

United States House of Representatives  
Committee on Financial Services  
2129 Rayburn House Office Building  
Washington, D.C. 20515

December 2, 2019

## Memorandum

**To:** Members, Committee on Financial Services

**From:** FSC Majority Staff

**Subject:** December 5, 2019, “Promoting Financial Stability? Reviewing the Administration’s Deregulatory Approach to Financial Stability”

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The Committee on Financial Services will hold a hearing entitled, “Promoting Financial Stability? Reviewing the Administration’s Deregulatory Approach to Financial Stability,” at 10:00 a.m. on Thursday, December 5, 2019, in room 2128 of the Rayburn House Office Building. This will be a single-panel hearing with the following witness:

- **The Honorable Steven Mnuchin**, Secretary, U.S. Department of the Treasury, and Chairperson, Financial Stability Oversight Council (FSOC)

### Overview

Pursuant to Section 112(a)(2)(N) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), Congress mandates the Financial Stability Oversight Council (FSOC) to submit an annual report to Congress on various issues, including its activities; significant financial market and regulatory developments; and potential emerging threats to the financial stability of the United States. Pursuant to Section 112(c) of Dodd-Frank, the Chairperson of the FSOC is required to testify before the Committee to discuss FSOC’s annual report.<sup>1</sup>

### Background

The Dodd–Frank Act established FSOC to, among other things, “identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace.”<sup>2</sup> The FSOC is composed of ten voting members – including the Secretary of the Treasury who serves as FSOC’s Chairperson – and five nonvoting members.<sup>3</sup> The Office of Financial Research (OFR) was established to conduct independent research and support FSOC’s work.<sup>4</sup>

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<sup>1</sup> Secretary Mnuchin last testified on FSOC’s annual report on February 6, 2018. *See* Financial Services Committee hearing entitled, “The Annual Report of the Financial Stability Oversight Council,” (Feb. 6, 2018), <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=401147>.

<sup>2</sup> 12 U.S.C. § 5322.

<sup>3</sup> Voting members include the chair of the FSOC (Treasury Secretary), heads of the banking agencies (Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and the National Credit Union Administration), Securities and Exchange Commission, Commodity Futures Trading Commission, Federal Housing Finance Agency, CFPB, and an independent insurance expert appointed by the President. Nonvoting members include the directors of the OFR and Federal Insurance Office, and state regulatory representatives, one each for insurance, banking, and securities. *See* CRS, “[Financial Stability Oversight Council \(FSOC\): Structure and Activities](#),” (Feb. 12, 2018); and CRS, “[Introduction to Financial Services: Systemic Risk](#),” (Jan. 8, 2019).

<sup>4</sup> 12 U.S.C. § 5344.

While FSOC is empowered to designate nonbank financial companies for enhanced oversight by the Federal Reserve or designate financial market utilities (FMUs) as systemically important,<sup>5</sup> FSOC can generally only recommend—but not compel—member agencies to undertake regulatory changes.

Following the 2007-2009 financial crisis, Congress created the FSOC and OFR to address an observed failure of the regulatory structure to consider the interconnectedness of the system, to coordinate among agencies on financial crisis planning, and to quantify and map systemwide risks. However, under the Trump Administration, FSOC and its member agencies have been criticized for being more focused on implementing financial deregulatory proposals than on mitigating systemic risks.<sup>6</sup> A summary of FSOC’s 2018 annual report and recent activities are described below.

### **Potential Threats to Financial Stability**

According to FSOC’s 2018 Annual Report, “Overall, risks to U.S. financial stability remain moderate, though they have evolved since the last annual report.... At the same time, financial stability risks outside the U.S. appear to have increased.”<sup>7</sup> The report identified six “potential emerging threats and vulnerabilities” to financial stability:

- **Cybersecurity**—the vulnerability of financial markets or institutions to cyberattacks;
- **Ongoing structural vulnerabilities**—the systemic importance of central counterparties and large, complex, interconnected financial institutions, LIBOR transition,<sup>8</sup> concentration risk in tri-party repo and risk opacity in bilateral repo, run risk in money market funds and cash management vehicles, financial innovation, and data gaps;
- **Developments related to prolonged credit expansion**—the potential reversal of elevated debt levels and asset values;
- **Changes in financial market structure**—reduced asset market liquidity provided by market makers, potential for high frequency trading to cause equity market volatility episodes, and risks associated with evolving Treasury market structure;
- **Vulnerabilities related to asset management**—liquidity and redemption risk, use of derivatives; and
- **Global developments**—Brexit, longer-term structural vulnerabilities in the euro area, Chinese economic slowdown, and emerging markets with large current account deficits, such as Argentina and Turkey.

**Leveraged Lending.** One potential threat to financial stability relates to leveraged lending.<sup>9</sup> Leveraged loans are loans made to businesses that are highly indebted by some measure, such as having a high ratio of debt to earnings or have a below investment grade credit rating. Most leveraged loans are syndicated, meaning that a group of bank or nonbank lenders, such as private equity funds, collectively fund a single borrower, in contrast to a traditional loan held by a single bank. Investors wishing to hold leveraged loans can do so either by investing directly in individual leveraged loans or investing in collateralized loan obligations (CLOs), which are securities backed by cash flows from pools of leveraged loans.

<sup>5</sup> <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>.

<sup>6</sup> For example, see Gregg Gelzimis, “[Strengthening the Regulation and Oversight of Shadow Banks](#),” Center for American Progress (Jul. 18, 2019), and Mayra Rodriguez Valladares, “[Mnuchin Should Require More Transparency About Leveraged Lending and CLO Markets](#),” Forbes (May 2, 2019).

<sup>7</sup> FSOC, *Annual Report*, 2018, p. 3, <https://home.treasury.gov/system/files/261/FSOC2018AnnualReport.pdf>.

<sup>8</sup> For more information, see CRS, “[The LIBOR Transition](#),” Sep. 20, 2019.

<sup>9</sup> See Consumer Protection and Financial Institutions Subcommittee hearing, “[Emerging Threats to Stability: Considering the Systemic Risk of Leveraged Lending](#),” June 4, 2019.

During the past decade, the U.S. leveraged loan market experienced rapid growth. While there is no official definition or single data source for leveraged loans, according to Fed Chair Jerome Powell, in 2018 “leveraged loans outstanding rose 20% and now stand at more than \$1 trillion.”<sup>10</sup> According to a number of industry observers, leveraged loans have also experienced deteriorating credit quality and decreased investor safeguards.<sup>11</sup> To date, default rates have remained low. Another notable trend in this sector is that, the share of leveraged loans originated by and held by banks has declined while the roles of nonbank participants, such as private investment funds and finance companies, have increased.<sup>12</sup> Although FSOC has discussed leveraged lending at recent meetings, leveraged lending appears only in the “Financial Developments” chapter of the 2018 Annual Report; it does not specifically appear in the “Recommendations” section or the “Potential Emerging Threats” section.<sup>13</sup>

**Repo Markets** . Another area of potential financial stability risk relates to the repo markets. Repurchase agreements (repos) involve the sale and repurchase of a security at a predetermined price and date and are economically equivalent to a short-term collateralized loan. Financial firms rely on repos as a source of short-term liquidity or access to securities. Firms are limited in how much they can borrow in repo markets by their available collateral and the amount that lenders are willing to lend against that collateral (the “haircut”). While many types of financial firms participate in repo markets, transactions typically involve securities dealers as borrowers or lenders. Repos can be bilateral (firm-to-firm) or triparty (cleared and settled through a clearing bank that is not a party to the transaction).<sup>14</sup> After JPMorgan Chase’s exit from the market at the end of 2016, Bank of New York Mellon is the only clearing bank for triparty repo.<sup>15</sup>

In the 2007-2009 financial crisis, a sudden increase in haircuts and rising fears of counterparty risk sharply reduced the amount of liquidity available to firms in repo markets, thereby worsening the crisis.<sup>16</sup> Markedly, in each of its annual report, FSOC has recommended changes to the oversight of the repo market as well as industry market practices. Over the years, several of FSOC’s recommendations and those of the Tri-Party Repo Infrastructure Task Force<sup>17</sup> have been adopted. Clearing banks reformed the tri-party settlement process to reduce the use of intraday credit and required pre-commitment to access it.

According to FSOC, the share of triparty repos relying on intraday credit from clearing banks fell from 92% in December 2012 to under 5% in December 2014.<sup>18</sup> In 2014, the OFR began a pilot project to collect

<sup>10</sup> Jerome Powell, “Business Debt and Our Dynamic Financial System,” speech, May 20, 2019, <https://www.federalreserve.gov/newsevents/speech/powell20190520a.htm>.

<sup>11</sup> In addition, some observers have noted certain similarities between leveraged lending and CLO market characteristics and those seen in certain mortgage lending and mortgage-backed securities (MBS) markets in the lead up to the 2007-2009 financial crisis. Also see Edison Yu, *Measuring Cov-Lite Right*, Federal Reserve Bank of Philadelphia, Banking Trends, Third Quarter 2018.

<sup>12</sup> IMF, *Global Financial Stability Report*, April 2019; Ayelen Banegas and Jessica Goldenring, “Leveraged Bank Loan versus High Yield Bond Mutual Funds,” Finance and Economics Discussion Series, No. 2019-047, Washington: Board of Governors of the Federal Reserve System, <https://www.federalreserve.gov/econres/feds/files/2019047pap.pdf>.

<sup>13</sup> More broadly, the “Recommendations” section recommends that “agencies continue to monitor levels of nonfinancial business leverage...”—in other words, overall business indebtedness. The “Threats” section notes that “...nonfinancial business leverage is at the upper end of historical ranges, increasing the risk of default.” (page 11, 2018 report) It notes that “Any impact [of leverage] on financial stability will depend on the extent and severity of business defaults, whether there are spillovers to other markets, and the ability of investors and intermediaries to manage the fallout. (page 112, 2018 report).

Also note leveraged lending was mentioned in the “Potential Emerging Threats” section of FSOC’s 2016 report.

<sup>14</sup> Viktoria Baklanova et al., *Reference Guide to U.S. Repo and Securities Lending Markets*, Federal Reserve Bank of New York, Staff Report No. 740, December 2015, [https://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr740.pdf](https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr740.pdf).

<sup>15</sup> “JPMorgan to stop settling government securities for dealers,” *Reuters*, July 22, 2016, <https://www.reuters.com/article/us-jpmorgan-settlement/jpmorgan-to-stop-settling-government-securities-for-dealers-idUSKCN1021VK>.

<sup>16</sup> Gary Gorton, “Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007,” working paper presented at Federal Reserve Bank of Atlanta, May 2009, <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.189.1320&rep=rep1&type=pdf>.

<sup>17</sup> The task force is a private sector task force to reform repo markets created in 2009 and sponsored by the New York Fed. Their website is <https://www.newyorkfed.org/tripartyrepo/index.html>.

<sup>18</sup> FSOC, *Annual Report*, 2015, p. 15, <https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/2015%20FSOC%20Annual%20Report.pdf>.

data on bilateral repos, and in February 2019 issued a final rule for data collection of centrally cleared repos.<sup>19</sup> FSOC’s 2018 Annual Report called for monitoring of repo markets and an assessment of the risks associated with the shift of all triparty repo settlement to one firm.

Furthermore, in September, the Federal Reserve began intervening in the repo market in response to a sudden and brief spike in repo rates. This was the first time it has lent in repo markets since the financial crisis. The Fed’s actions have stabilized the repo market, but questions have been raised about how monetary policy or other factors may have impacted the functioning of the market.<sup>20</sup>

***Climate Change.*** FSOC has not focused on climate change as a systemic risk. However, a variety of stakeholders and international bodies – including the IMF, Bank of England, and other European central banks – have raised concerns with the escalating problems arising from climate change, and the need to deploy financial and monetary policy tools to mitigate risks that are affecting the financial system.<sup>21</sup>

### **Recent FSOC Actions**

***Summary of 2019 FSOC Meetings.*** The Dodd-Frank Act requires FSOC to meet at the request of the Treasury Secretary “not less frequently than quarterly.” FSOC has met four times in 2019 to date—the fewest meetings it has held in a full year since inception. According to readouts and meeting minutes, FSOC has discussed several issues, including: cloud computing, accounting standards, nonbank mortgage origination and servicing, the LIBOR transition, Brexit, leveraged lending, and equity market structure.<sup>22</sup>

***Decline in FSOC and OFR Funding and Staffing.*** Treasury’s budget for FSOC staff and operational expenses (including for FSOC’s independent insurance expert) are proposed by the Treasury Secretary and approved by a simple majority of FSOC voting members. It is funded out of OFR’s budget. FSOC’s budget was reduced from a proposed FY2017 budget of \$8.5 million and 36 FTEs to a proposed FY2020 budget of \$6.1 million and 18 FTEs.<sup>23</sup> After reducing staff the last few years, FSOC currently employs 14 FTEs with plans to hire staff early in FY2020 to increase the number to 18 FTEs.<sup>24</sup> In addition, the OFR budget is financed through fees on large BHCs and designated SIFIs. After several years of growth, the OFR budget was reduced from a proposed budget in FY2017 of \$104 million and 255 FTEs to a FY2020 budget of \$75.2 million and 145 FTEs. OFR currently has about 100 FTEs and is in the process of hiring additional staff after a large staff reduction the last few years.<sup>25</sup>

***September 2018 Decision on Zions Bank.*** Under Section 117 of Dodd-Frank, if a bank holding company (BHC) subject to the Federal Reserve’s enhanced prudential standards participated in the Troubled Asset Relief Program (TARP) ceases to be a BHC, then it would automatically be considered a nonbank SIFI subject to enhanced oversight. This provision was intended to prevent a change in corporate structure for the purpose of avoiding enhanced oversight. Under Section 117, a company may appeal its SIFI status, which FSOC can overturn by a two-thirds vote including the Treasury Secretary. In April 2018, as it was in the process of eliminating its BHC, Zions Bank appealed its status as a nonbank SIFI upon completion

<sup>19</sup> For more information, see OFR, *Bilateral Repo Data Collection Pilot Project*, <https://www.financialresearch.gov/data/repo-data/>; OFR, *Centrally Cleared Repo Data Collection*, <https://www.financialresearch.gov/data/cleared-repo-data/>.

<sup>20</sup> CRS, “[Federal Reserve: Recent Repo Market Intervention](#),” Oct. 9, 2019.

<sup>21</sup> <https://blogs.imf.org/2019/09/04/a-role-for-financial-and-monetary-policies-in-climate-change-mitigation/>.

<sup>22</sup> FSOC Meetings, Meeting Minutes and Readouts, <https://www.treasury.gov/initiatives/fsoc/council-meetings/Pages/default.aspx>.

<sup>23</sup> FSOC, *Congressional Budget Justification FY2017*, p 3; and FSOC, *Congressional Budget Justification FY2020*, p. 3. In addition to staff of the FSOC secretariat, member agencies assign employees to work on FSOC tasks. See [Treasury](#) and [FSOC](#) budget documents for more details.

<sup>24</sup> See FSOC’s FY2020 [budget](#)

<sup>25</sup> [Testimony](#) of The Honorable Dino Falaschetti, Director, Office of Financial Research, U.S. Department of the Treasury, before the Subcommittee on Consumer Protection and Financial Institutions, Sep. 25, 2019. See also OFR, *Congressional Budget Justification FY2020*; OFR, *Annual Report, 2018*, pp. 54-55; and Pete Schroder, “[Trump Administration Cuts Staff at Financial Watchdog: Source](#),” *Reuters*, August 8, 2018.

of its conversion under Section 117. In September 2018, FSOC unanimously granted its appeal.<sup>26</sup> This was the first and only case of an appeal under Section 117.

***October 2018 De-Designation of Prudential.*** FSOC unanimously de-designated Prudential, the largest U.S. insurer, on October 17, 2018. GE Capital, AIG, and MetLife had reduced their size and scope of activities prior to de-designation. By contrast, Prudential had not undertaken any large-scale restructuring since SIFI designation—instead, it had grown larger. At the end of 2017 (the date used in the de-designation decision), Prudential had over \$800 billion in assets, comparable to Goldman Sachs or Morgan Stanley. In its decision, FSOC found that Prudential had not significantly decreased its total market exposure, investment portfolio, market share, or resolvability. However, FSOC noted that Prudential had reduced its leverage and counterparty exposures to the largest banks, and that state regulators had implemented sufficient changes related to its oversight. There are currently no nonbank financial companies that are designated by FSOC for enhanced oversight.<sup>27</sup>

***Proposed Guidance on Designations Process.*** In March 2019, FSOC sought public comment on proposed changes to its guidance on nonbank designations by unanimous vote.<sup>28</sup> The guidance would require FSOC to pursue a SIFI designation “only if a potential risk or threat cannot be addressed through an activities-based approach;” require a cost-benefit analysis of the designation, making a designation “only if the expected benefits justify the expected costs that the [designation] would impose;” assess the likelihood that a firm would become distressed; reduce the designation process from three to two stages; eliminate the six-category designation framework; and create “off-ramps” before and after designation where SIFIs can address risks identified by FSOC to end designation. The proposal has garnered strong concerns. In a recent letter to Treasury Secretary Mnuchin and Fed Chair Powell from former Fed Chairs Bernanke and Yellen, along with former Treasury Secretaries Geithner and Lew, the group warned, “Though framed as procedural changes, these amendments amount to a substantial weakening of the post-crisis reforms. These changes would make it impossible to prevent the build-up of risk in financial institutions whose failure would threaten the stability of the system as a whole.”<sup>29</sup>

### **Legislative Proposal**

- **H.R. 5194, Climate Change Financial Risk Act of 2019 (Casten).** The bill would require the FSOC to establish a subcommittee to help the Council identify and respond to emerging threats to financial stability as a result of climate change. The FSOC subcommittee would be required to annually assess risks posed by climate change to the efficiency, competitiveness, and stability of the U.S. financial system as a whole. The bill would also require the Federal Reserve to establish an advisory group of climate scientists and climate economists to help develop climate change scenarios for financial stress tests. The Fed, with the input of the advisory group, would create three stress test scenarios, and conduct stress tests every two years on the same large financial institutions that are currently subject to Comprehensive Capital Analysis and Review (CCAR) stress tests—i.e., firms with more than \$250 billion in total consolidated assets.<sup>30</sup>

<sup>26</sup> FSOC, *Final Decision of the Financial Stability Oversight Council Regarding the Appeal by ZB*, Sep. 12, 2018.

<sup>27</sup> <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>. FSOC previously rescinded the designation of AIG in September 2017 and GE Capital in June 2016. In January 2018, the Trump Administration [dropped](#) an appeal of a court ruling that reversed MetLife’s designation.

<sup>28</sup> FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 84 FR 49, Mar. 13, 2019, p. 9028.

<sup>29</sup> See Alan Rappeport, “[Former Top Financial Regulators Warn Against Move to Ease Oversight of Firms](#),” New York Times, May 13, 2019, and [Letter from Timothy F. Geithner, Jacob J. Lew, Ben S. Bernanke, and Janet L. Yellen](#) to Steven L. Mnuchin and Jerome H. Powell, May 13, 2019.

<sup>30</sup> <https://casten.house.gov/media/press-releases/casten-schatz-introduce-legislation-ensure-us-financial-system-prepared-climate>.