

**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**  
**May 22, 2013**

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify today regarding the Financial Stability Oversight Council's (Council) 2013 annual report.

My testimony today will describe the conclusions and recommendations made by the Council in its third annual report. The report represents extensive collaboration among staff of Council members and member agencies to provide Congress and the public with the Council's assessment of significant financial market and regulatory developments, potential emerging threats to financial stability, and recommendations to strengthen the financial system. The annual report is a key way that the Council can share its collective perspective and provide information on its activities to Congress and the public.

Since the Council's last annual report, our financial system has grown stronger in a number of ways:

- Bank capital has increased significantly in terms of both quality and quantity. This substantial amount of additional capital gives these companies a much stronger ability to withstand a future downturn.
- Companies' liquidity and funding profiles have strengthened dramatically as well. As higher liquidity and funding requirements are implemented in the United States and elsewhere, the financial system will be much less vulnerable to the destabilizing runs that we experienced during the crisis.
- Progress on comprehensive reform of the over-the-counter derivatives market has reduced risks in the system, increased transparency, and strengthened investor protections. Collectively, these measures help make financial institutions and the financial system as a whole safer and stronger. In March, mandatory central clearing of certain swap transactions began. More categories of swaps and an expanded universe of financial institutions will be subject to central clearing requirements as the year progresses, reducing risks to the financial system and to the financial institutions engaging in these transactions.
- We are seeing continued strengthening of the equity, fixed income, and housing markets. And implementation of the Dodd-Frank Act and international coordination on G-20 reform priorities have achieved significant progress toward establishing a more resilient and stable financial system, both domestically and globally.

On the topic of Dodd-Frank implementation, the Council and its member agencies continue to steadily put reforms in place. The Council will soon complete its initial evaluation of nonbank financial companies for potential designation, which would lead to supervision by the Federal Reserve Board (Federal Reserve) and enhanced prudential standards. The Council has already designated eight systemically important financial market utilities for similar increased oversight.

The Federal Reserve issued a new framework for the consolidated supervision of large financial institutions in December. The Federal Deposit Insurance Corporation (FDIC) continued to implement the new framework for the orderly liquidation authority. The Federal Reserve and the FDIC are implementing provisions related to living wills by the end of this year. Further, U.S. regulators are continuing to make significant progress on implementing the Basel III accords to set internationally agreed heightened capital and liquidity standards, which are expected to be fully phased in by 2019.

The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) continue to fill in the remaining pieces of a new comprehensive oversight framework for derivatives that will reduce risk and increase transparency. The Consumer Financial Protection Bureau finalized new mortgage rules that provide additional protections for borrowers. And the Federal Housing Finance Agency (FHFA) has taken steps to facilitate increased participation by the private sector in the mortgage markets, including the recent announcement of an effort to develop a common securitization platform that will facilitate a more efficient and sustainable housing finance infrastructure.

Despite these positive developments, there are still risks to U.S. financial stability. The Council's report identifies those risks and makes specific recommendations to mitigate them. The Council's 2013 report focuses on seven areas in particular:

- First, market participants and regulatory agencies should take steps to reduce vulnerabilities in wholesale funding markets that can lead to destabilizing fire sales.
- Second, significant reform in the housing finance system is still needed.
- Third, government agencies, regulators, and businesses should take action to address operational risks from internal control and technology failures, natural disasters, and cyber-attacks, which can cause major disruptions to the financial system.
- Fourth, as recent developments with the London Interbank Offered Rate (LIBOR) have demonstrated, reforms are needed to address the reliance on voluntary, self-regulated, and self-reported reference interest rates.
- Fifth, financial institutions and market participants should be cognizant of interest rate risk, particularly given the historically low interest rate environment of the past few years.
- Sixth, long-term fiscal imbalances that have potential economic and financial market impacts should be addressed.

- Finally, regulators need to continue to keep a close eye on potential threats to U.S. financial stability from adverse developments in the global economy.

I would now like to go into each of these areas in more depth.

## **Key Areas of Focus of the 2013 Annual Report**

### Wholesale Funding Markets

The Council remains concerned that vulnerabilities in wholesale funding markets could lead to destabilizing fire sales. Specifically, run-risk vulnerabilities related to money market mutual funds (MMFs), which became apparent during the financial crisis, still remain, despite an initial set of reforms implemented in 2010. In November 2012, the Council issued proposed recommendations for public comment to implement structural reforms of MMFs to reduce the likelihood of runs. Council members should also examine whether similar reforms are warranted for other cash management vehicles.

Vulnerabilities to fire sales also remain in the tri-party repo market, particularly with respect to borrowers such as securities broker-dealers. The Council's report recognizes the positive steps that have been taken in the last year to reduce the reliance on discretionary intraday credit, but recommends coordinated efforts by market participants and financial regulatory agencies to address the risks associated with the tri-party repo market, notably by better preparing investors and other market participants to deal with the consequences of the distress or default of a dealer or other large borrower.

### Housing Finance Reform

The housing finance system requires significant reform to enhance financial stability and facilitate the proper functioning of residential lending markets. The residential mortgage market still relies heavily on government support, while private mortgage activity remains muted. The Administration has long called for winding down the GSEs as part of comprehensive housing finance reform and remains focused on bringing back private capital into the market. Although progress was made in 2012, including finalization of some key mortgage rules, the completion of additional reforms is needed to add clarity to the market and attract more private capital. Specifically, the Council recommends that the FHFA continue to pursue changes such as a common securitization platform, model legal agreements, improvements to the mortgage recordation and title transfer system, and an improved compensation system for mortgage servicers.

### Operational Risks

The Council remains concerned about operational risks stemming from certain types of trading activities, natural disasters, and cybersecurity threats. Trading activity is becoming more

dispersed and automated, raising concern among Council members about operational failures. The extremely high speeds at which markets operate can compound the overall impact of even small operational failures. In 2012, equity markets experienced a number of control problems, including those related to the initial public offerings of BATS and Facebook, and losses by Knight Capital. The SEC has moved to strengthen the automated systems of important market participants, and the Council recommends that regulators continue to monitor the adequacy of internal control and corporate governance processes of financial institutions and market utilities.

Additionally, Superstorm Sandy tested the financial infrastructure, including critical financial utilities, demonstrating the need for regulators to assess their policies and guidance in the area of contingency planning. Cybersecurity also continues to be a central concern, with financial institutions subject to frequent and varied cyberattacks. The Council recommends that senior management at financial institutions remain engaged on these issues, improve communication within and between firms, and that government agencies enhance information sharing between the public and private sectors. However, only so much can be done without comprehensive cybersecurity legislation that allows for enhanced information sharing while addressing legitimate privacy and liability concerns. I am hopeful that continued bipartisan engagement will produce legislation that addresses these critical issues.

#### Reference Interest Rates

Over the past year, the Council has actively monitored developments related to LIBOR and other reference interest rates and their potential impact on financial stability. The combination of a weak governance structure and a small number of actual transactions in the unsecured, interbank lending market underpinning LIBOR reduce market integrity and raise financial stability concerns.

Investigations by regulators and law enforcement agencies across the globe concerning manipulations and false reporting of LIBOR and similar rates have exposed the structural vulnerabilities of these benchmarks, which provide significant incentives for misconduct.

The Council recommends that U.S. regulators cooperate with foreign regulators, international bodies, and market participants to promptly identify alternative interest rate benchmarks that are anchored in observable transactions and are supported by appropriate governance structures, and to develop a plan to transition to new benchmarks. The Council recommends that steps be taken to promote a smooth and orderly transition to alternative benchmarks, with consideration given to issues of stability and to mitigation of short-term market disruptions.

#### Interest Rate Risk

Yields and volatility in fixed income markets are very low by historical standards, which may be providing incentives for market participants to “reach for yield” by investing in lower-grade credit, investing in longer-maturity assets, or increasing leverage.

Yield-seeking behavior is apparent in several markets. The issuance of high-yield bonds reached a historical high in the fourth quarter of 2012. While underwriting standards remain conservative in many markets, there are some examples of loosening standards. In particular, certain real estate investment trusts, which are highly exposed to a rise in interest rates, have grown considerably in recent years. The report makes specific recommendations to regulators and risk managers of banks, broker-dealers, insurance companies, and pension funds to be vigilant and scrutinize how potential changes in interest rates could adversely affect their risk profiles.

### Impacts of Fiscal Policy

The strength of our financial system ultimately depends on the strength of our economy. Over the last several years, political fights over fiscal policy in Washington—including the debt ceiling crisis in 2011 and failure to come to bipartisan agreement on a balanced package to replace the sequester as required by the Budget Control Act—have hurt confidence, which is a key driver of economic activity. The sequester that went into effect earlier this year was intended to be a policy so painful and mutually disagreeable that it would ensure bipartisan action to replace it, but instead, the harsh and indiscriminate across-the-board spending cuts were triggered, creating a self-inflicted drag on economic growth and job creation. According to the non-partisan Congressional Budget Office, sequestration will shave off more than half a percent of economic growth in 2013 and cost as many as 750,000 full-time equivalent jobs. To guard against future threats to our economy and financial stability, policymakers should avoid using last-minute resolutions to fiscal policy matters such as the debt ceiling and deficit reduction as a negotiating tactic.

It is important to note that since 2011 the President and Congress have ultimately been able to come together to enact a series of agreements that have resulted in historic reductions to our budget deficits. Taken in combination, these bipartisan reforms—not counting the effect of sequestration—have locked in more than \$2.5 trillion in deficit reduction over the next 10 years, with more than two-thirds of that reduction coming from spending cuts. And today, because of these policies and other factors, the deficit is falling at the fastest rate in decades. Now, while more can and should be done to reduce the risk of long-term fiscal imbalances through sensible measures, shrinking the budget deficit cannot be the only focus of fiscal policy. Job creation and economic growth have to be a top priority.

### Global Economic and Financial Developments

Although external financial threats appear to have decreased over the past year, they remain a risk to U.S. financial stability and economic activity. Global demand has slowed and the euro area economy is on course to contract for the second year in a row. In the advanced economies, there is a need to recalibrate the pace of fiscal consolidation to promote economic growth and employment. Fiscal sustainability remains a concern, but is much easier to achieve in a growing

economy. The lack of demand rebalancing also remains a risk to the U.S. economy. China, for example has avoided an abrupt slowdown, but concerns persist about its ability to transition away from its export and investment-driven growth model toward increased domestic consumption. Nevertheless, Council members and member agencies will continue to monitor global economic and financial developments to respond to any threats that may arise.

In addition to those seven key areas that the Council has focused on, I would now like to spend a little time describing the Council's work over the last year and the progress that has been made on financial reform.

### **Activities of the Council**

Since its 2012 annual report, the Council has continued to fulfill its core mission. The Council met 12 times in 2012 to discuss and analyze emerging market developments, threats to financial stability, and financial regulatory issues. There were public sessions at three of those meetings. Through regular meetings of the Council and its staff committees, the Council plays an important role in facilitating coordination among federal and state financial regulators.

The Council is working to evaluate nonbank financial companies for potential designation for supervision by the Federal Reserve and enhanced prudential standards. The Council publicly announced that, in September and October 2012, it advanced an initial set of nonbank financial companies to the third and final stage of the evaluation process. The Council discussed its ongoing analysis at its most recent meeting on April 25, and it expects to vote on proposed designations of an initial set of nonbank financial companies in the near term.

The Council is also authorized to issue recommendations to a regulatory agency when financial activities and practices are creating risk for U.S. financial markets. In November 2012, the Council issued for public comment proposed recommendations to the SEC with three alternatives for reform to address the structural vulnerabilities of MMFs. The Council is currently considering the public comments on the proposed recommendations. If the SEC moves forward with meaningful structural reforms of MMFs before the Council completes its process, the Council expects that it would not issue a final recommendation to the SEC. However, if the SEC does not pursue additional reforms that are necessary to address MMFs' structural vulnerabilities, the Council should use its authorities to take action in this area.

Finally, the Council has authority to designate systemically important financial market utilities for enhanced risk-management standards. The Council designated eight systemically important FMUs last summer, and those entities are now subject to increased oversight by the SEC, CFTC, and Federal Reserve.

## Progress on Financial Regulatory Reform

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

Since the Council's 2012 annual report, Dodd-Frank Act implementation included further strengthening of supervision, capital, and risk-management standards for financial institutions and financial market utilities; procedures for stress tests of financial institutions; rulemakings related to the orderly liquidation authority; regulation of the derivatives markets to reduce risk and increase transparency; new standards to protect mortgage borrowers and reduce risks in the mortgage market; and other measures to enhance consumer and investor protection.

Nevertheless, important work remains to complete the implementation of financial reform. The Council, its members, and its member agencies will continue to strengthen coordination of financial regulation both domestically and internationally. In developing and implementing the international financial regulatory reform agenda, the Council members support the development of policies that promote a level playing field, mitigate regulatory arbitrage, and address regulatory gaps primarily through members' engagement with the G-20 and the Financial Stability Board (FSB). In particular, the Council is focused on:

- *Strengthening the regulation of large, complex financial institutions.* The Council supports global efforts led by the FSB, to impose consistent standards on large, complex financial institutions across jurisdictions.
- *Developing an international framework to resolve global financial institutions.* Effective cross-border cooperation will be essential to implementing the FDIC's orderly liquidation authority under Title II of the Dodd-Frank Act. The United States has substantially satisfied the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*, and continues to work with international counterparts to ensure robust resolution coordination.
- *Increasing the transparency and regulation of over-the-counter (OTC) derivatives.* The Council encourages continued development of these reforms, as they are essential to increase transparency and to mitigate risk, including cross border spillovers, that could arise from the OTC derivatives market. The FSB has been critical to facilitating international coordination on this issue.
- *Data resources and analytics.* The Council continues to recommend that improvement in data standards should be a high priority for financial firms as part of their risk

management process and for the regulatory community—not just in the United States, but globally. The Council recommends that the Office of Financial Research continue to work with the Council’s member agencies to promote data standards for identification of legal entities, financial products, and transactions, and to improve access to standardized, aggregate data by the regulators. The Council also recommends that cross-border exchange of supervisory data among supervisors, regulators, and financial stability authorities continues to be facilitated in a manner that safeguards the confidentiality and privacy of such information.

## **Conclusion**

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. The Council will continue to focus on the risk areas I have discussed today, while remaining vigilant to new risks, to promote financial stability and strengthen the U.S. financial system.

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 in preparing the 2013 annual report.

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.