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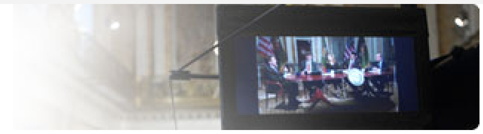

Testimony of Secretary Jacob J. Lew Before the House Committee on Financial Services

6/17/2015

As prepared for delivery

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify today regarding the 2015 annual report of the Financial Stability Oversight Council.[1]

The Council was created to identify and respond to vulnerabilities in the U.S. financial system and provide a mechanism for agencies to talk to each other and take collective responsibility for addressing potential threats to financial stability. At its 51st meeting last month, the Council released its fifth annual report, which highlighted many of the topics the Council has discussed over the last year, including cybersecurity, interest-rate risk, benchmark rate reform, potential fire sale risks in short-term wholesale funding markets, threats from market instability in Europe and emerging markets, and a host of other risks. Those discussions laid the groundwork for many of the recommendations in this year's annual report, and these issues will continue to be areas of focus in the coming year.

The Council's annual report serves as an important mechanism for public accountability and transparency regarding the Council's work. Each report is the product of extensive, data-driven 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 as well as a roadmap for the year ahead. Importantly, the annual report also contains an affirmation by each of the Council's voting members that the actions outlined in the report are the reasonable steps that should be taken to promote financial stability. This creates clear accountability for making progress.

Areas of Focus of the Council's 2015 Annual Report

The Council's 2015 annual report focuses on 11 themes that warrant continued attention and, in many cases, further action from the Council's members and member agencies.

Cybersecurity

Over the past year, financial sector organizations and other U.S. businesses experienced numerous cyber incidents, including large-scale data breaches that compromised financial information. Malicious cyber activity is likely to continue, and financial sector organizations should be prepared to mitigate the threat posed by cyber attacks that have the potential to destroy critical data and systems and impair operations. Treasury and U.S. regulators have taken steps to prompt financial institutions to mitigate risks to the financial system posed by malicious cyber activities, including developing new tools for financial institutions to evaluate their readiness to identify, mitigate, and respond to cyber threats, and by focusing on technology service providers' cybersecurity preparedness. As cyber threats continue to evolve, critical areas of focus must include strong collaboration and information sharing among financial service companies and government agencies, improvements in technology infrastructure;, and comprehensive plans for responding to and recovering from cyber incidents. The annual report contains specific recommendations about cybersecurity information sharing between the private sector and government, continued implementation of best practices, and the maintenance of robust plans for responding to a significant incident. Specifically, the Council encourages the establishment of a national plan for cyber incident response for the sector, coordinated by Treasury, which includes identifying and articulating the role of law enforcement, the Department of Homeland Security, and financial regulators. The Council also continues to support comprehensive cybersecurity legislation, including proposals to enhance cybersecurity information sharing and data breach notifications.

Increased Risk-Taking in a Low-Yield Environment

The historically low-yield environment continues to encourage greater risk-taking across the financial system. Investors may seek incremental gains in yield for disproportionate amounts of risk. Banks, credit unions, and broker-dealers have lower net interest margins, leading some firms to increase risk by holding longer-duration assets, easing lending standards, or engaging in other forms of increased risk-taking. In its annual report, the Council recommends that supervisors, regulators, and firm management continue to closely monitor and assess the heightened risks resulting from continued search-for-yield behaviors as well as the risks from potential severe interest rate shocks. The Council's report also recommends that the Federal Insurance Office and state insurance regulators continue to closely monitor and assess the growing risks that insurers have taken by extending the duration of their portfolios and by investing in lower-quality or less-liquid assets.

Changes in Financial Market Structure and Implications for Financial Stability

Financial market structure has evolved substantially over the years, owing to a confluence of factors including technology, regulation, and competition. Electronic trading platforms and algorithmic trading firms now play an increasing role in facilitating market liquidity. In addition, the business models and risk appetite of traditional broker-dealers have changed, with some broker-dealers reducing their securities inventories and, in some cases, exiting certain markets. New trading venues and platforms have also developed or expanded in certain markets, including new regulated exchanges, interdealer platforms, and dark pools among others. Cyclical factors in the current environment may further magnify the impact of these developments on market liquidity. As this evolution of market structure plays out across a broader collection of asset classes and markets, market participants and regulators should continue to monitor how it affects the provision of liquidity and market functioning, including operational risks.

The Council recommends that its members and member agencies continue to remain vigilant to the confluence of factors driving changes in market structure, the extent of their impact on market functioning and the provision of liquidity, and potential implications for financial stability. Regulators should assess the extent to which potential actions in certain markets might be applicable to other markets as well. Regulators should also work to better understand the linkages between and across markets, both regulated and unregulated, by improving data collection efforts and data-sharing arrangements across the member agencies. The Council also recommends that regulators continue to enhance their understanding of firms that may act like intermediaries and that may be outside the regulatory perimeter, work to develop enhanced tools, and, as warranted, make recommendations to Congress to close such regulatory gaps.

Central Counterparties

Following the crisis, U.S. and foreign regulators have encouraged or required more derivatives and other financial transactions to be cleared through central counterparties (CCPs). CCPs require robust frameworks for risk management if they are to enhance financial stability and increase market resiliency. Regulators have taken significant steps in recent years to promote strong risk management at systemically important CCPs and remain focused on identifying and mitigating any potential threats to financial stability that could arise from CCPs. In particular, it is important to evaluate whether existing rules and standards are sufficiently robust to mitigate the risk that CCPs could transmit credit and liquidity problems among financial institutions and markets during periods of market stress.

In its report, the Council recommends that the Federal Reserve, Commodity Futures Trading Commission (CFTC), and Securities and Exchange Commission continue to coordinate closely in the supervision of all CCPs that are designated as systemically important financial market utilities under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Wall Street Reform), and recommends that the agencies continue to actively evaluate whether recently enhanced rules and standards are sufficiently robust to mitigate potential threats to financial stability. Further, the Council's report recommends that the agencies continue to evaluate whether certain CCP-related risk areas are being addressed adequately. In addition, member agencies should continue working with respective international official sector bodies to identify and address areas of common concern as additional derivatives clearing requirements are implemented in other jurisdictions.

Global Economic and Financial Risks

In today's globally integrated financial markets, foreign shocks have the potential to disrupt financial stability in the United States. In 2014, concerns about stability in the euro area resurfaced amid weak economic growth and political uncertainty in Greece. Although there has been some progress during Greece's ongoing discussions with Europe and the IMF, the negotiations and the path to securing agreement are challenging and complex. We continue to urge a timely resolution so that Greece is able to continue to meet its obligations. We continue to monitor financial vulnerabilities in emerging market countries — including property market excesses and rapid growth in dollar credit — which could cause disruptions in economic and financial markets. Finally, fiscal policy tools and structural reforms are needed in a number of advanced economies to help support monetary policy and lead to a more balanced and sustainable growth path.

Financial Innovation and Migration of Activities

Technology, competition, and regulatory changes are continuously reshaping the financial system and bringing about innovations in products, services, and business practices, which benefit investors and consumers. Since the recent financial crisis, the changing financial system landscape has fostered many innovations. One challenge for regulators is the need to monitor new products or services in light of existing standards and regulations. Another challenge is the migration of activities to less regulated or unregulated institutions. In its report, the Council recommends that its members and member agencies remain vigilant to the potential financial stability risks that may arise from financial innovation, business practices, and migration of activities in the financial system. In particular, the Council recommends that state regulators continue to monitor concerns raised in its 2014 annual report about nonbank mortgage servicers and collaborate with the Consumer Financial Protection Bureau and Federal Housing Finance Agency (FHFA), as appropriate, on further developing and implementing prudential and corporate governance standards to strengthen these companies.

Short-Term Wholesale Funding

Domestic banking firms' reliance on short-term wholesale funding has decreased since the recent financial crisis. The decline partly reflects the large increase in retail deposits and adjustments some banks are making to their funding and balance sheet structures in response to enhanced liquidity standards, such as the liquidity coverage ratio, and capital requirements, including the supplementary leverage ratio. Similarly, total borrowing by primary dealers across all segments of the repurchase agreements (repo) market was essentially flat in 2014.

Previous annual reports have highlighted structural vulnerabilities in the tri-party repo market. Significant progress has been made in this market in recent years, in particular reducing the reliance of market participants on intraday credit from clearing banks. The risk of fire sales of collateral deployed in repo transactions remains an important financial stability concern. The industry is still working to bring the settlement of general collateral finance (GCF) repo transactions in line with the reforms effected for tri-party repo generally. In its report, the Council recommends that market participants continue to make progress toward extending improvements in the tri-party repo settlement process to GCF repo settlement. The Council also urges continued coordination between market participants and financial regulators to address the risk of post-default fire sales of assets by repo investors.

Risk-Taking Incentives of Large, Complex, Interconnected Financial Institutions

Wall Street Reform enhanced the safety and soundness of the largest financial institutions and instituted limits on the support that can be provided in the event of future financial crises. Specifically, Wall Street Reform requires the Federal Reserve to adopt enhanced prudential standards for the largest bank holding companies (BHCs) and designated nonbank financial companies. It also requires that certain companies develop and submit to the Federal Reserve and the Federal Deposit Insurance Corporation their own plans for rapid and orderly resolution, and limits the ability of the Federal Reserve to provide extraordinary support to individual institutions.

Although the largest BHCs have become even larger, some market-based measures indicate they have become less interconnected and less complex since the passage of Wall Street Reform. Additionally, some credit rating agencies have lowered their assessments of the likelihood of government support for the largest banks in times of stress. However, these rating agencies still factor into their ratings that there is some chance that the government will provide support to the largest banks if they become financially distressed. The Council recommended continued efforts by regulators to promote full implementation of Orderly Liquidation Authority and phasing in enhanced prudential standards in the coming years, which should help reduce remaining perceptions of government support for large, complex, interconnected financial institutions.

Reforms of Reference Rates

Investigations of manipulation of the widely used London Interbank Offered Rate (LIBOR) that surfaced in 2012 highlighted concerns about the integrity of interest rate and other financial benchmarks. Incidents of manipulation reduce public confidence in the financial system and risk financial instability, in part owing to the significant disruptions associated with changing the reference rates for financial contracts. Since the Council's 2014 annual report, administrators of LIBOR, the Euro Interbank Offered Rate, and the Tokyo Interbank Offered Rate have made substantial progress toward enhancing oversight, governance, transparency, and accountability of these benchmark rates. Official sector efforts have focused on developing multiple reference rates, which would allow the rate used in a financial transaction to be more closely tied to the underlying economic purpose, reduce the incentive to manipulate, and enhance stability by having more ready alternatives. Concerns have also been raised about other financial benchmarks, including swap rates and foreign exchange rates, which are used for valuing numerous contracts and portfolios of assets. The Council recommended that U.S. regulators continue to cooperate with foreign regulators and official sector bodies in their assessments of market practices for these benchmarks.

Housing Finance Reform

The housing market recovery continued in 2014, despite some signs of softness early in the year. As house prices continued to rise, the number of households with negative equity declined while the performance of outstanding loans improved. Congress has debated several housing finance reform proposals, including separate pieces of legislation that advanced out of the House Financial Services Committee in July 2013 and the Senate Banking Committee in May 2014. The Council recommended that comprehensive legislation address the conservatorship of Fannie Mae and Freddie Mac — the government-sponsored enterprises (GSEs) — and clarify the future role of the federal and state governments in mortgage markets. In the absence of housing finance reform, FHFA, primarily through its conservatorship and oversight of the GSEs, continued to make meaningful efforts to improve housing finance infrastructure and reduce the amount of taxpayer risk. However, core challenges persist. The GSEs remain in conservatorship, subject to FHFA supervision, with the vast majority of newly originated mortgages carrying a federal government backing either through the GSEs, the Federal Housing Administration, or other government-backed programs. The Council's report includes a number of recommendations to reduce the GSE's exposure to mortgage credit risk.

Data Quality, Collection, and Sharing

Data limitations can hamper the ability of market participants and regulators to fully comprehend the scope and size of risks throughout the financial system. Regulators took several steps in 2014 to improve the scope, comparability, and transparency of existing data collections. Promoting transparency in the over-the-counter derivatives markets is a major priority for the Council and international regulators, given the market's role in the financial crisis, its decentralized nature, and evolving infrastructure. The global Legal Entity Identifier (LEI) project progressed in 2014. In the United States, more regulatory reporting forms are requiring the use of the LEI. Also, in 2014, the CFTC and Office of Financial Research entered into a cooperative effort to enhance the quality, types, and formats of data collected from CFTC-registered swap data repositories. Although regulators now collect significantly more data on financial markets and institutions, critical gaps remain in the scope and quality of available data. For example, regulators and market participants lack comprehensive data on repo and securities lending markets. The Council's report recommends that regulators and market participants continue to work together to improve the quality, access and comprehensiveness of financial data in the United States and across global markets. The Council's report also recommends that its member agencies support the adoption and use of data standards, including the LEI and the unique loan identifier for mortgage data. Finally, the Council's report recommends that the member agencies continue to explore best practices for data sharing and for improving reporting efficiency.

The annual report goes into detail on each of these important issues. These 11 areas of focus also demonstrate the need for continued vigilance of the financial system and for the Council and its member agencies to draw attention to these risks.

Additional Work of the Council

The report also provides the public with a comprehensive summary of the progress regarding the Council's other work. For example, since our last annual report, the Council has continued to identify nonbank financial companies whose material financial distress could pose a threat to U.S. financial stability and conducted its first annual reevaluations of the three nonbank financial companies that were designated in 2013. The Council has also considered potential risks within the asset management industry, by focusing its efforts on industry-wide products and activities that could require additional attention. This work incorporated extensive engagement with stakeholders, including a formal solicitation of public comment.

The Council's annual report also highlights a number of Council initiatives over the past year that demonstrate its continued commitment to transparency and good governance, including the adoption of supplemental procedures related to its nonbank designations process, which addressed a number of suggestions made by stakeholders.

As the forum for the entire financial regulatory community to work collaboratively to identify and respond to potential threats to financial stability, the Council has done what Congress designed it to do, including asking the tough questions that will make our financial system safer. Our mandate has allowed us to shine a light on emerging threats before they can evolve into another financial crisis. As part of this responsibility, the Council has been responsive and has worked closely with a broad array of stakeholders as it conducts its work, including adapting its policies and procedures when good ideas are raised. Despite the Council's record, unfortunately, opponents of financial reform continue to back attempts to undermine the Council, its member agencies, and its ability to respond to potential threats to financial stability.

As we approach the five-year anniversary of the enactment of Wall Street Reform and the creation of the Council, we know that these reforms have made the financial system safer, more resilient, and supportive of long-term economic growth. Wall Street reform has put into place important consumer, investor, and taxpayer protections that support companies that play by the rules and serve their customers, small businesses that need access to credit to grow and create jobs, and working men and women trying to save for their children's education, a down payment on a home, and their own retirement. 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 or emerging threats to financial stability. I look forward to working with this Committee, and with Congress as a whole, to continue addressing these threats and promoting the strength and stability of the U.S. financial system.

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[1] The Council's 2015 annual report is publicly available at http://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2015-Annual-Report.aspx.