

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

September 20, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: September 25, 2019, “Promoting Financial Stability: Assessing Threats to the U.S. Financial System”

The Subcommittee on Consumer Protection and Financial Institutions will hold a hearing entitled, “Promoting Financial Stability: Assessing Threats to the U.S. Financial System,” on Wednesday, September 25, 2019, at 10:00 a.m., in room 2128 of the Rayburn House Office Building. This single-panel hearing will have the following witnesses:

- **The Honorable Dino Falaschetti**, Director, Office of Financial Research, U.S. Department of the Treasury
- **The Honorable Lael Brainard**, Governor, Board of Governors of the Federal Reserve System

Overview

The Dodd–Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act established the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR) to improve close regulatory gaps exposed by the 2007-2009 financial crisis and strengthen efforts to identify and mitigate threats to financial stability. OFR was established to support FSOC’s work and to, in part, “develop and maintain metrics and reporting systems for risks to the financial stability of the United States [and] to monitor, investigate, and report on changes in systemwide risk levels and patterns to the Council and Congress.”¹ Section 153 of the Dodd-Frank Act calls on the OFR Director to “report to and testify before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives annually on the activities of the Office, including the work of the Data Center and the Research and Analysis Center, and the assessment of the Office of significant financial market developments and potential emerging threats to the financial stability of the United States.” The OFR’s last annual report was published in November 2018.²

The Federal Reserve System has five primary functions, including: “conduct[ing] the nation’s monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy; promot[ing] the stability of the financial system and seek[ing] to minimize and contain systemic risks through active monitoring and engagement in the U.S. and abroad; promot[ing] the safety and soundness of individual financial institutions and monitor[ing] their impact on the financial

¹ 12 U.S.C. § 5344.

² OFR Annual Report to Congress 2018 (“OFR report”), (November 2018) available at <https://www.financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2018.pdf>

system as a whole.”³ On November 9, 2018, the Board of Governors of the Federal Reserve System (Federal Reserve) announced their intention to publish semiannual reports presenting the agency’s assessment of financial stability conditions. There is currently no statutory requirement that the Federal Reserve publish such a report. In their announcement, the Federal Reserve stated that these reports will “include a summary of the Board’s framework for assessing the resilience of the U.S. financial system and a discussion of key indicators related to the main financial stability vulnerabilities tracked by the Board: asset valuations, borrowing by businesses and households, leverage in the financial sector, and funding risks. The report is intended to help the public and market participants understand and evaluate the Board’s assessment of financial stability conditions.”⁴ The Federal Reserve’s last report was published in May 2019.⁵

The Federal Reserve Chair and OFR Director both serve on FSOC. Specifically, FSOC consists of 15 members, including the heads of nine member agencies – the U.S. Department of the Treasury, Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Consumer Financial Protection Bureau (CFPB), National Credit Union Administration (NCUA), Federal Housing Finance Agency (FHFA), Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). These members, along with an insurance expert appointed by the President, serve as the ten voting members of FSOC. The remaining five members, comprising of federal and state officials serve as nonvoting members, including the OFR Director. The Treasury Secretary chairs FSOC. Part of FSOC’s responsibilities are to, “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.”⁶ FSOC is required to publish an annual report that, among other things, describes emerging threats to U.S. financial stability and requires recommendations to enhance financial stability. FSOC’s most recent report was published in December 2018.⁷

The hearing will provide the Committee with an opportunity to review OFR’s and the Federal Reserve’s most recent financial stability reports, summarized below, as well as consider legislative proposals to promote financial stability.

OFR’s 2018 Annual Report and Federal Reserve’s May 2019 Financial Stability Report

The 2018 OFR report concludes that “risks to financial stability remain in the medium range, reflecting a mix of high, moderate, and low risks in the financial system. Market risk is highest, reflected in historically high stock prices and the sensitivity of bond prices to changes in interest rates. Credit risk is moderate, with risk rising from leveraged lending, tempered somewhat by risks from consumer credit.” These findings were based on the OFR’s analysis of six key risk categories it considers in its Financial System Vulnerabilities Monitor (see Figure 1 in the Appendix), specifically macroeconomic, market, credit, solvency/leverage, liquidity, and contagion risks.⁸

³ Federal Reserve, “Purposes and Functions – Overview of the Federal Reserve System,” available at https://www.federalreserve.gov/aboutthefed/files/pf_1.pdf.

⁴ <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181109a.htm>. Also see Federal Reserve, “Purposes and Functions -- Promoting Financial System Stability,” available at https://www.federalreserve.gov/aboutthefed/files/pf_4.pdf.

⁵ Federal Reserve, “Financial Stability Report – May 2019,” (“Federal Reserve report”), available at <https://www.federalreserve.gov/publications/files/financial-stability-report-201905.pdf>

⁶ 12 U.S.C. § 5322.

⁷ U.S. Department of the Treasury, “Financial Stability Oversight Council Releases Annual Report,” (Dec. 19, 2018), available at: <https://home.treasury.gov/news/press-releases/sm578>

⁸ <https://www.financialresearch.gov/financial-vulnerabilities/>

The OFR report points to high market risks driven by historically high stock prices and more uncertain macro outlook, and the possibility of bond price declines driven by rising interest rates. Similarly, the Federal Reserve report notes that high investor risk appetite is driving high asset valuations and historically low risk premium spreads. While equity prices are not only high overall, they are slightly higher relative to median forecast earnings when compared to the past 30 years. Commercial real estate valuations are up approximately 70% since 2010, while capitalization rates for commercial real estate, which measure the ratio of annual rental income to property values, have declined over the same time frame from 8 percent to approximately 6 percent.

Both reports identify leverage as an area to monitor, with moderate risks in household leverage, while hedge fund and corporate leverage pose potential emerging risks. Specifically:

- Household borrowing has remained relatively low overall since the financial crisis (see Figure 2 in the Appendix). While total inflation-adjusted lending to borrowers with prime credit scores recently surpassed pre-crisis levels, total lending to near-prime and subprime borrowers remains below pre-crisis levels. The composition of household debt has changed since the financial crisis. Mortgage debt accounts for approximately two-thirds of household debt, with a growing share of new mortgages to stronger credit borrowers, subject to stronger underwriting standards. Overall household leverage is “moderate,” backed by sufficient collateral, and a low ratio of mortgages with negative equity (see Figure 3 in the Appendix). The remaining third of household debt is composed primarily of student loans, auto loans, and credit card debts. Student loans and auto loans have grown rapidly over the past decade, overtaking credit card debt as a share of household debt (see Figure 4 in the Appendix).
- Hedge fund leverage may pose financial stability risks by “first, creat[ing] more connections to other financial institutions. Second, it may make the value of assets used as collateral more volatile. And third, it may increase the likelihood and potential impact of stress in the hedge fund industry being transmitted to the funds’ counterparties.” Total hedge fund borrowing increased from approximately \$1.9 trillion at end-2015 to over \$2.8 trillion in June 2018 while hedge fund total net assets grew marginally from \$2.7 trillion to \$3.1 trillion over that same period.
- Leveraged lending is another area of potential emerging risk.⁹ The OFR report notes that the rapid rise of leveraged loans has coincided with a rapid deterioration of credit quality in new loans (see Figure 5 in the Appendix), and a high share of covenant light loans. Moreover, with respect to the deterioration in underwriting standards, the report reveals that “half of all leveraged loans issued are rated B+ or lower (that is, highly speculative).” This may be disruptive to markets and the economy in the event of an economic downturn, as “many investment management strategies require an investment-grade rating. If there were widespread downgrades of bonds to non-investment-grade ratings, institutional investors with mandates to hold investment-grade assets would be pressed to sell their downgraded securities.”

Both reports include analysis of solvency risks facing financial institutions. Since the financial crisis, banks have significantly increased their capital buffers, and underwriting standards have remained relatively strong for commercial and industrial loans. However, according to the OFR report, while common equity has more than doubled for the largest U.S. banks since 2009, the Federal Reserve’s Comprehensive Capital Analysis and Review (CCAR) for 2018 “showed that the capital ratios of three of

⁹ OFR and Federal Reserve reports. The Committee examined these issues on June 4, 2019, when the Subcommittee on Consumer Protection and Financial Institutions held a hearing entitled, “Emerging Threats to Stability: Considering the Systemic Risk of Leveraged Lending,” <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403827>.

the eight U.S. G-SIBs could fall below at least one of their regulatory minimums under the severely adverse conditions applied in the review.” The OFR report also noted while solvency risks are low, “some large banks, insurers, and hedge funds could be vulnerable to severe stress situations.”¹⁰

The reports outline other risks to monitor, including new technology-enabled risks, and macroeconomic risks that threaten to destabilize the economy. The OFR report identifies cybersecurity risks as a continuing concern. Specifically, the report identifies cybersecurity risks as “high-profile operational risks” with potential impacts of cyber risks compounded by banks’ operations practices. Companies have begun organizing regular cross-company, cross-function war-gaming on cyberthreats, so-called “tabletop exercised,” to identify vulnerabilities and transmission risks.¹¹

Furthermore, the OFR report identifies cryptocurrencies as worth monitoring. While crypto-assets remain relatively small, they are growing fast in size, numbers, adoption and applications. The Federal Reserve report also includes a list of potential shocks – including those relating to trade tensions, slowing global growth, Brexit, leveraged lending, etc. – to the economy as cited by market and official sector contacts during its market intelligence outreach.

Financial Stability under the Trump Administration

Under the Trump Administration, financial regulators have been criticized for being more focused on implementing a number of deregulatory proposals than on addressing financial stability concerns.¹² For example, the FSOC under the leadership of Treasury Secretary Mnuchin has met less,¹³ rescinded all previously designated nonbank financial companies,¹⁴ and proposed a cumbersome designation process that, according to former officials, could make it difficult for the body to designate a future nonbank financial company that poses a systemic risk as AIG and other companies did in the last financial crisis. Specifically, in a May 2019 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.”¹⁵

Furthermore, former President Obama’s fiscal year 2017 budget estimated the OFR would spend about \$104 million, in part to employ a staff of 255 full-time equivalent (FTE) employees.¹⁶ President Trump’s fiscal year 2020 budget estimates the OFR will spend \$75 million, in part to employ a staff of

¹⁰ OFR report

¹¹ *Id*

¹² Mayra Rodriguez Valladares, “Mnuchin Should Require More Transparency About Leveraged Lending and CLO Markets,” *Forbes* (May 2, 2019), <https://www.forbes.com/sites/mayrarodriguezvalladares/2019/05/02/mnuchin-should-require-more-transparency-about-leveraged-lending-and-clo-markets/#3e71c6394d50>.

¹³ The average annual meeting time of FSOC dropped by almost 50 percent when comparing the Obama and Trump Administrations. See Gregg Gelzinis, “Strengthening the Regulation and Oversight of Shadow Banks,” (July 18, 2019), Center for American Progress, <https://www.americanprogress.org/issues/economy/reports/2019/07/18/471564/strengthening-regulation-oversight-shadow-banks/>.

¹⁴ <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>

¹⁵ See Alan Rappeport, “Former Top Financial Regulators Warn Against Move to Ease Oversight of Firms,” *New York Times* (May 13, 2019), <https://www.nytimes.com/2019/05/13/us/politics/financial-regulation-trump-administration.html>. See also 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), <https://int.nyt.com/data/documenthelper/887-bernanke-geithner-lew-yellen-letter/a22621b202dfcb0fe06e/optimized/full.pdf>.

¹⁶ Treasury, “Office of Financial Research: Program Summary by Budget Activity, FY 2017,” <https://www.treasury.gov/about/budget-performance/budget-in-brief/BIB17/15.%20OFR%20FY%202017%20BIB-1.pdf>.

145 FTEs,¹⁷ representing a staff budget reduction of more than 43 percent. Similarly, staff and budget reductions have also occurred at FSOC. Over the past two years, the FSOC’s budget has decreased by 15 percent, and the target staffing level has lowered from 36 FTEs in fiscal year 2017 to just 18 FTEs in its latest budget, representing a 50 percent reduction. Both the FSOC and OFR’s funding comes directly from an assessment charged to the largest banks and any nonbank financial company designated by FSOC.

Additional concerns have been raised about various regulatory modifications regarding capital, leverage, stress testing, and living wills for banks.¹⁸ Regulators have, in the words of former Federal Reserve Governor Dan Tarullo, been engaging in, “a kind of low-intensity deregulation, consisting of an accumulation of non-headline-grabbing changes and an opaque relaxation of supervisory rigor.”¹⁹ Furthermore, regulators have taken steps to undermine the Volcker Rule that was designed to prevent banks from gambling with federally-insured deposits.²⁰ As a result, this approach may leave financial institutions less prepared for a future downturn.

Legislative Proposals

- Discussion Draft of “Federal Reserve Financial Stability Report Act.” The legislation would codify the semiannual Financial Stability Report that the Federal Reserve initiated in November 2018 to provide regular updates on key indicators related to the financial stability vulnerabilities monitored by the Federal Reserve.
- Discussion Draft of “Appropriate Funding and Staffing for the Financial Stability Oversight Council Act”. This legislation would increase funding and staffing for FSOC by establishing minimum levels for FSOC back to levels included in President Obama’s fiscal year 2017 budget, specifically \$8.5 million and 36 FTEs, respectively.²¹
- Discussion Draft of “Systemic Risk Mitigation Act.” (Rep. Chuy Garcia). This legislation would stipulate that each FSOC member agency has a statutory mandate to ensure the financial stability of the United States. The bill would reform the nonbank financial company designation process authorized in Title I of Dodd-Frank to automatically designate companies for enhanced supervision roughly based on FSOC’s stage 1 metrics and establishing a process for FSOC to rescind the automatic designation of any such company for a two-year period that can be renewed for an unlimited number of additional 2-year periods. The bill grants FSOC backup rulemaking authority if an agency does not adequately follow a recommendation to promulgate a rule to mitigate systemic risks. Additionally, the bill increases funding and staff for FSOC and OFR, and promotes transparency through several provisions, including requiring the transcript of FSOC meetings to be made public 5 years after the date of such meeting.²²

¹⁷ Treasury, “Office of Financial Research: Congressional Budget Justification and Annual Performance Report and Plan, FY 2020,” <https://home.treasury.gov/system/files/266/16.-OFR-FY-2020-CJ.pdf>

¹⁸ Mayra Rodriguez Valladares, “The Weakening Of Big Bank Regulations Under Trump Is The Seed For The Next Financial Crisis,” *Forbes* (May 22, 2019), <https://www.forbes.com/sites/mayrarodriguezvalladares/2019/05/22/the-weakening-of-big-bank-regulations-under-trump-is-the-seed-for-the-next-financial-crisis/#2c8040ee4f4c>.

¹⁹ Dan Tarullo, “Taking the Stress Out of Stress Testing,” (May 21, 2019), <https://ourfinancialsecurity.org/wp-content/uploads/2019/05/Tarullo-AFR-Talk.pdf>.

²⁰ American Banker, “Volcker the man blasts Volcker the rule in letter to Fed chair,” (Sep. 10, 2019), <https://www.americanbanker.com/articles/volcker-the-man-blasts-volcker-the-rule-in-letter-to-fed-chair>.

²¹ <https://www.treasury.gov/about/budget-performance/CJ17/22.%20FSOC%20FY%202017%20CJ.PDF>

²² The proposal is generally based on recommendations made in a recent report on financial stability. See Gregg Gelzinis, “Strengthening the Regulation and Oversight of Shadow Banks,” (July 18, 2019), Center for American Progress, <https://www.americanprogress.org/issues/economy/reports/2019/07/18/471564/strengthening-regulation-oversight-shadow-banks/>.

Appendix

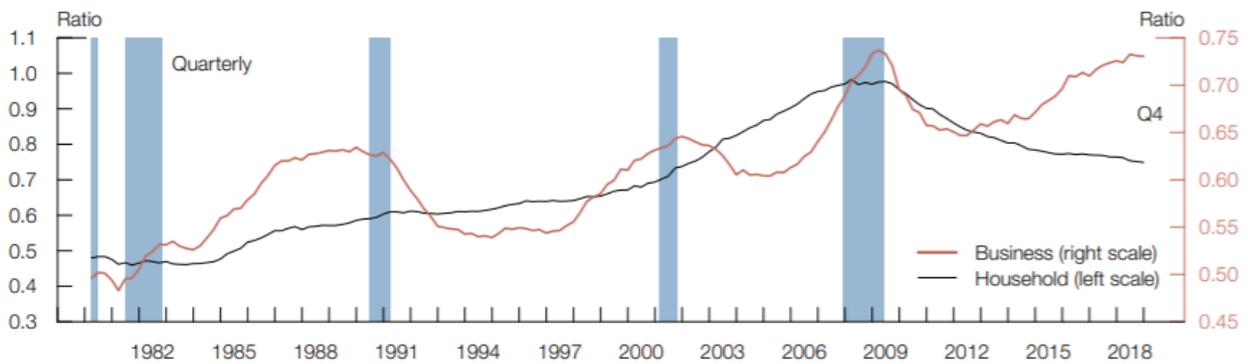
Figure 1. OFR Financial System Vulnerabilities Monitor²³



Note: Figure is from the OFR Financial System Vulnerabilities Monitor. Technical information about the monitor is available at www.financialresearch.gov/financial-vulnerabilities.

Sources: Bloomberg Finance L.P., Compustat, Federal Financial Institutions Examination Council Call Reports, Federal Reserve Form Y-9C, Haver Analytics, Morningstar, SNL Financial LC, the Volatility Laboratory of the NYU Stern Volatility Institute (<https://vlab.stern.nyu.edu>), OFR analysis

Figure 2. Business and Household Credit-to-GDP Ratios²⁴

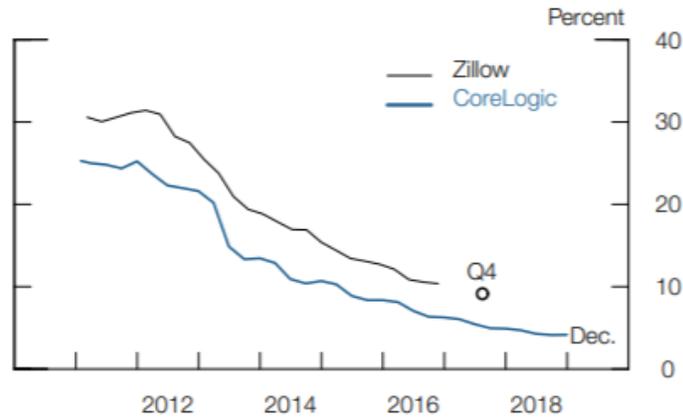


Source: Federal Reserve Board staff calculations based on Bureau of Economic Analysis, national income and product accounts, and Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."

²³ OFR report

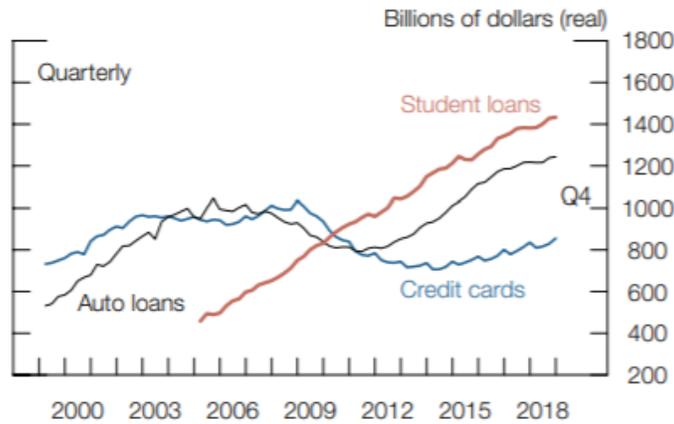
²⁴ Federal Reserve report

Figure 3. Estimate of Mortgages with Negative Equity²⁵



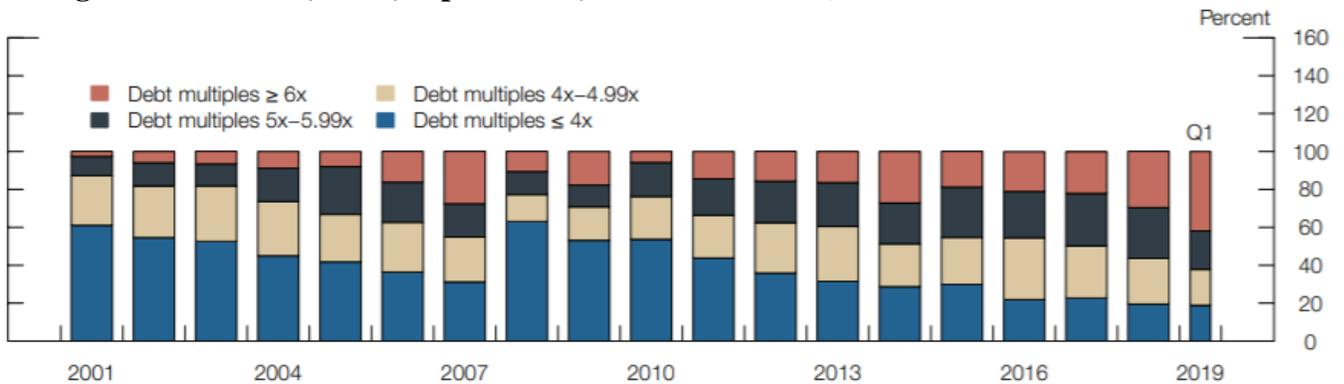
Source: CoreLogic; Zillow.

Figure 4. Consumer Credit Balances²⁶



Source: FRBNY Consumer Credit Panel/Equifax; Bureau of Labor Statistics consumer price index.

Figure 5. Distribution of Large Institutional Leveraged Loan Volumes, by Debt to EBITDA (earnings before interest, taxes, depreciation, and amortization) Ratio²⁷



²⁵ *Id*

²⁶ *Id*

²⁷ *Id*