U.S. DEPARTMENT OF THE TREASURY

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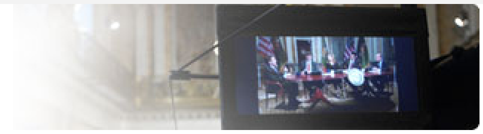

Remarks of Treasury Deputy Assistant Secretary Patrick Pinschmidt before the ABS East Conference

9/22/2014

MIAMI - Thank you for having me here today. I greatly appreciate the opportunity to discuss the work of the Financial Stability Oversight Council and how, working together, we can all promote the strength and stability of the U.S. financial system.

Today I want to start by describing how the Council conducts its work to identify risks to U.S. financial stability. I want to highlight the Council's most recent annual report and touch on some areas that may be of particular interest to you, including housing finance reform and interest-rate risk. Then I want to provide an update on the Council's recent work using its other authorities, including the designation of nonbank financial companies for Federal Reserve supervision and enhanced prudential standards, as well as ongoing work relating to the asset management industry.

In 2010, Congress passed the Dodd-Frank Act, the most significant set of financial reforms in decades, to create regulatory and supervisory safeguards to address the shortcomings that became apparent in the financial crisis. When the Council first convened in October of 2010, the country was just beginning to recover from the worst financial crisis since the Great Depression. It was a crisis caused by fundamental failures in our financial system, exacerbated by the complexity and velocity of modern finance. These failures cost us dearly – millions of lost jobs, trillions in lost savings, thousands of failed businesses, homes foreclosed, retirements delayed, and educations deferred. For much of the last century, our financial system had been the envy of the world. Post-crisis, a fundamental re-assessment of our regulatory and supervisory framework was essential.

As part of those reforms, Congress created the Council. Prior to the creation of the Council, no single official body was accountable for monitoring and addressing risks to financial stability; each regulator focused on the institutions, functions, or markets under its purview.

The Council's mission is to identify risks, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. To be clear, independent regulators continue to be responsible for regulating the markets and institutions they oversee. The difference in a post-Dodd-Frank world is that now they are all additionally engaged in a collaborative process that enables them to look across markets and institutions.

Now, about once a month, the Treasury Secretary, as Chairperson of the Council, hosts all of the major financial regulatory heads to collaborate on setting the interagency risk monitoring agenda.

At its most recent meeting, on September 4th, Secretary Lew hosted Federal Reserve Chair Yellen, FDIC Chairman Gruenberg, SEC Chair White, CFTC Chairman Massad, Comptroller Curry, who heads the OCC, FHFA Director Watt, CFPB Director Cordray, NCUA Chairman Matz, and Roy Woodall, an independent member of the Council with insurance expertise who is appointed by the President. The group also included the Council's five nonvoting members—the Directors of the Federal Insurance Office and the Office of Financial Research at Treasury, and state banking, securities, and insurance regulators—all of whom provide invaluable insight and analysis for the Council's work. Prior to Dodd-Frank, having all of these regulators in one room was almost unheard of.

But these regular meetings are just one manifestation of how the Council brings regulators together. The Council also fosters staff-level engagement on a daily basis to support its work. As one of my colleagues likes to say, in a time of crisis we no longer have to go through our rolodex to figure out who to call to respond to problems. Rather, the infrastructure is already in place – we all know each other and work together regularly.

Over just the past year, the Council has considered issues including market volatility, the debt ceiling impasse, interest rate risk, developments in Europe and emerging economies, housing finance reform proposals, operational incidents in the equity markets, and risks to financial stability arising from cybersecurity threats.

The Council has a broad array of tools available to address potential risks to financial stability. These include highlighting potential emerging threats in the Council's annual report to Congress; making recommendations to existing primary regulators to apply heightened standards and safeguards; and designating certain nonbank financial companies and financial market utilities for heightened supervision. In its efforts to look across different sectors and markets to evaluate risks, the Council seeks to use the most appropriate tools available for any risks that are present. For example, the Council used its nonbank designations authority to address company-specific risks presented by complex and interconnected firms, and a combination of other authorities to address risks relating to money market funds.

The Council provides a forum for regular and close collaboration among senior officials. In particular, the Council is supported by several committees composed of staff from each Council member agency that engage in ongoing discussions regarding financial market developments and the Council's activities. My job as Treasury's Deputy Assistant Secretary for the Council is to oversee an office within Treasury that supports this collaboration by providing leadership, analytical and research expertise, and operational and governance support to the Chairperson of the Council to facilitate the Council's work.

The Council's annual report represents an important vehicle for collaboration, providing a mechanism for regulators to level-set on the key risks to financial stability and the chief priorities for the financial regulatory community and industry alike in the year ahead. The report is the product of a highly integrated analysis conducted by the Council's member agencies to document to Congress and for the public the Council's views of the risks in all corners of the market, its assessment of how those risks might be transmitted to the broader financial system, and its recommendations for specific actions to mitigate those risks. Each of the Council's voting members signs a statement at the beginning of the report to indicate agreement that its recommendations should be implemented to address potential risks to financial stability.

The annual report also provides a roadmap for the Council's agenda for the upcoming year – what areas it will focus on, what areas may require additional attention, and how it expects to address them. This year's report, issued in May, focused on nine areas that warrant continued attention and possible action. I'd like to take a moment to briefly highlight each of them.

First, regulatory agencies and market participants should continue to take action to reduce vulnerabilities in wholesale funding markets, including tri-party repo and money market mutual funds, that can lead to destabilizing fire sales.

Second, regulators should continue to work with policymakers to implement the significant structural reforms needed to reduce taxpayers' exposure to risk in the housing market.

Third, cybersecurity threats, infrastructure vulnerabilities, and other operational risks remain a top priority for the Council, and regulators should continue to take steps to prevent operational failures and improve resiliency.

Fourth, as the financial system evolves in response to technological, competitive, and regulatory changes, regulators should remain attentive to financial innovation and the migration of certain activities outside of traditional financial intermediaries that could create financial stability risks.

Fifth, U.S. regulators should continue to cooperate with foreign counterparts to address concerns about benchmark reference rates such as LIBOR.

Sixth, regulators and institutions should remain vigilant in monitoring and assessing risks related to interest rate volatility, particularly as investors seek higher yields in a low interest rate environment.

Seventh, Council member agencies should continue to work with the Office of Financial Research (OFR) to fill financial data gaps and address related issues of data quality and comprehensiveness.

Eighth, regulators should continue implementation of Dodd-Frank reforms to reduce risk-taking incentives of large, complex, interconnected financial institutions.

And finally, there is a need for continued monitoring of adverse financial developments abroad and their potential impact on the U.S. financial system.

Let me talk in more detail about housing finance reform, and a few other topics on this list. We have seen improvement in the housing market over the past year, but as you are all aware, the housing finance system largely remains reliant on federal government support. Nearly 80 percent of newly originated mortgages in 2013 carried some form of federal backing. Thus, reforms to the system that foster greater involvement of private capital are critical. Some progress was made in Congress this year towards passing legislation, but of course there is still work to do, and the need for comprehensive reform remains. In the meantime, the Council will continue to encourage relevant agencies and Congress to develop and implement a broad plan to reform the housing finance system grounded in three principles: First, reduce the GSE footprint. Second, facilitate increased private mortgage market activity. And third, build a new housing infrastructure, as exemplified by the Common Securitization Platform.

It is also critical to remain attentive to financial innovation and the migration of certain activities outside of the traditional financial system. As we saw in the crisis, many forms of credit intermediation and risk taking were conducted in opaque markets by lightly regulated entities. In particular, this year's annual report highlighted concerns about mortgage servicing rights, or MSRs, noting that a large amount of MSRs have been sold to nonbank mortgage servicing companies in recent years. The Council recommends that state banking regulators work with the CFPB and FHFA to develop prudential and corporate governance standards to strengthen consistent oversight of these companies.

The annual report also highlights structural vulnerabilities in short-term wholesale funding markets—namely money market funds and tri-party repo. There has been significant progress focused on mitigating the risks from destabilizing runs in both areas. Following the Council's proposed recommendations for reform in November 2012, in July of this year the SEC adopted significant structural reforms of MMFs to address the risks to the financial system that were exposed during the financial crisis. The Council intends to monitor the effectiveness of the SEC's reforms in addressing risks to financial stability. Additionally, the Federal Reserve has been working with agent banks in the tri-party repo market to significantly reduce their intra-day credit exposures and strengthen operational procedures.

The annual report also raises awareness of interest rate volatility. This risk is particularly acute today, on the heels of many years of subdued and unusually low interest rates. History has shown us that interest rate cycles are unpredictable and directional shifts can often be quite sudden. In the meantime, low rates can drive investors to seek incremental yield through longer durations, weaker credits, or increased leverage. As we saw last summer, sharp directional shifts in rates can result in significant market volatility. This volatility can be exacerbated by low levels of liquidity, which can arise from large flows of one-way selling, a reduction in risk appetite by market makers, or other causes. Thus, the Council continues to highlight the importance of regulators and financial institutions remaining vigilant in their risk management practices and understanding the consequences from sudden interest rate shocks.

Now I'll turn to two other important aspects of the Council's work – the authority to designate nonbank financial companies for Federal Reserve supervision and enhanced prudential standards, and the authority to designate financial market utilities for enhanced risk-management standards. Last summer, the Council made its first designations of nonbank financial companies: American International Group (AIG), General Electric Capital Corporation, and Prudential Financial. The Council also designated eight financial market utilities for enhanced risk-management standards in July 2012.

The nonbank designations authority addresses a key weakness brought to light by the financial crisis: that large, complex, and interconnected nonbank firms without adequate supervision could pose risks to financial stability. The Council used a thorough and transparent process when considering these companies for designation, giving each company numerous and extensive opportunities to engage with the Council and its staff, as well as the opportunity to respond to the key factors underpinning a proposed action before a final vote by the Council.

Some out there refer to the Council's designations as identifying a new class of companies as "too big to fail." Let me explain why that is wrong. The designation of a nonbank financial company does not create a new ability or obligation for the government to bail out a company in distress. Instead, this authority addresses potential threats to the economy and the financial system by large, complex, and interconnected nonbank financial companies by subjecting them to Federal Reserve supervision and enhanced prudential standards. This is accomplished in part through the requirement to submit a living will to regulators, and other measures that are aimed at mitigating the impact of a firm's failure on the financial system.

It is worth noting that much of the Council's work—particularly in regards to companies under consideration for potential designation—relies on sensitive proprietary information that would not be shared by firms or regulators without an expectation of confidentiality. In all of the Council's endeavors, a delicate balance of information sharing is required. This balance involves a need to be open and transparent to the public without causing harm to individual firms or to the financial system by divulging sensitive market or company-specific information. Within this context, the Council is continually examining how it can open up more of its work to the public.

The Council understands that the perspective of the public enhances its analysis. Accordingly, it actively seeks input from outside parties to inform its work. In December 2013, a representative from the banking sector joined a public meeting of the Council to discuss cybersecurity. The Council also works with state and foreign regulators in its analysis of nonbank financial companies. And in May, the Council hosted a public conference on asset management to hear directly from industry participants, academics, and other stakeholders.

On a related note, the Council's work on asset management continues. At its meeting on July 31, the Council directed staff to undertake a more focused analysis of industry-wide activities and products to assess potential risks associated with the asset management industry. As the Council has long recognized, asset managers represent a different breed of financial institution. However, there are certain activities across the industry that could potentially pose risks, and thus warrant a closer review by the Council. There is no predetermined outcome from the Council's work in this area. First, the Council will work to identify risks, and then it will determine what remedies might be most appropriate to address those risks. The Council is working through next steps in its activities-based approach, and will keep the public informed as this work moves forward.

In closing, we have made significant progress since the financial crisis and the passage of the Dodd-Frank Act. Today, consumers have access to better information about financial products and are benefiting from new protections. Financial markets and companies are more resilient. Regulators are better equipped to monitor, mitigate, and respond to threats to financial stability. And today, our financial system is better capitalized, more transparent, and better prepared to withstand shocks. But clearly, there is still much more to do and we must remain vigilant to threats. Let's keep working together to promote the strength and stability of the U.S. financial system.

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