financial institutions. As a result, a severe crisis in Europe would necessarily have very substantial, adverse effects on the United States.

Europe's leaders are putting in place a package of long-term reforms—economic reforms to restore competitiveness, improve fiscal sustainability, and restructure their financial systems, and governance changes to transfer more responsibility to European institutions for oversight of national financial systems and how much nations can borrow. For these reforms to work, they need to be complemented by actions in the near term to restore financial stability and support economic growth, including strengthening the stability of the banking systems and bringing sovereign borrowing rates down in the countries implementing reforms.

Global economic growth has slowed and forecasts for future economic growth have been reduced. Europe is responsible for much of this, but not all of it. Growth in China, India, Brazil and other large emerging economies has slowed for a variety of reasons unique to those countries.

In the United States, the economy is still expanding, but the pace of economic growth has slowed during the last two quarters. In addition to pressures from Europe and the global economic slowdown, U.S. growth has been hurt by the rise in oil prices earlier this year, the ongoing reduction in spending at all levels of government, and slow rates of growth in income.

The slowdown in U.S. growth could be exacerbated by concerns about approaching tax increases and spending cuts, and by uncertainty about the shape of the reforms to tax policy and spending that are necessary to restore fiscal responsibility. As the Council's report discusses, the United States faces fiscal deficits that are unsustainable over the long run. The failure of policy makers to enact reforms in a timely and credible manner will be damaging to future economic growth.

These potential threats underscore the need for continued progress in repairing the remaining damage from the financial crisis and enacting reforms to make the system stronger for the long run.

Progress Implementing Financial Reform

Regulators have made important progress over the past two years designing and implementing the regulations necessary to implement financial reform. Nine out of 10 rules with deadlines before July 2, 2012, have been proposed or finalized. The key elements of the law will largely be in place by the end of the year. The financial system is already in the process of adapting to these reforms.

- We have taken important steps to limit risk-taking at the largest financial institutions. The Federal Reserve and other supervisors have negotiated new, stronger global capital and liquidity requirements. As part of this effort, federal banking regulators will impose even higher requirements on the largest banks.

- We now have the ability to put the largest financial companies under enhanced supervision and prudential standards, whether they are banks or nonbanks, and the ability to subject key market infrastructure firms to heightened risk-management standards.

- We are implementing the provisions of the law designed to protect taxpayers and the financial system from the failure of a large financial firm. Regulators, led by the FDIC, have established the new "orderly liquidation authority," a mechanism to unwind responsibly large, complex financial companies. This authority will help make sure that culpable management is fired and that investors pay for the failure of a firm, not taxpayers. Nine of the largest banks have now submitted "living wills," providing contingency plans for an orderly bankruptcy.

- The SEC and CFTC are putting in place a new framework for derivatives oversight, providing new tools for combatting market abuse and bringing the derivatives markets out of the shadows. Their recent joint adoption of a swaps definition will trigger the effectiveness of more than 20 key rulemakings and marks a major milestone in the implementation of derivatives reforms.

- Regulators are working to strengthen protections for investors and consumers. The CFPB has worked to simplify and improve disclosure of mortgage and credit card loans to help consumers make more informed financial decisions. The CFPB has also launched its supervisory program for very large depository institutions (in coordination with prudential regulators) and for certain nonbanks.

- As we put in place these reforms in the United States, we are working with supervisors and regulators in Europe, Japan, and around the world to provide a more level playing field. In addition to the new global standards for capital and liquidity requirements, we are negotiating global margin requirements for derivatives. On these and a range of other issues, we are trying to improve the prospect of tougher and broadly equivalent global standards and requirements, so that financial risk cannot simply move to where it cannot be seen or effectively constrained.

These are complicated reforms. This process is challenging because our financial system is complex, because we want to target damaging behavior without damaging access to capital and credit, because we want the reforms to endure as the market evolves, and because we need to coordinate the work of multiple agencies in the United States and many others around the world.

Recommendations to Improve Financial Stability

In addition to these important reforms, the Council has put forward recommendations in a variety of other areas to help strengthen our financial system.

<u>Risks in Wholesale Short-Term Funding Markets</u>
The Council recommends a set of reforms to address structural vulnerabilities, particularly in wholesale short-term funding markets such as money market funds (MMFs) and the tri-party repo market. As we saw during the crisis, these sources of funding were particularly vulnerable to disruption that can quickly spread through the markets.

The SEC adopted a number of reforms to money market funds in 2010, but they remain vulnerable to runs. The Council supports SEC Chairman Schapiro's efforts to address certain weaknesses, including (1) the lack of a mechanism to absorb a sudden loss in value of a portfolio security and (2) the incentive for investors to redeem at the first indication of any perceived threat to the value or liquidity of the MMF. The Council recommends that the SEC publish structural reform options for public comment and ultimately adopt reforms that address money market funds' susceptibility to runs. The Council further recommends that, where applicable, its members align regulation of cash management vehicles similar to MMFs within their regulatory jurisdiction to limit the susceptibility of these vehicles to run risk.

In tri-party repo markets, the Council supports additional steps toward reducing intraday credit exposure within the next six to 12 months. In addition, the Council recommends that regulators and industry participants work together to define standards for collateral management in the tri-party repo market, particularly for lenders (such as MMFs) that have certain restrictions on the instruments that they can hold.

Customer Fund Protection

The Council highlights the importance of establishing and enforcing strong standards for protecting customer funds deposited for trading. For example, the Council recommends that regulators consider strengthening regulations governing the holding and protection of customer funds deposited for trading on foreign futures markets. The Council also recommends that regulators seek ways to strengthen risk-management standards for clearinghouses and to develop and monitor best practices across their respective jurisdictions.

Risk Management and Supervisory Attention

The Council recommends continued work to improve risk-management practices, highlighting a number of specific challenges facing firms and their supervisors. The Council supports continued attention to strengthening capital buffers and stress testing. Firms also need to continue to guard against potential disruptions in wholesale short-term funding markets and bolster their resilience to interest rate shifts.

Firms need to continue to strengthen internal disciplines and safeguards in underwriting standards, the development of new financial products, and complex trading strategies. The report also notes that high-speed trading is an area where increased speed and automation of trade execution may require a parallel increase in trading risk management and controls.

Housing Finance Reform

The Council continues to support progress toward comprehensive housing finance reform. The U.S. housing finance system has required extraordinary government support since the financial crisis, and the market continues to lack sufficient private capital. As recognized in the framework for housing finance reform developed by certain member agencies of the Council, the return of private capital is crucial to reestablishing confidence in the integrity of the market and better aligning incentives.

However, in order for private capital to come back into the market, there needs to be greater clarity from regulators and Congress on new rules for all participants in the market. Challenges include the lack of broadly-agreed upon standards for mortgage underwriting (which are necessary to support the valuation and liquidity of mortgage-backed instruments), non-uniform foreclosure practices across different states, and uncertainty surrounding the potential liability of mortgage loan securitizers.

In addition, reform should address servicer compensation models and the need for national mortgage servicing standards, and it should strengthen protections for borrowers. Members of the Council are addressing many of these challenges through existing authority and the implementation of Wall Street Reform, yet comprehensive reform will require significant legislation, and the leadership of this Committee will be central to the effort. As we move forward, we must take care not to undermine the housing market, which is showing signs of recovery but is still weak in many areas.

Improving Transparency and Financial Data

One of the weaknesses in our old system of regulation was a lack of information—information that could be used to help identify threats and more effectively understand the financial system. Gaps in data and analysis remain a threat to financial stability, and an important part of reform efforts will continue to be the improvement and availability of financial data and information.

This project is being spearheaded by the Office of Financial Research (OFR), which was established by Wall Street Reform. The OFR's work is crucial to improving transparency, our understanding of how the financial system supports the economy, and our capacity to identify threats to financial stability. The OFR has done tremendous work over the past year, undertaking a number of initiatives, including steps to create a "legal entity identifier" for financial contracts, which will help us understand exposures in the market. Last week, the OFR released its first annual report, which analyzes threats to financial stability along with ways to address data gaps and promote data standards.

Conclusion

The member agencies of the Council have made considerable progress over the past few years in making our financial system safer and stronger—more resilient and less vulnerable to crisis, with better protections for investors and consumers.

We still have a lot of work ahead of us, however. We need your support to make these rules strong and effective. And we need your support to make sure the enforcement agencies have the resources they need to prevent fraud, manipulation, and abuse.

I want to thank the other members of the Financial Stability Oversight Council, as well as the staff of the members and their agencies, for the work they have done over the past year and their efforts to produce this annual report.

We look forward to working with this Committee, and with Congress as a whole, to build on the substantial progress we have made to create a stronger financial system.