U.S. DEPARTMENT OF THE TREASURY

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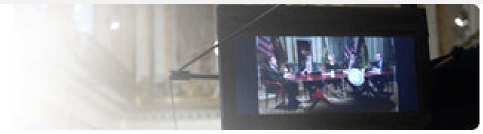

Remarks of Deputy Assistant Secretary of FSOC Office Patrick Pinschmidt at the Investment Adviser Association's (IAA) 2015 Compliance Conference

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As prepared for delivery

WASHINGTON - Thank you for having me here today. I appreciate the invitation to discuss the work of the Financial Stability Oversight Council.

Today, I want to start by describing why the Council was created and how it conducts its work. This is important background in understanding our approach to looking at potential risks. I will then focus on the Council’s review of potential risks related to asset management products and activities. In particular, I will walk through the Council’s request for public comment, which describes our work in this area. And finally, I’ll also touch on a separate issue the Council recently addressed: its process for evaluating nonbank financial companies for potential designation. The Council last month adopted changes to its designations process, and I’d like to briefly highlight the key impacts of those changes.

Now, let me begin with some grounding on the mandate of the Council. The financial crisis revealed a number of shortcomings in our financial system, including shoddy lending practices, overreliance on leverage, poor risk management, and shortcomings in regulatory oversight. These problems were exacerbated by the complexity and velocity of modern finance, in which interconnected products and markets transmitted instability across the financial system at lightning speed. The effects of the crisis were felt in communities throughout the nation – millions of lost jobs, trillions in lost savings, thousands of failed businesses, homes foreclosed, retirements delayed, and educations deferred. In the aftermath of the crisis, a fundamental re-assessment of our regulatory and supervisory framework was essential.

Congress responded in 2010 with the Dodd-Frank Act, the most significant set of financial reforms since the Great Depression. Dodd-Frank was designed to reduce the chances that we will experience another financial crisis of such a magnitude and to promote a financial system that works for consumers and businesses alike. These reforms have already helped make the financial system safer and more resilient by strengthening oversight and closing significant gaps in our regulatory framework.

As part of those reforms, the Dodd-Frank Act created the Financial Stability Oversight Council. Previously, no single entity was accountable for identifying, monitoring and responding to threats to financial stability; instead, each regulator focused on the institutions, functions, or markets under its purview. But as we learned during the crisis, risks are not always neatly packaged within particular asset classes or institutions and they don’t always align within the contours of our regulatory system. The Council’s role is to look across those silos to assess and respond to vulnerabilities by providing a mechanism for agencies to talk to each other about developments and take a broader look at the system as a whole. Through the creation of the Council, independent regulators now have additional tools to better oversee markets and institutions.

Now, about once every five weeks, the Treasury Secretary, as Chairperson of the Council, hosts all of the heads of the major financial regulatory agencies to collaborate on setting the interagency risk monitoring agenda. The Council has ten voting members and five nonvoting members, all of whom provide invaluable insight and analysis for the Council’s work. In recent months, the Council has considered issues including market volatility, interest rate risk, developments in Europe and emerging economies, benchmark reforms, and risks to financial stability arising from cybersecurity threats. This type of ongoing, collaborative engagement among federal and state regulators simply didn’t exist before the financial crisis.

But these regular meetings of the heads of the Council’s member agencies are just one manifestation of how the Council brings regulators together. The Council also fosters interagency staff-level engagement on a daily basis. 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 whom to call to respond to problems. Instead, the infrastructure is already in place – we work together regularly, and we have tried-and-true procedures for convening and addressing threats and major events affecting the financial system.

To support this engagement, the Council established staff-level committees to engage in regular discussions regarding financial market developments, regulatory policy developments, and emerging risk topics. These committees, which draw upon the collective policy, regulatory, and supervisory expertise of each of the Council members and member agencies, institutionalize opportunities for open discussion, collaboration, and coordination. The Council's Deputies Committee, which meets bi-weekly, coordinates the activities of the Council and oversees the work of the other staff-level committees. Those other committees include the Systemic Risk Committee, composed of staff of Council members and their agencies with supervisory, examination, data, surveillance, and policy expertise, who gather information about risks to financial stability; and a Data Committee, which is a forum to discuss data issues such as improving data sharing and closing data gaps. The Council also established two committees to support activities related to the designations of nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System and the designations of financial market utilities and payment, clearing and settlement activities. The Council also has committees focused on issues related to enhanced prudential standards and living wills.

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.

Let me highlight briefly the Council's annual report to Congress on potential risks to U.S. financial stability. This is a central product of the extensive collaboration among the Council members. The report's findings and recommendations set down a marker for action. They also promote transparency about the work of the Council and create accountability for its members. The Council's annual report provides a mechanism for regulators to discuss the key risks to financial stability and set a roadmap for the Council's agenda in the year ahead. The report is the product of extensive 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. A cornerstone of the report is that each of the Council's voting members signs a statement that says that the actions outlined in the report are the reasonable steps that need to be taken to ensure financial stability.

Let me emphasize that for anyone interested in the Council's views on developments in the financial system or potential risks, the annual report should be your primary resource.

But the annual report is just one of a broad array of tools available to the Council to highlight potential risks to financial stability. As the Council identifies different types of risks, it considers how those risks should be addressed. The Council can use its recommendation authority under Section 120 of the Dodd-Frank Act to propose that existing primary regulators apply heightened standards and safeguards for financial activities or practices, as it did with money market mutual funds. Another important tool of the Council is the ability to facilitate the sharing of information to assess threats to U.S. financial stability. The Council's designations authorities are also important tools to address firm-specific risks at nonbank financial companies and financial market utilities.

Now let me turn to the Council's work on asset management. Over the last year, the Council has been analyzing potential risks associated with the asset management industry and whether any such risks could affect U.S. financial stability. Before going into additional details on context and substance, let me remind everyone that the Council is still in the risk-identification stage of its work, so it is premature to speculate on any particular course of action the Council may take.

As part of the Council's effort in this area, in May 2014, the Council's Deputies Committee hosted a public conference on the asset management industry and its activities, at which practitioners—including CEOs, treasurers, and risk officers—as well as academics and other stakeholders discussed a variety of topics related to the industry. Last summer, the Council directed staff to undertake a focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry. The Council recognizes that asset management is an important component of the financial markets and that there are meaningful differences within the asset management industry, such as diverse investment strategies, corporate structures, regulatory regimes, and customers. However, the Council wouldn't be doing its job if it didn't consider whether certain industry-wide activities and products could potentially pose risks to financial stability.

As part of this work, on December 18 the Council issued a notice for public comment regarding asset management products and activities. Last month, the Council extended its comment period to March 25. I encourage everyone here to read it and contribute to the public discussion. Do not hesitate to reach out to my office if you have specific questions.

There has been a lot of discussion about the Council's review in this area, so let me stress some points on the context of our work. First, the Council recognizes that the investment risk-reward dynamic is of course inherent to market functioning. The Council's review of products and activities is not related to that dynamic. Rather, the notice seeks to understand whether the structure or mechanics of certain products or activities could create, amplify, or transmit risk more broadly.

Second, the topics covered in the notice reflect an ongoing dialogue across the industry. In many cases, regulators, market participants, and other stakeholders have been raising questions similar to those the Council is asking.

Third, high-quality data and information is central to the Council's ongoing work. This request for comment recognizes that in many cases more data is needed to better understand the nature and impacts of these potential risks. As part of this effort, the Council plans to assess whether sufficient data is available to evaluate potential risks, or whether there might be areas where additional data would be helpful to the Council or to market participants.

Finally, the Council's work is focused on potential risks to financial stability, rather than the day-to-day regulation of asset managers and protection of investors, which is of course the responsibility of the SEC. The Council is the only organization with the mandate to look across the financial system for potential risks to financial stability. As Chair White has noted, the SEC's work on asset management is complementary to the work of the Council, and vice versa.

In evaluating risks, the Council's threshold for action has been risks to financial stability. Input from all of the Council's members and from the public has been instrumental in shaping the Council's consideration of potential risks in diverse sectors of the financial markets. There is no universally accepted, bright-line definition for what constitutes a potential threat to financial stability. At its core, the Council's focus is on risks that could spread broadly to other market participants, markets themselves, or the broader economy and thereby disrupt the financial intermediation that is a cornerstone of economic growth. This is a high threshold that governs the work of the Council. In a number of instances, the Council has sought input from the public about how to identify these risks. For example, the Council requested public comment three separate times before adopting its final rule and interpretive guidance on nonbank financial company designations. In that context, the guidance states that the Council will consider a threat to U.S. financial stability to exist if there would be "an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." The Council's request for public comment on asset management continues this approach of engagement and transparency by seeking input on the extent to which risks may exist related to asset management products and activities. And the Council's annual report every year includes numerous examples of the specific types of risks that the Council is concerned about, ranging from cybersecurity to resolution planning to housing finance reform.

Now let me walk through the Council's request for comment on asset management and discuss the key risks the Council is seeking input on. The notice covers four primary topics: liquidity and redemption risk, leverage, operational risk, and resolution. Each section highlights potential areas of concern, identifies industry practices and regulations that may mitigate certain risks, and asks a number of questions about the existence and degree of risk, management practices to address the risks, and potential areas where additional data might be useful.

The first topic, on liquidity and redemption risk, focuses on whether structural features of pooled investment vehicles can create a "first-mover advantage" that could make fire-sale dynamics more likely. We are particularly interested in the growth in vehicles investing in less-liquid assets, such as high-yield bonds, and whether any redemption incentives could be magnified in a time of market stress. The Council is interesting in hearing how redemption rights and liquidity-management practices affect investor incentives; whether there are particular challenges associated with less-liquid assets; and how risk-management practices are executed in stressed markets, among other questions.

The second topic addresses leverage and focuses on two key potential risks: the degree to which the use of leverage by investment vehicles may increase the potential for forced asset sales, and the potential for leveraged vehicles to expose counterparties to losses or unanticipated market risks. This section of the notice highlights each of the main forms of leverage—such as margin credit, repos, securities lending, and derivatives—and emphasizes the Council's interest in exploring leverage risks in private funds, while still recognizing the use of derivatives by mutual funds and seeking views on potential risks there. The notice poses a number of questions to explore potential risks in this area, including whether the use of leverage by certain investment vehicles could increase the likelihood of forced selling, and any interplay with redemption practices; what the appropriate metrics are for assessing leverage; and what risk-management practices are used to monitor leverage and counterparty interconnectedness.

The third topic is operational risk, focusing on two issues: risks associated with the transfer of significant levels of client accounts or assets from an asset manager, and the extent to which asset managers rely on a small number of service providers for key functions. For example, with respect to the transfer of assets, the Council is seeking to understand the resiliency of market structures and practices to handle a scenario involving a sizable flight of clients away from one or more asset managers during a time of market stress. Are there scenarios that could potentially exacerbate stress conditions or amplify risks? With respect to service providers, the Council is interested in understanding any risks associated with the reliance on third-party service providers for important components of the asset management business, such as asset pricing and valuation or portfolio risk modeling. In areas where there is concentrated reliance on certain service providers, could there be significant problems if those entities ceased offering the service or if there were other serious disruptions or issues with the service?

The final topic in the notice is resolution, focusing on whether financial interconnections could present risks if an asset manager, investment vehicle, or affiliate were to become insolvent, declare bankruptcy, or announce an intent to close and liquidate. While there is a significant body of evidence that managers and investment vehicles close regularly without presenting a threat to financial stability, the ability to resolve institutions is vital to maintaining market discipline and properly functioning markets. The Council is seeking input on the nature of any financial interconnections both within a firm and across the marketplace that could complicate a resolution.

As a final note regarding the Council's asset management work, I think it's worth echoing what Secretary Lew said in December when the Council issued the request for public comment—and this certainly remains true today: there is no predetermined outcome, and no final decisions have been made in terms of potential risks relating to asset management products and activities. Once the Council has an opportunity to review public comments, it will be in a better position to identify any risks that may exist, and—to the extent any risks exist—assess the nature of those risks to better understand how a particular product or activity could pose a risk to U.S. financial stability.

Before I wrap up, let me also note the Council's recently adopted changes to its nonbank designations process. To be clear, with respect to asset management, the Council is currently focused on its review of industry-wide products and activities. But I know there has been a lot of interest in these changes, so a brief summary might be useful. The Council's nonbank designations authority addresses a key weakness brought to light by the financial crisis: that large, complex, and interconnected nonbank financial companies could pose risks to financial stability. As I mentioned earlier, the Council adopted a rule and guidance regarding nonbank designations in 2012, after three rounds of public comment. The Council has now designated four nonbank financial companies, and it used a thorough and transparent process when considering those firms. Each company had extensive opportunities to engage with the Council and its staff, and the opportunity to understand and respond to the key factors underpinning the Council's analysis before the Council's vote on a final designation. Nevertheless, as a young organization, it's important that the Council periodically examines its activities, so we conducted extensive outreach with a wide range of stakeholders last year to identify potential changes to supplement our process. The Deputies Committee hosted a series of meetings in November with more than a dozen organizations. We also solicited input from Congressional staff and each of the three companies then subject to a designation. In all, we heard the views of 20 different trade groups, companies, consumer advocates, and public interest organizations.

The key themes we heard from stakeholders related to company notification and engagement, transparency to the public, and engagement with companies as part of the annual review process for designated companies. The supplemental procedures approved last month by the Council address these three areas of input. First, companies will know early in the process where they stand, and they will have earlier opportunities to engage with the Council and staff, without compromising the Council's ability to conduct its work. Second, the changes will provide the public with additional information about the process, while allowing the Council to continue to protect sensitive, nonpublic materials. And finally, the Council will provide companies with a clearer and more robust annual review process. This will open the door to more engagement with the Council following a designation to make sure there is ample opportunity to discuss and address any specific issues that a company wants to put before the Council. I encourage folks to visit the Council's website for more information.

In closing, we have made significant progress since the financial crisis and the enactment 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. And regulators are better equipped to identify, monitor, and respond to potential threats to financial stability. As a result, our financial system is now better capitalized, more transparent, and better prepared to withstand shocks. Still, we must remain vigilant to potential threats, and that requires us to keep an eye on the full breadth of the financial markets. The Council's request for comment on asset management products and activities provides a good opportunity for us to engage with the public in a targeted manner on an important topic. Financial stability is clearly in all of our interests, so we should keep working together to promote the strength of the U.S. financial system.

Thank you very much for having me here today.

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