

Testimony of Dino Falaschetti
Director of the Office of Financial Research
U.S. Department of the Treasury
House Financial Services Subcommittee on Consumer Protection and
Financial Institutions
Hearing on “Promoting Financial Stability: Assessing Threats to the
U.S. Financial System”
September 25, 2019

The views expressed in this testimony are those of Dino Falaschetti, Director of the Office of Financial Research, and do not necessarily represent the views of the President.

Introduction

Chairman Meeks, Ranking Member Luetkemeyer, and members of your subcommittee, thank you for inviting me to testify this morning on behalf of our Office of Financial Research (OFR, the Office). I enjoyed meetings with a number of members on this dais, and look forward to working with each of you during my service in this position.

I am honored for the opportunity to share my testimony with you today, and look forward to discussing the productive role that OFR offers to our government’s financial stability framework.

Throughout my career in business, education, and public service, I enjoyed developing and sharing firmly grounded perspectives on important financial and economic matters. And I have especially enjoyed doing so through my public service, first at the President’s Council of Economic Advisors, then the House Financial Services Committee, and now as Director for our Office of Financial Research.

As you requested, my testimony today will cover the OFR’s 2018 Annual Report to Congress. But first, I would like to take a minute to recognize our staff.

Prior to my appointment as OFR’s Director, our Office underwent an extensive reexamination of mission, culture, and structure. Throughout this period of uncertainty, our staff members never let go of a mission that they

and I enthusiastically support. I am grateful to each and every one of you for your dedicated service as individuals and as a team. I begin my testimony today by acknowledging your service – thank you!

My priority and commitment to them going forward is providing for a safe, collegial, and fulfilling workplace so that they are able to thrive personally and professionally by furthering our important mission of serving the Financial Stability Oversight Council (FSOC, Council) and its member agencies.

To that end, I am meeting with each and every member of our staff, with the objective of better understanding what our ground truth looks like. This program will promote greater communication, collaboration, and transparency throughout our Office, and establish a rewarding sense of fulfillment that comes from good work done well.

Financial Stability and Economic Opportunity

When it comes to economic opportunity, the United States stands as the world's leader. A resilient financial sector is vital to maintaining that lead, and increasing the welfare of every American. The remarkable frequency of banking crises during the last three decades,¹ however, remind us that we can do better.

The Great Financial crisis is sometimes characterized as a perfect storm,² but it did not have to happen. Credible warnings were plentiful, but a lack of transparency and accountability³ saw too many people dancing until the music abruptly stopped.⁴

¹ Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises & Scarce Credit*, Princeton University Press, 2014, p. ix.

² International Monetary Fund, "The Perfect Storm," *Finance and Development*, June 2009, 46(2), <https://www.imf.org/external/pubs/ft/fandd/2009/06/blanchard.htm>; Anthony H. Catanach, Jr. and Julie Anne Ragatz, "2008 Financial Crisis: Black Swan, Perfect Storm or Tipping Point? (Buzzwords make it possible to deflect responsibility for financial cataclysm)," *Bank Accounting and Finance*, April-May 2010.

³ Dodd-Frank's preamble calls for greater transparency and accountability.

⁴ As Citigroup's CEO prior to the crisis, Charles Prince is quoted to have said that, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance."

In early 2006, the President released his Economic Report. One of the chapters focused on why financial services are vital for upward mobility in households and businesses alike. It also called on regulators “to mitigate the likelihood of systemic events.”⁵

Despite their accessibility and timeliness, none of these warnings could mitigate, let alone stop, the crisis that was to come.

Reflecting on this history, a prominent economist and former central banker eschewed calls for increased regulation of an already heavily regulated sector. Instead, he focused on opportunities for data analysis and monitors to increase transparency for inter-institution exposures and concentrations of risk in the financial system.^{6,7} Our Office was established to deliver on exactly those types of data and research services, so that regulators and the public can better gauge potential risks to financial stability.

OFR: A Simple but Consequential Mission

OFR was established to, in considerable part, increase the likelihood that future warnings will be more credible when grounded on economic fundamentals and informed by high-quality data and careful research.⁸

OFR supports the FSOC and its member agencies with data and research services that work toward that important end.⁹

<https://www.fn london.com/articles/chuck-princes-dancing-quote-what-we-have-learned-10-years-on-20170714>

⁵ *Economic Report of the President*, Transmitted to the Congress February 2006, Together with the Annual Report of the Council of Economic Advisers, pp. 208-210.

⁶ Justin Lahart, “Mr. Rajan Was Unpopular (But Prescient) at Greenspan Party,” Wall Street Journal, January 2, 2009. <https://www.wsj.com/articles/SB123086154114948151>

⁷ Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, 2010, Princeton University Press, page 173.

⁸ As one post-crisis author puts it, “increasing financial complexity with decreasing data quality is a toxic mix.” William A. Barnett, *Getting it Wrong: How Faulty Monetary Statistics Undermine the Fed, Financial System, and the Economy*, MIT press, 2012, p. xxxi.

⁹ “The purpose of the Office is to support the Council in fulfilling the purposes and duties of the Council and to support member agencies.” DFA Sec. 153. Purpose and Duties of the Office.

Americans have long enjoyed the greatest of economic opportunities. Even more are available through robust growth. Tailoring research and data services to Council and member needs can provide important support.

Reporting on Financial Stability

Dodd-Frank clearly defines our Office's purpose and duties as:¹⁰

- Collecting data for the Council,
- Standardizing data formats,
- Developing applied and long-term research, and
- Measuring and monitoring risks.

Complementing our Office's support of the Council and member agencies, our Office submits an Annual Report to Congress assessing the state of the U.S. Financial System. The Report analyzes threats to financial stability, shares key findings from our research and analysis, and reviews progress in fulfilling our mission.¹¹

The OFR's stability assessment starts with a consideration of risks in seven different categories. Macroeconomic, market, and credit risks arise from the interplay between the financial sector and the rest of the economy.

Solvency and leverage, funding and liquidity, and contagion risks arise from connections between financial sector firms.

And a seventh category of risks covers those that do not fit squarely (e.g., cybersecurity) into other categories. Vulnerabilities in any of these areas can originate, amplify, or transmit shocks and stress.

One of the many tools that informs the OFR's risk assessment is our Financial System Vulnerabilities Monitor - a quarterly heat map of indicators that is shared publicly online. Changes in these monitors can signal vulnerabilities that may benefit from deeper investigation.

Our Office also draws on a broader range of data and monitoring tools, qualitative information, and deeper analysis to build on our heat map and

¹⁰ Dodd-Frank, Sec.

¹¹ Dodd-Frank Sec. 154 (d) Reporting Responsibilities.

further refine our risk assessments. Finally, risks can evolve with changes in the financial system, and the OFR monitors those risks as well. Our Office's final assessment regarding any type of risk can thus be higher or lower than our heat map or any one monitoring tool indicates.

OFR Collaborations

Complementing our Office's efforts in research, analysis, and data products, the OFR regularly solicits stakeholder feedback, which importantly includes that from FSOC and its member agencies.

Another complement to OFR's important mission comes from our Office's Financial Research Advisory Committee. Established in 2012, this committee provides academic and industry expertise to advance the OFR's important mission.

Our Office also cosponsors two financial stability conferences. The OFR and University of Michigan's Center on Finance, Law, and Policy held their fourth annual conference in November 2018. That conference considered how activity and entity-based regulation might increase financial resiliency without creating an undue regulatory burden.

The OFR also co-sponsors an annual conference with the Federal Reserve Bank of Cleveland. The most recent Cleveland conference considered financial stability concerns and management more broadly.

2018 Annual Report to Congress: Financial Stability Assessment and Key Findings

Our Office's latest Annual Report to Congress was published on November 15, 2018. That Report finds that risks to financial stability remained in the medium range, reflecting a mix of high moderate, and low risks across different dimensions of our financial system.

The OFR continued to see relatively high market and cybersecurity risks. Market risk had been elevated for a few years. Stock market valuations, the U.S. Treasury term premium (a measure of compensation to long-term

investors for taking the risk of rising interest rates), and bond duration (price sensitivity to interest rate changes) signaled the most risk.

Our Office assessed credit risk as moderate overall, with increased risk from leveraged lending tempered somewhat by lower risk from consumer credit. The OFR assessed risk from solvency and leverage as remaining low, though some large banks, insurers, and hedge funds could be vulnerable to severe stress.

Similarly, funding and liquidity risk was low overall, thanks to favorable borrowing conditions and high liquidity buffers for most banks. However, these risks can change quickly.

Cybersecurity risk continued to warrant attention. Our Office first discussed risks from cybersecurity in the inaugural 2012 Annual Report, and has reported on them every year since. Our 2018 Annual Report also reported on how network analysis could provide a clearer view of risks from cybersecurity.

Our Office has continued its monitoring and risk evaluations since, and expects publication of the OFR's 2019 Annual Report later this year. Because that Report remains a work-in-progress today, I cannot speak to its details. Based on currently available data, however, our overall risk assessment will likely remain in the medium range, with trends identified in the 2018 report continuing.

Looking Ahead

Personnel Priorities

Since publishing our 2018 Annual Report, the OFR has continued its diligent monitoring and evaluation of risks to our financial system. We expect to publish OFR's 2019 Annual Report later this year.

Throughout, our Office will pursue priorities that continually strengthen the OFR's mission-focused capabilities. Our top priority in this important regard is making sure that current staff members have what they need to thrive. Conversations during our bi-weekly staff lunches are informing that effort, and we will continually solicit and act on that feedback as we move forward.

A second important goal is building a culture of accountability for all members of our staff, so that performance is driven by effectiveness and professionalism in contribution to mission. We are already taking concrete steps to realize this goal, and look forward to the empowering workplace environment and organizational efficiencies that it can bring.

Finally, our Office is recruiting, hiring, and retaining the most talented and motivated people to further OFR's incredibly important mission. This effort will allow current staff members to focus on the highest-value contributions associated with their roles, and strengthen our organizational abilities to best serve the Council and its member agencies with the data and research services they need to effectively evaluate and address risks in their regulatory domains.

Data Initiatives

Quality data are essential to conduct a robust review and analysis of systemic threats to the U.S. markets. As data quality improves, OFR, FSOC, and its member agencies can increasingly engage in more robust financial stability analysis.

Our Office ensures that our FSOC and its members have access to the most complete, relevant, and reliable information available. Documenting important work to this end, the OFR's 2018 Report also reviews the Office's work to fulfill data-related mandates through an array of initiatives, including the issuance of a rule to collect data on centrally cleared repurchase agreements, or repo, transactions.¹² This data collection will start next month, and bring greater transparency to a short-term funding market.

In addition, for several years, the Council has called for better insight and transparency into markets for securities financing transactions. These wholesale funding markets are critical to the functioning of our financial

¹² The OFR adopted a rule in February 2019 to establish a data collection covering centrally cleared funding transactions in the U.S. repurchase agreement (repo) market. The data collection is expected to begin in October 2019.

<https://www.financialresearch.gov/from-the-management-team/2017/11/22/ofr-update-on-bilateral-repo-collection/>

system. The interest rate data on cleared repo transactions will inform the Federal Reserve's production of the Secured Overnight Financing Rate (the SOFR). SOFR was selected to be an alternative to the London Interbank Offered Rate, or LIBOR. LIBOR has been a widely used interest rate benchmark in global financial markets and the economy, but attempted manipulation of LIBOR during the financial crisis and ongoing doubts about LIBOR's reliability, led to efforts to develop an alternative.

The data collection also will shed light more broadly on the specifics of repo funding. By doing so, the collection will help the Council and its members better understand and monitor stress in asset and funding markets.

Closing

American economic opportunity is the envy of the world. And the OFR's statutory charge plays an important role in fortifying financial stability for the world's greatest economy. I am honored to lead our Office, and very proud of the good people on our team who wake up every day to advance our incredibly important mission. Thank you again for your invitation to testify, and I look forward to addressing your questions.