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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
September 22, 2016

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify today regarding the 2016 annual report of the Financial Stability Oversight Council.[1]

Congress created the Council under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to bring together the entire financial regulatory community for the first time to identify and respond to emerging threats to U.S. financial stability. The Council convenes regularly to monitor market developments and to take action when needed to protect the American people from potential risks to the financial system. Our approach has been data-driven and deliberative, and we consistently provide the public with considerable information regarding the Council's actions and views.

The Council recently released its sixth annual report. The annual report represents the Council's consensus on key risk areas and recommendations to address those concerns. Each voting member of the Council signed a statement supporting the report's recommendations. This year's report highlighted many of the topics the Council has discussed over the last year, including cybersecurity, risks associated with asset management products and activities, reforms to wholesale funding markets, and global economic and financial developments. Those discussions

[1] The Council's 2016 annual report is publicly available at https://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2016-Annual-Report.aspx.

laid the groundwork for many of the recommendations in the annual report, and these issues will continue to be areas of focus in the coming year.

The Council's annual report is an important vehicle to highlight publicly potential threats to financial stability, and it serves as a key mechanism for public accountability and transparency regarding the Council's work. Each report is the product of extensive collaboration and analysis conducted by the Council and its member agencies that documents the Council's views of current risks and emerging threats to financial stability, along with recommendations for specific actions to mitigate those risks. The findings and recommendations set down a marker for action, providing transparency regarding the Council's upcoming priorities and a roadmap for the year ahead. Importantly, the statement in the annual report that is signed by each of the Council's voting members affirms that all of the issues and recommendations in the report should be fully addressed.

Areas of Focus of the Council's 2016 Annual Report

The Council's 2016 annual report focuses on 12 themes that warrant continued attention and, in many cases, further action from the Council members and member agencies.

- *Cybersecurity*: Government agencies and the private sector should continue to work to improve and enhance information sharing, baseline protections such as security controls and network monitoring, and response and recovery planning.

- *Risks Associated with Asset Management Products and Activities*: The asset management industry's increasing significance to financial markets and to the broader economy underscores the Council's ongoing consideration of potential risks to U.S. financial stability from products and activities in this sector, including further analysis of the activities of hedge funds.

- *Capital, Liquidity, and Resolution*: Regulators should continue working to ensure that there is enough capital and liquidity at financial institutions to reduce systemic risk, including finalizing rules setting standards for the minimum levels of total loss-absorbing capacity and long-term debt maintained by certain large banking organizations operating in the United States.

- *Central Counterparties (CCPs)*: Council member agencies should continue to evaluate whether existing rules and standards for CCPs and their clearing members are sufficiently robust to mitigate potential threats to financial stability, and also should continue working with international standard-setting bodies to implement more granular guidance with respect to international risk management standards in order to enhance the safety and soundness of CCPs.

- *Reforms of Wholesale Funding Markets*: Counterparty risk exposure has been significantly reduced in the tri-party repurchase agreement (repo) market, though the potential for fire sales of collateral by creditors of a defaulted broker-dealer remains an important risk. Better data are needed to assist the understanding policymakers have of how the aggregate repo market operates. Furthermore, regulators should continue to monitor and evaluate the effectiveness of structural reforms of money market mutual funds.

- *Reforms Relating to Reference Rates*: Regulators and market participants should continue their efforts to develop alternative benchmark interest rates and implementation plans to achieve a smooth transition to these new rates.

- *Data Quality, Collection, and Sharing*: While Council members have made progress in filling gaps in the scope, quality, and accessibility of data available to regulators, regulators and market participants should continue to work together to improve the scope, quality, and accessibility of financial data.

- *Housing Finance Reform*: While regulators and supervisors have taken great strides to work within the constraints of conservatorship to promote greater investment of private capital and improve operational efficiencies with lower costs, federal and state regulators are approaching the limits of their ability to enact wholesale reforms that are likely to foster a vibrant, resilient housing finance system. Housing finance reform legislation is needed to create a more sustainable system that enhances financial stability.

- *Risk Management in an Environment of Low Interest Rates and Rising Asset Price Volatility*: Depressed energy and metals commodities prices, large swings in equity valuations, and upward movement in high-yield debt spreads underscore the need for supervisors, regulators, and managers to remain vigilant in ensuring that firms and funds maintain robust risk management standards.

- *Changes in Financial Market Structure and Implications for Financial Stability*: The growing importance in certain markets of proprietary trading firms and automated trading systems may introduce new vulnerabilities, including operational risks associated with the very high speed and volume of trading activity. Increased coordination among regulators is needed to evaluate and address these risks.

- *Financial Innovation and Migration of Activities*: Financial regulators will need to continue to work hard to monitor new and rapidly growing financial products and business practices, even if those products and practices are relatively nascent and may not constitute a current risk to financial stability.

- *Global Economic and Financial Developments*: Market participants and regulators should be vigilant in identifying and responding to potential foreign shocks that could disrupt financial stability in the United States.

The annual report goes into detail on each of these important issues. These 12 areas of focus also demonstrate the need for the Council and its member agencies to persistently monitor these risks and to foster discussion and analysis around them.

As the forum designed to bring the financial regulatory community together to collaboratively identify and respond to potential threats to financial stability, the Council has done what Congress established it to do, including asking the tough questions that help us make our financial system safer. Our mandate is to shine a light on emerging threats before they can evolve into another financial crisis.

As part of this responsibility, the Council has worked closely with a broad array of stakeholders, and has adapted its policies and procedures in response to good ideas stakeholders have raised. We have improved our transparency policy, strengthened our internal governance, provided the public with additional information on the nonbank financial company designations process, and solicited public comment on potential risks to financial stability from asset management products and activities.

The Council remains a critical forum for identifying potential threats as the financial industry and regulatory environment continue to evolve. An example of this work is our ongoing evaluation of potential risks to financial stability from asset management products and activities. As these products and activities represent an increasingly important part of the financial sector, it is incumbent on the Council to evaluate any potential financial stability implications they present. To that end, in April of this year, we published a number of findings regarding potential liquidity and redemption risks and leverage risks, based on careful analysis that included engagement with key stakeholders. Our work in this area is ongoing, and we plan to provide timely public updates as our analysis continues. Separately, in the months ahead, the Council will monitor market responses to the implementation of the Securities and Exchange

Commission's money market mutual fund reforms that go into effect next month. Risks to financial stability arising from the money market mutual fund industry were an important area of focus for the Council in the aftermath of the financial crisis.

Finally, the Council will continue to monitor for potential threats posed by nonbank financial companies. The Council's nonbank financial company designations authority has been a critical tool to address a key weakness exposed by the financial crisis: that the failure of large, complex, and interconnected financial companies could threaten financial stability. The Council's process for considering nonbank financial companies for potential designation includes extensive engagement with companies and their primary regulators, and the reasons for designations are explained to the companies and to the public. The Council also annually reevaluates each of its previous nonbank financial company designations every year, and we take these reviews seriously. This June, the Council voted to rescind its designation of GE Capital because the company had implemented strategic changes that significantly reduced the potential for the company's material financial distress to threaten U.S. financial stability. The Council's action shows that the designation process works as intended— if a company changes in a way that addresses the risks it could pose to financial stability, there is a clear process for the Council to rescind a designation.

As we recently marked the eight-year anniversary of the collapse of Lehman Brothers, it has become clear that the reforms adopted in the Dodd-Frank Act, including the creation of the Council, have made the financial system safer, more resilient, and supportive of long-term economic growth. We should not forget how damaging weak oversight of the financial system can be to our country and our economy. The Council has proven itself as an important forum for the financial regulatory community to come together, identify risks, and work collaboratively to respond to emerging threats to financial stability. It would be a mistake to roll back the clock on these protections or to constrain the ability of the Council or its member agencies to address new risks as they arise, including the Council's nonbank financial company designations authority.

I look forward to questions Members of the Committee may have on the Council's annual report.