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THE ANNUAL REPORT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

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CONTENTS

	Page
Hearing held on:	
June 24, 2014	1
Appendix:	
June 24, 2014	61

WITNESSES

TUESDAY, JUNE 24, 2014

Lew, Hon. Jacob J., Secretary, U.S. Department of the Treasury	7

APPENDIX

Prepared statements:	
Lew, Hon. Jacob J.	62

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Lew, Hon. Jacob J.:	
2014 Annual Report of the Financial Stability Oversight Council	81
Written responses to questions submitted by Chairman Hensarling	228
Written responses to questions submitted by Representative Huizenga	250
Written responses to questions submitted by Representative Hurt	253
Written responses to questions submitted by Representative Luetkemeyer	255
Written responses to questions submitted by Representative Stivers	256

THE ANNUAL REPORT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL

Tuesday, June 24, 2014

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Bachus, Royce, Capito, Garrett, Neugebauer, McHenry, Bachmann, Pearce, Posey, Westmoreland, Luetkemeyer, Huizenga, Duffy, Hurt, Stivers, Stutzman, Mulvaney, Hultgren, Ross, Pittenger, Wagner, Barr, Cotton, Rothfus, Messer; Waters, Maloney, Sherman, Capuano, Hinojosa, McCarthy of New York, Lynch, Scott, Green, Cleaver, Moore, Perlmutter, Himes, Peters, Carney, Sewell, Foster, Kildee, Sinema, Beatty, Heck, and Horsford.

Chairman HENSARLING. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

This hearing is for the purpose of receiving the annual report of the Financial Stability Oversight Council (FSOC) to be presented by the Honorable Jacob J. Lew, Secretary of the Treasury and Chairman of the Financial Stability Oversight Council.

I now recognize myself for 5 minutes to give an opening statement.

Beginning this morning, we welcome back Secretary Lew to discuss FSOC, but before we do discuss FSOC, I would be remiss if I did not bring up the continuing scandal at the Internal Revenue Service, an agency that is part of Treasury. Mr. Secretary, 13 months ago you appeared before us and said, "My highest priority is to restore confidence in the IRS." I think we know, Mr. Secretary, both of us, that has not yet occurred.

Back then President Obama said of the IRS scandal, "The misconduct is inexcusable, and Americans are right to be angry about it, and I am angry about it." He said his Administration would cooperate with Congress to uncover the truth. That is what he said, but regrettably, that is not what has happened.

In just the last few days, we have learned the Administration has known since at least February that years' worth of IRS emails of eight IRS employees at the epicenter of the scandal have simply vanished. How terribly convenient for the Administration, but how inconvenient for the American people who expect equal protection under the law.

The American people, regrettably but understandably, are becoming increasingly cynical and fearful of their government. There is a growing resentment of one set of rules for Washington and another set of rules for everyone else. In other words, no one believes that simply saying, "Sorry, I have lost my emails," is an excuse the IRS would accept from a taxpayer being put through a torturous audit.

Mr. Secretary, I trust you agree that the American people deserve better, and it is past time for openness and transparency from this Administration, which you told this committee 13 months ago was your highest priority. It is also past time for openness and transparency at FSOC, which you chair, Mr. Secretary. While you and other Administration officials habitually cite the purported dangers of financial stability posed by the shadow banking system, you ignore those presented by the shadow regulatory system of which FSOC is front and center.

Indeed, with the exception of agencies dealing in classified information related to national security, FSOC may very well be the Nation's least transparent Federal entity. The public cannot view their proceedings because two-thirds of those proceedings were conducted in private executive sessions. And when the minutes are produced, on average they weigh in at a mere 5 pages long, with half of the pages devoted to memorializing attendees' names and resolutions considered.

Better Markets, a public interest group that consistently advocates for more regulation of our financial sector, has stated, "The FSOC's proceedings make the Politburo look open by comparison. No one in America even knows who they are. At the few open meetings they have, they snap their fingers, and it is over, and they are all scripted. They treat their information as it were state secrets."

To begin to remedy this sad situation is one of the reasons this committee has ordered H.R. 4387, the FSOC Transparency and Accountability Act, favorably reported to the House. The reason transparency and accountability are so important is because FSOC can designate practically any large financial firm in our Nation as a systemically important financial institution, a SIFI, and thus render effective control over it. Thus, it has the ability to render great damage to our economy and set back the dreams of tens of millions of our unemployed and underemployed Americans who are counting on their capital markets to work for them.

Recently Douglas Holtz-Eakin, the former Director of the CBO, has estimated that designating asset managers as SIFIs could cost investors as much as 25 percent of their return on their investments over the long term, or approximately $108,000 per investor. In other words, as it operates in the shadows, FSOC can take away the seed capital necessary to launch a small business or to send a child to college. That is both unfair and unwise.

And while FSOC seems dead set on trying to find systemic risk where no one else seems to find it, a review of their latest report indicates that they are willfully blind to the largest sources of systemic risk, with hardly a mention of Fannie Mae or Freddie Mac, who were at the epicenter of the last financial crisis, and without the leadership of the Administration to end permanent taxpayer

subsidies, they are certain to be at the center of the next financial crisis.

There has been no mention of the Federal Government itself, which is $17 trillion in debt and growing, with more debt incurred under this Administration than in our Nation's first 200 years. Our offices are all awash. The CBO and independent reports say the pace of spending is unsustainable, but rather than rein in government spending or prioritize interest payments on the debt, the Administration regrettably turns a blind eye and has even threatened to allow default on our sovereign debt.

This committee has also passed H.R. 4881, to place a 1-year moratorium on further designations of nonbank SIFIs. Again, Mr. Secretary, I would call on FSOC to cease and desist with these designations so Congress can have time to conduct effective oversight and get answers to questions that both Republicans and Democrats have raised about FSOC's decision-making process.

I now recognize the ranking member for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

Today I am very pleased that you are here, Secretary Lew, and I welcome you back. And I assure you that we are not poised here today to talk about the IRS. That has been done in our Oversight and Investigations Subcommittee. We don't have documents. We don't have emails. We don't have any information relative to that issue. We gather here today to receive your annual report of the Financial Stability Oversight Council, FSOC, as required by the Dodd-Frank Act.

To be honest, I am surprised to see so many of my colleagues on the other side of the aisle with us today given that the FSOC has joined the ranks of the Consumer Financial Protection Bureau, the Export-Import Bank, and the Terrorism Risk Insurance Act in becoming the latest target in a relentless Republican effort to tear down important engines of job creation, economic growth, and consumer protection.

I didn't think my colleagues on the other side of the aisle would have any interest in hearing about the Council's progress or in your views of the financial stability of the United States. In fact, just last week this committee approved two measures that, under the guise of transparency, would compromise the FSOC and erode the important role it plays. These partisan bills were nothing more than an effort to derail this cornerstone of the Dodd-Frank Wall Street Reform Act.

Mr. Chairman, the economic collapse of 2008 resulted in the greatest loss of wealth in a generation. Starting with the bankruptcy of Lehman Brothers, our economy quickly ground to a halt, leaving the American taxpayers to clean up the mess. All told, the financial crisis resulted in the destruction of more than $9 trillion in wealth and cost each American household approximately $50,000, while unemployment exploded throughout the country.

One problem leading up to the crisis was that no one in the private sector or in government saw the big picture or had the responsibility to deal with emerging threats before they caused damage to our economy. That is why Democrats created the Financial Stability Oversight Council, that is FSOC, to fill that void and serve as an advance warning system to identify and address systemic

risks posed by large complex companies, products, and activities before they threaten the economy.

In plain English, FSOC is charged with looking at every aspect of our financial system for possible weaknesses and risk, something that did not happen in the lead-up to the crisis. The Council's work is critical to ensuring that our financial regulators are working collaboratively to identify and respond to emerging threats to financial stability.

It remains a mystery to me why Republicans are spending the few legislative days we have left in this session pushing partisan legislation that would hamstring the FSOC's ability to protect homeowners, consumers, and the American economy. And it is obvious that, like with CFPB, Ex-Im, and TRIA, the Republicans' goal is to stop the program from its important work even if that means ending important protections for the American people in our economy.

Secretary Lew, I look forward to your insight on areas of systemic risk the Council has identified, particularly related to mortgage servicing, alternatives to reference rates like LIBOR, and perceptions of "too-big-to-fail." As we hear additional details from you about the risks identified in this year's report, I will be interested to hear whether Republicans believe FSOC should take action to mitigate those risks or turn a blind eye and invite another crisis.

Finally, Mr. Chairman, I am looking forward to hearing more from you about how we address concerns that I and other Members of Congress have raised regarding the transparency of the FSOC designation process. I am sympathetic to these concerns and would like to hear what steps you have taken and your suggestions on how to increase transparency in a way that continues to carry out FSOC's mission. I look forward to the Secretary's testimony and his insight on all of these issues, as well as what the FSOC is currently doing to monitor systemic risk and promote financial stability.

I yield back the balance of my time.

Chairman HENSARLING. The Chair now recognizes the gentlelady from West Virginia, Mrs. Capito, chairwoman of our Financial Institutions and Consumer Credit Subcommittee, for 1 minute.

Mrs. CAPITO. Thank you, Mr. Chairman, and thank you, Secretary Lew, for being with us today.

We are going to learn more about the FSOC, which was created by Dodd-Frank with the mission of monitoring systemic risk. This designation can have a significant effect on the institution by requiring increased levels of regulatory capital. The costs associated with heightened credential standards are quite clear; however, the processes and methodologies for determining a nonbank firm's systemic risk are much less clear.

In fact, in the recent designation of Prudential Insurance, the one member of the FSOC with significant insurance industry experience argued that there was little evidence to support the notion that a large life insurer poses a systemic risk. Furthermore, we know little about how an institution's designation will affect the end users.

Another issue I would like to discuss with you, Mr. Secretary, is, are there arbitrary thresholds in Dodd-Frank that determine if a

financial institution is systemically significant? There has been a lot of discussion about the different thresholds, and I would like to dig deeper on that with you. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney, ranking member of our Capital Markets Subcommittee, for 1½ minutes.

Mrs. MALONEY. Thank you, Mr. Chairman, and Ranking Member Waters, and welcome, Secretary Lew. I believe I speak on behalf of all New Yorkers when we say we are so proud of you and your many years of public service.

This is an important hearing. The Financial Stability Oversight Council was one of the keys of the Dodd-Frank financial reform, and it provides a forum for all of our financial regulators to come together to discuss the risks that they each see in the markets they regulate, but from a broad perspective, from a systemic perspective. It also requires them to publish an annual report that describes in detail the emerging threats that they see in the financial markets, and this is tremendously important.

It depends on what report you look at: the ranking member said $9 trillion; I have seen some reports that said that we suffered $16–$18 trillion in loss to our economy; Christina Romer testified before this Congress that the economic shocks we experienced in the last recession were 3 times greater than the Great Depression, and we managed it better.

But also, economists have testified before this panel and other panels that it was the only financial crisis in our history that could have been prevented by better financial market overview and regulation. We didn't keep up with the new products. We didn't keep up with the new trends. So FSOC was created to help us prevent another serious, damaging, painful economic loss that we could have prevented with better financial management.

I look forward to reading your report. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, chairman of our Capital Markets Subcommittee, for 2 minutes.

Mr. GARRETT. Thank you, Mr. Chairman.

Today FSOC has become a sort of super-regulator whose SIFI designation is effectively an implicit taxpayer guarantee. Over time, I believe "too-big-to-fail" SIFIs will use their capital cost advantage to drive smaller competitors out of business. In short, FSOC now picks the winners and the losers in our financial markets. As FSOC aggressively asserts itself over more and more sectors of our economy, insurance companies and asset managers most recently, they owe the American people an explanation for what they are doing.

Despite the recently released 147-page FSOC report, the vast majority of which is a rehash of basic economic information available on any financial Web site, FSOC's decision-making process remains a black box. Citizens whose livelihoods are directly affected by FSOC have little idea why FSOC makes the decisions it does.

As a Congressman, I can be briefed on the most sensitive intelligence in the national security information, but I am not allowed

to even sit quietly and listen in on an FSOC meeting. And companies that are designated by FSOC have only the vaguest notion of what aspects of their operation led FSOC to deem them systemically important. Without that knowledge, of course, they could do nothing to reduce their own systemic risk.

And more importantly, when Republican Members have asked questions of you and of FSOC in the past, the answers we receive have always been bland and evasive talking points designed simply to give us the impression of responsiveness without actually ever answering any of our questions, Mr. Secretary.

In fact, this committee asked you specifically last month for all the documents and all the communications between you, your Department, and the Financial Stability Board (FSB), and I have everything that you supplied us with right here in this box in response to your promise to supply us with all of those documents. We got absolutely nothing from you when you promised us that you would supply us with that information.

Mr. Secretary, this stonewalling by you and this Department must stop. We have to get real answers from you and from Treasury, and I hope that today, the process begins.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Colorado, Mr. Perlmutter, for 1½ minutes.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

And, Mr. Secretary, it is good to see you here. I want to thank you, and I want to thank the Administration. Since the President took over, since Dodd-Frank was passed, the stock market is up 10,000 points at about $1.3 billion per point. My math takes that to $13 trillion. Home prices are up, IRAs are up, and we put 10 million people back to work, and I just want to thank you for that.

We had kind of an age-old debate a few weeks ago. Mr. Scalia was here saying that Dodd-Frank and FSOC had too much discretion. We had members of the banking community saying there was too little discretion and too arbitrary lines of demarcation within the bill.

I have two areas I would like you to talk about today: first, the living will, what you are doing on the major institutions to find out if they fall apart, how you are going to take them apart; and second, I want you to talk a little bit about the GSEs.

I am one of those who thinks that with proper underwriting, the GSEs actually work very well, and the private market will come and go as they think they can make money in mortgages. And now, there isn't a lot that has to be done with respect to the GSEs.

So I would like you to talk about living wills and GSEs, and with that, I thank the chairman, and I yield back.

Chairman HENSARLING. The gentleman yields back the balance of his time.

Today, we welcome the testimony of the Honorable Jacob J. Lew, Secretary of the U.S. Department of the Treasury. Secretary Lew has testified before our committee on a number of occasions, so I trust he needs no further introduction. Without objection, Secretary Lew's written statement will be made a part of the record.

Mr. Secretary, you are now recognized for your oral presentation. Thank you.

STATEMENT OF THE HONORABLE JACOB J. LEW, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary LEW. Thank you very much, Mr. Chairman.

Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for the opportunity to testify today on the Financial Stability Oversight Council's 2014 annual report.

Nearly 4 years ago, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, creating the strongest safeguards for consumers and investors since the aftermath of the Great Depression. As everyone here recognizes, a stable, thriving financial sector is critical to our economic growth and prosperity, and that is why these historic safeguards were established.

Today our financial system is more resilient, confidence in our markets is robust, and the agencies charged with protecting consumers and investors are in a strong position to respond to emerging threats that could hurt our economy, damage Main Street businesses, and destroy jobs.

One of the lessons from the financial crisis was recognizing how important it is to detect and mitigate risks to financial stability. In the lead-up to the crisis, individual regulators focused on individual institutions, functions or markets. This siloed approach allowed risks to fall through the cracks. Congress changed that by creating the Financial Stability Oversight Council. Now regulators are obligated by statute to collectively monitor the stability of the entire U.S. financial system, to look over the horizon to identify potential risks, and to respond to threats that have been detected. In short, the Council's work to detect possible risk is not only mandated by law; it is sound economic policy.

That is why it both defies common sense and ignores recent history that some have suggested curtailing the Council's ability to analyze information regarding particular financial sectors, firms or activities. The Council cannot simply cordon off any sector or activity that could pose a threat. That would be a dereliction of its responsibilities and a complete disregard for the very purpose of the Council.

Some have even gone so far as to suggest that the Council should be prohibited from simply asking questions about certain activities or companies that could threaten financial stability. We have to be allowed to ask questions. As everyone here knows, during the run-up to the financial crisis, regulators should have asked more questions about institutions and activities, not fewer.

To be clear, asking questions does not equal regulatory action. Sometimes questions result in a conclusion that the Council does not need to act; that it needs to examine the issue further, or that it needs to gather more information. The Council asks questions with an open mind and without a predetermined outcome. In that vein, the Council's procedures are transparent. It has put in place a comprehensive delivery of approach to its evaluation of risks, and it solicits public input and carefully considers all points of view.

In fact, the Council's annual report exemplifies the Council's commitment to transparency and collaboration. It reflects a collective analysis and conclusions of Council members regarding the key risks to financial stability, and is an important example of how the

Council shares information about its work with Congress and the public.

Each annual report also provides a road map for the Council's agenda for the upcoming year, what areas it will focus on, what areas will likely require additional attention, and how the Council expects to address them.

This year's report focuses on nine areas that warrant continued attention and possibly further action from its members. These areas include wholesale funding markets, the housing finance system, cybersecurity threats, risk-taking by large financial institutions, and potential interest rate volatility.

Before closing, let me point out that since the Council's last annual report, we have reached a number of key milestones in financial reform implementation. That means that homebuyers, retirees, and investors have better safeguards and protections. To that end, the Volcker Rule has been finalized, qualified mortgage standards have gone into effect, tough capital standards are now in place, over-the-counter derivatives are now moving onto electronic trading platforms and into centralized clearing, fines have been imposed on abusive actions related to manipulation of LIBOR and other financial benchmarks, and the international community is making progress on increasing the stability of the global financial system.

Mr. Chairman, I want to thank the members of the Council and all of the staff involved with the 2014 annual report for their tireless work and commitment. As the Council fulfills its obligations to strengthen our financial system and limit risk to our economy, we will continue to work with the committee and with Congress to make real progress for all Americans.

Thank you, and I look forward to answering your questions.

[The prepared statement of Secretary Lew can be found on page 62 of the appendix.]

Chairman HENSARLING. The Chair now recognizes himself for 5 minutes for questions.

Mr. Secretary, I would like to start off with a matter that I left off with during your last appearance, for which I did not receive an answer. It is not a "gotcha" question, and when I receive the answer, I will certainly be fair and give you a brief moment to give it some context.

As you know, 11 months ago the G20's FSB, of which Treasury is a preliminary member, designated 3 U.S. insurers as global SIFIs. Did Treasury support these designations, yes or no?

Secretary LEW. Mr. Chairman, as I mentioned the last time I testified, the FSB operates by consensus, and the U.S. participants in the FSB joined in the consensus at that time.

Chairman HENSARLING. Okay. So Treasury considered in the designation, correct?

Secretary LEW. We joined in the consensus. There was not a vote, but we were part of the consensus.

But I need to really make the point quite clearly that action in the FSB and action in the FSOC are very different matters. The FSB is not a national authority. It doesn't designate institutions in a way that has a legal effect. And the FSOC, when it makes its determination, does it on a parallel path. Now, it may ask and answer questions in a similar way, but it doesn't necessarily.

Chairman HENSARLING. Let me ask this question, Mr. Secretary: Can a financial institution pose, in your mind, a systemic risk to the global economy without representing a systemic risk to our domestic economy?

Secretary LEW. Mr. Chairman, I think the question of designation is a moment in time and based on analysis it had at that time. In the case of a designation of a specific institution, the process at FSOC goes through a very detailed process.

Chairman HENSARLING. I understand there may be two different processes. What I am simply asking is in Treasury's opinion, if one is a potential systemic threat to the global economy, must they necessarily also present a systemic risk to the domestic economy?

Secretary LEW. And the reason I am answering your question the way I am is that in making a determination at the FSB level, it is based on the information and the analysis you have at that point. What you go through during an FSOC determination process is a very detailed exchange of information ultimately with a company—

Chairman HENSARLING. So you are simply telling me that two different processes may lead to two different answers?

Secretary LEW. It could.

Chairman HENSARLING. So Treasury, then, you are telling me, could support a designation of the exact same firm as systemically risky to the global economy but not systemically risky to the domestic economy?

Secretary LEW. The action taken in the FSB does not designate a company in the same way that FSOC does. So the only national authority that can designate a company for regulation is FSOC.

Chairman HENSARLING. Okay. Well, Mr. Secretary, my time is limited. Let me move on.

I think you know that Bloomberg—different subject—reported that when the Chairman of the SEC told the FSOC that they wanted to release the Office of Financial Research Asset Management study, which, as you well know, has been widely panned, Bloomberg reported that you personally called the SEC Chair "to express your displeasure." Is that story accurate?

Secretary LEW. I am not going to get into the details of private conversations that I may have had with other members of the FSOC, but—

Chairman HENSARLING. Okay. Let me ask the question this way: Did you favor or oppose releasing the study to the public?

Secretary LEW. My view was that the OFR study was going to be released to the public, and the public was going to be commenting on it. And the question of whether or not it would be released in any kind of a formal way asking for comments by an agency other than OFR is a different question.

Chairman HENSARLING. Should the OFR—

Secretary LEW. There was never a question that the OFR study would be published.

Chairman HENSARLING. Should the OFR's work be immune from public comment?

Secretary LEW. No. On the contrary, the OFR report was meant to be public, and it was meant to elicit a public debate, and that debate occurred. So I very much believe that it should have been

public, it was public, and the only question was should it be formally put out by one or another agency for comment in a formal way?

Chairman HENSARLING. Last year you said, "It is unacceptable to be in a place where 'too-big-to-fail' has not been ended. If we get to the end of this year and we cannot with an honest, straight face say that we have ended 'too-big-to-fail,' we are going to have to look at other options."

I think you may know that a few months ago your predecessor Secretary Geithner was asked if "too-big-to-fail" still exists. His answer, "Yes, of course it does."

Using your words, can you tell this committee today with an honest, straight face that we have ended "too-big-to-fail?"

Secretary LEW. Mr. Chairman, we have made enormous progress. I am not sure we will know the answer to that question until we have the next financial crisis. That is the challenge that we all have in asking have we gone far enough. But I will say that there is more work under way to continue to look at the areas where we can have more protection, things like supplemental—

Chairman HENSARLING. We have heard from multiple witnesses that the Volcker Rule will significantly reduce liquidity in the corporate bond market. The Financial Times has reported that the Federal Reserve is very concerned about the potential of large-scale withdrawals from investors and managers of corporate fund bonds. They are concerned about the illiquidity of the corporate bond market. So it strikes me as somewhat ironic that the Volcker Rule, which has been touted by you and others as necessary to ensure financial stability, may now be a part of financial instability.

This committee has requested information from Treasury and FSOC regarding the status of our corporate bond markets. We haven't received anything as yet. So has the FSOC conducted an analysis of the systemic risk that can result from a lack of liquidity in the corporate bond market?

Secretary LEW. Mr. Chairman, we obviously are just in the early months after the final publication of a Volcker Rule that is final. It hasn't taken effect in the marketplace yet, so it is premature to judge what its impact on the market is.

I think it is actually quite an accomplishment that five independent regulators published an identical rule on the same day providing clarity in an area that badly needed clarity so that there would not be uncertainty in the industry. I have actually received quite a lot of positive comment that that was the result.

Chairman HENSARLING. The time of the Chair has expired.

The Chair now recognizes the ranking member for 5 minutes.

Ms. WATERS. Thank you very much.

Some have criticized the FSOC's designation process as being opaque. The GAO also made several recommendations to the FSOC to improve its transparency. Would you please describe how the FSOC has addressed these recommendations? Would you also describe how the FSOC changed this transparency policy last month? Is the FSOC appropriately balancing the need for transparency against the need to protect sensitive market and supervisory information?

This is an issue I would like to get behind us and deal with it in ways that would allow FSOC to do its work. And so I am hoping that you have not only given considerable thought to this, but to help us to understand how we can better make sure that you can carry out your mission and not have those that you are regulating and giving oversight to believe that somehow you are trying to do all this in secret. And I don't want to spend all of my time on this, because I really do want to get to nonbank market servicing. So would you please respond to the first part of the question?

Secretary LEW. Congresswoman Waters, I think that the values of openness and transparency are very important to all of us. We have constructed a process in FSOC which I believe respects and reflects those values, and it gives an enormous opportunity for companies through the designation process to engage with FSOC without prematurely making public things that would not be appropriate to be a public discussion.

Much of the discussion in a designation process involves reviewing the internal information that is the kind of supervisory information with which regulators work. When we get to the final stage of the designation process, there is a back-and-forth that is quite voluminous with the company where the company is sharing proprietary information, information that gets to the essence of their business.

So I think what we need to balance is a process that requires a certain amount of confidentiality with transparency. We just recently made some changes, and it is a young organization that is continuing to evolve where we are noticing in advance topics to be discussed. We are putting out minutes of meetings, notes for meetings afterwards, and we will continue to try to perfect the process. But I don't think the answer is to say it should all be a completely open public discussion or the inquiry itself would be stymied.

Ms. WATERS. Mr. Secretary, I would like to ask you to make sure that the staff of FSOC gets what the staff of this committee, and I would hope that the chairman would agree, so that you could walk through whatever changes you have made—

Secretary LEW. I would be happy to do that.

Ms. WATERS. —in order to have more transparency. We need to understand that, because as you know, with H.R. 4387, this bill would subject FSOC to the Sunshine Act, expand its membership and change voting protocols for Commission and Board members, and allow Members of Congress to attend and participate in FSOC closed-door meetings.

Now, I think this is ridiculous, and I want to get off of that, and so if you will help us to understand more about what you have done, then hopefully we can engage with you about what we think about what you have done and maybe have some suggestions for you.

With that, do you have a moment to talk about what you have done in taking a look at nonbank mortgage services?

Secretary LEW. The question of mortgage servicers is a very important one. As they have moved out of banks into more independent businesses, the challenge is how to maintain consumer protections and oversight, and how to make sure that very important backbone to our mortgage finance system functions well.

I think if you look at the actions taken by the CFPB, they have taken on the role of consumer protection oversight in a very important way, and I think that is an area we have to continue to look at, understand, and, if we need to take more action, discuss what that is.

Obviously, the mortgage system requires that there are servicers who are reliable, who are there to handle the transactions between the borrower and the holder of the mortgage, and it is something that we cannot have be fragile. So it is something we are very much watching, and we think that the actions taken by the CFPB are very positive ones, and we will continue to review the situation.

Ms. WATERS. Mr. Secretary, let me just say, one of the things we discovered with the subprime meltdown was a lot of the problems were with the servicers: the loss of paper; the lack of understanding what their jobs really were; the inability to make determinations about whether or not people had sufficient income to meet a proposed modification; and on and on and on. So this is a serious area that—

Secretary LEW. It is a very important area. I totally agree.

Ms. WATERS. Thank you. And I yield back the balance of my time.

Chairman HENSARLING. The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, chairman of our Capital Markets Subcommittee.

Mr. GARRETT. Mr. Secretary, as you know, the chairman, some other members of the panel, and I have asked for specific documents from you, and we did so over a month ago, and you assured us that you would provide them. You formally responded only last Friday, and you did so with a nonresponse. The response contained none of the requested documents.

Mr. Secretary, this committee has to subpoena those documents. Can you promise us here today that any emails that make up those documents or files that we have requested will not fall victim to any mysterious or unexplained hard drive crash? And are you doing anything now to protect those documents that we have requested and you promised that you would supply, but after a month you still have not done so?

Secretary LEW. Congressman, as you noted, I did respond along with the Chairman of the SEC and the Chairman of the Federal Reserve Board to your inquiry. In that letter, we said our staff would work together to—

Mr. GARRETT. So will you protect those documents? Because you did not provide any of the documents that we requested.

Secretary LEW. Yes. And as the letter indicates, our staff will work with your staff on—

Mr. GARRETT. Are you protecting those documents?

Secretary LEW. We routinely protect our documents.

Mr. GARRETT. We know the routine over at the IRS. Is yours a better routine than they have?

Secretary LEW. Congressman, we have—

Mr. GARRETT. Okay. That is a "no."

Secretary LEW. No, Congressman, that is not a "no."

Mr. GARRETT. Mr. Chairman, I would suggest—

Secretary LEW. We protect our documents.

Mr. GARRETT. I would suggest that we consider issuing subpoenas sooner rather than later, given how fast emails are disappearing within the Treasury Department.

I have a question for you from home. This is a little bit off topic. But if the IRS is conducting an audit of a law-abiding taxpayer citizen—and I have gotten this a lot over the last several weeks—and the IRS asks for documents, and they do not come, and they say that they don't have them anymore because their hard drive crashed, the IRS and your response to them would be, that is okay because that is the routine system?

Secretary LEW. Congressman, as Commissioner Koskinen testified last week, if that happens to a taxpayer, the practice is for the IRS to work with the taxpayer based on documents that are available to proceed—

Mr. GARRETT. So I will take that as—and so we are going to be working with you, and that is why I suggested that we issue subpoenas now because you have not supplied the information that you have promised to this committee.

Mr. Chairman, I don't have any confidence in this Administration to be able to conduct a fair, impartial, and thorough investigation into that matter, nor to supply the information this committee has requested repeatedly. And for that reason, I do believe that a special prosecutor should be appointed to find the truth as to what actually happened there, and for us to go forward as quickly as possible with regard to subpoenas.

Now, to return to the matter at hand on FSOC and designations, the chairman asked you a very simple question with regard to consensus. I think most people watching understand what "consensus" means. It means that the parties at a table consent to something. That is the root word of consensus. So FSB in that process said there was a consensus on the matter, and his simple question was, did you consent? And you did not give an answer. Can you say whether, when they went around the table figuratively, did you consent? Did you say yes, no, or I really don't know what to answer?

Secretary LEW. Congressman, I answered the question. I said the U.S. Government representatives joined in the consensus.

Mr. GARRETT. So you said yes?

Secretary LEW. I answered the question.

Mr. GARRETT. No. And so when you made that determination, the chairman also asked the question, is it possible for a company to be globally designated but not to be designated nationally by a SIFI? And the answer to that one is also yes?

Secretary LEW. Yes. I said that they are parallel processes, and the FSOC, which is the national authority, would make its own determination based on the process conducted at FSOC.

Mr. GARRETT. So a company could be globally important but not here in the United States? How is that possible?

Secretary LEW. The process of the FSB designation is one that is not binding on national authorities. Obviously, it is something—

Mr. GARRETT. Binding doesn't matter . It is whether or not that company is actually systemically important on a global basis.

Secretary LEW. That is the reason that the FSOC goes through a very detailed analysis. There is more information—

Mr. GARRETT. Oh. So does that mean that the FSB process is not a detailed analysis?

Secretary LEW. No, I am not saying it is not a detailed analysis, and I am not saying that the outcome would be different. I am just saying that there is a parallel national process that takes place and—

Mr. GARRETT. In a legal matter, when a judge has made a decision in one case, they oftentimes have to recuse themselves when the same parties are involved in that or the same issues come up. Lawyers have to do that all the time. Will you recuse yourself from that deliberation process when these same companies come up for designation on the SIFI basis even though they are different processes?

Secretary LEW. Congressman, the responsibility that all of us at FSOC have is to review all of the information and make a decision based on the information presented in the FSOC process, which is what I will do.

Mr. GARRETT. So, the answer to that is "no."

Secretary LEW. I will do my job reviewing all the documents and all the analysis, and we will make a decision based on that.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Capuano, ranking member of our Housing and Insurance Subcommittee.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Secretary, I am tempted to talk about the batting averages of the Red Sox, but I think I will wait for another day for that. That is my biggest concern right now, to be perfectly honest with you.

I do want to talk about a couple of concerns. First of all, I want to thank you for the job you have done. I think you have done a great job. But like everything else, there are details that have to be worked out, and I have a lot of constituents who are concerned about questions that have not happened yet. I am very happy with what FSOC has done, but I have my concerns about some of the things they have not yet—the second shoe hasn't dropped.

I want to talk to you for a minute about the International Association of Insurance Supervisors, of which you are participating, and I got a response from you to a letter we had written. I want to read a section of that and put the letter on record. We were talking about the capital standards that are being developed by the IAIS and your letter stated that, "the capital standards being developed by insurance experts will not have any legal effect in the United States unless they are implemented by U.S. regulators in accordance with U.S. law," which, of course, is the answer that I wanted. I appreciate the answer, but I need to push it a little further.

And I say that because I am not opposed to internationalization. It is going to happen. I just think that we shouldn't put the cart before the horse. We haven't cleaned up our own house fully yet. I am not ready to pass it all over to an international standard. I want to make sure that in the standards correctly, though, that by doing so—I want to make sure how I understand that in accordance with U.S. law, I want to make sure that this is not some back-

door way to allow some Section 4807 of some treaty with some country I have never heard of to overtake our capital standards and insurance, and say, we have a treaty that we signed 400 years ago, and we have to therefore give it up. That is—I presume that you are not looking for that back door.

Secretary LEW. No. Congressman, I think it is worth taking a step back and talking about how important our involvement in these international bodies is. We could do an outstanding job in the United States putting a system in place that is safe and sound for all of our financial institutions, and we are still exposed to vulnerabilities if, around the world, the standard isn't raised as well. So we simultaneously participate in international discussions, and in a case like this, our insurance experts are very much a part of shaping the international debate.

Mr. CAPUANO. As I think you should be. I think you should be at the table, and I do think that you should participate, and I do think you should have a strong voice. I just don't have faith at the moment. I may have it at some future time that the international standards are going to be any better than we can do for ourselves.

Secretary LEW. And while our participation in the international process often leads to a result that reflects our judgment of what the outcome is, we retain, as do all national authorities, the right to make decisions.

Mr. CAPUANO. Fair enough.

Secretary LEW. In the case of insurance, it is the States that have a lot of the authority.

Mr. CAPUANO. The other question, though, is, number one, I want things straightforward. I believe in FSOC, I believe in what you are doing, I do believe internationalization is coming, but I don't want to find out the day after that, that somehow through the back door, we gave up our entire system of insurance regulation without knowing about it. If we do it, I think we need to do it conscientiously. I don't want to find out that some treaty did it, and I don't want to find out that somehow because somebody from Lichtenstein had a better idea, that now they run our insurance industry. And I don't expect that is going to happen, but I need to put that on the record.

Secretary LEW. That is not the way it works.

Mr. CAPUANO. You also talk about transparency, that, as far as I am concerned—let me back up 1 second. I also want to go and find out that under Dodd-Frank, as I understand it, the Fed and others have oversight on insurance companies that are SIFIs, or they have savings and loans holding companies. Other insurance companies are not subject to Federal regulation, and I just want to make sure that there is not some back-door way to expand jurisdiction. Though I do believe that Federal optional charters will come someday, they are not here yet, and I just want to make sure we are not trying to do that in a back-door way.

Secretary LEW. It is definitely not any kind of a back door into Federal regulation of all insurance, though there is a debate to be had, as you note, as to what is the right balance between State and Federal. But that has to be done directly, if it is done.

Mr. CAPUANO. That is what I wanted to hear.

I also want to talk a little bit about transparency. You also agree that transparency is important, and up until now there has been some—there has been give and take; you get transparent, and then you don't get transparent. And for me, one of the things when it comes to designating SIFIs is the SIFIs know what the measurements are, or the potential SIFIs know what the measurements are.

My argument is, it is like a traffic cop. If a traffic cop is sitting on a highway, the truth is most of the time I want the blue lights to be flashing because I am not interested in catching somebody going 3 miles an hour over the speed limit, I am interested in keeping them at the speed limit, and the best way to do that is let them know that there is a cop on the highway.

And the same thing here. I am not interested in catching someone into a SIFI if they want to avoid it and can avoid it. And the only way that can happen is if FSOC and others tell them, here are the measurements we are going to have. If you choose not to participate in these measurements between now and 6 months from now, you can take action to avoid it. Why is that not possible?

Chairman HENSARLING. Brief answer, Mr. Secretary.

Secretary LEW. I think that the standards that are used in FSOC actually are understood by the industry. We put out detailed rules early on in the process. When it gets to the point of actually engaging with a company, there is an enormous amount of give and take back and forth, which gives them the ability to make judgments as to how they want to organize their risk.

Mr. CAPUANO. I think we have to follow up on that at a later time.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from West Virginia, Mrs. Capito, chairwoman of our Financial Institutions Subcommittee.

Mrs. CAPITO. Thank you, Mr. Chairman.

As I mentioned in my opening statement, I believe that the process for designating the financial institutions should be based on activities of the institution as opposed to just arbitrary cut-off points, for instance, the $50 billion level, and then we have another level, $10 billion for the consumer supervision.

And what we are finding, I think, is—and this sort of pivots a little bit off of the previous questioner—if you have these arbitrary deadlines at $50 billion, you could have a financial institution that is maybe at $35 billion that is much riskier than, say, one that is at $100 billion because of their business platforms, their business—and the way they structured their business with less and fewer risks.

So I guess what I would ask is—and Governor Tarullo talked about this about a month ago, mentioned—just kind of threw out $100 billion to raise it up, because folks who are falling in those thresholds are having difficulty. How do you feel about that, rather than have an arbitrary asset limitation, to maybe look at what the risk profiles and base those designations on that? I know that is a discussion.

Secretary LEW. The threshold does not lead to designation automatically. There is only a designation if the analysis done suggests

that there is a risk that determines that it is systemically significant. And I think that the number of designations reflects the fact that we have seen the nonbank utilities designated, we have seen two insurance companies designated. It has not been a massive process.

Mrs. CAPITO. I think in the case of the banks, if they reach the $50 billion threshold, it is a—

Secretary LEW. I thought you were talking about the FSOC designation, the thresholds.

Mrs. CAPITO. I am talking about that in conjunction with, I guess, the other designations of significantly systemically important—

Secretary LEW. Yes. As far as the banks, I think after the financial crisis the burden certainly was on us to take a closer look at systemic risk in large institutions, and as we go through that process, as the regulators go through their more detailed reviews of both the financial conditions of those banks and their systemic risks, I think it is a discussion that we can continue to have.

But I think for the time being, we have to look back and forward. We weren't where we needed to be in 2005, 2006, 2007, and 2008. We need to make sure that we have visibility into any of the institutions that could create that kind of systemic risk. And as far as the designations at FSOC go, the same standard, I think, applies. We are not looking to designate for the sake of designating. We are only looking to identify where are there areas of systemic risk that if we look back at the next financial crisis, we would say, why didn't you catch that?

Mrs. CAPITO. I think that in the case of Prudential, they would argue—this is a slightly different question—that if they were to fail, their business model would not drag down the entire financial system. What kind of metrics were used for that, and how does that—yes, what kind of metrics did you all use to make those determinations when the insurance expert on the FSOC had a deep question about that?

Secretary LEW. There were detailed analyses done, and there was a hearing where Prudential came and exercised its right to ask for a hearing.

And, I think that the kinds of questions that you ask when you are looking to make the determination like this don't have to do with what happens if the company fails in good times; it has to do with what happens if there is a financial crisis and the company fails? What happens if it is a situation of great stress in the system? And that is not necessarily what regulators previously did, but when we saw what happened in 2007, 2008, at a time of great stress in the financial system, things do happen that don't happen at other times, and that is the kind of inquiry that we went through.

Mrs. CAPITO. Okay. I have asked you this, I think, every time you have come before us. Mr. Meeks and I have a bill out that would modernize and streamline the financial regulatory framework. We are hearing consistently, particularly from our community banks, but also others, that the piling on of the regulatory burden is really becoming a chiller in terms of being able to move forward with business.

And you mentioned that once every 10 years, there is an analysis of this. I think 10 years is too long a period, especially since we have gone into—a lot of these have gone into effect over the last 4 years. So what efforts are you making in that?

Secretary LEW. I have a certain amount of background in this, because when I was OMB Director, I conducted a review of all of the Executive Branch agencies to do a lookback, and we asked the independent regulators to do a similar lookback. We didn't have the authority to direct them to do that lookback.

I think that at the moment with the 10-year review coming up, the regulators have indicated it is their intention to do that kind of lookback. I think that is a very important thing.

Mrs. CAPITO. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Texas, Mr. Hinojosa, for 5 minutes.

Mr. HINOJOSA. Thank you, Mr. Chairman.

And thank you, Secretary Lew, for your testimony today.

Before the financial crisis that caused the Great Recession, the United States had many financial regulators, yet none took a comprehensive look at the economy as a whole. We were caught off guard because no one was tasked with looking at the big picture. Congress created financial stability over in FSOC as a cornerstone of the Dodd-Frank Act. It serves a critical function to keep watch for emerging financial threats.

So, Secretary Lew, prior to that passage of Dodd-Frank, what government agency, if any, was responsible for looking at the systemic risk in the U.S. financial system?

Secretary LEW. Congressman, I think one of the things we learned is that there was no single agency that had responsibility for looking across the system and identifying issues of systemic risk. One of the reasons FSOC was created was to make sure that in the future, agencies collectively as a body chaired by the Treasury Secretary would be charged with that responsibility.

I think it is critically important. I don't think that it would be responsible for us to go back to a world where you don't have that kind of ability to look across the different silos. And that is not to say that the regulators weren't regulating the industries for which they had responsibility. They weren't necessarily looking at the interconnections and the way that the entire systemic risk profile developed.

That is exactly what FSOC does. It is why it was created. It is why we need to be able to ask questions. And it is also why we need to be able to ask questions when we don't know what the answer is. It ought not to be that we have to have near certainty that there is a problem in order to ask a question. We have to be able to turn over a lot of stones and have the good judgment to only designate if the analysis of the facts warrant it.

Mr. HINOJOSA. So last week the committee passed H.R. 4387, the FSOC Transparency and Accountability Act. This bill would subject the FSOC to the Sunshine Act, expand its membership, and change voting protocols for Commission and Board members, and it would allow Members of Congress to attend and participate in FSOC closed-door meetings.

In addition, this bill, H.R. 4881, would prevent the FSOC from any further actions related to the designation of a nonbank SIFI, including even talking about the possibility of the designation for 1 year. By undermining FSOC, we undermine our ability to avoid a future crisis like we have just experienced.

Mr. Secretary, how do you view the bills passed last week out of this committee, and what is your primary concern?

Secretary LEW. Congressman, I think that transparency is important. We are trying to develop policies which make that very clear. I also think that there needs to be a space where financial regulators can have a conversation about confidential information that is a protected space. And the balance is an important one to strike.

I think the notion of complying with as much of the Sunshine Act as possible is something that we have reflected. Much of the Sunshine Act is reflected in the FSOC procedures. But because of the balance, it is not 100 percent, and I think it is the right balance for now, and we need to continue to work to strive for striking the proper balance.

Mr. HINOJOSA. I am with you.

Secretary LEW. As far as the participation of Members of Congress, I would just point out that Executive Branch meetings happen every day all day long, and it is not considered the norm nor appropriate for there to be congressional participation in Executive Branch meetings. I don't think it would be appropriate here either.

Mr. HINOJOSA. In looking at your annual report, the FSOC delineates recommendations to improve the health of our financial markets. Interest rates have been kept to a historic low in order to encourage lending and spur economic growth. To offset the effect of low interest rates, the banks and credit unions have increased risk-seeking behavior such as extending the duration of assets and easing lending standards.

So let me ask you this question: How much does the risk of increased interest rate volatility concern you?

Secretary LEW. I look at all of the different moving pieces in our financial system to keep track of them. Obviously, low interest rates do produce a certain tendency for there to be a kind of rush to yield. We have seen a narrowing of yield curves that suggests that. I don't think that—if you balance the kind of where we have come in our economic recovery and the policies that have led there, I think that we are at a place where this is a question that the Fed and others have to look at. But I am not going to comment on monetary policy.

Mr. HINOJOSA. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair recognizes the gentleman from Texas, Mr. Neugebauer, chairman of our Housing and Insurance Subcommittee.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

In his dissent, Roy Woodall, who is the FSOC's designated insurance expert, stated that the underlying analysis for the Prudential designation used scenarios which were "atypical to the fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the State insurance company resolution and guaranteed fund systems."

Do you agree with Mr. Woodall's statement?

Secretary LEW. Congressman, obviously the FSOC decision was one in which I participated. I thought the designation was appropriate, and the risk analysis warranted it.

Mr. NEUGEBAUER. So you disagree with his statements?

Secretary LEW. I am just going to comment on what informed my judgment in terms of the decision that we made.

Mr. NEUGEBAUER. So just for the record, Mr. Secretary, what is your background as far as experience in regulating insurance companies?

Secretary LEW. I don't pretend to have been an insurance regulator. I have worked on insurance policy as a policymaker from time to time. But, I think that the responsibility each of us has as FSOC members is to look at a very detailed analysis that is prepared by all of the staffs of the FSOC. It is quite voluminous and detailed. In the case of the Prudential designation, I participated in the hearing, and you make your judgment based on the record that is prepared.

Mr. NEUGEBAUER. So when you don't have a background in that industry yourself, I guess one of the reasons that Congress decided to put these insurance people on the FSOC process was obviously a lot of the regulators that—for example, the Fed and the Treasury and others don't really have much background or experience in regulating insurance companies, do they?

Secretary LEW. Look, Congressman—

Mr. NEUGEBAUER. Do they have a background or experience in doing that?

Secretary LEW. For the most part, they have backgrounds in the field that they are in, whether it is banking or securities.

But I think that if you look back at the financial crisis of 2006 and 2007 and 2008, the insurance industry was very integrated into the financial system and was very much a part of the cause of a systemic collapse. So I think that the questions—

Mr. NEUGEBAUER. The insurance industry was—

Secretary LEW. Parts of it, yes.

Mr. NEUGEBAUER. What part was that?

Secretary LEW. AIG was part of it.

Mr. NEUGEBAUER. But that wasn't the insurance aspect of their business, was it?

Secretary LEW. The inquiry about systemic risk is one where you look at all of the activities of a firm, and you look at whether or not it has transmission channels, if there is a problem in that into other parts of the financial system.

And I thought, and I continue to believe, that the analysis done was a very high-quality one, and it warranted the determination. And I will just point out that there was not an appeal of the judgment either.

Mr. NEUGEBAUER. One of the reasons for designating Prudential as a SIFI relates to FSOC's asset liquidation analysis. Are you familiar—

Secretary LEW. Yes.

Mr. NEUGEBAUER. —which it assumes that simultaneous runs against its journal, and separate accounts by millions of life insurance policyholders and a significant number of annuity and other

contract holders for products with a cash surrender value, this assumes a scale for which there is no precedent.

In other words, was there anything in Prudential that would indicate that they had ever experienced a catastrophic liquidation of policies or surrender of policies?

Secretary LEW. The question is not whether something has happened, but whether there is a systemic risk in the future. And I think the scenarios that you look at tend to be scenarios that have not been experienced because your goal is to avoid having a financial crisis that you could avoid.

Mr. NEUGEBAUER. The only problem with that, Mr. Secretary, is trying to forecast cataclysmic events. Really I don't know that anybody has any expertise in doing that. And by trying to come up with these what-if—I could come up with a lot of what-if scenarios where you wouldn't want to put your money in any financial institution.

But the problem is, when you start going down this road, you impact the business model and the customers who rely on a lot of these financial products for something that you are not sure is going to happen in the future, that has not happened in the past.

And then when you ignore the expertise of people who have been put on FSOC to give you some guidance in that area, I think that is one of the reasons that you hear so many of us question the mythology that is being used in this process.

Secretary LEW. Congressman, I don't disagree that the scenarios that you look at are not the likely scenarios, but that is not our task. Our task is to look at, in a crisis situation, is there a risk of financial stability being undermined.

And we know what the recession of 2008, 2009 looked like. We know what the Great Depression looked like. There are scenarios that we have gone through in our history. And it is not just pulling scenarios out of the air; the question is, in a time of great stress, is there risk? And if there is risk, it doesn't mean that you are changing the business model all that dramatically. It is a question of, is there greater oversight and greater scrutiny?

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you.

Over here, Mr. Lew. Thank you, and welcome. I think you are doing a fantastic job.

I want to first of all ask for a little help that you could give for me and my constituents in Georgia. You are familiar with the Hardest Hit Program?

Secretary LEW. Yes. I am.

Mr. SCOTT. And it is your program, thanks to the hard work of this committee. And I would deeply appreciate if you could assist us.

We have an issue in which my State was about a year late in getting this money out to help the hardest hit. Subsequent to that we have unleashed or unloaded a number of veterans, who—it happens to be one of the fastest-growing groups of the homeless, and that is because they are coming home, and their houses are being foreclosed on and mortgages.

So within the next couple of months, in August, we are putting a big event together down in Atlanta. In order to get moving on this, your predecessor, Mr. Tim Geithner, and the Assistant Treasury Secretary who started this was Mr. Tim Massad, who did excellent work, but unfortunately both of them have gone.

So what we need is just a nice call down to the Georgia Department of Community Affairs, first thanking them for moving, but reminding them that because of that 1-year delay, we only have 2, 3 years left. By 2017, as you know, if we don't get rid of that money, it is going. It would be a shame that we have veterans coming home, seeking employment. This is targeted just for them. So just a call down would be very helpful to the Department of Community Affairs, asking if there is any assistance that Treasury can give them, because if it weren't for Tim Geithner and Tim Massad coming down to that event to light a fire in Georgia, we would not be moving as we are.

I don't want a dime of that money coming back when we have soldiers coming home who are living under viaducts because they can't get that kind of help.

So I appreciate your doing this, and we will get the information to your offices of whom to call.

Now I have another point. I want to get to the emerging threats to our financial stability on the international stage. You have just returned from an international visit and working on—in this issue with some of our other counterparts. Also, Treasury is the enforcement arm for the Iran sanctions. Six months is coming up. Can you give us in a nutshell where we stand relative to the impact of the standstill, where are we are on those sanctions, and what are the emerging threats internationally?

Secretary LEW. Congressman, first, on the Hardest Hit Fund, I would welcome the information. Tim Bowler is running that office, and I will have him follow up as appropriate.

Mr. SCOTT. Thank you. My staffer will get in touch.

Secretary LEW. As far as the Iran sanctions go and the negotiations that are taking place, three points: first, the sanctions have been extremely effective. They have had a dramatic effect on Iran's economy. They have actually crushed Iran's economy and brought Iran to the negotiating table.

Second, the joint plan of action was very limited relief. It was several billion dollars of relief, not enough to reverse the harm that the sanctions do to Iran's economy. And, in fact, the ongoing impact of the oil restrictions in the sanctions does more damage than the relief granted. So the impact is building up, not reducing.

Third, we have made it clear that we are going to—we are committed to these negotiations, but not committed to a deal unless it is a good deal. No deal is better than a bad deal. We hope there is a good deal.

We are in the final month. I think that it will be an important month that determines whether or not there is seriousness on Iran's part to set aside its nuclear weapons program.

Mr. SCOTT. So we are at that final month, which is the apex of my question. Where do we go from there? Do we go back to square one, or will we ask for an extension?

Secretary LEW. I am not going to prejudge what the end of the month is. There have been no discussions to date of an extension. There is also not going to be pressure to take a bad deal because we are hitting a deadline. I think we will have to see where we are at the end of the month.

What we have said is that if the talks break down, if Iran is not willing to make concessions, we will look for tougher sanctions, and we will take no option off the table to make sure Iran does not get nuclear weapons.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. McHenry, chairman of our Oversight and Investigations Subcommittee.

Mr. MCHENRY. Secretary Lew, thank you for reappearing.

We had a hearing about the OFR asset manager report. And former Assistant Secretary Michael Barr testified that the OFR "was not something I would hang my hat on."

Would you hang your hat on the asset manager report?

Secretary LEW. I don't hang my hat on reports, Congressman.

Mr. MCHENRY. I guess—

Secretary LEW. The report was one step in the process. It is not a decision by FSOC. It was something that FSOC asked for as one of the things to consider.

We have done a lot of other work as well, an analysis within FSOC, and we had a public session, I believe the day before your hearing, where we had broad participation by the industry and by experts from academia, including Michael, who testified.

I think that one of the important things to remember is FSOC has made no decision to designate asset managers. All FSOC has done is ask the question. I think it is really important to ask the question. The answer could be that there is no need to designate. The answer could be that there is some other course of action that is advised. And we will continue to pursue that.

Mr. MCHENRY. And to that end, Chair White testified just a few weeks ago before this committee that the SEC has all the authority necessary; no new authority would be needed for the SEC to regulate the asset management industry.

Do you concur with that assessment?

Secretary LEW. I think it depends on what the answer is in terms of what is the appropriate step to take. And I am not going to prejudge the outcome of an inquiry that is not completed.

Mr. MCHENRY. Okay. Let me try that again. Do you believe the SEC has the authority to regulate the asset management industry?

Secretary LEW. I believe the SEC does have authorities to regulate the asset management industry. Whether it is the precise authority depends on what the mode of regulatory response, if any, would be.

Mr. MCHENRY. Yes. Thank you for clarifying, and that is helpful and very forthcoming.

And so, we have a number of other questions, obviously, but with the FSB, a number of us have questions about the process. And you have answered this to some degree, but we have—many of us have complaints about how nontransparent FSOC is, but FSB is even less so.

And so when the FSB designates G-SIFIs, and all those G-SIFIs within that category of an investment—investment companies are only U.S.-registered investment companies, it becomes problematic for us to see that—to judge whether or not the FSOC will take that same tack from the FSB.

And so to that end, in order to help us better understand the policymaking process, would you help us with better disclosure of what those discussions are like and what the discussions are at the FSB just going forward? I think that would be helpful in terms of transparency and in terms of making sure that we are asking appropriate questions, and you don't have to answer the same questions over and over again.

Secretary LEW. Our staff does try to keep congressional—interested congressional parties informed. We will continue to do that.

Mr. MCHENRY. Currently, I would say it is not sufficient. And so, we try harder to do better when it comes to transparency with FSB.

Secretary LEW. I try hard to do better at everything I do every day.

Mr. MCHENRY. That is a fantastic commitment. So, no hats and try harder.

All right. To that end, let me ask you another question, if we can get to this. We have passed a couple of major pieces of legislation through this committee and off of the House Floor that are bipartisan in nature. Some help credit unions, and others help community banks, basically lightening a bit of the overreach that the large bipartisan vote in Congress has shown. One is the swaps push-out bill that passed 292–122 on the House Floor, and the end user margin bill, which passed 411–12. So, there is a way for us to pass bipartisan legislation.

Give us your view. What is your encouragement for Congress to undertake bipartisan regulatory changes?

Secretary LEW. Look, in principle, I endorse bipartisan legislation as a general matter. And—

Mr. MCHENRY. But in a specific matter, would you help us with this process?

Secretary LEW. On the question of Dodd-Frank amendments, frankly, there has been an issue for the last 4 years where the question is, do you just make technical fixes, or do you go back and make broader changes? That is an important question. We don't think there should be a broad review of Dodd-Frank.

There is also a question as to whether or not you give agencies a chance to implement things before you legislate again, putting an overlay to top of it. But I am happy to continue the conversation with you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair wishes to announce to all Members that at approximately 11:30, the Chair intends to call a 5-minute recess.

The Chair now recognizes the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for being here. And we will also accept your thanks for sending Mel Watt from this committee to the Oversight Council.

Secretary LEW. We appreciate your sharing him.

Mr. CLEAVER. Yes.

Mr. Secretary, I have two questions. Do you believe that as a result of FSOC, we do have an authority that is accountable and responsible for monitoring the financial stability of the U.S. economy? Do you believe that without FSOC, the dangers would be increasingly more ominous?

Secretary LEW. Look, I believe we have a much higher level of visibility into the financial stability risks. We have relationships between regulators that are stronger and deeper than they ever were before, and we have the capacity, if we need to, for people to collaborate together in a much more effective way.

I think all of that leaves us much stronger than before, and to give that up would put us back where we were in 2007 and 2008, when regulators worked in their silos, and it was very hard to break through to look at the broader financial stability.

Mr. CLEAVER. That is interesting, because I am wondering how comfortable the members of this committee should be that the expectations that an American financial institution is still "too-big-to-fail." These huge interconnected bank holding companies or the nonbank financial giants—how comfortable should we feel that the "too-big-to-fail" has been either dramatically reduced or eliminated?

Secretary LEW. Congressman, I think we have made enormous progress. We have much more capital in our banks. We have resolution authorities that are now in place and are being exercised so that institutions, if they hit a failure, have a way to unwind without necessarily causing the kind of systemic risks that we saw in 2007, 2008. We have living wills for the largest institutions that have very detailed plans of what they would do if they got into distress.

And I think if you look at the question that is often asked about the implicit subsidy for large banks, that is a reflection of the market's belief that there is a willingness to step in, we are seeing that way lower, if not eliminated. It has been reduced by academics who study it. It has been reduced when the IMF looked at it. It has been reduced when rating agencies look at it.

So I wish I could tell you with absolute certainty that "too-big-to-fail" was a thing of the past. What I can say is we have made enormous progress. We will continue to work at the kinds of sensible ongoing policies that will make our system even stronger. And the test, unfortunately, only comes when you have a financial crisis, which I hope we don't experience.

Mr. CLEAVER. Yes. I was going there, that we won't know for sure as we didn't—I was on the committee when Secretary Paulson and others came in and told us essentially that if we didn't do something before the Asian markets opened the following Monday, that the world could fall into a depression.

I am assuming you are saying we can have a degree of greater comfort, but that comfort should be measured, because we don't really know and won't know unless we hit another—

Secretary LEW. I would add, Congressman, that many of the authorities that existed at the time have been changed in Dodd-Frank, and we don't have the tools that Secretary Paulson had at that time.

Mr. CLEAVER. Of course, he didn't have the tools. He made the tools up, by his own admission.

Secretary LEW. There were changes made in Dodd-Frank that limit what both the Fed and Treasury do, so we have less ability to step in. And it would require—Dodd-Frank, as a matter of law, ended "too-big-to-fail." So there is an obstacle, and that would be a change in the law to step in to exercise some of those authorities.

Mr. CLEAVER. Thank you. I yield back the balance of my time.

Chairman HENSARLING. The gentleman yields back the balance of his time.

The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Secretary Lew, welcome. I have a quick question for you with regards to mortgage-servicing assets. FSOC seems to be intent on trying to implement new capital standards on these folks. And I guess my first question is, where is the problem? And what problem are we trying to solve? Where is the risk?

Secretary LEW. Congressman, could I just ask for clarification as to which capital standards you are referring to?

Mr. LUETKEMEYER. FSOC capital rules on mortgage-servicing assets. And what we are seeing is that the small banks, even large banks, are selling all their mortgage-servicing assets to nonbanks as a result of the capital rules that are being implemented.

Secretary LEW. We are definitely seeing that there are higher capital standards for banks, in general for banks. And to the extent that banks choose to change their business plans and get out of one line of business or into another, that is obviously something that we need to keep an eye on.

Mr. LUETKEMEYER. I guess—let me back up here. The Basel III rule was the one that really is impacting this. And it is—again, it is something that is concerning me from the standpoint that we are allowing the foreign rules and regulations, which, to my knowledge, they don't have mortgage-servicing asset activity in foreign countries. So we are the only one that does this sort of activity, and yet we are allowing the Basel III rules, which were basically foreign rules, to impact our way of doing business here in this country.

Where is the risk? What is the problem? And why are we allowing the entities from other countries to regulate a business that is basically American in nature?

Secretary LEW. The capital standards that our regulators have put into place are actually in some ways tougher than Basel III. So it is not that Basel III put the capital requirements in place; our national authorities have to put our capital requirements in place.

We have driven Basel III to a higher standard, because one of the things we worry about is that a risk that we face is that other countries don't have the capital requirements that we have, and their banks are not going to be as sound as they need to be.

Mr. LUETKEMEYER. This is about mortgage-servicing assets. The servicer of these assets, where is the risk with the servicer, somebody who services loans?

Secretary LEW. I think the question actually is a broader one in terms of—

Mr. LUETKEMEYER. No, it is pretty specific. Where is the problem that entities that service loans need to have more capital? Where is the connectivity to our financial system that causes a greater risk, but they have to have more—

Secretary LEW. Capital requirements are on all of a bank's assets. So that, I think, is really the issue. But I am happy to follow up with you on the specific question of mortgage servicers.

Mr. LUETKEMEYER. It is interesting, because as we go through this process, I think with the previous question, one of the folks, I think, was talking— maybe Mr. McHenry—we are talking about some of the stress tests that banks are doing, and the big banks' modeling is allowed to be different than it is from smaller banks. And yet when you—we allow them to design their own modeling, you come up with a completely different capital ratio as if you would use that same modeling for smaller banks.

And so I think, again, you are using two sizes, two different sets of rules with regards to big guys versus little guys, and I have a real problem with that, and it continues to be rampant through all of the things that the Treasury does. There are two sets of rules.

Secretary LEW. The regulators have gone to great lengths to try and reflect the special circumstances around small banks and community banks. And it is not the banks that set the standards for stress tests, it is the regulators who conduct the stress tests.

Mr. LUETKEMEYER. Yes. But Mr. Secretary, you are allowing the banks to also determine their own models on how they determine their capital, and that is not right, because you have to have the same set of standards for everybody. You can't have two sets of standards. And it goes back to—I just have a real problem with that particular—let me just go—I only have about 24 seconds left.

I am just—your comment a while ago that insurance companies were a part of the cause of the collapse of 2007, 2008, which I wrote down here, it is stunning. Absolutely stunning. I defy you to give me an example of one insurance company that is truly—the insurance part of their business, was a cause of the collapse. Tell me, was it insurance policy, insurance rate, insurance lack of claims processing? Was that a cause of 2008, 2007?

Secretary LEW. I used AIG as the example and—

Mr. LUETKEMEYER. Mr. Secretary, you know as well as I do that AIG—the financial portion of that company wasn't the insurance position of that company, it was the financial portion of that company that was the problem, the connectivity of that.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Wisconsin, Ms. Moore, for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

And, Mr. Secretary, it is very nice to see you. Thank you for coming to speak with us today.

I was looking through your testimony, and I couldn't agree more that the formation of the FSOC was an important strategy toward having all of the senior regulators and principals look at the system across the spectrum to—because I was here, again, when Mr. Paulson came with this four-page bill, saying, give us $700 billion. I don't want to go through that anymore.

But my question is what—I think a good process leads to good policy. So I guess I saw Mr. Roy Woodall, the FSOC insurance expert, dissent from the decision to designate Prudential, and yet they were designated as a SIFI. And then we saw the SEC push back against FSOC on asset managers, an aspect of money market mutual fund reforms, and, of course, the SEC is the expert on these industries.

So I guess I would like—do you think it would be helpful for us to have a sense of how you see the role of the primary regulators in these discussions? Is there any deference to them? Did they just dissent from the decision so that they could—so that they wouldn't be on record as being against their industry? What are we to learn from the experts of the FSOC seemingly having less of a voice?

Secretary LEW. Congresswoman, I actually think all the members of FSOC have a voice, they are listened to, but ultimately not everyone will agree on every issue.

I think if you look at those issues separately, I have spoken at some length on the review of the insurance companies before the designations were made. I believe the record was a robust one, and it warranted the decision. Obviously, not every member of the Council agreed. But the decision stands, and the company has not appealed it through the courts, as it could have. And I actually think the process was one that reflected rigor and analytic quality, and I am both comfortable with it and concur with the judgment that was made.

As far as the issues you raised with regard to the SEC, obviously FSOC spoke to the money market fund issue before I was Chair of FSOC. It is an issue that was, again, at the heart of the financial crisis in 2008, and there was, I think, an urgency that was felt by FSOC to underscore that more action on that and on other issues that relate to the area of shadow banking was important.

The SEC has the direct regulatory authority. They are working on a rule. I am very hopeful that they will complete a rule this summer.

Ms. MOORE. Mr. Lew, thank you so much. I don't have much time, but I do think the SEC did push back on aspects of money market. That "breaking the buck" thing was resolved.

Finally, I guess you have heard the complaint that prior to designation, which is a big deal if you are designated as a SIFI, this is not an opportunity at all for the designee to present their case to the full board of principals of the FSOC, even to directly address the final information charges that are being presented to justify the decision. This seems to be just a little bit contrary to what we know as due process. I just want to know what your response to that is.

Secretary LEW. That is not correct. First, let me go back to the money market fund issue. I just want to remind everyone on this committee that there was a real problem in money market funds in the financial crisis, and the challenge to solve that crisis fell not on the SEC, but it fell to the Fed. So it was quite appropriate for FSOC to take a view, and, frankly, it is very appropriate for us to continue to take a view to make sure good action is taken.

Ms. MOORE. I only have a second. I do want you to answer that other question, Mr. Lew.

Secretary LEW. Remind me of the second question.

Ms. MOORE. It is the people don't get a chance to present their case.

Secretary LEW. Oh, yes. That is not correct. There is extensive back-and-forth between a company and the FSOC during the stage 3 process.

Ms. MOORE. Stage 3.

Secretary LEW. Yes, extensive. And there is no designation until till the end of that. At the end of the stage 3 process, they have a right to a hearing. And only one company has sought it, but we had a hearing. And then, they have judicial rights of appeal after that. So there is a robust due process.

Ms. MOORE. Stage 3. Okay. Thank you so much, Mr. Secretary.

Chairman HENSARLING. The time of the gentlelady has expired.

The committee will now stand in recess for 5 minutes.

[recess].

Chairman HENSARLING. The committee will come to order.

The Chair now recognizes the gentleman from Alabama, the chairman emeritus of the committee, Mr. Bachus, for 5 minutes.

Mr. BACHUS. Thank you.

Secretary Lew, this whole the-dog-ate-my-homework defense that the IRS and Lois Lerner is using, I don't—the American people are not buying it. But, more importantly, I think it calls into question the integrity of the process, and I think it is very disturbing to all of us.

We have computer crashes in our office from time to time. I think every Member has had them. And you immediately call in the technology people, you make sure that the hard drive is preserved, and you don't lose emails.

So I hope you will investigate this as Secretary of the agency and find out what happened.

Secretary LEW. Congressman, I think we all know that hard drives do crash, and that is what happened here. In 2011, when the hard drive crashed, efforts were made to recover what could be recovered. And subsequent to that, after it became a matter of interest, extensive efforts were made to put back together what could be put back together.

I believe that Commissioner Koskinen has testified to this. A report has been sent to Congress in great detail.

Mr. BACHUS. I am just saying the American people are still waiting on a good explanation.

Let me ask you this: Orderly liquidation has always struck me as a convoluted and kind of highly subjective process that does little to end "too-big-to-fail," and it gives an enormous amount of discretionary power to regulators. And FSOC makes resolution advice or gives recommendations to the FDIC.

The Judiciary Committee, with the Financial Services Committee, is looking at possible changes, several possible changes, in the Bankruptcy Code. We believe that a properly constructed bankruptcy would be a better way to deal with the resolution of failing institutions. There are established precedents.

Do you think that it is a worthwhile process for Congress to consider this approach?

Secretary LEW. Congressman, I think that orderly liquidation authority actually is an effective implementation of the law in Dodd-Frank. Obviously it is not the same as bankruptcy, but it is a process that has actually become one that the world is now looking at to see if a single point of interest system—

Mr. BACHUS. You don't think the bankruptcy process—

Secretary LEW. I would actually be interested in following up with you on what the changes in the Bankruptcy Code would be. What I was going to say is I don't think that all wisdom was contained in the actions taken in the wake of the crisis.

Mr. BACHUS. We would like to work as partners on this as we go forward because I—

Secretary LEW. And I don't know that it is instead of the orderly liquidation authority. I would not take the orderly liquidation authority away, and I don't know what proposals are, but I would be happy to look at them.

Mr. BACHUS. And I am not sure we do yet.

Six months ago, Congress was told that there would be more coordination and guidance on the implementation of the Volcker Rule. Unfortunately, I have not heard of a lot of follow-through on this pledge.

Would you review with us what is being done to provide financial services providers with guidance they need to comply with the many complexities of the Volcker Rule, and give us some assurance that implementation questions that were posed to the working group will be answered? I know 6 months later, only 6 of those 80 questions have been answered.

Secretary LEW. Congressman, I think the fact that an identical rule was issued on the same day by all the agencies actually was an important step to giving guidance. My fear was there would be differences that caused confusion, and I think it is very important there is one rule. So I actually think that is the foundation.

It hasn't actually gone into effect in terms of compliance yet. And the regulators are working amongst themselves as they go into the implementation stage to stay in close contact, because there is obviously the risk that you end up with common law in each of the agencies going in different directions. That is not an area we have direct responsibility over at Treasury or at FSOC, but I think it is an important question, and it is one that I ask the regulators as well.

Mr. BACHUS. Right. They still need more guidance in complying with Volcker, and I appreciate your willingness to give that. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Delaware, Mr. Carney, for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for coming in today. Thank you for all your good work. I have been reading through the FSOC annual report. There is lots of good information and data in there.

One of the things that is discussed in the annual report is the repo market as an area of vulnerability for our financial system. And, in fact, in a hearing back in February before this committee, Governor Tarullo cited the repo market as the second greatest

threat to the stability of our financial system after adequate capital requirements.

Do you share Governor Tarullo's concern? And what steps can be taken to prevent adverse consequences in the repo market during stress markets?

Secretary LEW. I think that the short-term funding issues are quite significant. That is why, whether you call them short-term funding or shadow banking, we are putting so much attention into them.

The risk that one day you open for business, and you don't either have the repo or the money market funding that you expected, we saw in the financial crisis, can cause an immediate collapse, and it is a collapse with an accelerant on it.

I think if you look at the amount of funding that is in the repo market and the money market funds, it is considerably down from where it was at the time—

Mr. CARNEY. So, less of a risk. But what can be done to prevent some of the adverse effects?

Secretary LEW. I think on both those issues, on triparty repo and on money market funds, it is important that the regulators continue to look at the issue and take action. So the Fed has a responsibility in the area of repo, and the SEC has a responsibility in the area of money market funds. I know that both are working on additional steps that could be taken to further reduce the exposure. There is an efficient market there until there is not.

Mr. CARNEY. Right.

Secretary LEW. And the question isn't what happens when it is working well; the question is what safeguards do you have that you won't see in a moment where it collapses. That is why I think the Fed is looking at what actions it can take and why it is so important that the SEC finalizes the money markets rule, because I think they are really parallel kinds of risks.

Mr. CARNEY. Moving on to GSE reform, there has been some discussion about it. Unfortunately, my colleague, Mr. Perlmutter from Colorado, is not here. He and I have kind of a different perspective on it.

Your report identifies it as an important issue, but it doesn't say too much about the negative consequences of not doing reform.

I have been working with Congressman Delaney and Congressman Himes on a piece of legislation that would provide a government backstop with a more explicit guarantee. What is your view on the risk of not doing reform in the short term?

Secretary LEW. Look, I believe that housing finance reform is really the unfinished business that didn't get addressed in the immediate wake of the financial crisis. And we have seen only recently with the estimates of the exposure that taxpayers ultimately have to the GSEs that, were there to be another crisis, we still have the same system that we had before, which wasn't very good—

Mr. CARNEY. With greater exposure.

Secretary LEW. Greater exposure.

So I believe that housing finance reform is very important. I think there is a lot of progress that has been made in the Senate working towards a bipartisan approach on this. I think there has

to be a bipartisan solution. And the key to a solution is making sure that there is access to finance; making sure that there is a clearly delineated responsibility that is not a government responsibility in terms of losses, particularly first losses; and to the extent that there is any remaining government backstop, that it be extraordinary circumstances and well-defined.

Mr. CARNEY. Right.

Secretary LEW. I think that the process in the Senate didn't make great progress on that. It is obviously not finished. And I would hope that a bill can get to conference so that it is an area in which we can see bipartisan legislation.

Mr. CARNEY. I hope so, too.

I don't have much time left. But there has been a lot of discussion, and actually a couple of pieces of legislation introduced here in the House about differentiating among financial institutions, banks, based on different criteria than just size. In fact, Governor Tarullo mentioned a few weeks ago that maybe the SIFI designation should be on firms that are $100 billion or greater. What are your thoughts on that?

We have legislation here that Mr. Luetkemeyer and my colleague Ms. Sewell have introduced that would differentiate on qualitative measures. Do you have any views about—

Secretary LEW. I think that it is hard to have a hard view that there is a size that makes you financially significant and creating the risk. The question is, does a combination of your size, your structure, your interconnection to the system, and it is something that requires our ongoing analysis.

Mr. CARNEY. Thanks. Thanks very much.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy.

Mr. DUFFY. Thank you, Mr. Chairman.

Welcome, Secretary Lew. It is nice to see you back at the committee again.

Just a couple of questions on emails: How does the Treasury back up their emails currently?

Secretary LEW. The main Treasury, I believe, has an auto backup, but I would have to get back to you on the specific details.

Mr. DUFFY. So after all of the information about emails and backups and IRS and Treasury, Housing, you have no idea how your emails are backed up?

Secretary LEW. I will just say that the main Treasury is much smaller than the IRS. It has a different volume. So it is a different kind of an email system.

Mr. DUFFY. How about with the White House?

Secretary LEW. It is generally my assumption that everything is backed up.

Mr. DUFFY. Okay. How about the White House? How does the White House back up its email?

Secretary LEW. I am not an IT professional, Congressman.

Mr. DUFFY. Neither am I, but I know as a former State prosecutor how the State of Wisconsin backs up our emails. I know how the House backs up our emails as a Congressman. You were the

Chief of Staff, and you are the—I am not an IT expert either. But you can't tell me how they are backed up?

Secretary LEW. When I was at OMB, and when I was at the White House, there was auto backup, but there also were occasionally periods where machines broke. So it—

Mr. DUFFY. And in regard to machines breaking, when you were the Chief of Staff at the White House, did you have a hard drive cash?

Secretary LEW. My personal hard drive?

Mr. DUFFY. Yes.

Secretary LEW. Not that I recall.

Mr. DUFFY. Okay. When you were the Chief of Staff at the White House, did you have meetings or a meeting with any IRS employees?

Secretary LEW. I do not remember. It was quite awhile ago, and there has been a lot since then. I would have to go back and check.

Mr. DUFFY. So you haven't pondered that question with all these—

Secretary LEW. I did not—I certainly—

Mr. DUFFY. If I could ask the question, then you could respond, please.

Secretary LEW. No, look, I am happy to go back. There were meetings that involved people from different agencies. We talked—

Mr. DUFFY. So the answer is, yes, you did meet with IRS employees?

Secretary LEW. The answer is, I don't remember, but I would go back and check if I could.

Mr. DUFFY. Okay. I am sure you can't recall.

Secretary LEW. I never had a meeting on any IRS policy matter that I recall. The question you are asking—

Mr. DUFFY. I mean political matters.

Secretary LEW. No, not on political matters either. I—

Mr. DUFFY. Did you have any email correspondence with anyone at the IRS?

Secretary LEW. Not that I recall.

Mr. DUFFY. When did you first learn about Lois Lerner's emails being lost, her hard drive crashing, those emails from 2010 and 2011 going missing? When did you learn about that first?

Secretary LEW. I only learned about it at roughly the same time the Congress did, when it was—

Mr. DUFFY. So you learned about it in the press?

Secretary LEW. —when there—pardon?

Mr. DUFFY. You learned about it in the press?

Secretary LEW. No, no. I learned about it right before the report was made to Congress.

Mr. DUFFY. So you were just given what, a day's notice? On the 12th of June, you learned about it?

Secretary LEW. I don't remember the day, but I believe—

Mr. DUFFY. A week before?

Secretary LEW. No. I believe it was more like the day before.

Mr. DUFFY. Okay. So you are the Secretary of Treasury, the IRS is the biggest bureau in Treasury, and you only learned about this the day before we did.

But isn't it true that Treasury was notified by the IRS that these failures existed, and they were notified in April? And then it was Treasury who notified the White House in April that the Lois Lerner emails were gone. But you only learned about this in mid-June.

Secretary LEW. The timeline, as I understand it, is that the lawyers at IRS and Treasury discussed the matter. They were notified about it.

Mr. DUFFY. In April.

Secretary LEW. In April. And—

Mr. DUFFY. And you didn't know anything about this, right?

Secretary LEW. And the guidance that was given at that time, I think appropriately—

Mr. DUFFY. You didn't know anything about this. Is that your testimony?

Secretary LEW. The guidance that was given, as I understand it—

Mr. DUFFY. So you didn't know anything about the emails, all the news about it. And the lawyers knew, but Mr. Lew, the poor Secretary of the Treasury, had no clue what was going on in the agency. Is that fair to say?

Secretary LEW. Congressman, I am happy to answer your question if you give me a moment.

Mr. DUFFY. If you would answer the question, I would appreciate it.

Secretary LEW. You ask the questions; I can answer the questions.

Mr. DUFFY. Well, you don't answer the question. That is the problem.

Secretary LEW. The lawyers at Treasury advised the lawyers at IRS, I believe correctly, to make sure they—

Mr. DUFFY. And did not advise you?

Secretary LEW. Congressman, I am happy to answer the question if you give me—

Mr. DUFFY. You are not answering the question.

I just—there is a level of frustration not just in this committee, not just throughout Congress, but with the American people. The arrogance that the Administration has shown, that the IRS has shown, that Treasury has shown with regard to this investigation is unbelievable.

And why wouldn't you be arrogant? You say, listen, we have the Presidency, we have the DOJ, we have the FBI. Why not be arrogant? We have the press. No one is going to report us for this. We are not going to answer your questions, we are not going to be forthright, we are not going to be honest, because who is going to come after us?

I have to tell you, this is a sad disservice to the American people the way this crisis has been handled.

I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now—

Secretary LEW. I would be glad to answer the question if I would be given an opportunity.

Chairman HENSARLING. I suspect there will be Members on this side of the aisle who will be more than happy to accord you more time, Mr. Secretary.

The Chair now recognizes the gentlelady from Alabama, Ms. Sewell, for 5 minutes.

Ms. SEWELL. Mr. Secretary, I will give you more time. You can use some of my time to answer his question, if you would like to, but I think that it is better served that we talk about the matter at hand, what you are here for—

Secretary LEW. I agree.

Ms. SEWELL. —which is your annual report for FSOC.

I would like to return back to the SIFI designation. In your testimony you highlight that designation is not the only alternative to address potential risk posed by firms and their activities.

What are some of the other policy options FSOC could look at? And how does the FSOC weigh the pros and cons of the different regulatory mechanisms in your toolbox?

Secretary LEW. Congresswoman, the initial inquiry is whether or not there is systemic risk, and if you don't make the determination of that risk being there, then one option is to do nothing. So there is always the option not to designate.

The question then becomes, what is the risk? Where is the risk? Is the risk in a firm? Is it in a product? Is it in a business line? And depending on the answer to the question, it could lead to different actions.

So I believe that there has been a kind of oversimplification of the process, which is if you ask the question, then the next step is designation. I actually don't think that is the case. I think that there will be many instances where the right answer is that there is not a risk, or the right answer is that you don't need to designate the firm. Regulators have sufficient authority, and there will be some cases where it will be a product as opposed to a firm that is the issue.

So I think we need to let the process run its course, and that means have full analysis, full awareness of the facts, and not be in a place where we are afraid to ask the question because the answer might be designation. I think that we have a responsibility, if we are going to have a system that prevents financial crises in the future, to ask those kinds of questions and not prejudge the answers.

Ms. SEWELL. I also wanted to know if the FSOC in its examination of an industry or individual firm indicates that a particular activity or business practice may cause systemic risk, are companies given an opportunity to address those concerns?

One result of additional notification throughout the designation process could be to encourage companies to reduce their own risk. And so, would the FSOC consider establishing a process by which a company would be given the opportunity to reduce its own risk profile before designation as a SIFI?

Secretary LEW. It is not only a question of does the company have the ability to modify in some way its business structure before, but FSOC looks on an annual basis to see whether or not the designation's continuing is indicated and what the status is. So companies have the ability afterwards to make changes.

As far as the involvement with the company goes, it begins in the middle of the process, not at the beginning of the process, I think for good reasons. We have a lot of information that is available within both the public record and that regulators have, and that you don't need to create a situation where by asking a question you trigger a public debate at the first instance of asking the question.

If it is serious, there is a huge amount of back-and-forth between the company and the FSOC staff.

Ms. SEWELL. I would like to—my last question is really about cybersecurity. I sit on the House Permanent Select Committee on Intelligence. I think cybersecurity is one of the biggest threats to disruption of the financial industry, along with the operational risks that it poses.

I want to know what the FSOC thinks about cybersecurity and what its recommendations have been to its firms.

Secretary LEW. Cybersecurity is something that I must say I, as Treasury Secretary, as Chair of FSOC, think about constantly. It is one of the kind of new frontiers of risk exposure. I believe that we have in the financial services sector made more progress than some of the other sectors of our economy, but there is still a lot of work to do.

Ms. SEWELL. Would you be open to information-sharing and reducing the liability so that companies can share?

Secretary LEW. I think information-sharing is very important. There is a big difference between what we see and what companies see. The information needs to flow in both directions.

I also think there is a big difference between what large companies have the capacity to do and what smaller businesses have the capacity to do. And where they are working together either directly or through an intermediary, whether it is a utility or a contractor, makes a great deal of sense.

We have sought legislation on cybersecurity. The President has issued an Executive Order that goes as far as he can with his executive authority, but legislation in this area would be very important. I think the industry would be very pleased to see more ability to collaborate.

Ms. SEWELL. Thank you, sir.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Virginia, Mr. Hurt, for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

And thank you, Mr. Secretary, for being here and presenting us the FSOC annual report.

I do want to ask some questions about that, but I was curious, based on just a follow-up to Mr. Bachus' questions about the IRS issue, it seemed to me your response was, well, in 2011, there was a hard drive crash, that is life, and that the IRS really has done everything it can to comply with congressional requests.

Do you think that it is important for Congress to get answers to its questions? And is it important for Congress to be able to see those emails, whether we recover them from IRS or some other agency? Do you think that is important?

Secretary LEW. Not only do I think it is important, I think that is what the IRS has been trying to do. And Commissioner Koskinen

has been working to assemble the emails to provide them for review, the Lerner emails.

Mr. HURT. But in your role as Secretary of the Treasury, and ultimately the authority over the IRS, do you believe you have the authority to independently look at what the IRS is doing to make sure that this gets done? What have you done, and what are you going to do to make sure that we pull out all the stops to get these emails?

Secretary LEW. I believe that they are working quite hard. The number of hours and man-years, person-years that have been put into this, the amount of money that has been spent is astronomical. They have made an enormous effort. Commissioner Koskinen has testified at length on it. Obviously, it is not a situation that anyone chose to have. There was a machine failure in 2011. But they have worked as hard as they could to reconstruct, and 70,000 emails, I believe, were turned over for review.

Mr. HURT. I understand. But obviously it is a very critical time period, and I guess what I would love to hear, as a Member of Congress who has constituents who are very worked up about this, is I would love to know that the Secretary of the Treasury is exercising everything within his power to make sure that the IRS is doing that. It does not sound like you have taken any direct role whatsoever, and that concerns me.

Secretary LEW. No. When I became aware of this, what I was told was that the message had been sent from Treasury, I believe appropriately, find out everything you can, find whatever you can, and give a complete report when you have that.

That report was completed, I concur with the advice that was given, and if there is any more that can be done, it should be done.

Mr. HURT. But you are the doer. It seems to me that is a passive—

Secretary LEW. What I can't do is make a hard drive that broke not be broken.

Mr. HURT. I understand that—

Secretary LEW. What they have gone and done is they have looked at all the recipients of emails to pull them out from the recipients' email records. They are doing everything they can, and an enormous amount of information has been provided.

Mr. HURT. All right. Thank you.

Let me just ask my—I only have 2 minutes left, but let me just ask you this question. I represent Virginia's Fifth District, a rural district, with a lot of Main Street small businesses, family farms, and working Virginia families. Access to capital is very important, and community banks and credit unions play a huge role in reaching the people whom I represent.

In the last 30 years, I am sure you know these figures, we have gone from seeing 18,000 community banks that held 40 percent of bank assets, 18,000 to now, today, fewer than 7,000 community banks, 18,000 to 7,000, and assets amounting to 40 percent to now down to 15 percent.

And I guess my question is, as a part of the mission of the Financial Stability Oversight Council, in your role as Chair, does that trend concern you, the idea that we are reducing the number of community banks and the assets that are held there? And does

that in and of itself present its own systemic risk when you have the consolidation of these assets in banks the way we have seen it the last 30 years? Does that concern you, and if it does, what do we do about it? What can you do about it? What is the FSOC doing about it?

Secretary LEW. Congressman, as the different agencies with the responsibility for implementing Dodd-Frank have taken action, each and every one has made efforts to try and treat community banks in a way that reflects the importance that they play in our economy and the fact that they are different from large institutions. There is a lot of discussion about it, there is a lot of attention to it, and I believe the rules reflect that.

We have a dynamic changing landscape in the financial services world. We have to keep an eye on what those changes are. I think the community banks play an important part in it, and we, as we have acted, have tried to reflect that.

Mr. HURT. But does that trend concern you? Where do we—I yield back my time.

Mr. HULTGREN [presiding]. The gentleman's time has expired.

Mr. HURT. Thank you.

Mr. HULTGREN. The gentleman from Illinois, Mr. Foster, is recognized for 5 minutes.

Mr. FOSTER. Thank you.

I would like, if we could, to turn our attention first to the upcoming July 20th deadline for the talks with Iran, which, obviously, these can succeed, fail, or come to some intermediate result. What sort of contingency plans are you looking at for the financial part of the sanctions, which may have to be strengthened or weakened or held in place?

And, second, what is the role you envision for Congress in the overseeing and concurring on any changes to the financial sanctions that may result as a result of these negotiations?

Secretary LEW. Congressman, we have kept in place the architecture of our Iran sanctions even during the period of negotiations. The Joint Plan of Action had very narrowly defined, denominated, one-time relief, and the rest of the sanctions stay in effect. Since we began the negotiations under the Joint Plan of Action, we have taken over 60 enforcement actions on the underlying sanctions. So we don't have to do anything to put it into place; it remains in place.

The question really is, what happens if the talks fail? Do we then go for tougher sanctions? We have made it clear that if the talks fail, there would be, I believe, the need to take tougher action on sanctions.

Mr. FOSTER. But my question is, do you have contingency planning for the possibility of tougher sanctions, the possibility of effectively monitoring relaxed sanctions if there is a—

Secretary LEW. In a world where there is an agreement, that is obviously a very different situation. And I am not going to prejudge what the sanction regime would be after that. We have multiple sanction regimes with Iran, and I can tell you that we will be vigilant about implementing all sanctions that remain in effect after an agreement.

If there is an agreement, obviously there will be some change, but we are not announcing in advance what that is. Frankly, we are not at the point yet where we are ready to say that we have seen a basis for making the decision to do that. We are going to have to see Iran making the kinds of concessions that it has to make, which means not having nuclear weapons.

Mr. FOSTER. Okay.

In your report, the section on data gaps and data quality, which were some of your systemic concerns, you mention that they are still unable to effectively monitor securities lending transactions and reinvestment of the cash collateral.

So what is the nature of that situation? What action is needed? How worried should we be about that?

Secretary LEW. Look, I think that there is both an increasing concentration of activity in certain places because we now, for example, in commodities have a registration, so it is transparent, what is happening. That puts more transactions in one place.

We also have the challenge of communicating amongst systems which are different systems.

The reason it was highlighted as a risk there is we do have more work to do on that. It is both a technical challenge, but it is also a question, ultimately, of the stability of the system. So I think that the observations in the report reflect the fact that we are going to keep working on it.

Mr. FOSTER. Do you feel like you have all the legislative authority you need in that specific area, or is this something where Congress might have—it is my recollection that, during the crisis, something like 40 percent of AIG's losses were from their securities lending business.

Secretary LEW. Right.

Mr. FOSTER. So this is not a trivial thing, despite what was said earlier in this hearing. And so—

Secretary LEW. We obviously have a lot more tools now. We have a whole set of rules, particularly in the derivatives area, that weren't there before. So we have made a lot of progress.

I actually don't know the answer to the question of whether we have all the authority we need, and I would like to follow up as we learn more.

Mr. FOSTER. Okay.

I will do everyone a favor and yield back early.

Secretary LEW. I'm sorry?

Mr. FOSTER. I yield back.

Mr. HULTGREN. The gentleman from Illinois yields back the balance of his time.

The gentleman from North Carolina, Mr. Pittenger, is recognized for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

Secretary Lew, thank you so much for being here today. I am always impressed by your presentations. You are a very eloquent man, even when we don't hear what we would like to hear.

You have an amazing pedigree: Harvard undergrad; Georgetown University; you worked for Speaker of the House Tip O'Neill; for Bill Clinton, been in the White House. You are one of the most powerful people in the world today.

My background is a little bit different. I grew up in central Texas. I went to the University of Texas, a fine university. I can't tell you I was one of the better students; I was not. My daddy told me, he said, "Son, if you want to be smart, you need to hang around a lot of smart people."

I built a real estate investment company, and one thing I did was hire a lot of smart people. We have half a dozen attorney groups who work with us around the country. I am no longer part of this company. We hired securities attorneys, we hired real estate attorneys. We hired market analysis people. I hired an economist that we kept for 25 years.

Their good work and counsel kept us out of a lot of trouble. I can say that after 25 years and a couple thousand investors and maybe 60 or 70 partnerships, we never had a failed one. That is by the grace of God, but really a lot of good, smart people telling this little boy from central Texas what he ought to be doing.

Today, we are looking at the operations of FSOC and what it is doing and its designations, and that is important to a lot of people. It is going to affect a lot of companies in the impact of this country. A lot of families will be affected.

Yet, when I read some of the input from some of the individuals who would be associated with FSOC and aware of it, I find that they take a different position than the position that you have.

I look at Doug Elliott with the Brookings Institution, which you have been a part of yourself, who says that heightened prudential standards would cause broad economic harm because the insurers of one of the largest providers of long-term investment funds, and limiting the ability of insurers to make long-term investments would be unfortunate, since many commenters have pointed out that they need to increase the supply of such funds, especially with regard to massive investments in U.S. infrastructure that are needed in the years ahead.

We look at Roy Woodall, an FSOC member, appointed by the President. His comment was that he felt that the FSOC's analysis relied on scenarios antithetical to a fundamental and seasoned understanding of the business of insurance and the insurance regulatory environment.

Barney Frank, a former chairman of this committee, stated that it was not his intent that asset managers be designated for heightened prudential standards or supervision by the Federal Reserve Board because they do not pose a systemic risk.

Mr. Lew, my point is that many of us believe that these designations undermine the market discipline, they allow some companies to be favored, to believe that they are protected from further losses. Some of us see that there are structural flaws at FSOC that allow this to continue.

I think the thing that is troubling to me is that you are a bright guy, you are nobody's fool, you didn't get to where you are by just slothing through, but you have some capable people who understand the business, like the folks who understand my business, that you don't appear to be listening to. And I would hate to think that, years ahead, you will look back and say, maybe I should have listened to those people a bit more.

And the concern that I have and frankly, a lot of my constituents have, is that the folks in Washington think they have superior knowledge, they are smarter than everybody else, they have it all figured out. And I would just commend to you that there is safety in good counsel, wise people who understand the business, like Mr. Woodall. He understands this business.

So that is really my comment, and we have 30 seconds left, and you are welcome to say whatever you like.

Secretary LEW. Congressman, first, I appreciate the kind personal remarks.

The process we go through in FSOC is, one, is a level of great detail and great rigor. And all the members of the Council have views that are worthy of being heard and considered. There isn't always a unanimous view. I believe the record that was built justified the action taken in the cases where designations were made, but I don't believe it always will.

And I just would point out that, particularly in the asset management area, no decision to designate has been made yet, so it is premature to know the outcome there.

Mr. HULTGREN. The gentleman's time has expired.

Mr. PITTENGER. Thank you.

Mr. HULTGREN. The gentleman from Michigan, Mr. Kildee, is recognized for 5 minutes.

Mr. KILDEE. Thank you.

And welcome, Mr. Secretary. It is always good to have you here.

Secretary LEW. It is always a pleasure to be here.

Mr. KILDEE. I just want to say how much I appreciate your participation, your candor, but also your demeanor in this hearing. And I concur with Mr. Pittenger's commentary—while I might not agree with his conclusions, I concur with his commentary and applaud his demeanor, as well. I wish that were more the norm. But your patience and politeness is noted, at least by some of us here.

I do agree that you don't necessarily get smarter when you come to Washington. I also have concluded that there is a certain amount of evidence that the trend is in the other direction. But I will say to you, I appreciate—and I am not speaking of you; I am talking about some of us on the other side of the dais—I appreciate your politeness.

I want to talk to you quickly about two things. One has to do with the Department of Treasury's TARP program. As you are aware, TARP includes a program called the Hardest Hit Fund. Mr. Scott mentioned it. It is intended to assist those communities and homeowners in communities that have been most negatively affected by the financial crisis.

Some communities have had a much more difficult time coming out of that crisis, largely because many of the communities that were hit by the crisis had already been hit by a long-term crisis in housing—depressed values, abandonment, et cetera.

So last fall, myself and my staff worked with your team at Treasury; it was specifically Former Assistant Secretary Tim Massad. And we were able to secure $100 million to be reallocated from the particular uses that Hardest Hit allowed to demolition.

What I would like you to consider, and you will be getting a letter from me later this week on this, is whether there has been any

consideration or discussion within Treasury to extend the use, the available uses, eligible uses, of Hardest Hit that could be used for demolition beyond just residential properties but to look at specific commercial properties and residential communities that have negative externalities and are depressing the value of property.

I say that because before I came to Congress, I was involved in doing a lot of work and research and activity in this area, and we were able to conduct a number of studies that measured the impact of demolition on surrounding property values.

In Flint, Michigan, my hometown, for example, we took a few million dollars, and were able to demolish several hundred homes, and saw surrounding property values have a positive impact. In fact, just several million dollars unlocked the value of local properties to the tune of about $112 million. Changing that value equation obviously is one of the factors that mitigates future abandonment resulting in foreclosure.

Is that something that you might consider at Treasury?

Secretary LEW. Congressman, the decision on using the Hardest Hit Fund for housing demolition was one of the first issues that I made a decision on when I became Secretary. And I—

Mr. KILDEE. You made a good decision. I appreciate that.

Secretary LEW. —believe the analysis was very solid, that if your goal is to keep houses from going underwater or get them from being underwater to being above water, having abandoned properties on the block was something that had a material impact. And since the purpose of those funds is to help homeowners get out from underwater, the relationship was quite direct.

I haven't looked at the question of commercial property. I would be happy to look at it. But it would have to meet a test that is permissible under the TARP program.

And I will just add, I had the pleasure of being in Michigan the day that the demolition began—

Mr. KILDEE. Right.

Secretary LEW. —in the Marygrove neighborhood in Detroit.

Mr. KILDEE. Right.

Secretary LEW. And you go block to block in that neighborhood, and you see where abandoned houses have been allowed to sit for a year and where they have been demolished. It has everything to do with the stopping the decline and helping the rebirth of a neighborhood. I think we made the right decision, and I was very pleased to be able to join the mayor there.

Mr. KILDEE. I very much appreciate it. It is definitely a direction that makes sense. The application of the funds to commercial properties within neighborhoods, I think, will have as dramatic, if not a more dramatic effect. So I will be communicating with you on that in the coming weeks.

And rather than ask a question, I just want to reiterate, on a completely different subject, my support for the work that Treasury continues to do in implementing sanctions regarding Iran. As you may be aware, I have a constituent who continues to be held in an Iranian prison; his name is Amir Hekmati. And it has certainly made a difference. The sanctions are what have brought the Iranian Government to the negotiating table. I can't prejudge what will happen in the P5+1 or with July 20th soon approaching, but

we know we wouldn't be in a position to even have the possibility of an agreement without those sanctions. I appreciate your work on that.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus, for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Thank you, Mr. Secretary. Good afternoon, now that we have passed the noon hour.

Just a few days after you testified before this committee in May, Douglas Holtz-Eakin, the former Director of the Congressional Budget Office, released a study in which he estimated that if the FSOC designates asset managers as SIFIs, investors could see their returns reduced by as much as 25 percent over the long term. As he puts it, designating asset managers could cost each investor more than $100,000.

And while the OFR's asset management study considers far-fetched in the remote hypothetical situations, it never considers the costs that will be imposed on investors and on the economy if the FSOC designates asset managers, nor does it consider whether the benefits of designation outweigh those costs.

Shouldn't the FSOC's SIFI designation process consider the costs of designation as well as its benefits?

Secretary LEW. Congressman, I just want to underscore that no decision has been made on whether to designate the asset managers or not. So the OFR study was one piece of analysis as part of a process.

Mr. ROTHFUS. And should they consider costs of designation?

Secretary LEW. The designation process is one that is aimed at determining whether or not there is systemic risk. It is not a—

Mr. ROTHFUS. So there is no consideration for the costs that will be imposed?

Secretary LEW. The statute creates a standard that we use, which is whether or not there is that level of risk that warrants a decision.

Obviously, as regulators, if they take responsibility for an area, they then weigh different approaches in terms of how to regulate, and then it is a different issue. But the statute does not actually create a cost-benefit standard.

I can't speak to the analysis that you are describing. Obviously, I am aware of it, I have seen it. But it makes assumptions about actions that have not been taken yet, so I think it is premature for anyone to draw a conclusion—

Mr. ROTHFUS. If you could take a look at the OFR's, the Office of Financial Research's September 2013 report, OFR argues that mutual funds with a floating net asset value are risky because they could create a run on redemptions during a time of stress. Then, when I look back to FSOC's attempts to subvert the SEC's jurisdiction over money market funds in 2012, FSOC proposed a floating NAV for money market funds.

These two examples seem to be contradictory. Doesn't this just reinforce the reason why regulating this industry should be left to the SEC, who has the needed familiarity and expertise?

Secretary LEW. The SEC, as I mentioned earlier, is in the process of considering a rulemaking with regard to money market funds, and I certainly hope that they reach a conclusion that provides the kind of oversight of the—

Mr. ROTHFUS. Should that be within the discretion of the SEC and not the FSOC?

Secretary LEW. The FSOC reached a conclusion, with the SEC being very much a part of the process, that this was an important area to address. The FSOC made recommendations; now the SEC has a rulemaking.

And I will also add that, in the process of going through the asset manager review, the SEC is fully a part of that process. They review drafts of the OFR study. They are part of the decision that FSOC will make, because the Chair is a voting member of FSOC and the staff work on all the preparation to it. So—

Mr. ROTHFUS. I would like to ask a question getting back to "too-big-to-fail" and whether it has been ended.

The President and this Administration have a sad history of overselling its policy objectives and initiatives. They oversold an $800 billion stimulus saying that it wouldn't cause—or, if you passed it, unemployment wouldn't go above 8 percent. They oversold the Affordable Care Act with the famous, "If you like your healthcare plan, you can keep it." They shockingly oversold, I would say misled, about the impact of a video in Benghazi. They oversold the ability to reset relations with Russia. They oversold the record-retrieval capacity of the IRS with the email scandal. They oversold their ability to manage the VA. They oversold the demise of Al Qaeda.

Now, as recently as July 2013, you stated, as a matter of law, that Dodd-Frank ended the notion that any firm is "too-big-to-fail." And you also said, if a financial firm fails, the taxpayer will not bear the cost of that failure.

Now, Secretary Geithner—or, today, you seemed to backtrack on that. When the chairman asked you if "too-big-to-fail" has been ended, you testified, "We won't know until the next crisis." But that is not how Dodd-Frank was sold to the American people.

Secretary Geithner now says that, of course, the "too-big-to-fail" still exists.

Would you agree that the Administration oversold the promises of Dodd-Frank?

Secretary LEW. Mr. Chairman, can I have a few seconds to answer?

Chairman HENSARLING. A brief answer, Mr. Secretary.

Secretary LEW. Congressman, I had tried to address that issue at some length earlier, but I believe we have taken enormous steps to make our financial system more safe and more sound and to make it so that, if a bank fails, a financial institution fails, they will bear that risk themselves. That is what the capital is going to help do; that is what the resolution rules will help do.

What I said in the response to the earlier question is a matter of fact. The true proof comes at the time of the next financial crisis. I believe we have taken very dramatic steps and made very dramatic progress.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Washington, Mr. Heck.

Mr. HECK. Thank you, Mr. Chairman.

Mr. Secretary, thank you so much for your presence here today.

As you know, in 2012, when the Congress reauthorized the extension of the Export-Import Bank, the Secretary of Treasury in your department was directed to enter and pursue negotiations with other major exporting companies, with an objective of substantially reducing and then—and with the goal of eliminating the role of export credit authority subsidies of goods sold.

I am curious as to whether or not, as a result of that process or any of your other conversations with finance leaders from other countries, has there ever been an indication to you of a willingness on the part of those other countries to "substantially reduce" their export credit authority.

Secretary LEW. Congressman, there actually is a working group on export credit subsidies that met at Treasury 2 weeks ago, and there were 15 countries represented at that.

The issue has come up in my conversations from time to time with other finance ministers, and I have made the same point to them that we have made in public, which is that there has to be a level playing field. It cannot be a question of the United States unilaterally withdrawing from these kinds of programs while other countries stay in, because that would put our firms at a disadvantage.

So I think the working group is a good thing, and a level playing field is the goal.

Mr. HECK. Have any of those countries indicated a willingness to do away with their export credit authorities?

Secretary LEW. I am not sure they have gone that far yet, but that is obviously one endpoint that would leave a very level playing field. But it can't be that the United States steps back while everybody else is subsidizing their exports.

Mr. HECK. As you are aware, China is, as we sit and speak, developing a commercial aircraft for sale, the C919. It is my impression that it is being substantially subsidized by China in its development. Would that be your impression, as well?

Secretary LEW. I do understand that there is a Chinese aircraft industry, and I don't know the exact structure of it, but they do have many state-sponsored enterprises.

Mr. HECK. And they also have a state-sponsored enterprise to develop small aircraft, which are being sold with the assistance of China's export credit authority already.

What would your opinion, then, Mr. Secretary, be as to whether or not China, in absolute dollars and as a percentage of GDP, about the largest export credit authority on the face of the planet, what is your opinion about whether or not the Chinese export credit authority would engage in financing of the sale of their C919s once they are developed?

I realize that no memo has been issued by them, but you are a worldly guy with a strong, firm grasp of how the economy works. Would you fully expect China to provide export credit authority for the sale of their commercial aircraft?

Secretary LEW. I think we have seen in the commercial aircraft industry worldwide that there is a willingness of governments to provide export support. I have no reason to believe that China would choose not to do that. I don't know of the specific intention.

I do think that it is a case where we either all have to agree to not do it or the United States has to maintain the Export-Import Bank kinds of support so that our industries can compete on a fair basis with other manufacturers who have access to export support programs. There is not a place for the middle ground where we withdraw and others don't.

Mr. HECK. I don't want to put words in your mouth, to be sure, so let me do a little reflective listening. Here is what I think I heard you say: If our future is that Airbus is provided export credit authority for purchases of financing sales and the Chinese-made, at some point in the future, C919 aircraft is provided with Chinese export credit authority financing assistance and airplanes made in the United States of America are not provided with export credit authority financing, that would put us at a material disadvantage to compete in the global market.

Secretary LEW. Yes, I think that is correct.

And I also think that our Administration's support of the Export-Import Bank has been clear. We think it is an important aspect of how not just our aircraft industry but many large and small U.S. firms can play on a level playing field in a world where other exporters have access to credits. We can discuss a world where there were no such credits, but in a world where others engage in that, we can't unilaterally disarm.

Mr. HECK. Thank you. Fair enough.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Mexico, Mr. Pearce, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

And thank you, Mr. Secretary, for being here today.

Mr. Secretary, you had written in your comments on page 2 that we learned from the 2008 financial crisis that regulators should have asked more, not fewer, questions about the institutions and the activities they oversaw.

So why do you think that we weren't asking enough questions going into this 2008 time period?

Secretary LEW. I can't go back and tell you exactly why different institutions and individuals behaved the way they did, but I think we saw the results, that there was a financial crisis—

Mr. PEARCE. No, I am—

Secretary LEW. —that took everyone by surprise.

Mr. PEARCE. I think it wasn't the institutions themselves. It is that regulators should have asked more. Why were the regulators not asking more questions?

Secretary LEW. There was no regulator that had broad responsibility for looking across the financial horizon and asking about financial stability. Regulators each had their siloed areas of regulatory authority. And in their areas, they asked questions the way they had in the past.

Mr. PEARCE. There hadn't been anything in the past that had caused people to say, hey, we need to start asking more questions,

we ought to work back and forth across these silos? Nothing had come up about that?

Secretary LEW. In retrospect, there were people saying that there were questions about that which needed to be asked, but the system didn't respond. And—

Mr. PEARCE. When you say the system didn't respond, what does that mean?

Secretary LEW. I think that in the 1990s, there was the debate about derivatives, and in the early 2000s, there was a run-up in the housing market and development of highly leveraged—

Mr. PEARCE. What system was not responding?

Secretary LEW. Depending on the issue, it was different regulators. You had relatively lax regulation in some of the banking regulators. You had—

Mr. PEARCE. Was anyone calling attention to that?

Secretary LEW. Was anyone calling attention to it?

Mr. PEARCE. Yes, sure. Anyone in your field of interest, your sphere of interest.

Secretary LEW. I was not in Washington at the time, so I don't want to pretend to have been participating. But the build-up in mortgage credit on riskier and riskier terms was viewed as a narrow housing issue, not a systemic issue.

Mr. PEARCE. But nothing in your experience gave you cause where you would elevate the concerns?

Secretary LEW. It was not my set of responsibilities at the time, but—

Mr. PEARCE. If I would take a look back at 1994 to 1997, you were Deputy Director of OMB, and in 1998, you were made the Director. And when I take a look at the Web page for OMB, it says that it is oversight of agency performance, oversight of all agency performance, measures quality of agency programs, policies, and procedures.

Now, it was exactly during that period that long-term capital did almost exactly the same thing. They almost collapsed the world economy, according to the leading articles of the day. And, under your watch, you had the ability to see that this extremely dangerous thing was occurring in the markets.

And what they were doing was ramping up their asset—or they were taking their asset value down as low as 3 percent. That is exactly what Bear Stearns did 10 years later, down to 3 percent. And it was one of the original partners at Long-Term Capital who was the head of Bear Stearns.

So, we had 10 years to assess. And the system knew exactly what was going on. You were the one in charge of the OMB; you were the one in charge at the White House. And yet, you make the statement here that regulators should have asked more, not fewer, questions. You were the one who should have been saying to the regulators, "Your system is not working." This is a very dangerous thing that went on.

And, yet, now and today, we are sitting here, and on page 3 you say, "As the distance in time since the financial crisis grows, we must not forget the financial and emotional pain endured by millions of American families who lost their homes or retirement savings or jobs."

It would be nice if that same perspective had been kicked out after the Long-Term Capital failure, saying, let's not let this happen again, but instead, 10 years later, the same thing happens again. And I find your statements to be surprising.

I yield back, Mr. Chairman.

Secretary LEW. Congressman, if I could just respond briefly.

Mr. PEARCE. If I have time, sure.

Secretary LEW. First of all, when I was at OMB, the Office of Budget and Management has relatively limited insight into independent regulatory agencies, their rules, and the actions they make. They are independent regulators.

One of the reasons FSOC was created was to have a place where there was an ability to look across all of the independent regulators and work together. I think FSOC actually is an important solution to that problem.

Mr. PEARCE. Again, the warning sign was there. We almost collapsed the world economy. You were the guy in charge of checking the economy.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you.

Mr. Secretary, the last 2 or 3 times you have come here, I have focused your attention on the worldwide unitary system of taxation. Last time you were here, you said that your Assistant Secretary for Tax Policy had reviewed that and was anxious to talk to me about it. He hasn't reviewed it.

I would hope that you would commit now that your Department would devote some serious high-level time to reviewing what would be a system that would increase our tax revenues by over $1 trillion over 10 years and is the system that has been used by the 50 States to deal with multi-jurisdictional income taxes long before globalization occurred and multi-jurisdictional income tax meant international rather than multi-State.

Can I get a commitment that you and your Department are going to look at the—

Secretary LEW. Congressman, he has reviewed it. If he hasn't been in touch with you, I will make sure he gets in—

Mr. SHERMAN. Oh, no, he was in touch. He basically—we talked for a few minutes, but he had not looked at the issue.

Secretary LEW. My understanding is that there are people in his office who have looked at it. I will make sure they contact you.

Mr. SHERMAN. They are streamed on other things.

I have read Ayn Rand. Ex-Im Bank is not mentioned in any of her books. I dream of a world in which all competition is fair and as uninfluenced by government as possible.

Do you think you could be successful in getting Germany and France and Japan to eliminate their analogs to the Ex-Im Bank if we would just eliminate ours first?

Secretary LEW. I don't know the answer to that question. Obviously, the engagement that is under way is aimed at trying to answer that question.

What I do believe is that it would be wrong for us to unilaterally withdraw from the Export-Import Bank while other countries are

providing export subsidies, putting our manufacturers and exporters at a disadvantage. There needs to be a level playing field.

Mr. SHERMAN. It is strange, because I am on the Foreign Affairs Committee, where sometimes Members of our party are accused of being in favor of unilateral disarmament, and then I come here and it is folks on the other side in favor of—or at least some, in favor of unilateral disarmament.

Secretary LEW. And I don't disagree with the notion that it would be a good thing if there were no export subsidies. The two positions are not inconsistent.

Mr. SHERMAN. Right. But if we eliminated the Ex-Im Bank, wouldn't our foreign trading partners have absolutely no incentive to eliminate theirs?

Secretary LEW. I think if we did it on a unilateral basis, yes. If it was part of a negotiation, that would obviously be very different.

Mr. SHERMAN. Right. That would be like doing missile control with the Soviet Union by eliminating all our missiles and then going to the missile control—

Secretary LEW. I am not sure I would want to compare the stakes, but I understand the analogy.

Mr. SHERMAN. Okay.

You have to define SIFIs. The tendency is to define SIFIs based on the size of their assets. I want to urge you instead to look at the size of their liabilities.

What causes a SIFI to bring down the entire economy is that people were expecting that they would meet their obligations and they are unable to do so. For example, if you had a company with a great name but modest assets that went out and incurred a trillion dollars of contingent liabilities by writing a bunch of credit default swaps, that entity would be a SIFI, assuming defaulting on a trillion dollars of credit default swaps would bring down the economy—maybe the number would be bigger—regardless of the size of its assets. As a matter of fact, the smaller its assets, the worse situation we are in, if they are engaging in more than a trillion dollars of credit default swaps.

With that in mind, as to mutual funds, they don't have liabilities, except if they are leveraged, except for one thing, and that is they have the contingent liability that if the custodian function is not handled correctly and you open the safe and there is nothing there, then they have a liability.

So I would hope that when you are dealing with an unleveraged mutual fund with extremely strong custodian functions that you would not be designating that as a SIFI.

I don't know if you have a comment?

Secretary LEW. As I have said a number of times this morning and afternoon, we have not made a decision yet, but we definitely understand that there are different kinds of assets in asset management funds, custodial funds. I understand the important difference between leveraged and unleveraged funds.

We will complete this process and reach a determination as to whether or not there is a basis for designation. But asking the question does not mean we decided to designate.

Mr. SHERMAN. Okay.

And, likewise, insurance companies seem to be well-regulated. It is when you let the unregulated portion of AIG write credit default swaps that you have a SIFI problem.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

And thank you, Secretary Lew, for being here.

I want to follow up on how we can work together in a bipartisan and constructive manner, as Subcommittee Chairman McHenry had questioned a few minutes ago.

As he noted, we have passed a couple dozen bills by super-majorities out of this committee, including many by voice vote, and many of those have passed the House, as well, that made sensible reforms to Dodd-Frank.

Notably, even former Fed Chairman Ben Bernanke, in his last appearance here, when asked where Congress should focus and where the Fed would be interested in engaging, he stressed a couple of different things: first, he stressed swaps push-out, which creates more systemic risk and impacts end-users' ability to hedge; second, he mentioned end-user margin, which Congress never intended and where regulators need clarity; and third, he said regulatory relief for banks, especially smaller financial institutions.

I wonder, does the Administration intend to support any of these sensible reforms? And does Treasury have a list of bipartisan reforms that we can work on?

Secretary LEW. Congressman, as we have indicated, we think that many of these issues are premature, that regulators are dealing with these issues and that the need for legislation is not yet clear.

And as I mentioned in my response to an earlier question, the idea of going in and amending Dodd-Frank, if it is a question of truly technical fixes that don't open other issues, obviously is different than if it is part of an effort to take a broader look at Dodd-Frank.

We have not thought that the legislation was appropriate up until now. That continues to be our view. But we look forward to working with you going forward.

Mr. HULTGREN. I would say, please hurry. People are suffering under these things. Again, as Chairman Bernanke recognized, these do have an impact. And further delay is absolutely impacting the economy and many of these institutions that are just trying to get answers and trying to figure out how to work.

And, again, when these are done in a super-majority way, to me, it would seem like it would draw light to the Administration and to the Treasury that this is important, that this isn't just something that we are tinkering with or pushing on, but instead this is what we are hearing from people who are trying to respond in a very difficult climate already. And I would say delay and confusion is making it worse.

Let me move over a little bit to oversight function of FSOC. I believe oversight is extremely important, that this committee has to be engaged in this because of the design of FSOC, which really

makes it much more opaque and unaccountable than other regulatory agencies.

Certainly, this includes broad statutory discretion that the FSOC has to designate certain companies as SIFIs. We have talked about that a lot today. That is why I am a cosponsor of Chairman Garrett's bill, the FSOC Transparency and Accountability Act, which would implement commonsense reform measures to the FSOC that would improve the SIFI designation process.

One example of FSOC's inadequate structure is how it constitutes who a voting member is. I wanted to ask you some questions on this. The FSOC is dominated by the heads of bank regulatory agencies: the Chairman of the Federal Reserve; the Comptroller of the Currency; the Chairman of the National Credit Union Administration; and the Chairman of the Federal Deposit Insurance Corporation. Not surprisingly, these regulators have a bankcentric view of the world.

Secretary Lew, I wondered, can you explain to the committee why it is that the expertise and judgment of bank and credit union regulators should be substituted for that of the SEC in the case of asset managers, or State insurance regulators in the case of insurance companies, when determining how these firms should be regulated? Are these persons really qualified to vote on whether to designate nonbank financial institutions as SIFIs?

Secretary LEW. I think the statute was set up quite correctly to require all of the members of FSOC to look across our financial system and look at risks that cut across the responsibilities of different regulators and that might not be visible if you looked at it just in one channel.

The view of each member of FSOC is important. And I think that the nature of the debates, the discussions within FSOC are very collegial and very respectful. And if you look before FSOC existed, there were barely relationships between many of the regulators. So, we have come a long way in terms of closing a gap that was part of what contributed to the financial crisis.

Mr. HULTGREN. I think the problem is so much of it is bankcentric-focused and not seeing that there are very different risks out there, depending on the group that we are talking to.

And let me, in the last few seconds that I have, shift over to ask about the possibility that certain mutual funds could be designated as SIFIs.

Mutual funds use little or no leverage. In fact, the 14 largest U.S. funds had an average leverage ratio of 1.04 to 1, compared to U.S. commercial banks, which had an average ratio of 9 to 1.

Does the fact that mutual funds are not leveraged make it impossible for them to fail in the same way that banks do?

Secretary LEW. Look, we are in the process now of looking at the asset management industry and the products of the industry, and the answer to your question will come at the end of our inquiry, not now.

Mr. HULTGREN. My time has expired, and I yield back. But I do want to say, this has an impact on industry, and the sooner, the better. This is taking a long time.

Thank you. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Nevada, Mr. Horsford, for 5 minutes.

Mr. HORSFORD. Thank you, Mr. Chairman, and Ranking Member Waters.

Mr. Secretary, thank you for being here today.

I want to ask a question about the effect of the housing crisis on the majority of U.S. homeowners who are still struggling to recover.

I am from Nevada. Unfortunately, our State is still the third highest in the country for foreclosures, with 1 in 717 housing units currently in or pending foreclosure filing, and some 34 percent of Nevada homes are still seriously underwater, the highest in the Nation.

As part of the Administration's response to the housing crisis, the Treasury, under TARP, established two central programs, the Making Home Affordable and the Hardest Hit Fund. And I noticed your media advisory yesterday about an announcement that you will be making this Thursday at the Making Home Affordable Anniversary Summit on new housing initiatives. It is my understanding that you plan to announce additional policies to assist struggling homeowners, provide more affordable housing options for renters, as well as expand access to credit for borrowers.

Can you provide any further details about these initiatives or the announcements that you plan to make on Thursday?

Secretary LEW. Congressman, we have been looking hard at all aspects of the authorities we have and that regulatory agencies have that affect access to credit and relief that might be available to homeowners.

I would refer back to the announcements made by the FHA and the FHFA to deal with this issue of put-back risk that is closing down the credit box so that people who are fully creditworthy are not getting access to mortgages. I think that is going to make a big difference.

We need to finalize the risk retention rules so we eliminate any remaining uncertainty as to what the final rules are.

And we are constantly looking, in the Making Home Affordable program, at what can we do with authorities we have to, based on the current situation in the market, provide appropriate relief to homeowners. And I hope to be able to make some more comments about that on Thursday.

Mr. HORSFORD. Wonderful. I am eager to hear about the Treasury's efforts in this regard, particularly for struggling homeowners, as you said, like those in my home State of Nevada.

And I would like to ask if I can meet with you and members of your staff following your announcement on Thursday so that I can make sure that these initiatives are helping the people who need the relief the most at this time.

Secretary LEW. I am happy to have our staff follow up with yours.

Mr. HORSFORD. Thank you very much.

Mr. Secretary, as well, are there any other areas that you see, particularly around the housing area, where this committee should be working with you and other leaders to help provide the relief that homeowners are seeking?

Secretary LEW. Congressman, that is obviously a very important question. If we look at the recovery to date, we are doing pretty well in most areas, most sectors of the economy. The place that has not been recovering where it should is construction and housing.

Some of that is a question of market conditions. We had a financial crisis with a huge overhang of inventory and credit-stressed institutions and investors and borrowers. I think, as we now get to the point of a more healthy economy, we have to make sure that creditworthy people have access to credit and that we don't have the pendulum go to the point where it is blocking out of the market people who are not a risk.

It is certainly not that we need to return to the days of before the crisis when we had low-doc, no-doc loans, people who got into mortgages they couldn't afford. But if you have somebody with a FICO score of 740 who can't get a mortgage, then the system has overcorrected. And the put-back decisions, the announcements on put-back risk, should have an effect on that. I have talked to CEOs of banks who think it will have a material effect.

As we go through the process of seeing what the effect of what we have done administratively is, I would look forward to continuing the conversation as to whether there are other actions, other tools that we don't have the authority to do on our own.

Mr. HORSFORD. One other area, in my concluding time, that I would like to have a conversation about is the review of the criteria that credit reporting agencies use in which to measure consumers. That is an area that I think needs review. This committee has not had a hearing on that in well over a year. And we are in a different landscape and setting today than we were pre-2008.

Secretary LEW. I think that is correct. And I think it is also the case that there are many people for whom the credit rating agencies miss the test of their true creditworthiness because they are paying their utility bills and other things on a regular basis.

Mr. HORSFORD. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Florida, Mr. Ross, for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman.

Mr. Secretary, let me ask you quickly, if I can, because I know your time is coming to a close here, companies are notified under Stage 3 of the SIFI designations that they have been designated as a SIFI, correct?

Secretary LEW. That is correct.

Mr. ROSS. And there is really no other opportunity to be notified, though, other than Stage 3?

Secretary LEW. We all know notification is Stage 3, and there is plenty of time in Stage 3—

Mr. ROSS. The SIFI designation states, "In general, this analysis, Stage 2, will be based on a broad range of quantitative and qualitative information available to the Council through existing public and regulatory sources, including industry- and company-specific metrics beyond those analyzed in Stage 1 and any information voluntarily submitted by the company."

It just seems kind of odd that if they are not aware until Stage 3, how would they know to volunteer any information at the Stage 2 level?

Secretary LEW. The—

Mr. ROSS. I guess what I am getting at is it is almost like a "gotcha" situation. Because they don't want to be a SIFI if they don't have to be, and so they would like to work with you—

Secretary LEW. Companies know if they meet the Stage 1 standard, because the Stage 1 standard is a publicly available—

Mr. ROSS. But they are not notified that they are being reviewed.

Secretary LEW. No, but the companies know that if they are in the group of companies that meet the threshold, that they can voluntarily provide information.

Mr. ROSS. Yes, but they don't know if they are in Stage 2. Don't you think it would be better and more transparent if there was an opportunity for notification in the Stage 2 level of a company that is under review for SIFI purposes?

Secretary LEW. The process was actually set up in a very careful way to try to get information that was available to use to make preliminary determinations before engaging a company in a process where—

Mr. ROSS. And it should be a cooperative process, I agree.

Secretary LEW. But if a company is notified, that creates all kinds of other issues, which—

Mr. ROSS. But it could cause self-correctness.

Secretary LEW. It could what?

Mr. ROSS. It could cause self-correctness. In other words, they could—look, they would want to cooperate, I would think. And not only would they want to cooperate, but I think other companies in the same industry may also want to have the opportunity to prevent them from being under that review.

Wouldn't that be a more transparent, a more cooperative process?

Secretary LEW. I think the tension—the transparency of the process is very high, because Stage 3 is where the detailed back-and-forth with the company and FSOC goes on.

Mr. ROSS. I do agree. All I am saying is, if they can have some opportunity to avoid Stage 3, wouldn't that be better and enure to the benefit not only of the company but also—

Secretary LEW. I am not sure it would benefit the company. I think that, for many companies, if there was a kind of preliminary designation they were notified of, that would create a sense that they were about to be going through Stage 3. They may have to disclose it; it could have an effect on their business.

Mr. ROSS. But most companies don't know really that they are even going to be Stage 3.

Secretary LEW. I think the financial firms that are at the Stage 1 threshold level do understand that they are there.

Mr. ROSS. Let me change topics here. Just recently, the International Association of Insurance Supervisors came out with their plan to implement capital standards for insurance companies, hopefully on a global basis. Unfortunately, they seem to be rushing things. And I think that the NAIC's head, former Senator Ben Nel-

son, has expressed his dismay and concern that they are going at breakneck speed.

My question to you is, if the United States doesn't participate in these global standards for capitalization for insurance companies, really they don't become global. And, in fact, there may be other countries that may follow our lead.

Can you give us some assurances from the Treasury and the FIO that everything is being done to make sure that the interests of domestic insurance carriers are being advocated and protected as we go through this process of assessing—

Secretary LEW. Congressman, there is robust participation by insurance commissioners and others who are expert in the U.S. insurance industry in that process. And I can tell you that it is with a great deal of input from the United States that the discussion goes forward.

Mr. ROSS. And with regard to statutory accounting procedures and generally accepted accounting procedures, those two being at odds, too, most insurance companies now having to potentially have to keep two sets of accounting principles, which would be very duplicative, very costly.

Can we get some assurances from Treasury that we will focus on not a duplication but rather a continued streamline process for accounting principles such as the SAP, or statutory accounting principles?

Secretary LEW. I will have to get back to you on the specific issue regarding the insurance accounting principles.

I can tell you, as a broad matter, my view has been, if we can in international conversations eliminate some of the noise between different systems—

Mr. ROSS. And duplication.

Secretary LEW. —it would be a good thing. The problem is that it is not always as easy to accomplish as you would like.

Mr. ROSS. I agree, which is why we would like your advocacy in that regard.

Secretary LEW. Yes.

Mr. ROSS. With that, Mr. Chairman, I will yield back.

Chairman HENSARLING. The Chair intends to recognize the gentleman from California, followed by the gentleman from Kentucky, and then we will excuse the Secretary.

The Chair now recognizes the gentleman from California, Mr. Royce, chairman of the House Foreign Affairs Committee.

Mr. ROYCE. Thank you, Mr. Chairman.

At the outset, I would just like to set the record straight on an issue that I think was raised twice today, and that is the story of AIG.

If I could submit for the record, Mr. Chairman, the story that ran in last week's American Banker?

Chairman HENSARLING. Without objection, it is so ordered.

Mr. ROYCE. Thank you.

It is by Hester Pierce. It is entitled, "AIG's Collapse: The Part Nobody Likes to Talk About." And that part, of course, is the securities lending portfolio run for the benefit of the State-regulated life insurance subsidiaries of AIG.

And if I could briefly quote from the article: "Government rescue money was critical to the recapitalization effort of AIG. Taxpayer funds were also critical in meeting securities borrowers' demands for cash. Securities lending counterparties received $43.8 billion in the last quarter of 2008, comparable to $49.6 billion in collateral postings and payments to AIG's derivatives counterparties."

The record is pretty clear here. The taxpayer bailout associated with AIG, which I opposed, by the way, applies both to its Financial Products unit in London and to its State-regulated insurance arm right here in the United States.

But on to my question here for the Secretary.

Secretary Lew, as you know, the U.S. and the EU are currently engaged in trade talks as part of the TTIP negotiations. And with regard to banking and securities regulation, the EU has put forth a limited but reasonable proposal to strengthen U.S.-EU regulatory cooperation and to create a more results-driven dialogue that avoids market disruption and regulatory fragmentation. It is focused on consistency of regulation, limiting extraterritorial impact, and laying the foundation for recognition where appropriate.

So the EU has made this a top priority. Do you not believe that enhancing this dialogue is an important objective and could lead to a high-standard comprehensive regulatory regime?

Secretary LEW. Congressman, I believe that both TTIP and TPP are very important trade negotiations. And I have spent a great deal of time working with my counterparts on the aspects of those trade negotiations that fall in my area.

I do think there are challenges in TTIP, particularly with regard to financial services, that we have not yet reached an agreement on.

Mr. ROYCE. Right, right, but this would be a way to get there. If you feel that financial services regulatory issues being part of TTIP discussions would be important, this would be a way to bridge that.

Secretary LEW. Our view—my view is that, to the extent that the question is should financial regulatory standards, prudential standards, be subject to a trade negotiation, the answer there, I believe, has to be "no." We can't be in a place where we are subjecting our financial regulatory standards to trade remedies.

We have to regulate to make sure we have a sound financial system and drive through the G-20 and other bodies to have the international standards reflect our high standards.

I think competition in the marketplace for financial service companies ought to be part of a discussion, and we ought to have open access subject to our national authorities.

Mr. ROYCE. Here is a point. The Wall Street Journal article recently, in which Acting CFTC Chair Mark Wetjen takes issue with the process and policies with the CFTC cross-border guidance, here is his quote: "I don't think that was the right decision. If you have equally comparable comprehensive regulations in Europe, as an example, then what's the reason why we wouldn't allow for substituted compliance in that situation?"

There's the question, and if you can have that dialogue in order to substantiate that.

And the second would be an article I am going to quote here, "Transatlantic Swap Liquidity Split Persists," which highlights two polls that show concrete evidence that "regulators have failed in their attempts to tackle a liquidity split by two swap market reforms in Europe and the United States."

Now, the Administration has pointed to the current regulatory dialogue, the financial management regulatory dialogue, as an appropriate forum. But what success has that produced? It hasn't, in terms of regulatory cooperation and consistency.

So I think you have an opportunity here. Many of the challenges we have seen today—uncertainty, market disruptions, which we talked about—could be avoided if we go down the road of this dialogue.

Secretary LEW. Mr. Chairman, if I may just very briefly respond?

I think that in the area of substitute and compliance we have made a good deal of progress, but the challenge is what is true comparability. And that is something that I believe is being worked through in the derivatives area with the CFTC and their counterparts both in Europe and in Asia.

And if it is true substitute and compliance on a basis of comparable standards, that is one thing. I just don't believe that a trade context is the appropriate place to resolve those matters.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr.

Mr. BARR. Thank you, Mr. Chairman.

And thank you, Mr. Secretary, for your patience. It looks like I may be the very last questioner, so I appreciate your patience.

Mr. Secretary, you have repeatedly said that an institution can appeal its SIFI designation if it disagrees with the FSOC determination that it poses systemic risk.

But the first appeal is to FSOC itself, an appeal that seems useless, given that the institution is not appealing to an independent arbiter but instead to the same agency that is making the original designation.

And then the second appeal would be to the courts, but that appeal would also seem fairly useless, given the fact that FSOC has not promulgated some objective standards to guide its terminations, and the court couldn't effectively review those designations and would have to defer to FSOC's original judgment.

And, secondly, the institution wouldn't challenge the regulators' judgment anyway, for fear of retaliation in the supervisory process. Just last month, Former Assistant Treasury Secretary Michael Barr pointed out that institutions may refuse to appeal these designations precisely because they fear regulatory retaliation.

So my question is this: Given the substantial flaws in the appeals process, both the original, initial administrative appeal and then the judicial appeal, does the designation process really give institutions a meaningful opportunity to challenge their designations?

And, given these flaws, would you support an alternative process which would create an independent ombudsman or arbiter as an alternative to review the initial designation?

Secretary LEW. Congressman, I actually don't agree with that assessment of the current process. I think that the engagement at the Stage 3 level is robust and it does affect the thinking at the staff level and the principal level. I think that when we had the one face-to face hearing, it was actually a very substantial exchange of questions that were responded to.

And I think that as far as recourse to judicial resolution, it has not been the case that financial institutions or others are afraid to challenge judgments that they don't agree with when the regulators make them.

Mr. BARR. So you would not reform the current statutory process?

Secretary LEW. I think the current process is actually working pretty well.

Mr. BARR. Okay.

In regard to Ex-Im reauthorization, you have said that every other developed country has an export credit agency, and we shouldn't go it alone, we shouldn't unilaterally disarm, regarding export support.

But, given the fact that we have unilaterally burdened financial institutions with the Volcker Rule while the rest of the world does not have a similar regulatory regime, since we have unilaterally burdened our manufacturers with greenhouse gas standards not imposed by other countries, since we have unilaterally subjected our financial institutions with higher capital standards than the rest of the world, since we have unilaterally subjected the United States business community to the highest corporate tax rate in the world, what is the difference?

Secretary LEW. Congressman, I would actually counter on two of those issues and on the third agree with you.

I think, when it comes to Volcker, you have processes going on through other international processes, Liikanen and Vickers, where they are looking to put in similar kinds of systems.

I think if you look at climate rules, the agreements made in Copenhagen were very important. We are complying, meeting our standards; other countries are doing the same.

On the tax rate, I agree with you; we need to do business tax reform. We should not have a statutory business tax rate as high as we do, and I would look forward to a bipartisan effort to do that.

Mr. BARR. I am glad you at least agree on that point. And I take it you take my point on the others, particularly with respect to the greenhouse gas rules, which other countries, developed countries, China, India, certainly are not adopting.

Really quickly, final minute, I do want to ask you about the lost IRS emails. We knew that targeting of conservative groups by the IRS began in February-March 2010. Despite repeated inquiries from Congress in 2011, the IRS responses did not mention knowledge of the targeting.

In fact, in February of 2012, Commissioner Shulman was aware of the inappropriate targeting, but in March of 2012, the Commissioner said, "I can give you assurances"—this is to the Ways and Means Committee—that there was absolutely no targeting."

There was further stonewalling. The Administration said this was a rogue office in Cincinnati. As it turns out, we know that was

not the case. There was also the story that this was targeting of both progressive and conservative groups. TIGTA George confirmed that the progressive groups were not targeted.

And then we find out about these lost emails, and there was stonewalling, when Commissioner Koskinen knew about the hard-drive program in February and when Treasury knew about the hard-drive program in April of early year. We didn't find out until 11 days ago that there were these lost emails.

So when the President says there was not a smidgeon of corruption and when we find out that the hard drive crashed 10 days after Chairman Camp first sent a letter inquiring into this matter back in 2011, do you agree with this assessment that there is, maybe not corruption—I am sure you don't agree with that—but that the stonewalling is inappropriate?

Chairman HENSARLING. The time of the gentleman has expired. If the Secretary wishes to give a brief answer.

Secretary LEW. If I can just responsd briefly.

Congressman, I don't believe there is any evidence of any political interference to date. And I don't think any of the issues that have come up undermine that view.

I think if you look at the reaction that we had when the TIGTA report came in, the first step we took was to replace the top leadership. Danny Werfel came in. All the leadership between him and the program was changed at a Senior Executive Service level. Procedures were put in place so that it was a very different process going forward.

I think the fact that a hard drive broke is only evidence that a hard drive broke.

Chairman HENSARLING. The time of the gentleman, again, has expired.

I would like to thank the Secretary for his testimony today.

The Chair notes that some Members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to this witness and to place his responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing stands adjourned.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]

A P P E N D I X

June 24, 2014

The Honorable Jacob J. Lew
U.S. Department of the Treasury
Hearing on the Financial Stability Oversight Council Annual Report to Congress
House Committee on Financial Services
June 24, 2014

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify today regarding the 2014 annual report of the Financial Stability Oversight Council.

Nearly four years ago, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the most comprehensive set of reforms to our financial regulatory system since the Great Depression. As a result of the implementation of these new rules, consumers have access to better information about financial products and are benefiting from new protections. Financial markets and companies have become more resilient. Regulators have become 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.

As many of you know, one of the important reforms in the Dodd-Frank Act was the creation of the Financial Stability Oversight Council (Council). Before the Council, no single authority was accountable for monitoring and addressing risks to financial stability, and each regulator focused on the institutions, functions, or markets under its purview. As we learned, without a mechanism to look at the entire financial system, risks to financial stability can spread quickly across

institutions and markets. This siloed approach allowed certain risks to fall through the cracks of the regulatory system and failed to protect us in the lead-up to the crisis.

Congress changed that. With the establishment of the Council, senior regulators from across the system now meet regularly to facilitate a more coordinated approach to monitoring, identifying, and responding to potential threats to financial stability. Today, the Council provides a forum to foster regular and close collaboration among its members at both the federal and state levels. This collaboration features frequent meetings between senior officials, as well as dedicated and ongoing engagement among staff on a near-daily basis.

Independent regulators continue to be responsible for regulating the markets and institutions they oversee. But they are now also part of a process that enables them to look across markets and institutions to monitor the entire financial system and identify potential risks to U.S. financial stability. Some now suggest that this function should be curtailed, but hindering the Council's ability to analyze information regarding particular sectors, firms, or activities runs the risk of missing the next threat to our financial system and the U.S. economy. This is an important responsibility that the Council must fulfill.

Today, there are even some who challenge the notion that the Council should ask questions about whether certain activities or companies might pose risks to the stability of the U.S. financial system. But asking questions does not equal regulatory action. We learned from the financial crisis that regulators should have asked more, not fewer, questions about the institutions and

activities that they oversaw. And today we should ask these questions equally prepared to find a reason to take action or not. But if we avoid or are discouraged from asking questions all together, our financial system will be more exposed to unseen risks, potentially leading to large scale problems.

There are many possible outcomes to the Council examining a particular risk. If the Council determines there is a risk that requires action, Congress provided the Council with a broad range of authorities and potential remedies. But the Council may conclude that it does not need to act, that it needs to examine and issue further, or that it must gather additional data. What the Council should not do is cordon off any sector or activity without even considering it. That would be a dereliction of Council responsibilities and a complete disregard for the very purpose of the Council.

Some also claim that the Council's processes are opaque and its outcomes are predetermined, but that is simply wrong. The Council has voluntarily adopted a robust transparency policy and put in place a comprehensive, deliberative approach to its evaluation of risks, and it solicits public input and carefully considers all points of view. Its report, which I will be discussing today as the subject of this hearing, describes the work of the Council.

As the distance in time since the financial crisis grows, we must not forget the financial and emotional pain endured by millions of American families who lost their homes, their retirement savings, or their jobs. We cannot return to a regulatory environment that failed to detect risks to

financial stability and was unequipped to mitigate those risks and prevent the damage to our financial system and economy.

In this context, the Council's annual report stands as a testament to how the Council is executing on its statutory duty to identify and respond to potential threats to financial stability. The report reflects the collective judgment of Council members regarding the key risks to financial stability and provides an important example of how the Council shares information about its work with Congress and the public in a clear and transparent manner. Each annual report is the product of a highly collaborative analysis conducted by the Council's member agencies to document for the public the Council's sense of the risks present 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.

The Council's annual report also provides a roadmap for the Council's agenda for the upcoming year – what areas it will focus on, what areas will likely require additional attention, and how it expects to address them. The 2014 annual report focuses on nine areas that warrant continued attention and possibly further action from the Council's members:

- 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 that are needed to reduce the 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 innovations 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.

Activities of the Council

Since its 2013 annual report, the Council has continued to fulfill its statutory responsibilities to identify risks to U.S. financial stability, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. The Council regularly examines significant market developments and structural issues within the financial system. For example, over the past year, the Council considered issues such as market volatility, the government shutdown and debt ceiling impasse, interest rate risk, economic developments in Europe and emerging economies, housing finance reform proposals, the NASDAQ trading halt in August 2013, and risks to financial stability arising from cybersecurity threats. Recognizing the need to be vigilant in responding to new and emerging challenges, the Council will continue to monitor potential threats to financial stability and to facilitate coordination among its member agencies.

In addition, last year, the Council made its first designations of nonbank financial companies. The Council's designations authority addresses a key weakness brought to light by the financial crisis: the existing regulatory structure allowed some large, complex nonbank firms to pose risks to financial stability that were not subject to adequate supervision. As a result, the Dodd-Frank Act allows the Council to designate nonbanks whose distress or activities could pose a threat to U.S. financial stability, and subject them to supervision by the Federal Reserve and enhanced prudential standards. The Council has 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 and to understand the detailed reasons for any designation.

The Council voted in July 2013 to make final determinations regarding American International Group (AIG) and General Electric Capital Corporation. In September 2013, the Council voted to make a final determination regarding Prudential Financial. The Council had notified those companies in the fall of 2012 that they were under review for potential designation, and the companies submitted information for the Council to consider in its evaluations. The lengthy and careful analyses conducted by the Council included frequent and substantive interactions with the companies under consideration.

Let me give you an example. For one of the companies that has been designated, Council staff spent over a year conducting an analysis that considered more than 200 data submissions from the company that totaled over 6,000 pages. The Council or its staff met with the company 20 times. Prior to a final determination the Council prepared and shared with the company an approximately 200-page document outlining the Council's analysis and rational for a proposed determination. The company responded to this document and discussed it with all the members of the Council before the Council made a final decision. This determination – and any others made by the Council regarding nonbank financial companies – are based on the standards set forth by Congress in the Dodd-Frank Act and follow the process laid out in the Council's public rule and guidance.

One final point I would like to make here is that given the global nature of the financial system, the United States has made strong commitments to international efforts to institute financial regulatory reforms comparable to and consistent with ours. Such efforts are important to safeguarding the U.S. financial system from threats resulting from weaker regulation abroad, as well as to promoting a level playing field for U.S. firms that operate internationally.

The Council's Governance and Transparency

The Council is committed to conducting its work publically. Indeed, as I noted publicly at our May meeting, the Council's annual reports will continue to serve as a key tool for communicating our activities to the public and Congress.

However, much of the Council's work – particularly in regards to companies under consideration for potential designation – relies on sensitive company and industry data and information that would not be shared by firms or regulators without an expectation of confidentiality. Accordingly, the Council is committed to conducting its meetings in public whenever possible and to releasing minutes for all its meetings. Though no statute requires the Council to do so, we believe taking these steps helps provide the public with insight into the Council's work. We have kept those commitments over the past three and a half years, including holding twelve open meetings and releasing minutes for forty meetings.

The Council also understands that it can always improve upon its commitments. To that end, the Council has undertaken a review of its governance and transparency policies, beginning in 2013, to determine whether it can even better enhance its openness and accountability to the public while still protecting sensitive information. This review included consideration of the practices of other organizations with similar structures, memberships, or responsibilities as the Council. For example, during a public session in May, the Council revised its transparency policy to incorporate several enhancements to improve communication with the public. Additionally, the Council adopted bylaws for its Deputies Committee that will provide further visibility into some of its staff work.

The Council understands that its analysis is enhanced by the perspective of the public. Accordingly, it actively seeks input from outside parties to inform its work. For example, in December 2013, a representative from the banking sector joined a public meeting of the Council to discuss cybersecurity. And in May, the Council hosted a public conference on asset management to hear directly from industry representatives, academics, and other stakeholders on topics related to asset management. The Council continues to work with state and foreign regulators in the course of its analysis on nonbank financial companies. The Council continues to benefit from this type of engagement with external stakeholders and expects to continue to be informed by outside experts on its work going forward.

Progress on Financial Regulatory Reform

The 2014 annual report discusses the significant progress that Council member agencies, both individually and collectively, have made implementing Dodd-Frank Act reforms. As a result of the implementation of these reforms, consumers have access to better information about financial products and are benefiting from new protections. Financial markets and companies have become more resilient and transparent. And regulators have become better equipped to monitor, mitigate, and respond to threats to the financial system.

Over the past year, the regulators reached a number of key milestones in financial reform implementation, including:

- finalization of the Volcker Rule, bank capital rules, a supplementary leverage ratio for the largest banks and bank holding companies, enhanced prudential standards for the U.S. operations of large foreign banks, and the development of clearing, trading, and registration requirements for certain swaps markets;
- proposed rulemakings on money market mutual fund (MMF) reform, risk retention for securitizations, and requirements for short-term liquidity coverage for large banking organizations; and
- significant reductions in intraday credit exposures in the tri-party repo market and significant progress on the strategy for financial institution resolution under the orderly liquidation authority.

On a related note, there has been continued progress towards achieving an international minimum standard that would allow national authorities in the majority of the world's largest economies to wind down failing global banks without the use of taxpayer money. We also anticipate progress on a framework for cross-border cooperation in the future resolutions of global banks.

Now let me provide greater detail about the nine areas of focus covered in the report.

Areas of Focus of the Council's 2014 Annual Report

Wholesale Funding Markets

The Council has highlighted run risks associated with MMFs and the tri-party repo market since our first annual report in 2010. Regarding MMFs, in June 2013 the SEC proposed rules to reform the structure of MMFs in order to make them less susceptible to runs. This proposal includes a number of the same principles and concepts, such as requiring a floating NAV, that were part of the proposed recommendations for reform issued by the Council in November 2012. The Council recommends that the SEC move forward and adopt meaningful structural reforms designed to address MMF run risk. The Council also recommends that its member agencies examine the nature and impact of any structural reform of MMFs that the SEC implements to

determine whether the same or similar reforms are appropriate for other cash-management vehicles.

In the tri-party repo market, there has been significant progress in reducing market participants' reliance on intraday credit from the clearing banks. The share of tri-party repo volume funded intraday by the clearing banks fell from 92 percent in December 2012 to under 20 percent in December 2013. But vulnerabilities to fire sales remain, particularly with respect to borrowers, such as broker-dealers, that rely heavily on these markets for financing. The Council acknowledges the work that has been done in the past year to reduce the reliance on discretionary intraday credit, which is forecasted to be less than 10 percent by the end of 2014. Yet, a default of a broker-dealer remains a key vulnerability that could lead to fire sales of repo collateral, and may lead to the disruption of certain asset and financing markets. The Council recognizes that regulatory reforms implemented since the crisis, such as increases in the amount of capital, liquidity, and margin changes for U.S. broker-dealers, may help to mitigate the risk of default. However, the Council advises all U.S. regulators of firms that rely on this market for funding to assess whether additional steps may need to be taken to protect borrowers from funding runs.

Housing Finance Reform

The housing finance system continues to require significant reform to enhance financial stability. The residential mortgage market relies heavily on government guarantees, while private mortgage activity remains muted. Increasing the presence of private capital and reducing risk to

taxpayers in housing finance remains a priority. Fannie Mae and Freddie Mac achieved their targets for risk-sharing transactions and reductions in their mortgage investment portfolios. Member agencies also made progress on the risk-retention rule, and infrastructure reforms such as the development of the Common Securitization Platform are moving forward. The annual report outlines the ongoing need for market participants, regulators, and Congress to work together to create structural reforms that will help reduce uncertainty in the housing finance market, provide access for creditworthy borrowers, and protect taxpayers. In the past year, progress was made towards establishing a new framework for housing policy, but ultimately Congress must pass legislation to achieve comprehensive housing finance reform.

Operational Risks

Cybersecurity remains a top priority for the Council, as deliberate attempts to disrupt institutions, markets, and commerce continue, as seen in the high-profile cyber-attack on Target that resulted in the theft of bank card and customer information. While companies and financial markets become more dependent on complex technologies and networks, the frequency, severity, and sophistication of such incidents are likely to rise. The Council recommends that financial regulators continue their efforts to assess cyber-related vulnerabilities facing their regulated entities and identify gaps in oversight that need to be addressed. In addition, the Council recognizes the importance of removing legal barriers to information sharing between public and private sector partners to enhance overall awareness of cyber threats, vulnerabilities, and attacks

in a manner that continues to protect privacy and civil liberties, including the passage of comprehensive cybersecurity legislation by Congress.

Market continuity and confidence were also challenged this past year with an increase in outages and failures resulting from technological and infrastructure vulnerabilities. Some of these incidents led to the temporary suspension of trading. Other incidents involved software failures that sent involuntary orders through automated trading systems, leading to large losses. The vulnerabilities that are associated with such incidents may be heightened, particularly in fragmented markets, by high-frequency or low-latency automated trading activities. The Council recognizes that alternative trading venues and methods may present operational and other risks by magnifying system-wide complexity. As such, the Council recommends that regulators focus not only on centrally traded products, but also on a broader set of financial products and trading methods off exchanges.

Financial Innovation and Migration of Activity

The financial system is constantly evolving, with the development of new products, services, and business practices. These changes can provide a number of benefits to the financial system, but they may also present new risks. While new products or services are often developed as a result of technological and competitive forces, sometimes they are created to circumvent regulation. In other instances, the migration of some activities may move a regulated activity outside of the regulatory perimeter. The changing landscape of the post-financial crisis world has fostered

many innovations which should be monitored for the potential to create risks to financial stability.

Reference Rates

Beginning in the second half of 2012, investigations uncovered multiple instances of systematic false reporting and manipulation of widely used survey-based benchmark interest rates, such as LIBOR and EURIBOR, by reporting banks. More recently, concerns have been raised about the integrity of certain foreign exchange (FX) rate benchmarks. One important insight from the recent allegations in FX markets is that transactions-based benchmarks can also be subject to manipulation and adversely impact related markets.

While some progress has been made to find viable alternative interest-rate benchmarks, more work is needed. The Council recommends U.S. regulators continue to cooperate with foreign regulators and international bodies to identify alternative interest rate benchmarks anchored in observable transactions and supported by appropriate governance structures, and to assess market practices and benchmarks in the FX markets. The Council also recommends development of a plan to implement a smooth and orderly transition to any new benchmarks.

Resilience to Interest Rate Volatility

The prolonged period of low interest rates and low volatility has provided incentives for investors and financial institutions to search for yield by extending the duration of their portfolios, investing in lower-quality credit, increasing leverage, or easing underwriting standards. Such strategies may increase short-term profits, but at the risk of potentially large losses in the event of a sudden yield curve steepening or a large rise in rates.

Despite the relatively benign impact on financial stability of last year's sharp rise in interest rates, volatility remains a potential threat to financial stability. For this reason the Council recommends that supervisors, regulators, and financial firm management continue to monitor and assess the growing risks resulting from search-for-yield behaviors as well as the potential risk of severe interest rate shocks.

Data Quality and Comprehensiveness

High quality and readily available access to financial data is critical for regulators, supervisors, and financial firms, but access to comprehensive data is limited. For example, regulators lack sufficient data to thoroughly analyze all repo markets, and they are still unable to effectively monitor securities lending transactions and the reinvestment of cash collateral. In addition, some regulators still face difficulties in accessing data stored at swap data repositories. However, regulators have made significant progress in addressing financial data gaps in recent years. They

now collect real-time data from various markets and institutions. There has also been progress in improving the standardization of certain financial data, including the legal entity identifier (LEI), which will help to identify parties to financial transactions. The widespread adoption of LEI both domestically and globally, together with the work to enhance the consistency and availability of swaps data reported by swaps data repositories, would improve the ability of regulators to monitor emerging risks in the financial system. The Council supports these efforts and recommends that member agencies and the OFR continue to work together to promote high-quality data standards and fill data gaps where they exist.

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

Historically, when large, complex, interconnected financial institutions became distressed, official authorities often intervened to maintain financial stability. The Dodd-Frank Act addresses the incentives and abilities of large, complex, interconnected financial institutions to engage in excessive risk-taking that could result from implicit expectations of future official sector intervention. Financial regulatory reforms have created much stronger financial institutions, with capital levels doubling compared to pre-crisis levels, significantly reducing the likelihood of failure. Reforms have also been designed to minimize the damage that any single firm's failure would have on the broader financial system.

During 2013, the largest U.S. financial institutions continued to reduce their complexity in some dimensions. Additionally, credit rating agency assessments of potential government support to

U.S. bank holding companies reflect declining expectations of the likelihood of government support. However, rating agency opinions continue to explicitly factor in the possibility that the government will provide support to the largest banks if they become financially distressed. The full implementation of the orderly liquidation authority, and the phasing in of enhanced prudential standards in coming years, should help reduce remaining perceptions of government support for large, complex, interconnected financial institutions.

Foreign Markets Risks

In 2013, domestic market participants remained concerned about the adverse consequences of financial developments abroad. However, the areas from which these risks emanate have changed considerably. In previous years, stability in peripheral Europe was a key area of concern for global financial markets. Over the past year, economic and financial conditions in the euro area have stabilized. At the same time, potential risks emanating from emerging markets have become more prominent. Beginning in the late spring of 2013, emerging market economy exchange rates and asset prices became much more volatile, and economic growth subsequently slowed in some of these economies. The potential spillover effects on the United States from emerging markets' stresses appears limited, but a substantial worsening of these stresses is a risk.

Conclusion

In summary, the Council plays a critical role in our financial regulatory system by bringing together federal and state financial regulators to identify potential risks across the system and prevent problems from falling through the cracks. The annual report is a reflection of the collaboration and collective judgment of these officials. And its findings and recommendations are a critical statement that guides action, promotes transparency, and creates accountability.

Indeed, I strongly believe that the actions of the Council and its member agencies have made the financial system more stable and less vulnerable to future economic and financial stress. Yet, the Council must continue to remain vigilant to new risks while focusing on the risks highlighted in the annual report.

I want to thank the other members of the Council, as well as their staffs, for their work over the last year and their efforts in preparing the 2014 annual report, as well as their ongoing contributions to the important work of the Council. We look forward to working with this Committee, and with Congress as a whole, to continue to make progress in creating a more resilient and stable financial system.

FSOC FINANCIAL STABILITY OVERSIGHT COUNCIL

2014 ANNUAL REPORT

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Financial Stability Oversight Council

The Financial Stability Oversight Council (Council) was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and is charged with three primary purposes:

1. 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.

2. To promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the U.S. government will shield them from losses in the event of failure.

3. To respond to emerging threats to the stability of the U.S. financial system.

Pursuant to the Dodd-Frank Act, the Council consists of ten voting members and five nonvoting members and brings together the expertise of federal financial regulators, state regulators, and an insurance expert appointed by the President.

The voting members are:

- the Secretary of the Treasury, who serves as the Chairperson of the Council;
- the Chairman of the Board of Governors of the Federal Reserve System;
- the Comptroller of the Currency;
- the Director of the Bureau of Consumer Financial Protection;
- the Chairman of the Securities and Exchange Commission;
- the Chairperson of the Federal Deposit Insurance Corporation;
- the Chairperson of the Commodity Futures Trading Commission;
- the Director of the Federal Housing Finance Agency;
- the Chairman of the National Credit Union Administration; and
- an independent member with insurance expertise who is appointed by the President and confirmed by the Senate for a six-year term.

The nonvoting members, who serve in an advisory capacity, are:

- the Director of the Office of Financial Research;
- the Director of the Federal Insurance Office;
- a state insurance commissioner designated by the state insurance commissioners;
- a state banking supervisor designated by the state banking supervisors; and
- a state securities commissioner (or officer performing like functions) designated by the state securities commissioners.

The state insurance commissioner, state banking supervisor, and state securities commissioner serve two-year terms.

Statutory Requirements for the Annual Report

Section 112(a)(2)(N) of the Dodd-Frank Act requires that the annual report address the following:

i. the activities of the Council;
ii. significant financial market and regulatory developments, including insurance and accounting regulations and standards, along with an assessment of those developments on the stability of the financial system;
iii. potential emerging threats to the financial stability of the United States;
iv. all determinations made under Section 113 or Title VIII, and the basis for such determinations;
v. all recommendations made under Section 119 and the result of such recommendations; and
vi. recommendations—
   I. to enhance the integrity, efficiency, competitiveness, and stability of United States financial markets;
   II. to promote market discipline; and
   III. to maintain investor confidence.

Approval of the Annual Report

This annual report was approved unanimously by the voting members of the Council on May 7, 2014. Except as otherwise indicated, data cited in this report is as of March 31, 2014.

Abbreviations for Federal Member Agencies of the Council

- Department of the Treasury (Treasury)
- Board of Governors of the Federal Reserve System (Federal Reserve)
- Office of the Comptroller of the Currency (OCC)
- Bureau of Consumer Financial Protection (CFPB)
- Securities and Exchange Commission (SEC)
- Federal Deposit Insurance Corporation (FDIC)
- Commodity Futures Trading Commission (CFTC)
- Federal Housing Finance Agency (FHFA)
- National Credit Union Administration (NCUA)
- Office of Financial Research (OFR)
- Federal Insurance Office (FIO)

Contents

1 Member Statement 1

2 Executive Summary 3

3 Annual Report Recommendations 7

3.1 Reforms to Address Structural Vulnerabilities 7

3.2 Heightened Risk Management and Supervisory Attention 8

4 Macroeconomic Environment 15

4.1 U.S. Economic Activity 15

4.2 Nonfinancial Balance Sheets 18

4.3 Government Finance 23

BOX A: Macroeconomic and Financial Market Impacts of the Debt Ceiling and Government Shutdown 25

BOX B: Detroit and Puerto Rico: Municipal Market Impact 28

4.4 External Environment 29

5 Financial Developments 37

5.1 Asset Valuations 37

BOX C: The 2013 Bond Market Selloff, Market Liquidity, and Broker-Dealer Balance Sheets 41

BOX D: Global Monetary Policy Actions 48

5.2 Wholesale Funding Markets 57

5.3 Bank Holding Companies and Depository Institutions 62

5.4 Nonbank Financial Companies 71

BOX E: Concerns Related to Captive Reinsurance 75

BOX F: Carry Trade Strategies and Susceptibility to Shocks 80

5.5 Investment Funds 81

5.6 Derivatives Infrastructure 87

6 Regulatory Developments; Council Activities 91
6.1 Safety and Soundness 91
6.2 Financial Infrastructure, Markets, and Oversight 99
6.3 Consumer and Investor Protection 102
6.4 Data Standards 105
6.5 Council Activities 108
BOX G: Governance and Transparency 111

7 Potential Emerging Threats 113
7.1 Risk of Reliance Upon Short-Term Wholesale Funding 113
7.2 Developments in Financial Products, Services, and Business Practices 113
7.3 Risk-Taking Incentives of Large, Complex, Interconnected Financial Institutions 115
7.4 Reliance upon Reference Rates as a Vulnerability 117
7.5 Financial System Vulnerability to Interest Rate Volatility 118
7.6 Operational Risks 120
7.7 Foreign Economic and Financial Developments 121
7.8 Data Gaps and Data Quality 123

Abbreviations 125
Glossary 131
List of Charts 143

1 Member Statement

The Honorable John A. Boehner
Speaker of the House
United States House of Representatives

The Honorable Nancy Pelosi
Democratic Leader
United States House of Representatives

The Honorable Joseph R. Biden, Jr.
President of the Senate
United States Senate

The Honorable Harry Reid
Majority Leader
United States Senate

The Honorable Mitch McConnell
Republican Leader
United States Senate

In accordance with Section 112(b)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, for the reasons outlined in the annual report, I believe that additional actions, as described below, should be taken to ensure financial stability and to mitigate systemic risk that would negatively affect the economy: the issues and recommendations set forth in the Council's annual report should be fully addressed; the Council should continue to build its systems and processes for monitoring and responding to emerging threats to the stability of the United States financial system, including those described in the Council's annual report; the Council and its member agencies should continue to implement the laws they administer, including those established by, and amended by, the Dodd-Frank Act, through efficient and effective measures; and the Council and its member agencies should exercise their respective authorities for oversight of financial firms and markets so that the private sector employs sound financial risk management practices to mitigate potential risks to the financial stability of the United States.

Jacob J. Lew
Secretary of the Treasury
Chairperson, Financial Stability Oversight Council

Janet L. Yellen
Chair
Board of Governors of the Federal Reserve System

Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency

Richard Cordray
Director
Bureau of Consumer Financial Protection

Mary Jo White
Chair
Securities and Exchange Commission

Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation

Mark P. Wetjen
Acting Chairman
Commodity Futures Trading Commission

Melvin L. Watt
Director
Federal Housing Finance Agency

Debbie Matz
Chairman
National Credit Union Administration

S. Roy Woodall, Jr.
Independent Member with Insurance Expertise
Financial Stability Oversight Council

2 Executive Summary

Over the past year, the U.S. financial system continued to recover from the damage sustained during the financial crisis. The regulatory reforms required by the Dodd-Frank Act and contemplated in The Group of Twenty (G-20) agreements moved meaningfully towards completion. Although significant risks remain, financial markets, institutions, and investor confidence showed resilience over the past year amid challenging market conditions, including a period of heightened volatility in fixed income markets, concerns about the U.S. debt ceiling, and pressure on emerging markets (EMs).

The regulatory community reached a number of key milestones in financial reform implementation, including finalization of the Volcker Rule, bank capital rules, a supplementary leverage ratio for the largest banks and bank holding companies (BHCs), enhanced prudential standards for the U.S. operations of large foreign banks, and the advent of clearing, trading, and registration requirements for swaps markets. Policy development continued with proposed rulemakings on money market fund (MMF) reform, risk retention for securitizations, and requirements for short-term liquidity coverage for large banking organizations. Also, there have been significant reductions in intraday credit exposures in the tri-party repurchase agreement (repo) market and significant progress on the strategy for resolution under the orderly liquidation authority (OLA). In addition, the Council designated three nonbank financial companies for enhanced prudential standards and supervision by the Federal Reserve.

In what follows we summarize some of the key potential emerging threats and reforms identified by the Council that are further described in this year's annual report. In some cases, we call attention to threats and reforms identified in previous reports.

Short-Term Wholesale Funding Markets

The influx of customer deposits in recent years has afforded banks the opportunity to reduce their dependence on short term wholesale funding. Although the usage of commercial paper (CP), repo, time deposit, and other sources of wholesale funding fell this past year, financial institutions without access to customer deposits and prohibited from using customer cash and securities for proprietary purposes, such as broker-dealers, remain dependent on wholesale markets for funding. Since the Council's inaugural annual report nearly three years ago, the structural vulnerabilities of the tri-party repo markets have been highlighted. This past year witnessed important progress in tri-party repo reform. For example, through supervisory authority, the Federal Reserve has worked with the two clearing banks and market participants to greatly improve operational efficiencies and controls in the management and transfer of tri-party repo collateral. As a result, intraday credit exposure was reduced below the 10 percent goal for one clearing bank while the other is expected to have less than 10 percent of this exposure by the end of 2014.

In addition, reform efforts continue for MMFs, with the SEC releasing a proposed rulemaking in June 2013. Currently, the SEC is assessing comment letters and other data and information to determine the best approach to prevent possible runs on MMFs in the event of a severe liquidity or credit shock to MMFs, such as occurred during the financial crisis. Until structural reforms are adopted, the potential for run risk remains significant. Similarly, the possibility of tri-party repo collateral fire sales still poses significant risks for the financial system. Policymakers continue to examine ways to minimize potential tri-party repo spillover effects if such fire sales were to occur.

Developments in Financial Products, Services, and Business Practices

The financial system is constantly evolving with the development of new products, services, and business practices. These changes can occur for a variety of reasons, including improvements in technology, new regulations, and competition. Financial evolution provides a number of benefits to the financial system. However, along with these benefits come new challenges to supervisors and regulators. New products or services are sometimes developed to circumvent regulation. New practices may move a regulated activity outside of the regulatory perimeter either by moving the activity offshore or by moving it from a heavily regulated entity to an entity that is less regulated. It is important to be alert to the potential adverse effects that may arise with these changes. This is particularly relevant in the current environment, because the changing financial landscape of the post-crisis world has fostered many developments in financial products, services, and business practices.

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

Historically, when large, complex, interconnected financial institutions became distressed, official authorities often intervened to maintain financial stability. Past support can engender expectations of future support, and such expectations provide incentives for further increases in size, interconnectedness, and complexity. They also can lead market participants to discount risk, giving these institutions incentives to take on excessive risk. The Dodd-Frank Act addresses and attempts to mitigate the incentives and abilities of large, complex, interconnected financial institutions to engage in excessive risk-taking.

During 2013, the largest U.S. financial institutions continued to reduce their complexity as well as their interconnectedness in some dimensions. Additionally, rating agencies lowered their assessments of the likelihood of government support. However, credit rating agency opinions continue to explicitly factor in the possibility that the government will provide support to the largest banks if they become financially distressed. The full implementation of the OLA, and the phasing in of enhanced prudential standards in coming years, should help reduce remaining perceptions of government support for large, complex, interconnected financial institutions.

Reforms of Reference Rates

Beginning in the second half of 2012, investigations reported multiple instances of systematic false reporting and manipulation of widely used survey based benchmark interest rates, such as the London Interbank Offered Rate (LIBOR) and Euro Interbank Offered Rate (EURIBOR) by reporting banks. Since the Council's 2013 annual report, additional financial institutions have been linked to manipulative activity. Financial firms have paid fines and penalties in excess of $6 billion globally to settle charges related to benchmark interest rates.

More recently, concerns have been raised about the integrity of certain foreign exchange (FX) rate benchmarks. One important observation from the recent allegations in FX markets is that transactions-based benchmarks can also be subject to improper behavior that distorts the benchmarks and adversely impacts related markets, highlighting the need for stronger governance and oversight. These revelations erode public confidence in benchmark interest rates and introduce potential risks to financial stability. Concerns about manipulation in a range of markets show that a significant conflict of interest can exist between the private individuals and firms operating in these markets and the need for fair benchmarks to promote financial stability and efficient market functioning. The international community continues to move to reform the governance process for financial benchmarks and enhance the integrity of related markets.

Financial System Vulnerability to Interest Rate Volatility

The prolonged period of low interest rates has led investors to extend maturities, purchase lower quality credit, and increase leverage in a search for yield. As a result, higher-yielding strategies have experienced substantial inflows of funds. Financial institutions also have responded to the low interest rate environment. Banks have eased loan underwriting standards, while insurance companies and MMFs have moderately increased the duration of their portfolios. Although interest rates have risen from historic lows, rates could rise further and impose losses for the holders of fixed income assets. Additionally, since the majority of leveraged lending is floating rate and borrowers are highly leveraged, a sharp increase in interest rates could increase the risk of default of these borrowers and impose costs on their lenders. Of course, a continued low rate environment also has risks. It continues to weigh on earnings of banks, insurance companies, pension funds, and retirement funds, putting further pressure on them to pursue riskier investments in order to meet their targeted returns.

Operational Risks

Market continuity and confidence were challenged this past year with an increase in outages and failures resulting from technological and infrastructure vulnerabilities. Some of these incidents, as in the case of the NASDAQ securities information processor outage which led to the suspension of trading, resulted mainly from hardware and network connectivity problems. Other incidents involved software failures that sent involuntary orders through automated trading systems, leading to large losses on trades that were never intended to occur. Deliberate attempts to disrupt institutions, markets, or commerce also occurred, as in the recent high-profile cyber-attack on Target that resulted in the theft of bank card and customer information. As interconnected firms and financial markets become more dependent on complex technologies and networks, the frequency, severity, and sophistication of such incidents are likely to rise.

Foreign Markets Risks

In 2013, domestic market participants remained concerned about the adverse consequences of financial developments abroad. However, the areas from which these risks emanate have changed considerably. In previous years, euro area stability was a key area of concern for global financial markets. Over the past year, economic and financial conditions in the euro area have stabilized. At the same time, EMs have become a focus of concern. Beginning in the late spring of 2013, emerging market economy (EME) exchange rates and asset prices became much more volatile, and economic growth subsequently slowed in some EMEs. The potential spillover effects to the United States of current levels of EME stress appear limited, but a substantial worsening of EME stress is a risk.

Data Gaps and Data Quality

High quality and readily available access to financial data is critical for regulators, supervisors, and the financial services industry. Access and comprehensiveness of data is limited and gaps exist. For example, regulators lack sufficient data to thoroughly analyze all repo markets. They are still unable to effectively monitor securities lending transactions and the reinvestment of cash collateral. In addition, some regulators still face difficulties in accessing data stored at swap data repositories (SDRs). However, regulators have made significant progress in addressing financial data gaps in recent years. They now collect real-time data from various markets and institutions. There has also been progress in rolling out the legal entity identifier (LEI) to identify parties to financial transactions as well as in the creation of SDRs or security-based swap data repositories (SBSDRs). The widespread adoption of LEI both domestically and globally, together with the work to enhance the consistency and availability of swaps data reported by swaps data repositories, would improve the ability of regulators to monitor emerging risks in the financial system.

Housing Finance Reform

Conditions in the housing and housing finance markets showed signs of improvement in 2013, although challenges remain. House prices nationally experienced strong increases in the beginning of the year with recent levels rising more moderately. Home purchasing levels rose modestly, while loan performance also improved as fewer borrowers fell behind on their mortgages or missed their monthly payments. Amid these improving market conditions, home equity lending also rose. The government-sponsored enterprises (GSEs) still provide the majority of financing for borrowers, though they continue to reduce their mortgage investment portfolios. In order to attract more private capital, the GSEs completed risk sharing transactions associated with $75 billion in mortgages. Additionally, the GSEs worked to create significant infrastructure improvements to support the securitization market. Legislative reform efforts also have continued with legislation under consideration in the Senate and the House.

3 Annual Report Recommendations

3.1 Reforms to Address Structural Vulnerabilities

3.1.1 Reforms of Wholesale Funding Markets

Tri-party Repo

In its 2013 annual report, the Council highlighted three vulnerabilities in the tri-party repo market:

- Heavy reliance by market participants on intraday credit extensions from the clearing banks.
- Weakness in the credit and liquidity risk management practices of many market participants.
- Lack of a mechanism to ensure that tri-party repo investors do not conduct disorderly, uncoordinated sales of their collateral immediately following a broker-dealer's default.

Significant progress has been made over the past year in reducing market participants' reliance on intraday credit from the clearing banks. The share of volume funded intraday by the clearing banks fell from 92 percent in December 2012 to under 20 percent in December 2013, and is projected to fall below the Tri-Party Repo Infrastructure Reform Task Force's goal of 10 percent by December 2014. Both clearing banks have re-engineered the settlement process in ways that require much less intraday credit extension and have increased the price of credit they still provide. Market participants now face stronger incentives to manage their risk prudently; many dealers have extended the weighted-average maturity of their tri-party repo funding thereby sharply reducing their rollover risk exposure.

General Collateral Finance (GCF) repo activity, which settles on the tri-party repo platform, is still relatively reliant on clearing bank intraday credit to facilitate settlement. Improving the resiliency of GCF repo settlement is a key focus of industry reform for 2014. The Council urges that market participants work to extend improvements in the tri-party repo settlement process to GCF repo settlement as soon as possible.

The risk of fire sales of collateral by creditors of a defaulted broker-dealer, many of whom may themselves be vulnerable to runs in a stress event, remains an important financial stability concern given the destabilizing effect such sales may have on markets and their potential to transmit risk across a wide range of participants. The Council recognizes that regulatory reforms implemented since the crisis, such as increases in the amount of capital, liquidity, and margin changes for U.S. broker-dealers, may help to mitigate the risk of default. However, the Council advises all U.S. regulators of firms that rely on this market for funding to assess whether additional steps may need to be taken to further increase tri-party repo borrowers' protection against funding runs in the broader context of liquidity regulation. The Council also urges coordination between market participants and financial regulators to address the risk of post-default fire sales of assets by tri-party repo investors.

Transparency

The Council recognizes that while activity has become more transparent in some areas of the wholesale funding markets, such as GCF repo and tri-party repo, improvements are needed in other segments of the market, notably bilateral repo and securities lending. Regulators and policymakers will have a growing need for information as they attempt to monitor and assess how regulatory reforms are affecting wholesale funding market functioning and how risks evolve in these markets. The Council recommends that all member agencies continue to collaborate with the OFR to improve transparency in this area of the financial system.

Money Market Funds

In June 2013, the SEC proposed rules to reform the structure of MMFs in order to make them less susceptible to runs. The SEC's proposal includes two principal changes that could be adopted alone or in combination. One alternative would require a floating net asset value (NAV) for prime institutional MMFs. The other alternative would allow the use of liquidity fees and redemption gates in times of stress. The proposal also includes additional diversification, disclosure, and stress testing measures that would apply under either alternative. The SEC's proposed reforms would supplement the MMF reforms adopted by the SEC in 2010 that were designed to improve the risk-limiting conditions on MMFs by, among other things, instituting minimum liquidity requirements, reducing MMFs' weighted-average maturities, and enhancing the credit quality of holdings.

In November 2012, the Council, under Section 120 of the Dodd-Frank Act, issued a proposed recommendation that the SEC implement structural reforms to mitigate the vulnerability of MMFs to runs. That proposed recommendation included three alternatives for public consideration: (1) a floating NAV; (2) a stable NAV with a NAV buffer of up to 1 percent and a minimum balance at risk of roughly 3 percent of a shareholder's account value; and (3) a stable NAV with a 3 percent NAV buffer in addition to other measures, including more stringent diversification, liquidity, and disclosure requirements.

When making the proposed recommendation, the Council stated and reiterates today that the SEC, by virtue of its institutional expertise and statutory authority, is best positioned to implement reforms to address the risk that MMFs present to the economy. The Council does not expect that it would issue a final Section 120 recommendation to the SEC, if the SEC moves forward with meaningful structural reforms of MMFs. The Council understands the SEC is currently in the process of reviewing public comments on its proposed reforms, and the Council recommends that the SEC move forward and adopt structural reforms designed to address MMF run risk.

The Council recommends that its member agencies examine the nature and impact of any structural reform of MMFs that the SEC implements to determine whether the same or similar reforms are appropriate for other cash-management vehicles, including non-Rule 2a-7 MMFs. Such an examination would provide for consistency of regulation while also decreasing the possibility of the movement of assets to vehicles that are susceptible to large-scale runs or otherwise pose a threat to financial stability.

3.1.2 Housing Finance Reform

In the past year, there were signs of considerable improvement in the residential housing market. Home prices increased, delinquency rates declined, and home sales strengthened. However, the housing finance system remains highly reliant on federal government support, with nearly 80 percent of newly originated mortgages in 2013 carrying some form of government backing. The development and implementation of broad reforms for the housing finance system that fosters the involvement of more private capital is critical. Congress is actively debating the issue. The House Financial Services Committee approved legislation in July 2013, and members of the Committee have released additional proposals for consideration. In the Senate, members of the Senate Banking Committee introduced legislation in June 2013; and leadership of the

Committee released a draft proposal in March 2014, which builds upon the earlier legislation. The Council recommends that the Treasury, U.S. Department of Housing and Urban Development (HUD), and FHFA continue to work with Congress and other stakeholders to develop and implement a broad plan to reform the housing finance system. These efforts, along with some of those described below, should help to reduce uncertainty in the housing finance market, provide access for creditworthy borrowers, and protect taxpayers.

Review of 2013 Recommendations and 2014 Goals

Since the Council's 2013 annual report, member agencies have advanced reform in many ways, including:

- The GSEs achieved FHFA's targets for risk-sharing transactions and reductions in their mortgage investment portfolios in 2013. The GSEs engaged in multiple types of risk-sharing transactions associated with $75 billion in mortgages. In addition, the GSEs met the target of disposing of 5 percent of the less-liquid portion of their mortgage investment portfolios, while meeting the overall goal of 15 percent reduction.

- Member agencies made progress on finalizing the risk-retention rule, required by the Dodd-Frank Act, by reviewing and inviting comments on a revised proposal in August 2013.

- FHFA and the GSEs continued to make progress on the development of a Common Securitization Platform (CSP). These efforts included analyzing functions, testing capabilities, and establishing an operating structure.

Notwithstanding the above, further progress needs to be made in 2014. Outlined below are steps Council members plan to take in 2014 in order to help meet the Council's housing finance goals.

Reducing the GSEs' Footprint

In 2014, FHFA plans to continue encouraging the development of risk-sharing transactions in terms of size, depth, and types of transactions. In addition, FHFA plans to continue efforts to reduce the size of the GSEs' retained investment portfolios with a focus on less-liquid assets. The Council recommends that FHFA continue these efforts in order to help bring more private capital back into mortgage finance.

Facilitating Increased Private Mortgage Market Activity

New issue nonguaranteed mortgage issuance remains significantly depressed compared to historical averages. A significant amount of work remains to foster increased levels of private activity in the mortgage finance market. To help facilitate this, the Council recommends that the relevant agencies continue their work to finalize the risk-retention rule, including the qualified residential mortgage (QRM) definition. More broadly, FHFA, Treasury, HUD, CFPB, and Congress must continue to address the weaknesses that became evident in the recent housing crisis by promoting the development of standards and best practices in the mortgage market. While some testing of different approaches to better clarify representations and warranties, enforcement mechanisms, and other terms has begun, the Council recommends continuing collaboration and standardization among market participants and regulators in these areas.

Building a New Housing Finance Infrastructure

The GSEs have made progress toward developing and improving infrastructure through the CSP and standardization in various aspects of the mortgage finance market. In October, the GSEs established a joint venture, Common Securitization Solutions, LLC, which will own the CSP and related business and operational functions. In 2014, FHFA plans to complete the scoping of the CSP's functional requirements and develop GSE/CSP integration plans. The Council recommends FHFA continue to explore changes to the GSEs' operations that would lead to a more efficient and sustainable mortgage market.

3.1.3 Reforms Relating to Reference Rates

In its 2013 annual report, the Council recommended international cooperation for the development of high-level principles for financial benchmark governance, controls, data sufficiency, and oversight. The Council also recommended U.S. regulators cooperate with foreign regulators, international bodies, and market participants to promptly identify alternative interest rate benchmarks anchored in observable transactions and supported by appropriate governance structures, and to develop a plan to accomplish a transition to new benchmarks while such alternative benchmarks were being identified. While some progress has been made, more work is needed to achieve these recommendations.

In addition to achieving the aforementioned efforts, the Council recommends that U.S. regulators continue to cooperate with foreign regulators and official sector bodies in their assessment of market practices and benchmarks in the FX markets. The Council also recommends that U.S. agencies consider the International Organization of Securities Commissions (IOSCO) principles into their ongoing assessment of financial benchmarks in the United States. Finally, the Council recommends development of a plan to implement a smooth and orderly transition to any new benchmarks.

3.2 Heightened Risk Management and Supervisory Attention

3.2.1 Developments in Financial Products, Services, and Business Practices

In recent years, the financial system has undergone significant changes resulting from technology, competitive forces, and new regulations. While such changes and advancements can create significant benefits, unforeseeable risks can potentially arise in new forms and venues. The Council recommends that members and member agencies remain attentive to the potential implications for financial stability that may arise from developments in financial products, business practices, and migration of activities in the financial system.

Specifically in the case of nonbank mortgage servicing companies, a large amount of mortgage servicing rights (MSRs) have been sold to nonbank mortgage servicing companies in recent years. These companies are subject to regulation by the CFPB under federal consumer financial laws and are important counterparties to the GSEs. Prudential standards at the state level consist of bonding and net worth requirements. The Council recommends that, in addition to continued monitoring, state regulators work together to collaborate on prudential and corporate governance standards to strengthen these companies, in collaboration with the CFPB and FHFA, as may be deemed appropriate.

3.2.2 Capital, Liquidity, and Resolution

Capital and Liquidity

Considerable progress is being made on robust capital and liquidity planning at U.S. financial institutions. The Federal Reserve continues to conduct its supervisory stress tests to ensure that the largest U.S. BHCs have sufficient capital and rigorous forward-looking capital planning processes to enable banking firms to continue operations throughout periods of severe stress. NCUA recently finalized a stress testing and capital planning requirement for credit unions over $10 billion in assets. The Federal Reserve also recently finalized enhanced prudential standards, including enhanced capital and liquidity standards, for the largest domestic BHCs and foreign banking organizations (FBOs) with a U.S. banking presence. In July 2013, the federal banking agencies finalized regulatory capital rules that implement Basel III reforms. The Council recommends that the agencies continue to promote forward-looking capital and liquidity planning at large BHCs, U.S. operations of FBOs, and other depositories.

While many different forms of funding are an integral part of the traditional banking model, firms should diversify their funding base and place prudent limits on the volume of credit-sensitive, short-term liabilities. On liquidity risk management, the Council recommends that supervisors and private sector risk managers closely monitor the risks inherent in short-term funding of longer-term assets. In 2013, the federal banking agencies proposed a liquidity coverage ratio (LCR) that would strengthen the liquidity position of large banking firms. The Council recommends that the agencies continue to work expeditiously to finalize the LCR and continue work on potential quantitative rules that would address longer-term liquidity needs for banking organizations.

Resolution Planning

Resolution plans and the OLA, in conjunction with enhanced prudential standards, are critical elements of Dodd-Frank Act reform. Effective resolution planning for the largest financial institutions is an important tool to address the operational and legal complexity of these firms on an ongoing basis. All BHCs with total consolidated assets of $50 billion or more and nonbank financial companies designated by the Council for supervision by the Federal Reserve are required to develop, maintain, and periodically submit resolution plans that would facilitate these entities' resolution under the Bankruptcy Code. If the Federal Reserve and the FDIC jointly determine that a resolution plan is not credible or would not facilitate an orderly resolution under the Bankruptcy Code, then the company must resubmit the plan with revisions. If the company fails to resubmit a credible plan that would result in an orderly resolution under the Bankruptcy Code, the Federal Reserve and the FDIC may jointly impose more stringent capital, leverage, or liquidity requirements; growth, activities, or operations restrictions; and, after two years and in consultation with the Council, divestiture requirements.

In 2013, 11 financial institutions, including those with nonbank assets greater than $250 billion, submitted the second submission of their resolution plans, including information responding to guidance provided to the firms by the Federal Reserve and FDIC. Also in 2013, 120 additional firms submitted their initial resolution plans. The Federal Reserve and FDIC are reviewing and analyzing all submissions received during the year. The Council recommends that the Federal Reserve and FDIC continue to implement their authority in a manner that fosters sound resolution planning and better prepares firms and authorities for a rapid and orderly resolution under the Bankruptcy Code.

The United States has been working diligently to develop the capabilities needed for an orderly resolution of a global systemically important financial institution (G-SIFI) using the OLA provided in the Dodd-Frank Act. The FDIC issued a Federal Register notice for comment on the single point of entry (SPOE) strategy. An important part of this effort has involved working with foreign counterparts to establish a framework for effective cross-border cooperation in the event a G-SIFI requires resolution. The Council recommends that the FDIC and Federal Reserve continue to work with international counterparts to identify and address issues of mutual concern as the FDIC develops strategies for the orderly resolution of G-SIFIs.

3.2.3 Risk of Increased Interest Rate Volatility

Depository Institutions, Broker-Dealers, and Bank Holding Companies

While financial markets experienced a significant rise in interest rates this past year, the overall levels of rates remain quite low by historical standards. The extension of the low interest rate period continued to weigh on earnings of banks, credit unions, and broker-dealers, further incentivizing risk-seeking behavior such as extending the duration of assets and easing lending standards. Duration extension and increased credit risk-taking may increase short-term profits, but at the risk of potentially large losses in the event of a sudden yield curve steepening, a large rise in rates, or a significant widening of credit spreads. The Council recommends

that supervisors, regulators, and firm management continue to monitor and assess the growing risks resulting from the continued search-for-yield behaviors as well as the risks from potential severe interest rate shocks.

Insurance Companies

Despite a significant rise in longer-term interest rates this past year, the insurance industry continued to report investment margins that were below historic averages. If historically low interest rates persist, insurance companies could face a challenge generating investment returns that are sufficient to meet the cash flow demands of liabilities. Some insurers have extended portfolio durations or invested in lower credit quality fixed income assets, or both. Some have also increased investments in commercial mortgage loans, equity real estate, and alternative assets such as private equity funds and hedge funds, all of which are generally less liquid than investment-grade fixed-income investments. Movement into longer-duration, lower-quality, and less liquid assets increases the vulnerability of insurers to surges in interest rates. Life insurers, which typically have investments in longer-duration fixed-income assets that are held to maturity to match long-tail liabilities, are vulnerable to interest rate volatility if they have to sell such assets prior to maturity to meet liability cash flow demands. The Council recommends that FIO and state insurance regulators continue to monitor and assess interest rate risk resulting from severe interest rate shocks.

3.2.4 Operational Risk

Cybersecurity

The vulnerabilities posed by cross-sector dependencies and interconnected systems across firms, markets, and service providers can lead to significant cybersecurity risks. These risks could impact economic security, demanding a coordinated and collaborative government-wide commitment and partnership with the private sector to promote infrastructure security and resilience.

The Council recommends that the Treasury continue to work with regulators, other appropriate government agencies, and private sector financial entities to develop the ability to leverage insights from across the government and other sources to inform oversight of the financial sector and to assist institutions, market utilities, and service providers that may be targeted by cyber incidents. The Council recommends that regulators continue to undertake awareness initiatives to inform institutions, market utilities, service providers, and other key stakeholders of the risks associated with cyber incidents, and assess the extent to which regulated entities are using applicable existing regulatory requirements and non-regulatory principles, including the National Institute of Standards and Technology (NIST) Cybersecurity Framework.

The Council recommends that financial regulators continue their efforts to assess cyber-related vulnerabilities facing their regulated entities and identify gaps in oversight that need to be addressed. The Council also recognizes the overarching contribution the private sector makes to infrastructure cybersecurity and urges continued expansion of this work to engage institutions of all sizes and their service providers.

The Council recommends that the Finance and Banking Information Infrastructure Committee, financial institutions, and financial sector coordinating bodies establish, update, and test their crisis communication protocols to account for cyber incidents and enable coordination, and with international regulators where warranted, to assess and share information.

In addition, the Council recognizes the importance of removing legal barriers to information sharing between public and private sector partners to enhance overall awareness of cyber threats, vulnerabilities, and attacks, including through Congress' passage of comprehensive cybersecurity legislation.

Market Infrastructure and Market Continuity

Operational risk includes the risk of malfunctions in the technology of automated markets. While such malfunctions can have varying degrees of market impact, they can potentially erode market confidence and affect the strength and resilience of the financial system. In the past year, there were several disruptions in market infrastructure systems that are designed to facilitate the transmission of data and support other automated trading systems.

During 2013, regulators took various approaches to continue to address infrastructure and automated-trading system vulnerabilities. The Council notes that, although most of the concerns raised relate to activities occurring on public and centralized exchanges and venues, such technology issues can have similar ramifications in other markets, each of which rely on automated systems. The Council also recognizes that alternative trading venues and methods may present operational and other risks by magnifying system-wide complexity. These vulnerabilities may be heightened, particularly in fragmented markets, by high frequency or low latency automated trading activities. As such, regulators should focus not only on centrally-traded products, but also on a broader set of financial products and trading methods that trade off exchanges.

3.2.5 Data Quality and Comprehensiveness

Data standards are critical because they facilitate the sharing, exchange, comparison, and aggregation of data for analysis and risk management, and because they reduce costs. Standards are particularly important to assure quality in data collections. Data should be precisely defined and appropriately stored and protected. Also, domestic and cross-border exchange of supervisory data among supervisors, regulators, and financial stability authorities should be facilitated in a manner that safeguards the confidentiality and privacy of such information. The Council recommends that regulators and market participants continue to work together to improve the quality and comprehensiveness of financial data in the United States as well as globally.

The LEI is a valuable tool to precisely identify the parties to particular financial transactions, which is essential for effective counterparty risk management and related purposes. The Council recommends that members and member agencies continue to evaluate the use of the LEI and promote, where appropriate, its use in reporting requirements and rulemakings. The Council notes that several of its member agencies actively participate in the global Regulatory Oversight Council, which currently governs the LEI initiative. The development of financial product identifiers, such as the unique mortgage identifier (UMI) is another important step in improving the quality of financial data. The Council recommends that this important work continues.

For derivatives markets, swaps must now be reported to new entities known as SDRs and SBSDRs. It is important that these data be sufficiently standardized for effective analysis by regulators and with appropriate aggregation and protection for public dissemination. In addition, regulators' access to these data remains a challenge both in the United States and globally. The Council recommends that members and member agencies work with international regulators to promote high standards in derivatives data reporting and recommends that impediments to U.S. authorities' access to data stored at repositories be resolved.

Addressing data gaps also is critical. While regulators have broadened the scope of data they collect since the crisis, significant gaps remain. Specifically, with respect to the repo and securities lending markets, member agencies still do not have complete data encompassing these markets. The Council recommends that members, member agencies and the OFR continue to work together to fill these data gaps. Also, following on the OFR's study on Asset Management and Financial Stability, which was prepared at the Council's request, the Council recommends that member agencies and the OFR discuss additional sources of data for that industry, particularly with respect to the management of separate accounts.

4 Macroeconomic Environment

4.1 U.S. Economic Activity

4.1.1 Real Gross Domestic Product

Economic growth picked up somewhat in 2013, with real gross domestic product (GDP) expanding an estimated 2.6 percent following a gain of 2 percent in 2012 (**Chart 4.1.1**). Some of this modest acceleration owes to factors likely to be temporary, such as an increased pace of inventory investment. More persistent sources of final demand strengthened in the second half of the year. Consumer spending stepped up modestly, reflecting improving labor market conditions and rising equity and house prices. In contrast, changes in federal fiscal policy had a dampening effect on demand: the expiration of the temporary payroll tax cut and income tax increases for high-income households limited consumer spending, together with sizable reductions in federal government purchases, particularly for defense, weighed negatively on domestic demand. Additionally, by mid-year the on-going recovery in the housing market slowed in response to a rise in mortgage rates.

Consumption and Residential Investment

Real personal consumption expenditures increased at a moderate pace of 2.33 percent in 2013, supported by improvements in labor market conditions, continued growth in household net worth, improvements in credit availability, and more optimistic levels of consumer sentiment (**Chart 4.1.2**). Nevertheless, consumer sentiment remains below pre-crisis norms, labor under-utilization continues to be elevated, and credit availability remains limited for many households with constrained financial resources or credit history. Growth in real disposable income was modest in 2013, in part reflecting the rise in payroll and income taxes at the start of the year.

Housing activity continued to step up through the first three quarters of 2013, supported by

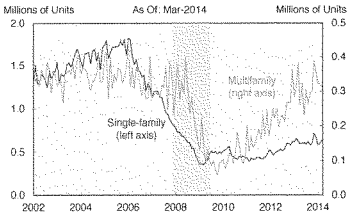
4.1.1 Change in Real Gross Domestic Product

Source: BEA, Haver Analytics Note: Annual changes are Q4/Q4.

4.1.2 Change in Real Personal Consumption Expenditures

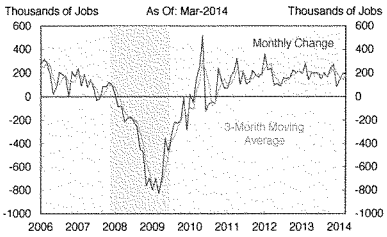
Source: BEA, Haver Analytics Note: Annual changes are Q4/Q4.

4.1.3 Private Housing Starts



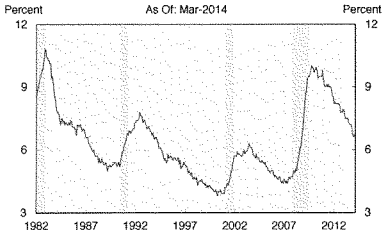
Source: Census Bureau, Haver Analytics Note: Seasonally adjusted at an annualized rate. Gray bar signifies NBER recession.

4.1.4 Net Change in Nonfarm Payroll Employment



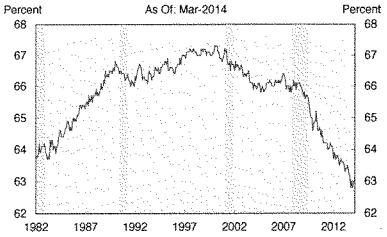
Source: BLS, Haver Analytics Note: Gray bar signifies NBER recession.

4.1.5 Civilian Unemployment Rate



Source: BLS, Haver Analytics Note: Gray bars signify NBER recessions.

4.1.6 Labor Force Participation Rate



Source: BLS, Haver Analytics Note: Gray bars signify NBER recessions.

improving labor market conditions, pent-up demand from depressed household formation rates during the recession, and historically low mortgage rates. Between June and August, mortgage rates rose about 1 percentage point and remained near this level for the rest of 2013. Following this increase, housing starts **(Chart 4.1.3)** and sales of new and existing homes all turned down in the fourth quarter, although some of this may be due to adverse weather conditions towards the end of the year. For the year, housing demand was still likely restrained by more conservative underwriting standards, especially for individuals with lower credit scores **(see Section 5.1.4)**.

Business Fixed Investment

Real business fixed investment rose moderately in 2013. Growth in business investment was stronger in the second half of 2013 than in the first half, supported by the acceleration in business output and general economic activity, and with earlier uncertainties around the debt ceiling having faded **(see Box A)**. Also, supportive of business investment for the year were favorable corporate financial conditions, with high profitability, historically low interest rates on corporate bonds, and improving financial terms for business loans. However, high vacancy rates and relatively tight financing for building investment continue to weigh on business investment in new structures.

Government Purchases

The contraction in real government purchases at the federal level more than offset the small gains in purchases at the state and local levels. Real local and state government purchases edged up slightly over the year, after declining sharply in 2010 and 2011 and flattening out in 2012, mainly owing to improving budgetary conditions driven by increases in tax revenues. Real federal government purchases fell at a rate of 6 percent over the year, after decreasing 2 percent in 2012, with large declines in defense and nondefense spending reflecting the budget caps, the sequestration, and the ongoing drawdown in overseas military operations.

Imports and Exports

Real exports of goods and services strengthened in 2013, boosted by improving foreign GDP growth in the second half of the year and by strong sales of petroleum products—associated with the boom in U.S. oil production—and of agricultural goods. Imports increased for the year as well, consistent with the pickup in domestic aggregate demand. Altogether, net exports made a small but positive contribution to real GDP growth in 2013.

4.1.2 The Labor Market

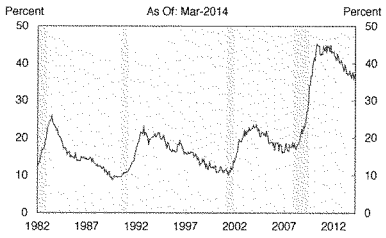
The labor market continued to improve in 2013, although it is far from having fully normalized. Nonfarm payroll employment increased at an average monthly rate of 194,250 jobs in 2013 **(Chart 4.1.4)**, similar to the pace over the previous two years. The private sector added on average 197,000 jobs per month, while government payrolls dropped at an average rate of 3,000 per month.

These job gains helped reduce the unemployment rate from 7.9 percent at the end of 2012 to 6.7 percent in December 2013 **(Chart 4.1.5)**. Nonetheless, the unemployment rate remains elevated. Additionally, labor force participation has continued to fall, dropping another 0.6 percentage points since the end of 2012 and bringing the decline since the beginning of 2008 to just less than 3.25 percentage points **(Chart 4.1.6)**.

In December 2013, 38 percent of unemployed workers had been out of work for more than six months **(Chart 4.1.7)**. Much of the declining trend in the labor force participation rate may be due to ongoing demographic changes related to the retirement of the baby boomers. However, some may also be due to cyclical factors, such as discouraged job seekers leaving the work force.

The high rate of unemployment in the current economic expansion has raised concerns that the natural rate of unemployment may have risen over the past few years in the United States. However, the continued decline in the

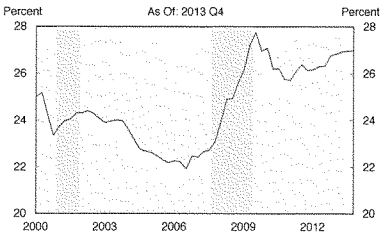
4.1.7 Long-Term Unemployment



Source: BLS, Haver Analytics

Note: Long-term unemployment as a percent of total unemployment. Gray bars signify NBER recessions.

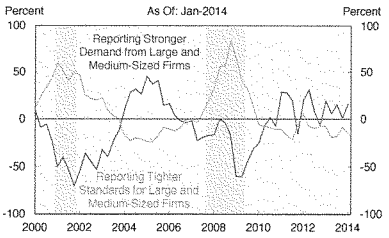
4.2.1 Debt to Assets for Nonfinancial Corporations



Source: Flow of Funds, Haver Analytics

Note: Gray bars signify NBER recessions.

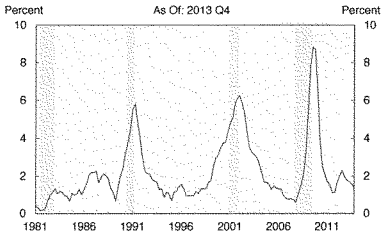
4.2.2 Bank Business Lending Standards and Demand



Source: SLOOS, Haver Analytics

Note: Gray bars signify NBER recessions.

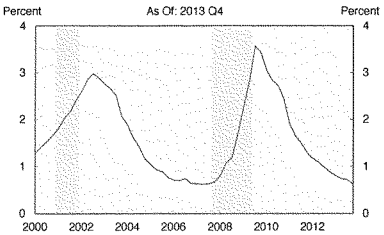
4.2.3 Nonfinancial Corporate Bond Default Rate



Source: Moody's Investors Service

Note: Default rates are annual rates calculated on a quarterly basis. Gray bars signify NBER recessions.

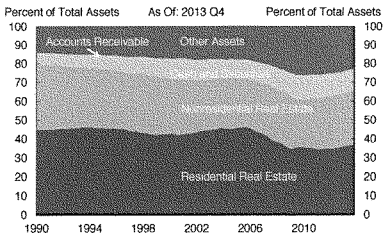
4.2.4 Noncurrent Commercial and Industrial Loans



Source: FDIC, Haver Analytics

Note: Percent of total C&I loans. Gray bars signify NBER recessions.

4.2.5 Noncorporate Assets



Source: Flow of Funds, Haver Analytics

rate of unemployment suggests the natural rate may be normalizing. Wage growth for those employed remains subdued by historical standards.

4.2 Nonfinancial Balance Sheets

4.2.1 Nonfinancial Corporate Sector

In 2013, corporate balance sheets remained strong as profits grew. Continued growth in earnings supported further rises in the share prices of nonfinancial corporations and allowed them to boost capital **(see Section 5.1.3)**.

Improved credit quality and corporate profits, as well as the low level of interest rates and declining spreads on corporate debt, supported substantial gross borrowing in corporate bond markets by nonfinancial firms **(Chart 4.2.1)**. Refinancing accounted for a record share and volume of corporate leveraged loans, more than doubling to $682 billion in 2013 from $283 billion in 2012. Total outstanding bank and nonbank loans to the nonfinancial corporate sector increased modestly in 2013. Commercial and industrial (C&I) loans funded by banks continued to rise. Bank respondents to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) reported stronger demand for C&I loans by large and medium-sized firms for twelve of the last seventeen quarters as well as some easing of underwriting standards for sixteen of the last seventeen quarters **(Chart 4.2.2)**.

Available indicators of corporate credit quality point to continued improvement. The default rate on nonfinancial corporate bonds continued to decline in 2013 **(Chart 4.2.3)**, as did delinquency rates on C&I loans **(Chart 4.2.4)**.

4.2.2 Noncorporate Business Sector

Compared to conditions in the corporate sector, financial conditions in the noncorporate business sector have improved at a slower pace. This sector, composed primarily of small businesses, accounts for slightly less than one-third of total nonfinancial business debt

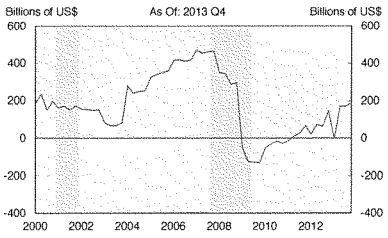
outstanding. However, since small businesses generally have access to a narrower range of financing options than corporations, the majority of small business debt is composed of bank loans. Therefore, developments in the noncorporate business sector affect the health of many banks' balance sheets, especially for smaller banks.

Real estate represents the majority of assets owned by noncorporate businesses **(Chart 4.2.5)**. The decline in real estate collateral values since the beginning of the financial crisis has hampered noncorporate borrowers' ability to borrow from banks. However, there are signs that credit conditions are gradually improving, supported by rising real estate values and improving business conditions. Net borrowing by nonfinancial noncorporate businesses, which had dropped dramatically through 2010, was slightly positive for most of 2013 except immediately following the federal government shutdown **(Chart 4.2.6)**. Respondents to the SLOOS noted some easing on loan standards for small firms, while demand for loans by small businesses generally continued to be tepid **(Chart 4.2.7)**. Additionally, according to the National Federation of Independent Businesses (NFIB), the number of small businesses indicating difficulty in obtaining credit continued its downward trend in 2013 **(Chart 4.2.8)**.

4.2.3 Household Sector

Household debt increased sharply in the years leading up to the financial crisis, reaching a high of 135 percent of disposable personal income in the third quarter of 2007. Since then, households have been deleveraging. By the end of last year, the ratio of household debt to disposable income had declined to its 2003 level of roughly 104 percent **(Chart 4.2.9)**, mostly due to decreases in outstanding mortgage debt, which accounts for about three-fourths of all household debt. The contraction in mortgage debt appeared to halt in the third quarter of 2013 **(Chart 4.2.10)**. The apparent bottoming out of mortgage debt follows continued housing-market activity and a pick-up in home

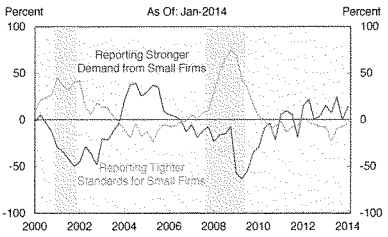
4.2.6 Net Borrowing by Nonfinancial Noncorporate Businesses



Source: Federal Reserve, Haver Analytics

Note: Seasonally adjusted at an annual rate. Gray bars signify NBER recessions.

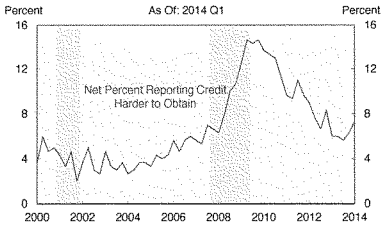
4.2.7 Bank Business Lending Standards and Demand



Source: SLOOS, Haver Analytics

Note: Data includes firms with annual sales of less than $50 million. Gray bars signify NBER recessions.

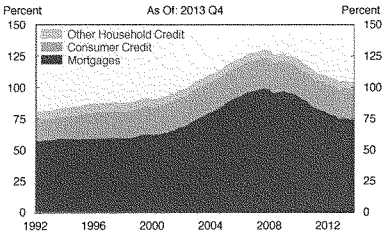
4.2.8 Small Businesses' Difficulty Obtaining Credit



Source: NFIB, Haver Analytics

Note: Percent of firms reporting credit was harder to obtain minus those reporting easier to get over the past three months. Gray bars signify NBER recessions.

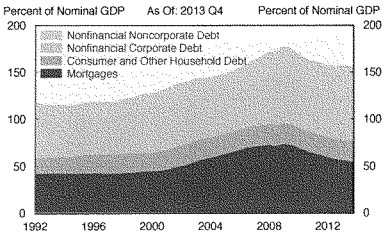
4.2.9 Household Debt as a Percent of Disposable Personal Income



Source: BEA, Flow of Funds, Haver Analytics

Note: Other Household Debt includes debts of both households and nonprofits.

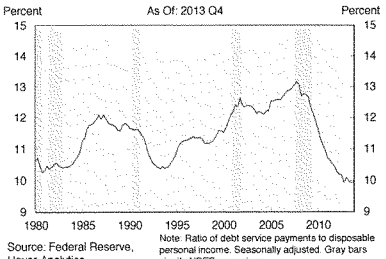
4.2.10 Private Nonfinancial Debt



Source: BEA, Flow of Funds, Haver Analytics

Note: Other Household Debt includes debts of both households and nonprofits.

4.2.11 Household Debt Service Ratio



Source: Federal Reserve, Haver Analytics

Note: Ratio of debt service payments to disposable personal income. Seasonally adjusted. Gray bars signify NBER recessions.

prices last year, aided by low mortgage rates and improving labor markets. Borrowers with high credit scores and equity generally have access to conforming GSE-backed mortgages, and federal programs have extended refinance assistance to borrowers in agency-guaranteed loans without equity, but access to credit by other borrowers remains tight relative to pre-crisis levels.

Slow debt growth, historically low interest rates, and modest increases in employment and income have reduced the household debt service ratio (the ratio of debt service payments to disposable personal income) to 30-year lows **(Chart 4.2.11)**. Reduced debt burdens have allowed households to slowly but steadily become more current on their debts. Since 2009, the percentage of household debt that is delinquent has decreased from 12 percent to 7 percent, but still remains significantly above pre-crisis levels. The share of seriously delinquent debts also remains at roughly 2008 levels **(Chart 4.2.12)**. Moreover, while aggregate measures of the debt burden have improved, a large number of households continue to face difficulties meeting their financial obligations, and many are still underwater on their mortgages.

Aggregate household net worth (the difference between assets and liabilities) rose about $10 trillion in 2013 to a historical high of nearly $81 trillion **(Chart 4.2.13)**. The ratio of household net worth to disposable personal income also increased. Capital gains from rising asset prices, especially corporate equities, accounted for most of the increase in net worth, though active saving, and the decline in outstanding debt noted above, also contributed in smaller part. Owners' equity as a share of household real estate continued to move up with rising house prices and falling mortgage debt, although it still remains about 8 percentage points below its 1990 to 2005 average **(Chart 4.2.14)**. As discussed in **Section 5.1.4**, the share of mortgages underwater declined.

Unlike mortgage debt, non-mortgage consumer credit, which accounts for slightly more than 20 percent of total household debt, has been growing over the past three years. During 2013, consumer credit outstanding increased about 6 percent to $3 trillion. Auto loans and student loans accounted for almost all of this increase **(Chart 4.2.15)**. Costs of education rose, and federal programs remained the dominant source of education lending, continuing to expand at a rapid pace in 2013.

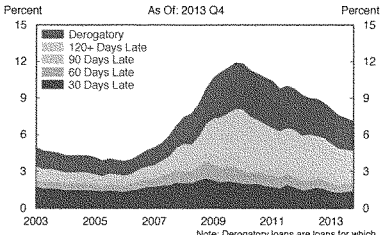
The increase in auto loans reflects availability of credit and rising consumer demand for motor vehicles. About $75 billion of auto loan asset-backed securities (ABS) was issued in 2013. Subprime auto loan ABS issuance reemerged, although reportedly with stronger credit support than before the crisis.

Indicators of changes in the demand for credit were mixed in 2013. Respondents to the SLOOS reported stronger demand for credit by consumers, especially for auto loans. However, credit applications were little changed, on net, over the year, and remained generally subdued relative to the pre-crisis period **(Chart 4.2.16)**.

Although last year's delinquency rates on auto, credit card and mortgage loans fell to 2008 levels, delinquencies on student loans and home equity lines remained considerably higher than their pre-crisis levels **(Chart 4.2.17)**. Lower delinquency rates for revolving credit and auto loans in 2013 likely reflected, in part, the composition shift toward borrowers with higher credit scores. The delinquency rates on these loans to consumers with prime and super-prime credit scores are currently near their historical averages.

While households are becoming more current on most types of debt, the delinquency rate on student loans outstanding rose to 12 percent at the end of 2013. Large and growing student debt burdens and continued weakness in labor markets have pushed many younger borrowers into delinquency, despite the longer grace periods that typically accompany student loans.

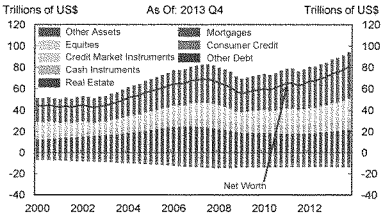
4.2.12 Share of Household Debt by Delinquency Status



Source: FRBNY Consumer Credit Panel/Equifax, Haver Analytics

Note: Derogatory loans are loans for which there are reports of a repossession, charge off to bad debt, or foreclosure.

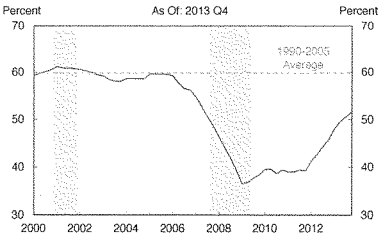
4.2.13 Household and Nonprofit Balance Sheets



Source: Flow of Funds, Haver Analytics

Note: Other Assets primarily include life insurance reserves, pension entitlements, and noncorporate equities. Other Debt primarily include security credit, trade payables, and unpaid life insurance premiums.

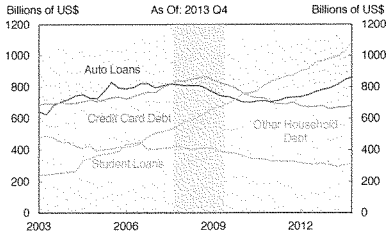
4.2.14 Owners' Equity as Share of Household Real Estate



Source: Flow of Funds, Haver Analytics

Note: Gray bars signify NBER recessions.

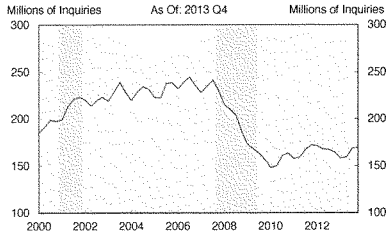
4.2.15 Components of Consumer Credit



Source: FRBNY Consumer Credit Panel/Equifax, Haver Analytics

Note: Gray bar signifies NBER recession.

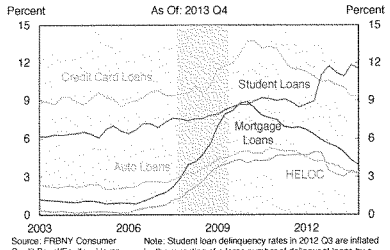
4.2.16 Applications for Credit



Source: FRBNY Consumer Credit Panel/Equifax, Haver Analytics

Note: Number of Equifax inquiries within 6 months. Gray bars signify NBER recessions.

4.2.17 90+ Day Delinquency Rate by Loan Type



Source: FRBNY Consumer Credit Panel/Equifax, Haver Analytics

Note: Student loan delinquency rates in 2012 Q3 are inflated by the reposting of a large number of delinquent loans by a single servicer. Gray bar signifies NBER recession.

The risk to lenders is mitigated by the fact that both federal and private student loans are difficult to discharge in bankruptcy, and that the federal government has extraordinary collection authorities. However, rising student-loan debt burdens and delinquencies may have implications for households. Despite features of federal student loans that facilitate flexible repayment and loan modifications, high student-debt burdens may dampen consumption and could impact household demand for housing purchases in coming years, as heavily indebted and delinquent borrowers may be less able to access mortgage credit.

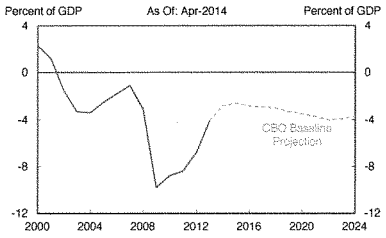
4.3 Government Finance

4.3.1 Federal Government

The deficit in the federal unified budget was 4.1 percent of nominal GDP in fiscal year 2013, a 2.7 percentage point reduction from the 6.8 percent deficit posted in 2012. Outlays declined modestly reflecting spending restraint from the 2011 Budget Control Act and sequestration. Revenue growth in 2013 was strong owing to policy changes—the expiration of the payroll tax cut, the reduction in bonus depreciation allowances, and provisions applying to high-income taxpayers in the American Taxpayer Relief Act and Affordable Care Act—as well as solid growth of taxable incomes of both corporations and individuals.

The medium-term budget outlook is subject to considerable uncertainty with respect to the performance of the economy, the future stance of fiscal policy, and other factors such as the pace of health care cost growth. The Congressional Budget Office estimates that the deficit will continue to decline to 2.6 percent of GDP in 2015, owing in large part to robust revenue growth as the economy continues to recover and changes in tax law provisions, especially the bonus depreciation provision. Starting in 2016, the deficit is expected to gradually increase, reaching 3.7 percent of GDP by 2024 **(Chart 4.3.1)**. The rise in the deficit is driven primarily by projected increases in Social Security and health care costs due to the aging of the population and the expectation that per-capita health care expenditures will grow faster than GDP, as well as increases in interest payments **(Chart 4.3.2)**. The ratio of debt held by the public to GDP is expected to drift up as the projected deficits are not low enough to stabilize the debt-to-GDP ratio **(Chart 4.3.3)**.

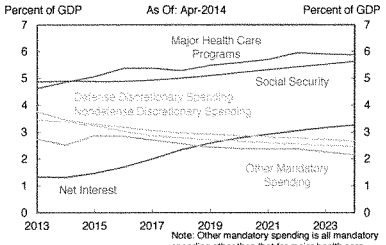
4.3.1 Federal Unified Budget Surplus/Deficit



Source: CBO, Haver Analytics

Note: Negative values denote a deficit. Data for fiscal years. Years after 2013 are projected.

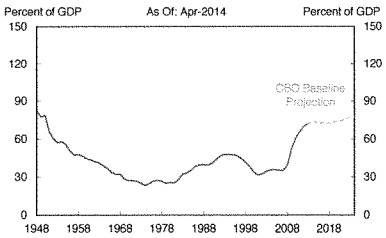
4.3.2 Projected Spending in Major Budget Categories



Source: CBO, Haver Analytics

Note: Other mandatory spending is all mandatory spending other than that for major health care programs, Social Security, and net interest.

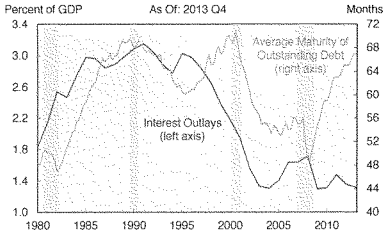
4.3.3 Federal Debt Held by the Public as a Percent of GDP



Source: CBO, Haver Analytics

Note: Data for fiscal years. Years after 2013 are projected.

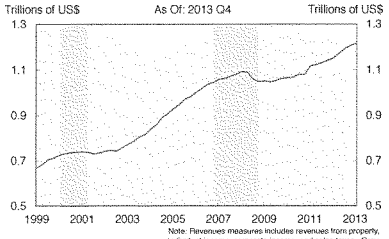
4.3.4 Interest Outlays and Average Maturity of U.S. Public Debt



Source: BEA, OMB, Haver Analytics

Note: Gray bars signify NBER recessions.

4.3.5 State and Local Government Tax Revenues



Source: Census Bureau

Note: Revenues measures includes revenues from property, individual income, corporate income, and sales taxes. Gray bars signify NBER recessions. Revenue shown represents the trailing 4 quarters.

The increase in interest payments that is likely to follow the high level of public debt projected over the medium term may have important consequences for fiscal policy moving forward. In the near term, however, net interest outlays remain near historical lows and the average maturity of outstanding debt continues to lengthen **(Chart 4.3.4)**.

All three major rating agencies maintained their overall ratings for the United States in 2013, with Moody's and Fitch assigning the United States their highest ratings and Standard and Poor's (S&P) assigning the second-highest rating. Fitch placed U.S. sovereign debt on negative ratings watch in October, citing political brinksmanship as a concern for the U.S.' creditworthiness **(see Box A)**, but changed the outlook back to stable in March 2014. Moody's and S&P also maintain a stable outlook for the United States.

BOX A: Macroeconomic and Financial Market Impacts of the Debt Ceiling and Government Shutdown

The federal debt ceiling was extended on two separate occasions in 2013. On both occasions, uncertainties surrounding the debt ceiling led to temporary disruptions in some key short-term markets. Investor concerns about the risk of a missed payment on some Treasury securities led to a temporary increase in term borrowing costs for the U.S. government.

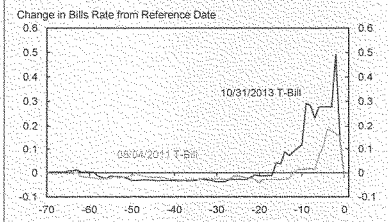
On December 26, 2012, Treasury Secretary Geithner announced that the statutory debt ceiling would be reached on December 31, 2012 and that Treasury would begin taking certain extraordinary measures to temporarily postpone the date that the United States would otherwise default on its legal obligations. In mid-January 2013, Treasury Secretary Geithner announced that the Treasury would exhaust its extraordinary measures between mid-February and mid-March of that year. Extraordinary measures are actions, such as suspending investments in certain federal trust funds, that temporarily extend the Treasury's ability to meet the government's obligations. The ensuing political debate with regard to a debt ceiling increase led some investors to avoid owning certain Treasury bills out of concern that the principal would not be repaid on time. Accordingly, yields on bills maturing in late-February and early March briefly spiked higher than those of surrounding maturities on the yield curve. However, in late-January an agreement was reached and on February 4, 2013 a law was enacted that suspended the debt ceiling through May 18, 2013, and conditions in the Treasury market quickly normalized.

After May 18, with the debt limit suspension period ended, the Treasury was able to again take extraordinary measures to temporarily continue borrowing without breaching the ceiling, and pressures were largely absent from financial markets during the second and third quarters of 2013. Yields on Treasury bills remained at near-zero rates until the end of the third quarter. However, in late-September concerns began to reemerge after Treasury Secretary Lew announced Treasury's estimate that extraordinary measures would be exhausted no later than October 17, 2013 and as it became apparent that there was no clear plan for Congress to extend the debt ceiling in a timely manner. Those concerns were later compounded by a 16-day government shutdown that began on October 1, 2013.

In early October, the market began to consider a scenario in which Congress would be unable to reach an agreement to raise the debt ceiling before the Treasury exhausted its extraordinary measures. This led yields to rise on bills maturing around that date as investors grew concerned about the potential for a delayed payment.

In the days leading up to October 17, 2013, yields on Treasury bills with maturities from mid-October to late-October became extremely volatile relative both to the preceding months and historical averages. For example, the yield on the Treasury bill maturing on October 3, 2013 rose from 3 basis points on September 30, 2013 to 53 basis points on October 15, 2013, a larger reaction than in similarly affected bills during the 2011 debt ceiling episode **(Chart A.1)**.

A.1 Treasury Bill Yields: 2011 vs. 2013



Source: Bloomberg, L.P.

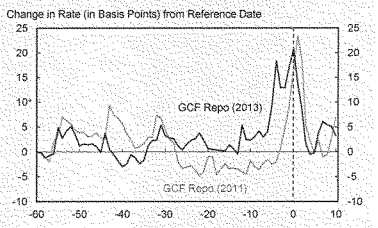
Note: Horizontal axis refers to the number of days prior to the debt ceiling agreement. 2013 debt ceiling agreement date is 10/17/13. 2011 debt ceiling agreement date is 8/1/11.

Stress in the Treasury bill market soon spread to the repo market as some cash lenders excluded certain Treasuries as acceptable collateral for tri-party repo transactions **(Chart A.2)**. Moreover, some counterparties took temporary informal actions by requesting that Treasury securities maturing in 2013 not be accepted as collateral in repo and securities lending transactions. In contrast to the illiquidity experienced in the market for short-dated bills, overnight repo markets remained liquid.

Additionally, some investors publicly stated that they did not hold certain Treasury securities that could have been affected by the debt ceiling. These factors widened bid-ask spreads for Treasury bills, which under normal market conditions have minimal transaction spreads. Operational risks about a missed Treasury payment were also a concern, since systems that handle securities clearance, settlement, financing, collateral management, payments, and pricing could have required manual workarounds and advanced payments to clients to limit market disruption.

Once an agreement to suspend the debt ceiling was reached, short-dated bills rapidly returned to near zero rates. Market participants have emphasized significant strains in Treasury bill and money markets would likely occur sooner and with more severity during future debt ceiling debates.

A.2 Treasury Collateralized Borrowing Rate



Source: Bloomberg, L.P.

Note: Horizontal axis refers to the number of days prior to the debt ceiling agreement. 2013 debt ceiling agreement date is 10/17/13. 2011 debt ceiling agreement date is 8/1/11.

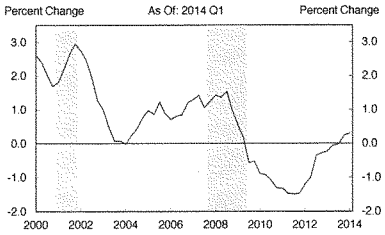
4.3.2 State and Local Governments

In general, the fiscal position of state and local governments improved in 2013. State and local tax revenues increased, continuing the trend since 2009 **(Chart 4.3.5)**. The improved revenue picture for both state and local governments was accompanied by a stabilization of employment during 2013 **(Chart 4.3.6)**.

Net credit flows to state and local governments were mixed in 2013. Long-term municipal bond mutual funds experienced outflows for 10 of the last 12 months, and long-term bond issuance was down 12.6 percent to $332 billion **(Chart 4.3.7)**. However, much of this decrease reflected a decline in refundings from the 2012 levels, due in part to higher interest rates. In many instances, municipal bond spreads, a proxy for municipal yields relative to index levels, also declined **(Chart 4.3.8)**.

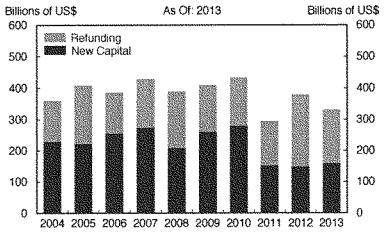
In spite of the relative stability that the sector experienced during 2013, state and local governments continue to face significant long-term challenges. In some municipalities, the slow pace of economic recovery has restrained income and sales tax growth. Additionally, home values remain below peak values in some parts of the country, restraining property tax revenue. Other challenges include increased spending pressure from pension liabilities and other post-employment benefits. Thirteen states contribute less than 80 percent of their annual required contribution to their public pension funds. In some municipalities, pension and other post-employment benefits costs are beginning to crowd out other services.

4.3.6 Growth of State and Local Government Employment



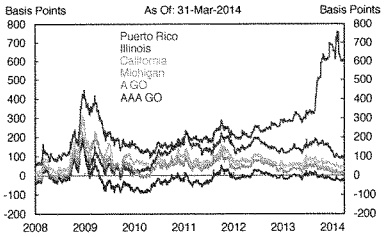
Source: BLS, Haver Analytics Note: Gray bars signify NBER recessions.

4.3.7 Municipal Bond Issuance



Source: Thomson Reuters, SIFMA Note: Excludes maturities of 13 months or less and private placements.

4.3.8 Municipal Bond Spreads



Source: Thomson Reuters MMD Note: Spreads to 10-year Treasury.

BOX B: Detroit and Puerto Rico: Municipal Market Impact

Developments in municipal markets—Detroit's filing for Chapter 9 bankruptcy protection and the downgrade of Puerto Rico's credit rating to non-investment grade status—have drawn significant investor and media attention. While market participants largely view these events as idiosyncratic, they might have the potential to affect the municipal bond market **(Chart B.1)**.

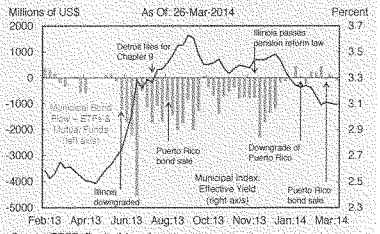
Although Detroit's bankruptcy is unique in many respects, there are two primary ways in which the unfolding story in Michigan could impact municipalities elsewhere. Investors may begin to demand higher interest rates from cities with weak economic fundamentals similar to Detroit, including population decline, chronic deficits, large unfunded pension liabilities, and an eroding tax base.

Additionally, if the treatment of claims in Detroit's bankruptcy ultimately differs significantly from other previous municipal bankruptcies, this could create uncertainty and lead to some amount of broader re-pricing of risk by investors.

Puerto Rico's financial challenges have also drawn investor and media attention. Its overall economy remains weak, having been in a recession since 2006. Additionally, Puerto Rico's outstanding debt of roughly $73 billion represents a large percentage of GDP. A significant portion of Puerto Rico's debt is exempt from federal, state, and local taxes in the United States and is widely held by investors.

Despite downgrades to non-investment grade status by all three major ratings agencies in February 2014, Puerto Rico was able to issue $3.5 billion in debt in early March, which authorities have said will allow them to meet their obligations until the end of calendar year 2015. However, a material deterioration in the economic and financial conditions in Puerto Rico could heighten concerns of municipal market investors, whose current sentiment remains fragile.

B.1 Weekly Municipal Bond Fund Flows and Yields



Source: EPFR, Bank of America Merrill Lynch, Haver Analytics

4.4 External Environment

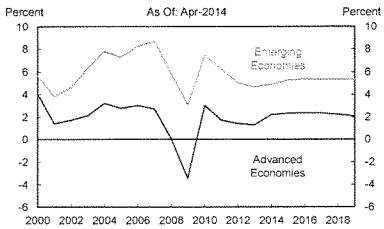
4.4.1 Advanced Foreign Economies

GDP growth in the advanced economies remained sluggish in 2013, at slightly below the already subdued pace of the previous two years **(Chart 4.4.1)**. However, the quarterly trajectory was more favorable, with most economies seeing a notable pickup in growth during the second half of the year. Growth in the euro area resumed in the second quarter after six consecutive quarters of contraction. Although the region's recovery remains subdued, the exit from recession removes what had been a major drag on global activity.

For the major foreign advanced economies (the euro area, Japan, the United Kingdom, and Canada), real GDP increased 0.6 percent in 2013 on a calendar year, GDP-weighted basis. A slower pace of fiscal consolidation and significant easing in financial stresses helped recovery take hold in the euro area. In Japan, additional discretionary fiscal stimulus, improved sentiment, and strong corporate profits helped support consumer and business spending amid a reflationary monetary policy program.

Thus far in 2014, activity in the major foreign advanced economies appears to have held close to the improved pace maintained during the second half of 2013. The International Monetary Fund (IMF) projects major foreign advanced economies to expand 1.4 percent in calendar year 2014. The IMF expects growth in these economies to pick up to a pace of 1.6 percent over the medium term, as headwinds from fiscal consolidation and deleveraging after the Great Recession continue to fade **(Chart 4.4.2)**.

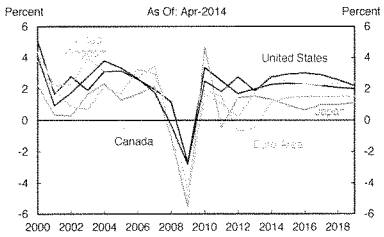
4.4.1 Real GDP Growth



Source: IMF, Haver Analytics

Note: Year-over-year percent change. Data after April 2014 is projected.

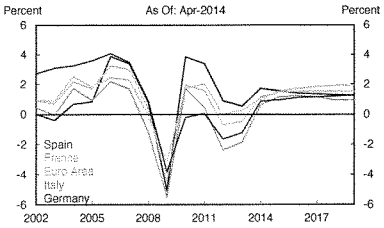
4.4.2 Advanced Economies Real GDP Growth



Source: IMF, Haver Analytics

Note: Year-over-year percent change. Data after April 2014 are projected.

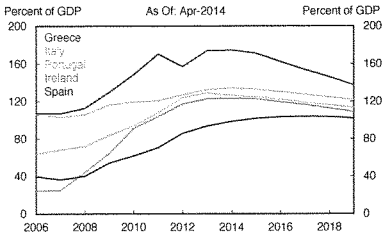
4.4.3 Euro Area Real GDP Growth



Source: IMF, Haver Analytics

Note: Year-over-year percent change. Data after April 2014 are projected.

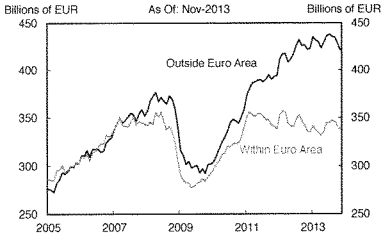
4.4.4 Peripheral Europe: Gross Public Debt



Source: IMF, Haver Analytics

Note: Data after April 2014 are projected.

4.4.5 Peripheral Merchandise Exports



Source: IMF, Federal Reserve, Haver Analytics

Note: Seasonally adjusted, 3-month annualized rolling sum. Peripheral Europe includes Ireland, Italy, Spain, Greece, and Portugal.

Euro Area

Policy actions by euro area authorities have reduced concerns about a systemic event in the region, and since mid-2012, have helped to substantially ease previously severe market pressures. However, fiscal and financial headwinds remain. After a year and a half of recession, the euro area economy saw a tentative rebound in the middle of 2013, with GDP expanding over the second and third quarters. However, euro area GDP growth remains about 2.5 percentage points below its rate in the first quarter of 2008, and unemployment is running at a near-record high of 12 percent. The pace of economic recovery in the euro area is expected to remain gradual. The IMF forecasts regional real GDP growth in 2014 to track at roughly 1.2 percent, with growth in most periphery countries expected to remain measurably below 1 percent **(Chart 4.4.3)**.

The fiscal consolidation measures implemented to date in the periphery have resulted in progress in stabilizing fiscal deficits and arresting the upward trajectory of public debt burdens. Altogether, euro area governments are estimated to have reduced fiscal deficits from 6.4 percent of GDP in 2009 to 3 percent of GDP at the end of 2013. Euro area periphery public debt levels are now projected to stabilize at high levels over the coming few years **(Chart 4.4.4)**.

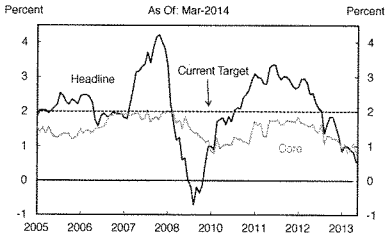
The euro area's overall current account balance shifted from a small deficit in 2008 to a consistent surplus with the surplus reaching 2.4 percent of GDP in 2013. The Netherlands and Germany have continued to run substantial current account surpluses since 2011, while the current account deficits of Italy and Spain and the smaller economies in the periphery have contracted significantly. Weak periphery domestic demand due to deleveraging has not been offset with stronger exports to the core **(Chart 4.4.5)**.

Euro area consumer price inflation has declined to well below the European Central Bank's (ECB) 2 percent target rate. Inflation readings (both headline, which includes volatile items, and core, which excludes those items) were tracking near or below 1 percent during the final months of 2013 **(Chart 4.4.6)**. With inflation dropping to multi-year lows in recent months, the euro area faces the risk of a prolonged period of substantially below-target inflation or outright deflation. This could slow recovery, hinder the internal rebalancing that is needed between the core and periphery, and increase the real burden of public and private debts. IMF and ECB forecasts are for euro area inflation to stabilize.

Meanwhile, European authorities are pushing forward with efforts to deepen regional financial integration and enhance market confidence in the capital adequacy of European banks. A single supervisory mechanism for euro area banks is in the process of being established under the ECB (expected to be in place by November 2014) and comprehensive assessments (by the ECB in cooperation with the national competent authorities) of approximately 130 of the largest banking groups also are underway.

European policymakers also have reached agreements to pass legislation harmonizing banking rules and regulation across the European Union (EU), including national deposit guarantee schemes, bank recovery and resolution frameworks and common bail-in rules, and their new capital requirements legislation is now in force. In March 2014, EU finance ministers and the European Parliament reached a provisional agreement on the Single Resolution Mechanism, which establishes a common resolution authority and single resolution fund for European banks.

4.4.6 Euro Zone: Consumer Price Inflation



Source: Statistical Office of the European Communities, Haver Analytics Note: Year-over-year percent change.

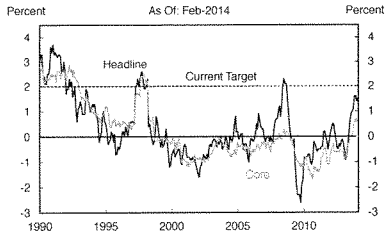
Japan

In 2013, Japan's new Liberal Democratic Party government launched an economic reform program designed to revive the economy and exit almost two decades of deflation. (The program is popularly termed Abenomics, in reference to Prime Minister Shinzō Abe.) The program consists of the so-called "three arrows": aggressive monetary stimulus; short-term fiscal stimulus, paired with long-term measures to reduce large, structural fiscal deficits; and structural reforms, to boost the economy's long-term growth potential. The IMF projects that GDP growth will be 1.4 percent in 2014, down slightly from 2013.

Household spending picked up significantly in 2013 partly in response to rising equity prices and broader expectations of economic growth under Prime Minister Abe's policies. Consumption is expected to further boost GDP in the first quarter of 2014, ahead of the April 2014 consumption tax hike. Temporary fiscal stimulus of 1 percent of GDP passed in December will only partially offset the initial impact of the consumption tax increase and the overall fiscal impulse in 2014 will be contractionary.

Japan's larger banks have begun to reduce their sizeable Japanese government bond (JGB) holdings in response to the Bank of Japan's (BoJ) asset purchase program. From March 2013 through December 2013, banks' holdings of JGBs dropped ¥29,474 billion and deposits at the BoJ went up ¥35,685 billion. Domestic lending began to pick up throughout 2013, averaging 2.6 percent growth for the year. There also are signs that Japan may be moving from entrenched deflation to sustained moderate inflation. The overall Consumer Price Index was up 1.5 percent from its year-ago level in February. Consumer price inflation excluding food and energy reached 0.7 percent in February 2014, the highest in roughly 15 years (**Chart 4.4.7**). Survey measures of expected inflation have also risen somewhat.

4.4.7 Japan: Consumer Price Inflation



Source: Ministry of Internal Affairs and Communications, Haver Analytics Note: Year-over-year percent change.

4.4.2 Emerging Market Economies

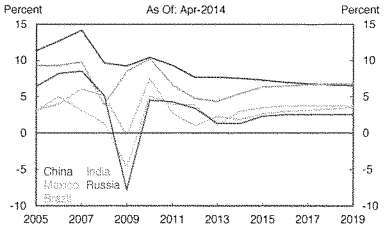
Emerging Market Economies

Economic growth remained generally sluggish in 2013 across the EMEs (**Chart 4.4.8**). Growth for all EMEs was an estimated 4.4 percent in GDP-weighted calendar year terms, down slightly from 2012 and roughly 2.5 percentage points below growth during the 2003-07 global boom. Growth for EMEs excluding China was 3.1 percent in 2013, also down slightly from 2012 and almost 3 percentage points below the 2003 to 2007 average. Recent indicators—including industrial production, exports, and purchasing manager surveys—show that a slight recovery may be underway. The IMF is expecting a modest pickup in growth to 4.6 percent this year, and 3.4 percent excluding China.

The EMEs continue to act as the main source of global growth. Last year, EMEs contributed three-fourths of global GDP growth, and according to the IMF forecast EMEs will contribute some two-thirds of global growth in 2014 (**Chart 4.4.9**). Importantly, estimates suggest that trend growth has slowed across the largest EMEs. The IMF now forecasts EME real GDP trend growth at roughly 5.25 percent, down some 1.5 percentage points from its forecast just two years ago.

EME asset prices came under pressure beginning in May 2013, with EMEs experiencing reduced capital inflows in the second and third quarter, reflecting in part changing expectations for Federal Reserve policy, deteriorating longer-term EME growth prospects, political unrest, and structural vulnerabilities in some prominent EMEs. While the market selloff in May and June (**see Box C**) broadly affected EME assets, markets displayed discrimination, putting countries with large external financing needs, elevated inflation, and more unpredictable policy frameworks under greater pressure. Policy makers in a number of EMEs responded to market strains by tightening monetary policy and by taking steps to rebuild policy credibility.

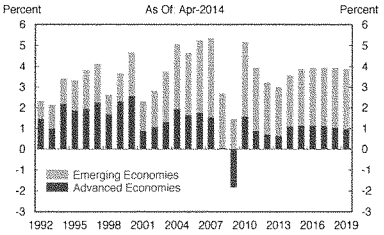
4.4.8 Emerging Economies Real GDP Growth



Source: IMF, Haver Analytics

Note: Year-over-year percent change. Data after April 2014 are projected.

4.4.9 EME Contributions to Global Growth



Source: IMF, Haver Analytics

Note: Data after April 2014 are projected.

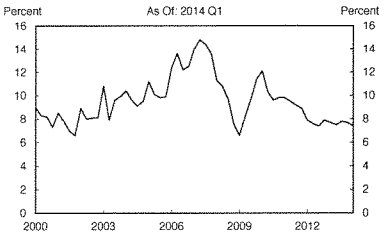
Moving forward, tighter financial conditions and weaker exchange rates across the EMEs represent a key question mark for both the growth and inflation outlooks. EMEs generally have benefitted from strong capital inflows over the past several years, something that has helped support domestic credit growth and financial system deepening. Nonetheless, such rapid domestic credit growth across a number of EMEs has increased asset quality risks and funding vulnerabilities and could weigh on growth prospects moving forward.

China

Developments in China remain particularly important, as China contributed 35 percent of global GDP growth in 2013. China's economic growth held steady in 2013 at 7.7 percent—the same rate as the previous year—but showed some signs of modest deceleration in mid-2013 and in early 2014 **(Chart 4.4.10)**. Growth in China had slowed steadily from the first quarter of 2010 through the third quarter of 2012, reflecting in part the government's desire to slow the pace of credit growth and rein in investment in some sectors of the economy, as well as sluggish external demand in the advanced economies. Chinese authorities announced an important new economic reform agenda in November 2013, which entails, among other things, a hardening of budget constraints for some state-owned enterprises and local governments and enhanced supervision of the nontraditional credit intermediation system. China's current account surplus declined from 10.1 percent of GDP in 2007 to about 2.1 percent of GDP for the four quarters ending in December 2013, driven by factors such as exchange rate appreciation, weak external demand, and increased imports for domestic investment purposes.

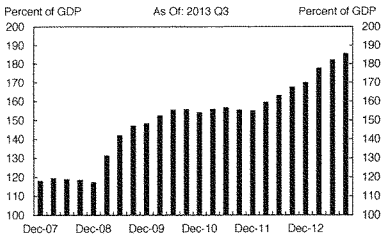
Private sector debt in China has increased rapidly over the past five years. From December 2008 to June 2013, private sector debt grew by 167 percent, over twice as fast as GDP growth over the same period (which was 72 percent) **(Chart 4.4.11)**. Nonbank financing channels (off-balance sheet lending, trust loans, and

4.4.10 China Real GDP Growth



Source: China National Bureau of Statistics, Haver Analytics
Note: Quarterly data. Percent change from the same quarter of the previous year.

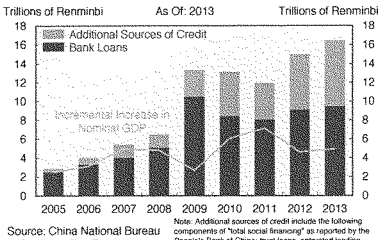
4.4.11 China: Credit to the Private Sector



Source: China National Bureau of Statistics, BIS, Haver Analytics
Note: Rolling 4-quarter sum of GDP.

corporate bond issuance) account for an increasing share of the flow of new credit. The rapid growth of credit **(Chart 4.4.12)** has raised questions about the efficiency of credit allocation and the potential for defaults over the medium term. Much of the funding for this new credit has come via wealth-management products (WMPs), which may have increased liquidity risk in the financial sector. Sold to investors as higher-yielding alternatives to time deposits, WMPs are largely off-balance sheet investment vehicles offered by banks, trusts, and securities companies. Increased competition for funds has led to the rapid growth of WMPs—to 10 percent of system deposits—as well as increased reliance on interbank borrowing, particularly at smaller banks.

4.4.12 China: Annual Increases in Credit and GDP



Source: China National Bureau of Statistics, The People's Bank of China, Haver Analytics

Note: Additional sources of credit include the following components of "total social financing" as reported by the People's Bank of China: trust loans, entrusted lending, undiscounted bankers' acceptances, and net new corporate bond issuance.

5 Financial Developments

5.1 Asset Valuations

5.1.1 Fixed Income Valuations

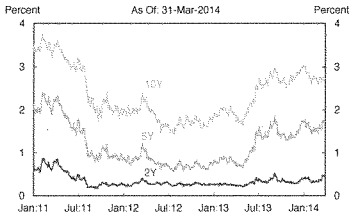
The past year was a year of transition for domestic fixed income as market participants perceived a reduction in the tail risk of contagion from a European financial crisis and focused attention on U.S. fiscal and monetary developments. Fixed income markets experienced a general rise in nominal medium- to long-term yields and some periods of elevated volatility. The increase in volatility was most notable during late spring and summer amid changes in monetary policy expectations and in October during the U.S. government shutdown and debt ceiling debate. Although yields rose in the majority of fixed income sectors, they remain well below long-term averages.

Treasury yields rose year over year across maturities as seen by the change in 10-year yields from 1.86 percent to 2.73 percent **(Chart 5.1.1)**. Yields for five-year and seven-year maturities rose on average by 1.02 percent while shorter maturity yields remained unchanged over the same period. The most significant yield increases were seen in the months of May through August 2013, a period of considerable volatility **(see Box C)**. The Treasury yield curve steepened **(Chart 5.1.2)**, retracing to 2011 levels, reflecting a notable increase in long-term yields.

While fixed income implied volatility remains at historically low levels, periods of elevated volatility did occur in 2013. Fixed income implied volatility, as measured by prices of options on Treasury securities and interest rate swaps, nearly doubled during May and June 2013 **(Chart 5.1.3)**.

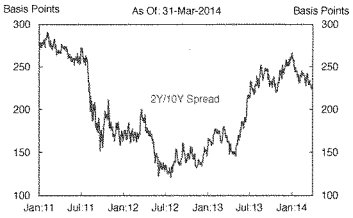
Agency mortgage-backed securities (MBS) experienced significant price declines and higher yields resulting from interest rate

5.1.1 Treasury Yields



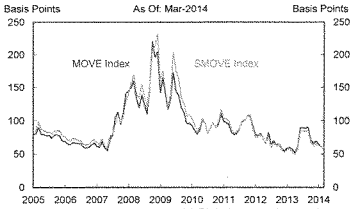
Source: U.S. Department of Treasury

5.1.2 Slope of the Treasury Yield Curve



Source: U.S. Department of Treasury

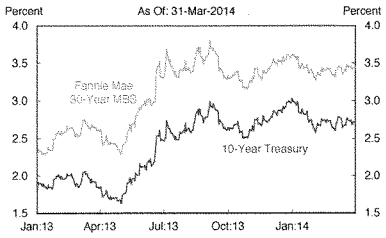
5.1.3 Implied Volatility



Source: Bank of America Merrill Lynch, Haver Analytics

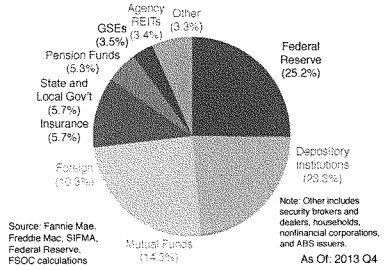
Note: MOVE is the yield curve weighted index of the normalized implied volatility on 1-month Treasury options. SMOVE is the yield curve weighted index of the normalized implied volatility on 1-month swaptions.

5.1.4 Agency MBS and Treasury Yields



Source: Bloomberg, L.P.

5.1.5 Outstanding Agency MBS by Holders



Source: Fannie Mae, Freddie Mac, SIFMA, Federal Reserve, FSOC calculations

volatility (**Chart 5.1.4**). The combination of significant declines in MBS duration from declining interest rates and increases in borrower refinancing incentives since mid-2012 increased the possibility of a convexity event. As noted in the Council's 2013 annual report, a convexity event is where an initial increase in long-term interest rates is amplified by many MBS investors actively hedging the duration of their MBS, resulting in rapid increases in long-term interest rates. While agency MBS suffered sizeable losses mid-year, the market impact from a rise in interest rates was not as severe as the 2003 convexity event, when 10-year Treasury yields rose by 1.4 percentage points in a six-week period. By comparison, the 10-year yield rose by 1.0 percentage point in about the same time frame at mid-year 2013. There are several reasons why this convexity event was less severe. First, unlike in 2003, the Federal Reserve held a substantial portion of outstanding MBS in 2013, thus absorbing a significant part of the overall MBS universe duration extension as interest rates rose. Because the Federal Reserve was not engaged in hedging activities that other large-scale investors would be engaged in, this lessened the impact of higher rates resulting from hedges. Second, interest rate options, a major driver of higher rates in 2003's convexity event, experienced lower volumes due to less participation in this market by the GSEs.

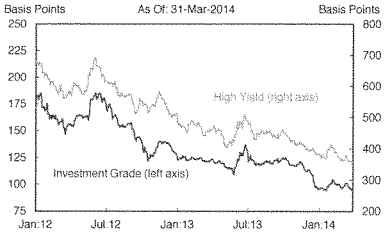
Lastly, the predominant holders of agency MBS outside of the Federal Reserve are composed of banks, investment funds, life insurance companies and pensions (**Chart 5.1.5**). These investors, which tend to rebalance their duration hedges infrequently, have increased their holdings since 2003. While these investors are sensitive to price fluctuations, they tend to have longer investment horizons and very stable sources of funding compared to agency real estate investment trusts (REITs) or hedge funds.

Like Treasury securities, corporate bonds experienced a significant increase in yields in May and June 2013. Investment grade yields year over year increased on average from 3.26

percent to 3.65 percent. Average yields for high-yield bonds remained relatively unchanged year over year at 5.7 percent. Credit spreads continued to tighten for both investment grade and high-yield bonds **(Chart 5.1.6)**. Issuance of corporate bonds remained strong, with over $1.4 trillion, nearly the same amount as 2012 **(Chart 5.1.7)**. Some market participants attribute this level of activity in the corporate bond market to improved credit conditions and low levels of default, while others cite greater demand by a broader set of investors searching for yield.

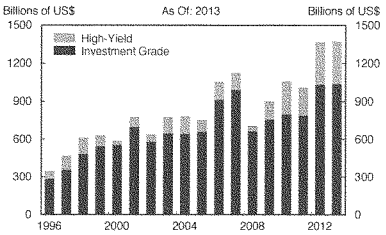
Leveraged loans, generally issued to speculative grade obligors, also had a very strong year of issuance and credit spread performance **(Chart 5.1.8, Chart 5.1.9)**. Strong demand from collateralized loan obligations (CLOs) and from private and public funds searching for yield helped propel leveraged loan growth. CLOs witnessed stronger demand in 2013 than 2012, with gross issuance rising almost $83 billion **(Chart 5.1.10)**. As with leveraged loans, CLOs have seen a broadening of the investor base as more institutions seek to find higher yields. Analysts and market participants have raised concerns that new investors may be unprepared for the limited liquidity and potential for large credit losses that both markets could experience as firms may be taking on outsized risk in exchange for incremental yield.

5.1.6 U.S. Corporate Bond Option-Adjusted Spreads



Source: Bloomberg, L.P.

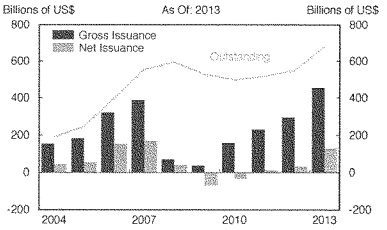
5.1.7 U.S. Corporate Bond Issuance



Source: Thomson Reuters, SIFMA

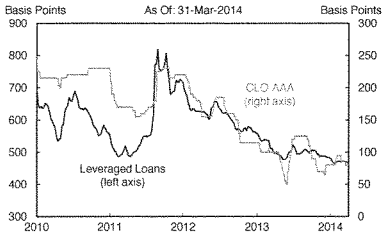
Note: Includes all non-convertible corporate debt, medium term notes, and Yankee bonds, but excludes all issues with maturities of one year or less and CDs.

5.1.8 Institutional Loans Issuance and Market Size



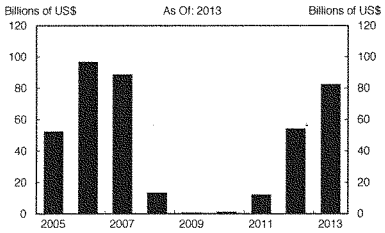
Source: S&P LCD

5.1.9 CLO and Leveraged Loan Spreads



Source: JP Morgan, S&P LCD Note: Spreads relative to 3-month LIBOR.

5.1.10 Annual CLO Issuance



Source: S&P LCD

The Shared National Credits (SNC) Review for 2013 indicates that while credit quality of syndicated loans remains broadly unchanged from the previous year's review, a focused review of leveraged loans found material widespread weaknesses in underwriting practices, including excessive leverage, inability to amortize debt over a reasonable period, and lack of meaningful financial covenants. The review included an evaluation of underwriting standards on SNCs that were originated in 2012, and examiners noted an increased frequency of weak underwriting. This trend heightened the agencies' concern, and agencies reiterated that they expect financial institutions to properly evaluate and monitor underwritten risk in leveraged loans, and ensure borrowers have sustainable capital structures, consistent with the updated leveraged lending supervisory guidance issued in March 2013.

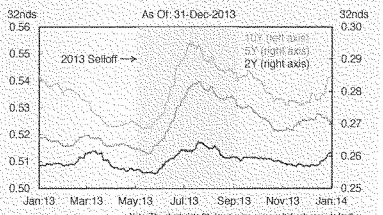
BOX C: The 2013 Bond Market Selloff, Market Liquidity, and Broker-Dealer Balance Sheets

In its 2013 annual report, the Council pointed to a rapid rise in longer-term yields as a potential vulnerability. Since last year's report, longer-term yields increased substantially, with the sharpest increase occurring between May 2, 2013 and September 5, 2013 when the 10-year Treasury yield rose from 1.69 percent to 3.13 percent. This sharp increase in yield corresponded to a loss of 13.41 percent on the value of 10-year Treasury holdings. The selloff was reportedly triggered by investors' reassessment of the future path of asset purchases by the Federal Reserve.

Market liquidity in Treasury markets declined during the selloff. Bid-ask spreads, which measure the cost of buying and selling assets, widened **(Chart C.1)**. The price impact, which measures how much prices move in response to selling pressure, increased **(Chart C.2)**. Market depth, which measures how much buying and selling can be supported at a given moment, declined **(Chart C.3)**. These effects were not limited to Treasury markets, but rather they reverberated to major fixed income markets.

At the time of the selloff, some buy-side market participants and the press speculated whether companies' preparation for enhanced regulatory capital requirements may have magnified the severity of the selloff by reducing broker-dealers' willingness to provide market liquidity. Broker-dealers intermediate between buyers and sellers, putting capital at risk. The less broker-dealers choose to intermediate supply and demand imbalances, the lower market liquidity is likely to be. To gauge broker-dealer market-making broadly, **Chart C.4** shows 10-week changes in broker-dealers' gross positions in fixed-income securities. The biggest decline in long positions in 2013 occurred between May and July (the diamonds labeled 2013 to the extreme left of the lower-left quadrant), suggesting that broker-dealers reduced their market-making activities during the selloff. Other instances in which there were large changes in both long and short positions are limited to the height of the financial crisis in 2008, the bond market selloff of 1994, and the financial market turmoil of 1998.

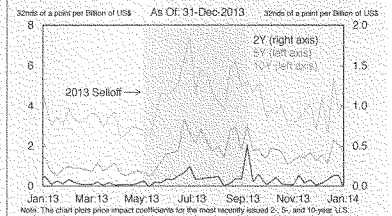
C.1 Bid-Ask Spreads on U.S. Treasury Notes



Source: Unattributed BrokerTec data, FRBNY calculations

Note: The chart plots 21-day moving average bid-ask spreads for the most recently issued 2-, 5-, and 10-year U.S. Treasury notes. The spread is calculated by subtracting the best bid price from the best ask price in the limit order book and then averaging over the trading day. They are calculated from January 2, 2013 to December 31, 2013.

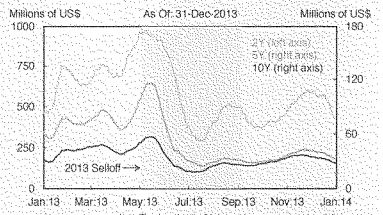
C.2 Price Impact of Trades Increases during the Selloff



Note: The chart plots price impact coefficients for the most recently issued 2-, 5-, and 10-year U.S. Treasury notes. The coefficients are calculated on a weekly basis from univariate regressions of 5-minute price changes on net order flow (buyer-initiated volume − seller-initiated volume) over the same interval from January 2, 2013 to December 31, 2013. Grey bar signifies 2013 selloff.

Source: Unattributed BrokerTec data, FRBNY calculations

C.3 Quoted Treasury Market Depth



Source: Unattributed BrokerTec data, FRBNY calculations

Note: The chart plots the 21-day moving average quoted depth for most recently issued 2-, 5-, and 10-year U.S. Treasury notes. The quoted depth is calculated by taking the average of the first tier bid depth and first tier ask depth of the limit order book and then averaging over the trading day. They are calculated from January 2, 2013 to December 31, 2013.

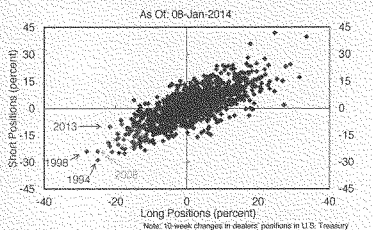
A look at risk measures of broker-dealers helps to better understand why broker-dealers pared positions during the selloff.

Broker-dealer leverage declined markedly during the recent financial crisis, suggesting that broker-dealer risk-taking has moderated since the crisis **(Chart C.5)**. Another indicator of risk-taking is value-at-risk (VaR), which is a forecast of the worst loss at the 99 percent confidence interval for a daily horizon. The sum of firm-wide daily VaR across eight large U.S. broker-dealers has trended down since the financial crisis. The decline in broker-dealer VaR reflects the decline in market volatility since the financial crisis as well as the smaller balance sheet capacity of broker-dealers.

The data presented in **Chart C.6** suggests that companies' preparation for enhanced regulatory capital requirements was not a major contributing factor in broker-dealers' willingness to provide market liquidity. In fact, broker-dealer subsidiaries of BHCs with less regulatory capital before the selloff reduced their net positions less than other broker-dealers during the selloff, suggesting that capital constraints at the consolidated BHC were not a meaningful exacerbating factor. In particular, U.S. broker-dealers with a higher VaR gap (which measures the difference between a broker-dealer's VaR and its VaR limit), and U.S. broker-dealer subsidiaries of BHCs with higher Tier 1 capital ratios, Tier 1 leverage ratios, and Basel III common equity Tier 1 ratio buffers (which measures the difference between a BHC's reported ratio and its proposed ratio requirement) before the selloff tended to reduce their net positions more during the selloff. That is, broker-dealer subsidiaries of BHCs with higher capital levels actually sold off more. This relationship suggests that broker-dealer behavior during the selloff was driven more by differences in risk appetite than by enhanced regulatory requirements.

The evidence also suggests that broker-dealers managed their balance sheets more conservatively at a time when investors were repricing interest rate risk rapidly, triggered by changes in expectations about the future path of the Federal Reserve's asset purchase program. Broker-dealers' withdrawal of liquidity may have amplified the sharp rise in rates and volatility.

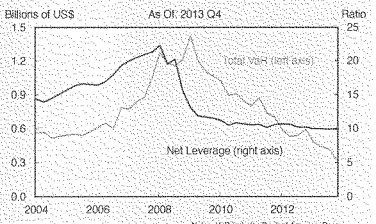
C.4 Change in Broker-Dealers' Long Vs. Short Positions



Source: Federal Reserve, FRBNY calculations

Note: 10-week changes in dealers' positions in U.S. Treasury securities, agency debt securities, and agency MBS from September 12, 1990 to January 8, 2014. Highlighted points are all those from 1994, 1998, 2008, and 2013 with significant decreases.

C.5 Broker-Dealers' VaR and Net Leverage



Source: Flow of Funds, Bloomberg, L.P.

Notes: VaR includes Bank of America, Bear Stearns, Citibank, Goldman Sachs, JP Morgan, Lehman, Merrill Lynch, and Morgan Stanley. Net leverage is total financial assets over equity capital.

C.6 Capital Constrained Broker-Dealers Are Associated with Less Selling

Correlation between Change in Net Positions and Constraint Prior to the Selloff	
Measure of Broker-Dealer Constraint prior to the Selloff:	
• VaR Gap (May 1, 2013)	-60%
• Basel III Common Equity Tier 1 Ratio Surplus (March 31, 2013)	-83%
• Q1 Tier 1 Capital Ratio (March 31, 2013)	-74%
• Q1 Tier 1 Leverage Ratio (March 31, 2013)	-6%

Note: The table shows pairwise correlations between broker-dealers' changes in net positions in U.S. Treasury securities, agency debt securities, agency mortgage-backed securities, and corporate securities in the 10-week period spanning the May-July run-up in yields; and dealers' constraints shortly before the selloff. To calculate the ratio requirement for the Basel III Common Equity Tier 1 Ratio, we include the 4.5% minimum requirement; 2.5% capital conservation buffer; and the Global Systemically Important Bank (G-SIBs) additional loss absorbency buckets proposed by the Financial Stability Board in November 2012.

Source: Federal Reserve, FRBNY calculations

5.1.2 Sovereign/Foreign Corporate Debt and Foreign Exchange

U.S. Sovereign Debt

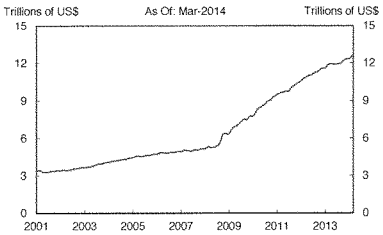
The total amount of outstanding U.S. sovereign debt held by the public (including Federal Reserve holdings, but not other intra-governmental debt) rose to $12.6 trillion as of March 2014 **(Chart 5.1.11)**. Long-term Treasury yields rose starting in May 2013, in part in response to changing expectations regarding Federal Reserve policy. The Federal Reserve announced a modest reduction in the monthly pace of asset purchases at its meeting in December 2013, amid an improving U.S. economic backdrop and labor market. As of the end of 2013, 10-year Treasury yields had risen 138 basis points since May to 3.04 percent, the highest level since July 2011.

Foreign holdings of Treasury securities continued to grow. Year over year ending February 2014, they rose by $194 billion to $5.9 trillion. The largest investors—investors from China and Japan—collectively accounted for $2.5 trillion of Treasury securities, while other foreign accounts held $3.4 trillion. Since the end of 2012, the shares and holdings of euro area and Japanese investors have risen, while the combined share of other countries has fallen **(Chart 5.1.12)**.

European Sovereign Debt

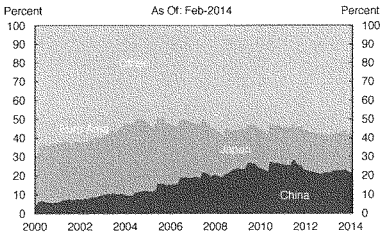
German and other core euro area sovereign debt yields rose over the course of 2013 as concerns about periphery country credit risk continued to abate and economic activity improved. At the end of March 2014, the yield on the German 10-year government bond was 1.57 percent, compared to 1.29 percent a year earlier. Other core country yields rose by a similar magnitude. The compression of periphery spreads began following a July 26, 2012, speech in which ECB President Draghi signaled the creation of the Outright Monetary Transactions (OMT) program, which allows the ECB to make unlimited purchases of sovereign bonds conditional on policy reforms, and vowed to "do whatever it takes" to prevent the breakup

5.1.11 Publically Held Federal Debt Outstanding



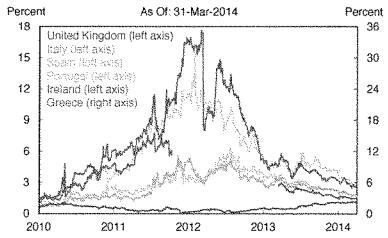
Source: U.S. Department of Treasury, Haver Analytics

5.1.12 Foreign Holders of U.S. Federal Debt



Source: U.S. Department of Treasury, Haver Analytics

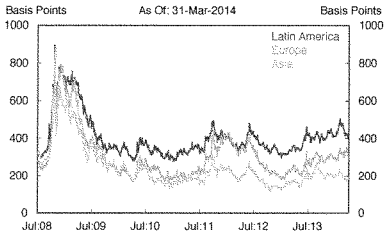
5.1.13 Euro Area 10-Year Yield Spreads to German Debt



Source: Bloomberg, L.P.

Note: Ireland did not issue 10-year debt between 10/12/2011 and 3/14/2013.

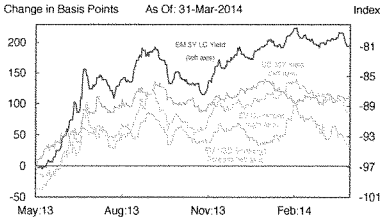
5.1.14 Emerging Market Bond Spreads



Source: JP Morgan, Haver Analytics

Note: JP Morgan EMBI+ Sovereign Spreads indices for each region.

5.1.15 EM Assets and U.S. Treasuries: Performance Since May 1, 2013



Source: Bloomberg, L.P., IMF

Note: Index = 100 for May-1-2013. EM 5Y is GDP-weighted average of interest rate swaps for: Malaysia, Korea, Indonesia, Philippines, Thailand, Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Hungary, Poland, South Africa, Turkey. EM Currencies is a GDP-Weighted average of FX spot rates for: Indonesia, India, Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Poland, South Africa, Turkey.

of the euro area. The spreads on Spanish and Italian 10-year government bonds to German equivalents were respectively 639 and 536 basis points on the eve of the speech and by the end of March 2014, Spanish and Italian spreads to German bonds were 166 and 173 basis points, respectively **(Chart 5.1.13)**. The spreads of government bonds to German equivalents in Ireland and Portugal also narrowed substantially and these nations were able to re-enter debt markets.

Ten-year sovereign yields in the United Kingdom rose over the course of the year, ending March 2014 at 2.74 percent, compared to 1.77 percent a year earlier. Yields were supported by the broader rise in advanced economy interest rates as well as the economic recovery in the United Kingdom.

Japanese Sovereign Debt

In April 2013, the BoJ implemented a policy known as Quantitative and Qualitative Easing. Under the policy, the BoJ is seeking to expand the monetary base at an annual rate of about 60 to 70 trillion yen. The policy seeks to achieve an inflation rate of two percent in about two years. As part of the policy, the BoJ increased its purchases of government bonds, and extended the duration of its purchases.

Emerging Market Debt

Beginning in May 2013, EM sovereign debt spreads widened versus Treasury yields, as measured by the Emerging Market Bond Index Plus **(Chart 5.1.14)**. Investors began to increase their level of concern regarding economic activity **(see Section 4.4.2)**, credit conditions, external financing needs and elevated inflation rates in several EMs. Economic and credit conditions in China in particular were a source of concern regarding EMs. Political risks in several EMEs further weighed on market performance **(Chart 5.1.15)**.

Foreign portfolio inflows to EMEs, which were very heavy since mid-2009 due in part to carry trade strategies, declined sharply in the second quarter of 2013, and had a significant impact on

EME yields **(Chart 5.1.16)**. Gross capital flows to EMEs declined in the second and third quarter but remained positive with foreign direct investment flows continuing to comprise the largest component **(Chart 5.1.17)**.

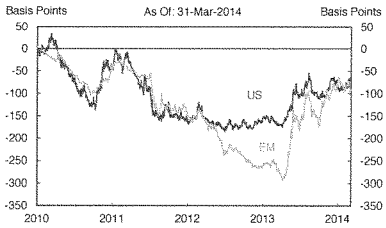
EM financial markets came under renewed pressure in early 2014. Unlike during stress episodes in 2013, changes in expectations of Federal Reserve policy did not appear to play a leading role, as EM asset prices weakened even as long-term Treasury yields declined. Instead, EM market weakness appeared to be driven by a series of country-specific developments in China, Turkey, Argentina, Ukraine, and Russia. Declines appeared to be amplified by a more generalized reduction in global risk sentiment in the aftermath of extended rallies in some risk assets (such as U.S. equities) and weaker data from the United States and China.

In 2013, EMs issued a record amount of corporate debt and the outstanding amount reached its highest-ever share of GDP **(Charts 5.1.18, 5.1.19)**. The issuance of U.S. dollar-denominated (USD) corporate bonds, at $422 billion, was almost four times that of the $111 billion issuance of sovereign bonds. This rise in issuance comes as EMEs represent an increasing share in global economic activity.

Asian firms were the most active issuers of international debt securities in recent years, followed by Latin American firms. Asian corporates currently account for 40 percent of outstanding EM corporate bonds, with Chinese firms doing much of the borrowing. Brazilian firms account for the majority of Latin American borrowing.

Growth of the EME corporate bond market is generally seen as a positive development reflecting the increasing global integration of firms in EMs and an improvement in access to funding. Portfolio diversification incentives and risk-return preferences suggest an ongoing

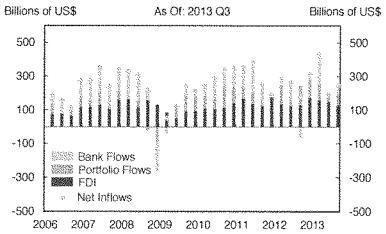
5.1.16 Cumulative Changes in 5-year Government Yields



Source: Bloomberg, L.P., IMF

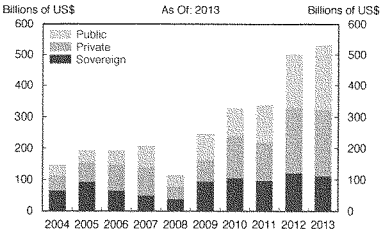
Note: EM includes GDP-weighted average of Brazil, Chile, Czech Republic, Hungary, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland, South Africa, South Korea, Thailand, and Turkey.

5.1.17 Gross Capital Flows to EMEs



Source: Haver Analytics

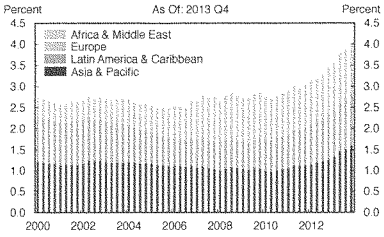
5.1.18 EME Gross Global Bond Issuance



Source: Dealogic

Note: Public includes issuance by state-owned enterprises.

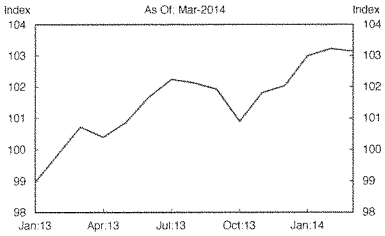
5.1.19 EME Corporate Debt Securities Outstanding



Source: BIS, IMF, Haver Analytics

Note: Debt expressed as percentage of EME GDP.

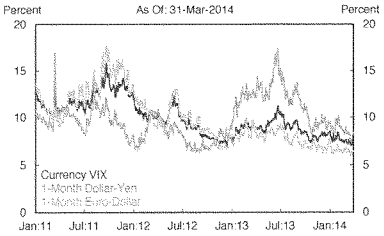
5.1.20 U.S. Dollar Trade Weighted Index



Source: Federal Reserve, Haver Analytics

Note: U.S. Dollar Trade Weighted Index is a weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners.

5.1.21 Currency Implied Volatility



Source: Bloomberg, L.P.

demand for EM assets commensurate with their economic and financial growth. These developments, however, come with risks:

- **Currency mismatch:** The stock of EME corporate debt reveals that dollar-denominated liabilities still constitute a substantial share of outstanding liabilities. The debt burden of an EME corporate borrower that has foreign currency liabilities but primarily local currency denominated revenues will rise in the event of depreciation in its local currency.

- **Market illiquidity:** Low trading volume in the secondary market and a lack of risk management products (i.e. corporate credit default swaps (CDS)) could amplify the market reaction in the event of a selloff, leading to a sharp hike in corporate lending rates.

- **Negative transmission linkages to banking sector and real economy:** Heightened corporate default rates could generate losses for domestic banks—both in their loan books, if they are large lenders to heavily indebted corporates, and in their securities holdings, if they hold corporate debt. This could weaken bank asset quality and capital adequacy and constrain credit availability to the domestic economy.

Foreign Exchange

In 2013, the USD appreciated modestly on a trade-weighted basis, appreciating the most against the Japanese yen and EM currencies **(Chart 5.1.20)**. The level of option-implied volatility across major currency pairs has remained near historic lows **(Chart 5.1.21)**. Market participants cited improved U.S. economic data and the actual announcement of a decrease in the pace of asset purchases by the Federal Reserve as supporting the dollar. However, the USD depreciated against the euro, the British pound, and the Swiss franc, due to improving sentiment toward these economies **(Chart 5.1.22)**.

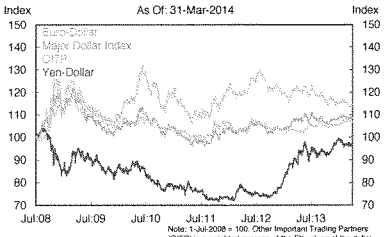
The euro has appreciated 7.4 percent versus the dollar since reaching year-to-date lows in July, and implied volatility continues to trade near multi-year lows. This was partly due to an improvement in economic data across the region, most notably GDP, Purchasing Managers Index, consumer confidence, and to a relatively benign political backdrop. Rising short-term interest rates also contributed to the appreciation of the euro.

The Japanese yen's recent performance has been range-bound, as most of the currency's nearly 20 percent depreciation versus the dollar from late 2012 to early 2013 had coincided with aggressive fiscal and monetary policy changes. Investors also remain highly focused on the outcome of Japan's ongoing structural reform efforts.

Year over year, ending March 2014, the British pound appreciated against all major currencies, including 9.4 percent versus the USD, on improved economic data and expectations that the Bank of England's (BoE) unemployment threshold of 7 percent could be reached earlier than initially expected, and may result in a reduction of BoE accommodation.

EM currencies have come under pressure on investor concerns about the longer-term impact of less accommodative monetary policy by advanced economy central banks and less optimistic growth outlooks for many EMEs **(Chart 5.1.23)**. After the initial April 2013 selloff, some differentiation has occurred, though depreciation pressures remain for some EM currencies. After an initial sharp depreciation, pressures on the Mexican peso and Indian rupee diminished over the latter half of the year. Despite this trend, South Korea and China have seen their currencies appreciate from April 2013 to March 2014.

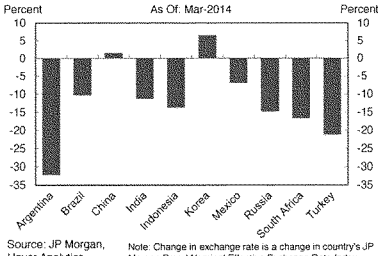
5.1.22 U.S. Dollar Exchange Rates



Source: Federal Reserve, Haver Analytics

Note: 1-Jul-2008 = 100. Other Important Trading Partners (OITP) is a weighted average of the FX values of the dollar against a subset of currencies in the broad index that do not circulate widely outside the country of issue.

5.1.23 Change in Exchange Rates (April 2013-March 2014)



Source: JP Morgan, Haver Analytics

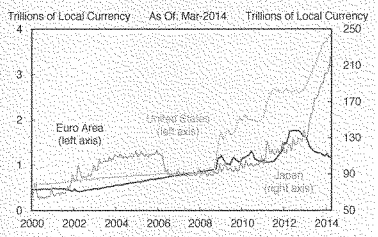
Note: Change in exchange rate is a change in country's JP Morgan Broad Nominal Effective Exchange Rate Index.

BOX D: Global Monetary Policy Actions

Even though the economic recovery has solidified over the past year, activity in most advanced economies still remains below potential, and inflationary pressures remain subdued, with inflation well below central bank targets in some instances. In response, central banks in the advanced economies have continued to adjust their policies to sustain their accommodative support **(Chart D.1)**. The BoJ substantially increased the size of its asset purchase program, while the ECB further cut its main policy rate, and both the ECB and the BoE introduced forms of forward guidance **(Chart D.2)**. Although the economic recovery in the United States led the Federal Reserve to begin to reduce the pace of its asset purchases, it has reinforced its guidance that monetary policy will remain accommodative for some time.

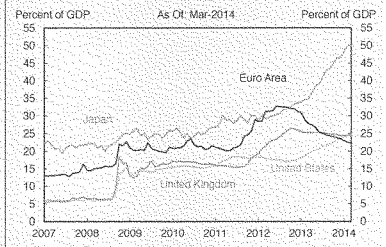
The BoJ has continued to pursue achieving and maintaining a 2 percent inflation rate. Targeting a range of increase in the monetary base of ¥60 to ¥70 trillion annually by purchasing JGBs and also some riskier assets such as exchange-traded funds (ETFs) and Japanese REITs, the BoJ's assets have grown rapidly. The yen depreciated substantially in late 2012 through early 2013, and Japanese sovereign yields remain at very low levels even as sovereign rates in other advanced economies have risen. So far, the shift in policy seems to be successful in helping to stimulate the Japanese economy and raising both inflation and inflation expectations, though year-over-year inflation remains below the BoJ's 2 percent target.

D.1 Advanced Economy Base Money



Source: Bank of Japan, Federal Reserve, European Central Bank

D.2 Central Bank Assets



Source: Haver Analytics

At its August policy meeting, the BoE introduced new forward guidance to provide greater clarity and to "keep market participants from revising up excessively" their expectations of future monetary policy. The BoE's Monetary Policy Committee (MPC) announced that it intended to keep the policy rate at its current level of 0.5 percent and the stock of assets purchased at £375 billion at least until the unemployment rate has fallen to 7 percent, noting that it expected this to occur around mid-2016. The MPC stipulated that its guidance would cease to hold if it expected inflation to rise more than 0.5 percent above its target, or if it thought that inflation expectations had become unanchored or its policies posed a significant threat to financial stability. Following a much more rapid drop in the unemployment rate than was anticipated at the time that its forward guidance was adopted, the BoE recently revised its guidance, tying lift-off of its policy rate not just to the unemployment rate but to the MPC's overall assessment of spare capacity in the U.K. economy. In another effort to stimulate growth, the BoE and U.K. Treasury extended the length and terms of their Funding for Lending Scheme, which was designed to encourage lending to households and small- and medium-sized enterprises; however, in November, in

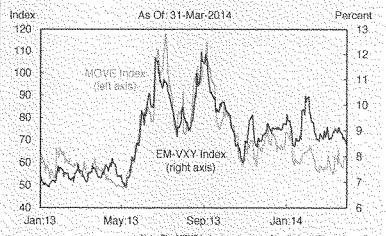
light of a pickup in the housing market, the terms of this extension were changed to remove support for lending to households while continuing to support lending to small- and medium-sized enterprises.

The ECB continued to offer three-month funds through its longer-term refinancing operations; however, as financial conditions improved in the euro area, many banks began to repay funds borrowed from earlier, three-year, ECB loan operations, and overnight interest rates began to drift up somewhat. In light of a still-fragile economic recovery and declining inflation, the ECB sought to provide further monetary stimulus, using both conventional monetary policy and forward guidance. The ECB cut its benchmark policy rate by 25 basis points in both May and November, lowering the rate from 75 to 25 basis points. At its July meeting, the Governing Council of the ECB issued forward guidance by announcing that it "expects the key ECB interest rates to remain at present or lower levels for an extended period of time."

In the United States, the Federal Open Market Committee (FOMC) maintained the pace of large-scale asset purchases through last year, continuing to add to its holdings of agency MBS and longer-term Treasury securities at a pace of $40 billion and $45 billion per month, respectively. At its December 2013 meeting, as the outlook for labor market conditions continued to gradually improve, the FOMC announced that, starting in January, it would modestly reduce the pace of its purchases of agency MBS and longer-term Treasury securities to $35 billion and $40 billion per month, respectively. At the same time, the FOMC reinforced its forward guidance on the path of the federal funds rate, indicating that it would consider not only the unemployment rate but also other indicators—including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments—in determining how long to maintain a highly accommodative stance of monetary policy. Based on these factors, the FOMC anticipated that it would likely be appropriate to maintain the current federal funds rate target well past the time that the unemployment rate declined to below 6.5 percent, especially if projected inflation continued to run below the FOMC's 2 percent longer-run goal. With incoming information broadly supporting the FOMC's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the FOMC announced further modest reductions in the pace of asset purchases at its January and March of 2014 meetings, bringing the pace of purchases to $25 billion per month for agency MBS and $30 billion per month for longer-term Treasury securities.

The relatively modest EM currency market reaction to the FOMC's December 2013 and January 2014 announcements could be attributed to the fact that expectations for a reduction in the pace of purchases were already priced into the market. Indeed, there had been more market turmoil in May and June of last year, when speculation that the FOMC would begin to reduce the pace of its asset purchases first intensified **(Chart D.3)**. Long-term interest rates in the United States and other foreign economies increased substantially at that time. Interest rates in some EMEs increased, however the dollar appreciated against most other currencies. Some EME central banks also intervened to support their currencies. However, these responses were not uniform; central banks in some of the EMEs with stronger fundamentals, including Mexico and South Korea, had enough leeway to cut their policy rates as economic growth moderated.

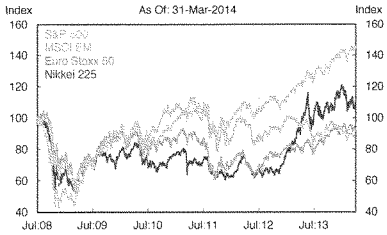
D.3 Market Volatility



Source: Bloomberg, L.P.

Note: The MOVE Index is a measure of implied volatility on 1-month Treasury options. The EM-VXY Index is a measure of aggregate volatility in currency markets.

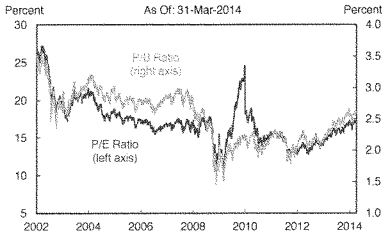
5.1.24 Selected Equities Indices



Source: Haver Analytics

Note: 01-Jul-2008 = 100.

5.1.25 S&P 500 Key Ratios



Source: Bloomberg, L.P.

5.1.26 Returns in Selected Equities Indices

	Change from 1-Apr-2013 to 31-Mar-2014	Change from 5-Year Low to 31-Mar-2014
Major Economies		
U.S. (S&P)	20%	131%
Euro (Euro Stoxx)	22%	67%
Japan (Nikkei)	22%	82%
U.K. (FTSE)	3%	68%
Selected Europe		
Germany (DAX)	23%	131%
France (CAC)	18%	58%
Italy (FTSEMIB)	41%	75%
Spain (IBEX)	31%	74%
Emerging Markets		
Brazil (Bovespa)	-10%	20%
Russia (RTS)	-15%	79%
India (Sensex)	19%	126%
China (Shanghai SE)	-9%	4%
Hong Kong (Hang Seng)	-1%	64%

Source: Capital IQ

5.1.3 Equities and Commodities

Equities

All major equity indices in advanced economies exhibited significant gains in 2013 **(Chart 5.1.24)**. The rise in developed market equities was bolstered by an improved global growth outlook, low interest rates, and accommodative monetary policy **(see Box D)**. In the United States, the price performance of equity indices continued to be positive, with a gain of over 20 percent for the S&P 500 Index since April 2013. Corporate equity valuations increased notably, as the price-to-earnings ratio for the S&P 500 rose over the course of the year **(Chart 5.1.25)**. These increased valuations reflected corporate earnings growth that started to shift from cost savings to a rise in sales and revenue. In the euro area, the Euro Stoxx Index rose by approximately 22 percent since April 2013 **(Chart 5.1.26)**. In the United Kingdom, the FTSE 250 index rose by 3 percent. Finally, Japanese equity markets rose by 22 percent.

In contrast, EM equities declined significantly over the past year. The declines were led by Brazil and Russia, which fell by 10 percent and 15 percent, respectively, and were reflected more broadly in the MSCI Emerging Markets Index, which was down 4 percent. Underperformance in EMs reflected concerns regarding economic activity, credit conditions, and exchange rate risk. Chinese equity markets also weakened due to economic growth concerns as the Shanghai and Hang Seng indices fell 9 and 1 percent, respectively. In Russia, equity markets fell sharply at the start of March 2014 in response to tensions around the purported annexation of Crimea from Ukraine, political instability and violence in Eastern Ukraine, and potential repercussions from U.S. and EU sanctions.

U.S. equity market implied volatility, as measured by the Chicago Board Options Exchange Volatility Index (VIX), averaged roughly 14 percent in 2013. This marks a return of the VIX not only to pre-crisis levels, but also

toward the lowest levels of the past 20 years (**Chart 5.1.27**). Implied and realized volatility fluctuated significantly during the year, with the VIX ranging between 12 and 21 percent. The fluctuations were most acute in early May when discussion of tapering by the Federal Reserve increased, around U.S. fiscal negotiations in October 2013, and again in January 2014 when EM asset price volatility rose amid increasing global growth concerns.

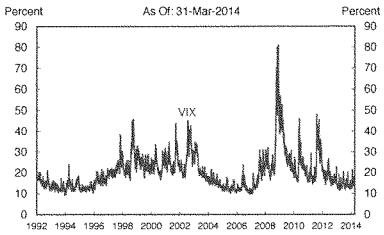
Commodities

Oil prices varied within a narrow band and experienced less volatility than in prior years as sharp U.S. domestic supply growth offset sanctioned Iranian exports, reductions in Libyan supply, and shocks to the geopolitical risk premium due to the conflict in Syria. Consequently, average retail unleaded gasoline prices in the United States experienced more muted seasonal price spikes in comparison with prior years. The difference between West Texas Intermediate, the principal U.S. oil benchmark, and Brent, the international benchmark, narrowed in 2013 but the spread between the two persists with a backdrop of further projected gains in domestic energy production.

Growth of natural gas production in the United States has slowed as producers have shut down projects or shifted their focus to oil and other more high value liquids amid the low U.S. natural gas prices of the last few years. However, a surge in demand due to unusually cold weather led to a spike in natural gas prices in early 2014.

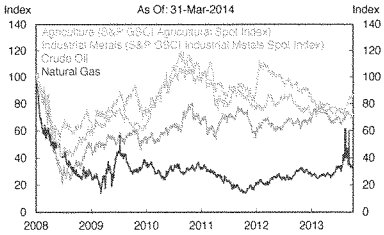
Industrial metal prices that are heavily influenced by demand from Asia remain depressed relative to 2011 peaks as market participants coalesce around lower growth expectations for Asia and the emerging world more broadly (**Chart 5.1.28**).

5.1.27 Market Volatility



Source: Capital IQ

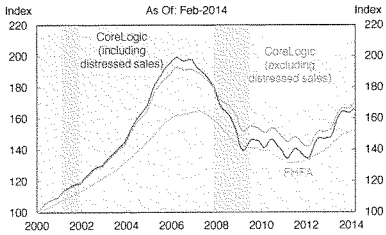
5.1.28 Commodities



Source: Energy Information Administration, S&P, Haver Analytics

Note: 01-Jul-2008 = 100.

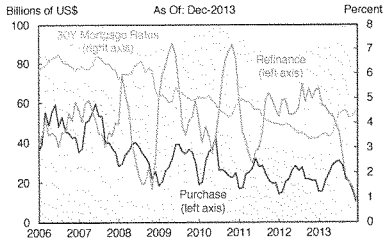
5.1.29 National Repeat Sales Home Price Indices



Source: CoreLogic, FHFA, Haver Analytics

Note: Gray bars signify NBER recessions.

5.1.30 Monthly Originations by Purchase and Refinance



Source: CoreLogic, FHLMC

5.1.4 Real Estate Markets

Housing Market Overview

Housing prices in 2013 continued to recover, though the pace of recovery slowed in the second half of the year as mortgage rates rose following increased uncertainty and anticipation around the timing of Federal Reserve tapering. Home prices in January 2014 were up 7.4 percent over one year earlier according to the FHFA's repeat sales home price index **(Chart 5.1.29)**, which reflects sales of single-family detached homes purchased with conforming loans. From March through October 2013, seasonally adjusted monthly existing home sales remained the highest since 2007 with the exception of November 2009. New single-family home sales continued to slowly recover, rising 4.5 percent over one year earlier in December 2013, still well below historical norms, as both sales and supply of new homes remained muted. Housing starts followed a similar pattern, rising 4.2 percent over one year earlier in December 2013 to a seasonally adjusted annual rate of 1.0 million units, still well below the historical average rate of 1.5 million units. Macroeconomic factors such as unemployment contribute to the low demand for new housing units, as do low rates of household formation that have averaged around half historical levels since 2006.

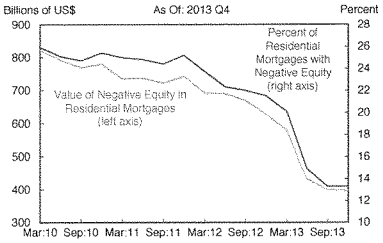
Refinancing, which made up over three-fifths of the dollar volume of mortgage originations in 2013, fell considerably during the course of the year **(Chart 5.1.30)**. While mortgage purchase originations recovered slowly, climbing to a two-year high of $30.9 billion in July, refinance originations fell in each month of 2013 from a high of $67.4 billion to $12.2 billion by year end. Overall, total originations fell in each month except May and purchases have outpaced refinancing originations since October of 2013.

The performance of outstanding loans improved significantly since 2012. Delinquent loans declined from 3.1 million in December 2012 to 2.7 million in December 2013, partly due to reduced rates of negative equity and

improved macroeconomic conditions. As a result of price increases, completed foreclosures on underwater loans, loan modifications, and the amortization of older loans, the fraction of mortgages with negative equity declined markedly from 21.6 percent at the end of 2012 to 13.3 percent in the fourth quarter 2013, with the total value of negative equity falling from $628 billion to $398 billion during the same period **(Chart 5.1.31)**. The backlog of mortgages in foreclosure has also showed signs of improvement **(Chart 5.1.32)**. The share of loans with payments more than 90 days past due dropped from 3 percent to 2.6 percent between December 2012 and December 2013 and the share of all loans that were delinquent fell from 7.5 to 6.7 percent. Over the same period, the share of mortgages in foreclosure dropped from 3.7 percent to 2.9 percent.

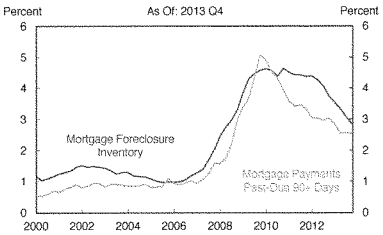
Current credit standards remain more conservative than prior to the financial crisis. The average FICO score of individuals receiving purchase mortgages from Fannie Mae and Freddie Mac reached a two-decade high of 766 in June 2013. Borrowers with credit scores of 760 and above make up an increasing volume of all purchase mortgages. The portion of first lien purchase mortgages that went to borrowers with credit scores in this range rose from 47 percent in December 2012 to 53 percent one year later **(Chart 5.1.33)**. However, there is evidence of credit loosening in refinancing, with the portion of refinance mortgage volume going to borrowers with credit scores of 760 and above falling from 57 percent to 45 percent over the same period. With refinances making up the bulk of mortgages for 2013, the percentage of banks reporting looser standards in the SLOOS exceeded the percentage reporting tighter standards by 4.6 to 8.7 percent throughout the year. While FHFA and the GSEs have made progress in developing a new representations and warranties framework, lenders reportedly continue to employ tighter standards above minimum GSE credit standards, reflecting the perception of increased put-back risk associated with lower-credit-quality and higher loan-to-value ratio loans.

5.1.31 Mortgages with Negative Equity



Source: CoreLogic

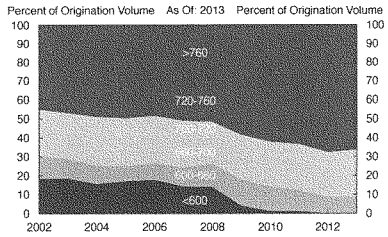
5.1.32 Mortgage Delinquency and Foreclosure



Source: Mortgage Bankers Association, Haver Analytics

Note: Percent of all mortgages.

5.1.33 Purchase Origination Volume by Credit Score



Source: CoreLogic

Note: Includes first lien purchases only.

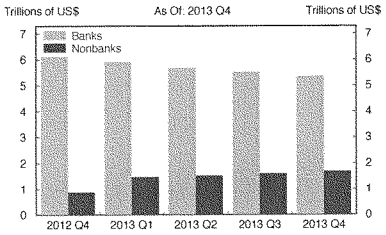
Over the next few years, the bulk of home equity line of credit (HELOC) originations, which were made in increasing volumes leading up to the crisis, are approaching the end of their draw periods, meaning that homeowners face the beginning of repayment of the principal borrowed and in some cases balloon payments of their entire principal balances. In 2014, roughly $23 billion in outstanding HELOC balances are expected to reach the end of their interest-only periods. Another estimated $41 billion will reach the end of their draw period in 2015, followed by $49 billion in 2016 and $54 billion in 2017.

Investor activity in home purchases increased in 2013, particularly in regions that experienced significant home price increases over this same period. Investors purchased homes for rental. They also participated in this market via equity REITs. In addition, the first rental property securitization bond was issued in late 2013 with the potential for more issuance in the future.

U.S. commercial banks and thrifts continued to transfer MSRs throughout 2013 **(Chart 5.1.34)**. By the end of the year, banks held $5.4 trillion in unpaid balance, down $758 billion from 2012 as many banks sought to reduce holdings subject to enhanced capital requirements that begin to go into effect in 2014. In contrast, nonbank holdings increased by $806 billion to $1.7 trillion.

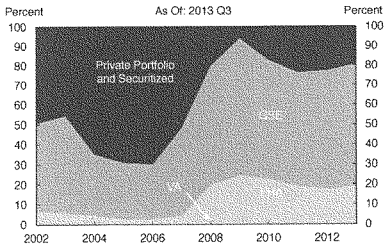
At their peak in 2006, prior to the financial crisis, private portfolios and securitization comprised nearly 70 percent of mortgage originations. With the collapse of the MBS market and the onset of the financial crisis, private capital dried up in mortgage markets, leaving government and agency guarantees to back over 90 percent of originations in 2009 **(Chart 5.1.35)**. With the housing recovery, a limited amount of private capital has taken on credit risk, primarily in jumbo loans for very high-credit-quality borrowers. However, private capital still has less than a third of the market share it had at its pre-crisis peak. Today, the share of all originations through

5.1.34 Servicing Growth: Banks vs. Nonbanks



Source: Inside Mortgage Finance

5.1.35 Mortgage Originations by Program



Source: Inside Mortgage Finance

the Federal Housing Administration (FHA), the U.S. Department of Veterans Affairs, and GSEs stands at 81 percent. There is evidence that risk-bearing private capital is reentering the market primarily via portfolio lending and whole loans rather than securitization, in part due to barriers to investor reviews of the underwriting of securitized loans that persist. Although private securitization volume doubled in 2013, it still remains less than one percent of all originations.

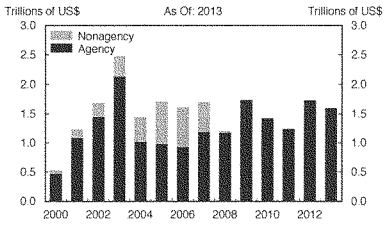
The GSEs completed nearly 4.1 million refinancings in 2013 through December, with the Home Affordable Refinance Program representing 22 percent of this amount. In addition, the FHA Streamline Refinance program completed nearly 512 thousand refinancings. With the uptick in interest rates and depletion of refinance-eligible homes, the GSEs' refinance volume decreased in the fourth quarter of 2013 by 63 percent over the fourth quarter of 2012.

Government Sponsored Entities

Through the third quarter of 2013, the GSEs accounted for approximately 76 percent of MBS issuances, with practically all remaining issuances coming from Ginnie Mae (**Chart 5.1.36**). As market conditions recovered, the financial health of Fannie Mae and Freddie Mac also improved. Fannie Mae and Freddie Mac posted net incomes of $84.0 billion and $48.7 billion, respectively in 2013 (**Chart 5.1.37**). While the health of these enterprises has improved, their recent profits are not expected to be indicators of steady future profits, particularly because most of the 2013 income came from one-time sources such as the release of loan loss reserves.

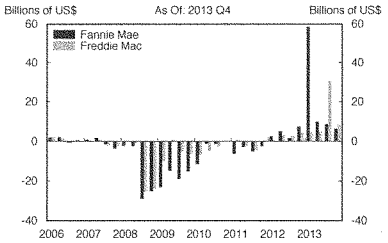
In 2013, under FHFA guidance, the GSEs completed three transactions which were aimed at minimizing taxpayer risk by sharing credit risk with private investors who pre-fund collateral at the time of transactions. These transactions accounted for the bulk of the GSEs' credit risk-sharing transactions associated

5.1.36 Issuance of RMBS



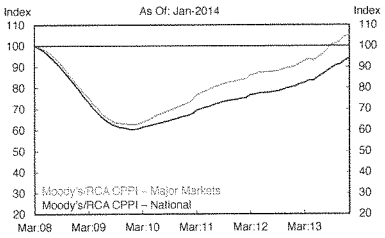
Source: Thomson Reuters, Dealogic, Fannie Mae, Freddie Mac, SIFMA

5.1.37 GSE Net Income



Source: SNL Financial

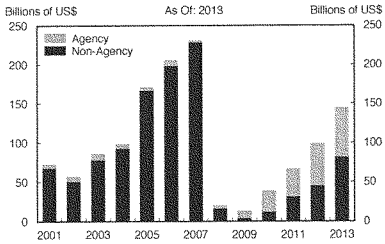
5.1.38 Commercial Property Price Indices



Source: Real Capital Analytics, Moody's Investors Service

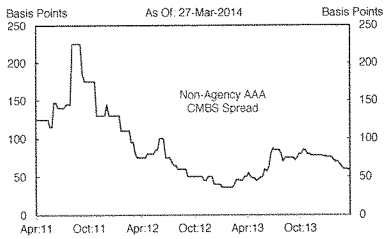
Note: Mar-2008 = 100.

5.1.39 CMBS New Issuance



Source: Commercial Mortgage Alert

5.1.40 CMBS Senior Debt Spreads



Source: Barclays

Note: Spread of Non-Agency 3.0 AAA 5-Year CMBS to Swaps.

with $75 billion in mortgages that were completed in 2013. The remaining transactions were based on insurance structures.

Commercial Real Estate

Commercial real estate (CRE) markets continued to improve in 2013. Price indices rose in CRE markets (**Chart 5.1.38**), though price appreciation for retail properties continued to lag the rest of the sector. Delinquency rates on CRE loans at banks continued to improve, falling from 4.12 percent in the fourth quarter of 2012 to 2.46 percent in the fourth quarter of 2013.

Commercial REITs issued almost $27 billion in unsecured notes in 2013, higher than any year in the preceding decade. Private commercial mortgage-backed securities (CMBS) issuance rose in 2013 to $81.6 billion, a level in line with years prior to 2005 (**Chart 5.1.39**). Market participants expect issuance to slow due to the rising rate environment. Meanwhile, the reduction in CRE delinquencies at banks is reflected in CMBS as well: the fraction of CMBS loan balances in Fitch-rated deals that were 60 or more days delinquent or in foreclosure fell from 7.99 percent in December 2012 to 5.98 percent in December 2013. This improvement is also reflected in slightly lower CMBS senior debt spreads (**Chart 5.1.40**). However, refinancing risks for these CMBS could be significant if cash flows from the properties do not increase enough to support higher rates in the future.

5.2 Wholesale Funding Markets

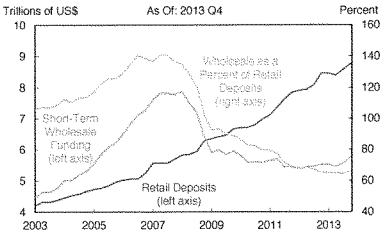
Short-term wholesale funding markets provide financial intermediaries with funds, on a secured or unsecured basis, that supplement other funding sources such as retail deposits and long-term debt. Major short-term wholesale funding types include federal funds, CP, repos, certificates of deposit (CDs) and large time deposits. Financial institutions have varying reliance on short-term wholesale funding. U.S. branches of foreign banks and broker-dealers tend to rely more on short-term wholesale funding than domestic banks, which have access to U.S. retail deposits. Sources of short-term wholesale funding include cash on balance sheets of nonfinancial companies, MMFs, reinvestments of cash collateral obtained from securities lending activities, and cash held by mutual funds, pension funds, and sovereign wealth funds. Domestic banking firms' reliance on short-term wholesale funding measured as a share of retail deposits has decreased since the financial crisis. The decreased reliance on wholesale funding primarily reflects growth in retail deposits **(Chart 5.2.1)**.

5.2.1 Commercial Paper, Asset-Backed Commercial Paper, and Large Time Deposits

CP outstanding of $952 billion in December 2013 was essentially unchanged from a year ago **(Chart 5.2.2)**. Asset-backed commercial paper (ABCP) outstanding continued to decline over 2013, extending a trend since the financial crisis. As of December 2013, ABCP accounted for 28 percent of total CP outstanding, while financial CP and non-financial corporate CP accounted for 52 and 20 percent, respectively.

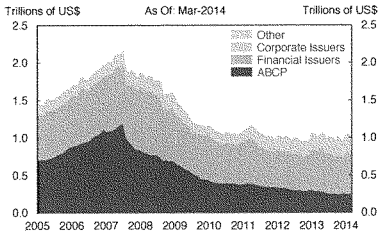
Overall, domestic CP outstanding (excluding ABCP and including both financial and non-financial CP), was generally stable over 2013 **(Chart 5.2.3)**. Domestic financial CP issuance declined to all-time low levels, which market participants largely attributed to a reduction in demand for short-term funding from domestic banks, as noted above. In contrast, domestic non-financial CP outstanding modestly

5.2.1 Composition of Bank Short-Term Funding



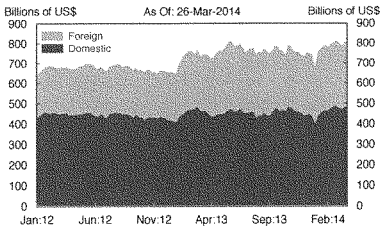
Source: FDIC, Federal Reserve, Haver Analytics

5.2.2 Commercial Paper Outstanding



Source: Federal Reserve, Haver Analytics

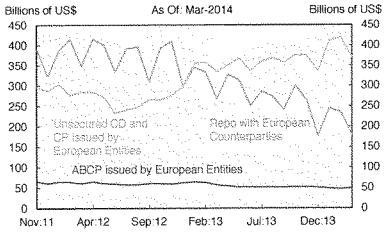
5.2.3 Commercial Paper Outstanding



Source: Federal Reserve

Note: Does not include ABCP. Domestic includes CP issued in the U.S. by entities with foreign parents.

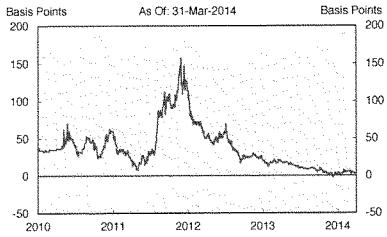
5.2.4 U.S. MMF Holdings of European Entities' CP, CD, and Repos



Source: SEC Form N-MFP filings, OFR Calculations

Note: Assets valued at amortized cost.

5.2.5 Premium for Borrowing U.S. Dollars for 3 Months



Source: Bloomberg, L.P.

Note: Premium for borrowing U.S. dollars is the negative of the 3 month Euro-U.S. Dollar FX Swap.

increased, consistent with increased overall corporate funding needs.

Foreign CP outstanding increased by approximately 30 percent year-over-year in 2013, driven by increased issuance by euro area financial institutions. This has generally been attributed to improving investor sentiment with regard to Europe and low U.S. money market rates prompting some "search for yield" behavior. Consistent with these trends, U.S. prime MMFs increased the amount and extended the average tenor of their unsecured euro area exposures (**Chart 5.2.4**). However, prime MMFs continue to have small direct exposure to peripheral euro area institutions.

U.S. commercial bank large time deposits, which include wholesale CDs, modestly increased in 2013 to reach $1.6 trillion. Similar to dynamics in the CP market, growth was led by deposits at foreign institutions, which increased 14.2 percent. Large time deposits at domestically chartered banks declined 4.1 percent.

Consistent with relatively benign conditions in offshore USD funding markets, the premium for borrowing USD via FX swap markets remained small (**Chart 5.2.5**). Moreover, the premium for borrowing USD against euros in the three-month tenor was negative in late 2013. This indicates the existence of a premium for borrowing euros, which happened for the first time since early 2008, reflecting eased conditions in dollar funding markets and tighter conditions in euro money markets.

5.2.2 Repo Markets

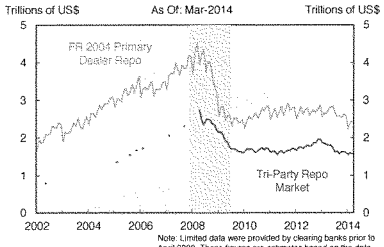
A repo is the sale of securities for cash with an agreement to buy back the securities at a specified date and price. This arrangement resembles a secured loan with securities as collateral. Securities broker-dealers play a significant role in repo markets. There are three repo market segments: the tri-party market, in which broker-dealers primarily obtain funding from cash investors and transact utilizing the collateral management and

settlement services of the two tri-party repo clearing banks (JPMorgan Chase and Bank of New York Mellon); GCF repo, which is centrally cleared by FICC over the tri-party platform; and bilateral repo, in which transactions are executed without the services of the two tri-party clearing banks.

Repos outstanding decreased in 2013, as measured both in the tri-party repo statistics and in the Federal Reserve Bank of New York (FRBNY) primary dealer survey **(Chart 5.2.6)**. The decrease was particularly pronounced for agency MBS and, to a lesser extent, Treasury securities. Many institutions reduced their reliance on wholesale funding more generally, both repos and other forms of wholesale funding, in response to an influx of retail deposits. Market observers also have cited other factors in reference to the decline in repo activity, such as the purchases of Treasury securities and agency MBS by the Federal Reserve, as part of its large-scale asset purchases, as well as deleveraging by financial institutions in anticipation of enhanced capital regulations, notably the supplementary leverage ratio. The relative size of the primary dealer term repo market compared to the overnight repo market remained similar in 2013 versus the prior year **(Chart 5.2.7)**.

The majority of tri-party repo financing remains collateralized by assets that are eligible for use in Federal Reserve open market operations, such as Treasury securities, agency debentures, and agency MBS. As of December 2013, these types of collateral accounted for 75 percent of all tri-party repo collateral **(Chart 5.2.8)**. The remaining 25 percent of collateral used in tri-party repos includes corporate bonds, equities, agency and private label collateralized mortgage obligations, ABS, CP, other money market instruments, whole loans, and municipal bonds. Haircuts in the tri-party market have been stable in the last few years across all collateral classes, suggesting an unchanged stance towards collateral quality and potential price volatility.

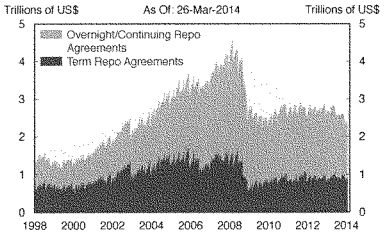
5.2.6 Value of the Repo Market



Note: Limited data were provided by clearing banks prior to April 2008. These figures are estimates based on the data provided. Gray bar signifies NBER recession.

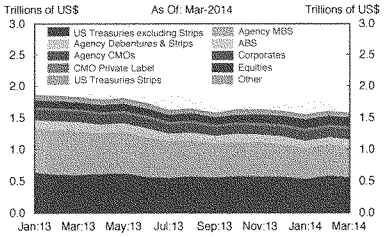
Source: FRBNY

5.2.7 Primary Dealer Repo Agreements



Source: FRBNY

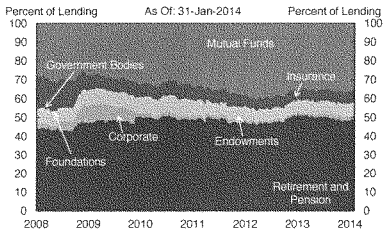
5.2.8 Collateral in Tri-Party Repo



Note: Other = CDO, International, Money Market, Municipal Debt, and Whole Loans.

Source: FRBNY

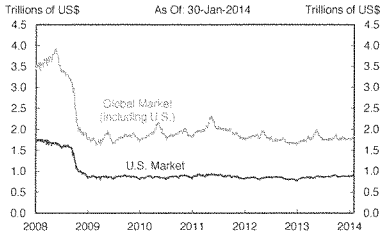
5.2.9 Share of Securities Lending by Lender Type



Source: Markit Group Limited

Note: Data is based on a survey of agent based lenders.

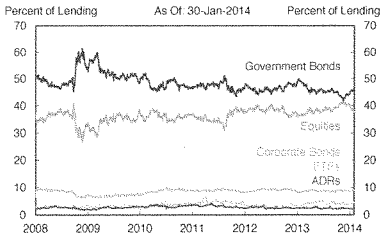
5.2.10 Value of Securities on Loan



Source: Markit Group Limited

Note: Data is based on a survey of agent based lenders.

5.2.11 Composition of Securities Lending by Security Type



Source: Markit Group Limited

Note: Data is based on a survey of agent based lenders.

While risks to financial stability remain in the tri-party repo market, over the past two years, the industry has made significant progress in implementing the vision of the Tri-Party Repo Infrastructure Reform Task Force **(see Section 3.1.1)**.

5.2.3 Securities Lending

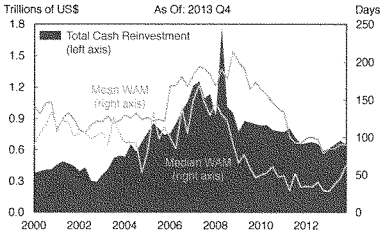
Securities lending is a transaction involving the temporary transfer of a security by one party (the lender) to another (the borrower), in exchange for collateral in the form of either cash or non- cash instruments. Institutions may want to borrow securities to facilitate short selling, for derivative hedges, to deliver a security to another party to settle a transaction, or to obtain a particular security to post as collateral in another transaction. The main lenders of securities are institutional investors, such as pension plans, mutual funds, and insurance companies **(Chart 5.2.9)**. The main borrowers are hedge funds, broker-dealers, derivatives traders, and market makers. Most domestic securities lending is done against cash collateral. Typically, the lender of a security pays an interest rate to the borrower for the cash collateral. Lenders seek to earn a higher return by investing the cash collateral in a MMF or other short-term investment fund which, in turn, may invest in CP, repos, and other short-term wholesale funding instruments as discussed above.

The global value of securities lending transactions remained fairly flat in 2013, at an average value of around $1.8 trillion, effectively unchanged from 2012, according to available estimates **(Chart 5.2.10)**. The composition of assets being lent, both globally and in the United States, remained consistent with 2012, with government bonds and equities continuing to comprise the vast majority of securities lent in 2013 **(Chart 5.2.11)**. Overall, market commentary suggests little change in lending terms throughout 2013, which is further supported by results of Senior Credit Officer Surveys on Dealer Financing Terms.

Both securities lending on a cash-collateral basis and on a non-cash collateral basis pose some risks. In securities lending on a non-cash collateral basis, a party usually swaps, or temporarily exchanges their lower quality assets, by posting them as collateral for higher quality assets, such as Treasury securities. This process is typically termed "collateral transformation." Risks of collateral transformation are twofold: the value of the lower quality collateral could decline beyond the initial margin such that additional collateral must be posted to maintain adequate overcollateralization, which can force deleveraging if the borrower does not have the additional collateral needed; and financial institutions providing collateral swaps might introduce additional counterparty and liquidity risk exposure.

As is the case of non-cash collateral, loans of securities against cash collateral also pose risks. Before the crisis, cash collateral was often reinvested in assets with longer weighted-average maturities, causing significant maturity and credit mismatches between their invested assets and their liabilities (cash) that became problematic when collateral needed to be returned on a same-day basis. However, despite recent data showing an increased share of lending on a cash collateral basis, the weighted-average maturity of cash reinvestment remains well below levels seen in the pre-crisis timeframe (**Chart 5.2.12**), which suggests that the investment strategy of these cash collateral reinvestment pools remains conservative, at least with respect to duration risk.

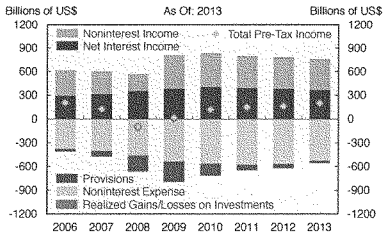
5.2.12 Securities Lending Cash Reinvestment



Source: The Risk Management Association

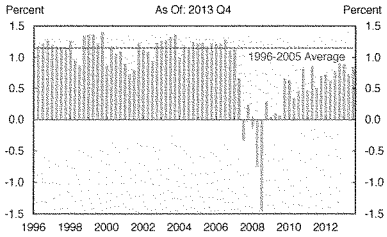
Note: WAM = Weighted Average Maturity. Data is based on a survey of agent based lenders.

5.3.1 Aggregate BHC Pre-Tax Income



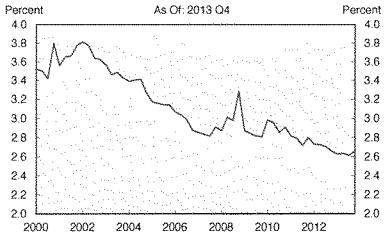
Source: FR Y-9C

5.3.2 Return on Average Assets for BHCs > $10B



Source: FR Y-9C

5.3.3 Annualized Net Interest Margin



Source: FRBNY Quarterly Trends Report

Note: For domestic BHCs and commercial banks.

5.3 Bank Holding Companies and Depository Institutions

5.3.1 Bank Holding Companies and Dodd-Frank Act Stress Tests

Performance

BHCs are companies with at least one commercial bank subsidiary. Subsidiaries of BHCs may also include nonbanks such as broker-dealers, investment companies, or insurance companies. As of the fourth quarter of 2013, there were 1,054 BHCs in the United States (excluding Puerto Rico) with greater than $500 million in assets, whose aggregate assets totaled $18.0 trillion.

The domestic banking sector in 2013 continued to face a challenging interest rate environment, enhanced regulatory requirements, and a sluggish, but slowly recovering, macroeconomic environment. Beginning in May 2013 and continuing for the remainder of the year, shifting expectations about the timing of the Federal Reserve's reduction in asset purchases resulted in higher Treasury yields that weighed on capital markets and mortgage banking revenues. Despite headwinds, earnings grew in the sector in 2013, mostly as a result of expense control measures and lower loan-loss provisions as credit quality continued to improve. Aggregate pretax income for all BHCs increased 25 percent in 2013 to $199.1 billion (**Chart 5.3.1**). Nevertheless, the return on assets across BHCs remained lower than the levels that prevailed in the 10 years before the crisis (**Chart 5.3.2**).

BHC net interest margins (NIM) continued to decline through most of 2013, as they have for more than a decade, although the rate of compression decelerated (**Chart 5.3.3**). NIM compression was driven by the run off of higher-yielding securities amid relatively low reinvestment yields and increased competition across some loan categories. In addition, deposit costs remained near the zero-bound, limiting the extent to which BHCs could benefit

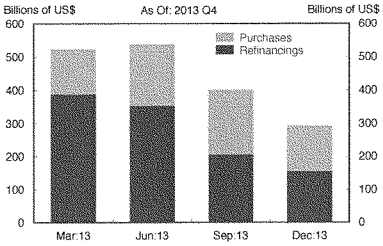
from lower funding costs. Moreover, some large BHCs took steps to increase holdings of lower-yielding, high quality liquid assets to improve their liquidity profiles, further pressuring NIMs.

The rise in Treasury yields and steepening of the yield curve that began in May 2013 have not yet translated into wider NIMs. Further, short-term rates remain low, so banks have not benefited from yield increases on their floating-rate assets. BHCs mitigated the effects of the compressed rate environment through various cost control measures, including restructurings and compensation reductions. For example, some banks began reducing expenses in their mortgage banking businesses in the latter half of 2013, as higher MBS rates and lower origination volumes adversely affected mortgage-related revenues **(Charts 5.3.4, 5.3.5)**.

Despite continued margin pressure, the largest banks did not appear to assume outsized credit or duration risk, although competition for loans has increased in the more profitable small business and middle market segments. However, some smaller banks continue to lengthen the maturity of their asset portfolios, as evidenced in the estimates of the asset/liability maturity and repricing interval gap **(Charts 5.3.6, 5.3.7)**.

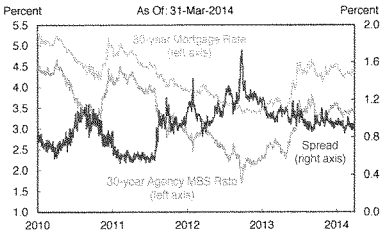
Large BHCs reduced some legal uncertainly in 2013 as a result of settling certain outstanding legal matters, primarily related to pre-crisis mortgage lending **(see Section 6.1.5)**. In addition to reduced legal uncertainty, BHCs benefited from greater clarity on impending regulations **(see Section 6)**. Nevertheless, BHCs still face ongoing investigations into certain matters, such as manipulation of LIBOR and FX markets. These incidents highlight the need for BHCs to have effective risk management policies and practices in place to address potential legal risk.

5.3.4 Total Residential Mortgage Originations



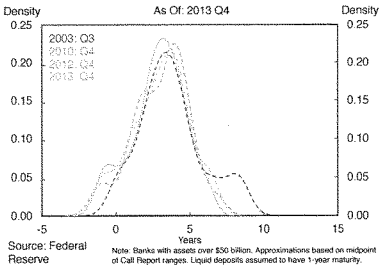
Source: Mortgage Bankers Association

5.3.5 U.S. Mortgage Spread



Source: Bloomberg, L.P.

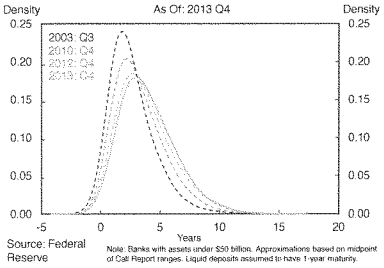
5.3.6 Maturity Gap at Large Banks



Source: Federal Reserve

Note: Banks with assets over $50 billion. Approximations based on midpoint of Call Report ranges. Liquid deposits assumed to have 1-year maturity.

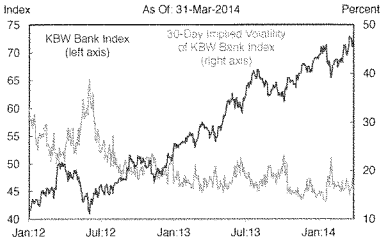
5.3.7 Maturity Gap at Small Banks



Source: Federal Reserve

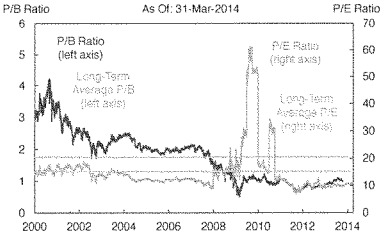
Note: Banks with assets under $50 billion. Approximations based on midpoint of Call Report ranges. Liquid deposits assumed to have 1-year maturity.

5.3.8 KBW Bank Index and Implied Volatility



Source: Bloomberg, L.P.

5.3.9 Average P/B and P/E Ratios of 6 Large Complex BHCs



Source: Bloomberg, L.P.

Note: Market-cap weighted average of BAC, C, GS, JPM, MS, WFC

Market Indicators

BHC share prices rose in 2013. As of the end of March, the KBW bank index had increased 29 percent year over year and implied volatility had declined (**Chart 5.3.8**). The market value of the six largest BHCs increased 31 percent in aggregate and the market-capitalization weighted-average price-to-book ratio for this group was slightly above 1.0 at year end. Valuations are at the highest level since early 2011, though they remain well below pre-crisis levels (**Chart 5.3.9**). Five-year CDS spreads of these six BHCs tightened approximately 20 to 50 percent in 2013, and finished the year near pre-crisis levels, due primarily to continued strengthening of bank balance sheets (**Chart 5.3.10**). Advanced systemic risk measures, which attempt to gauge systemic risk at the six largest BHCs in real time, continued to decline in 2013 and remain well below crisis levels (**Chart 5.3.11**).

Capital

Aggregate capital ratios, as defined per the Federal Reserve's Capital Assessments and Stress Testing reporting requirements (that is, the Y-14A report) for BHCs increased modestly in 2013 with the Tier 1 common capital ratio increasing 25 basis points to 11.70 percent. The domestic implementation of Basel 2.5 in January 2013 led to a large increase in risk-weighted assets (RWAs) in the first quarter of 2013 (**Chart 5.3.12**), negatively affecting Tier 1 common capital ratios, particularly at the largest banks with significant market risk and trading activities. Nevertheless, this decline was offset by increases in retained earnings, driven by positive operating results and by modest capital raising.

Large BHCs, in aggregate, improved their Basel III common equity Tier 1 capital in 2013 despite the rise in interest rates during the second half of the year. The rise in rates led to a large decline in net unrealized gains on available-for-sale (AFS) securities portfolios.

During 2013, most BHCs increased their capital distributions. Dividends paid by BHCs that participated in the 2013 Comprehensive Capital Analysis and Review (CCAR) increased approximately 19 percent in the aggregate while share repurchases increased approximately 76 percent from 2012. However, capital distributions remain subdued relative to pre-crisis levels.

Liquidity

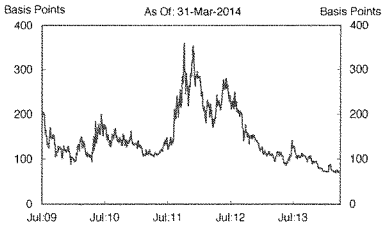
Liquidity profiles continued to improve in 2013. As of the fourth quarter of 2013, the consolidated liquidity ratio (liquid assets/total assets) of all BHCs reached 22 percent, far above historical levels **(Chart 5.3.13)**.

The improvement in consolidated liquidity ratios since the crisis is driven in part by inclusion of two large broker-dealers that converted to BHCs in 2009, as well as the acquisitions of broker-dealers by BHCs in 2008. Broker-dealers typically have significant holdings of liquid assets, which are often encumbered and funded with shorter-term wholesale funding **(see Section 5.4)**.

In recent years, BHC liquidity profiles also have benefitted from large inflows of deposits, which have grown 29 percent since the first quarter of 2009, compared to 4 percent growth in total loans. The strong deposit growth, amid subdued loan growth due to economic uncertainty and an uneven recovery, has resulted in BHCs increasing cash balances and holdings of liquid securities.

The potential implementation of the LCR in the United States as part of the Basel III liquidity framework has also been a driver for improved liquidity profiles. The LCR as proposed by banking agencies, which would be fully implemented by 2017 if adopted, would require banking institutions to hold a sufficient amount of highly liquid assets to meet their liquidity needs during a short period of severe liquidity stress.

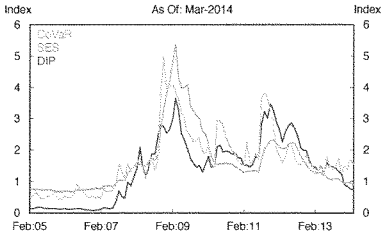
5.3.10 CDS Spreads of 6 Large Complex BHCs



Source: Markit Group Limited

Note: Equal-weighted average of BAC, C, GS, JPM, MS, WFC.

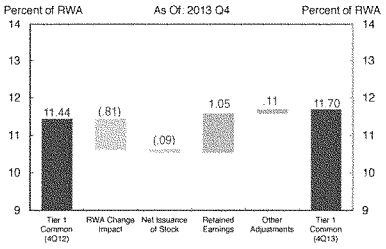
5.3.11 Systemic Risk Measures



Source: Bloomberg L.P., OFR calculations

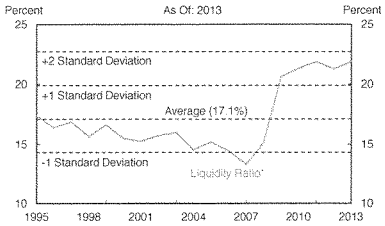
Note: Sample consists of BAC, C, JPM, WFC, GS, and MS. Measures are standardized by their historical volatility.

5.3.12 Change in Tier 1 Common Ratios for Aggregate U.S. BHCs



Source: FR Y-9C

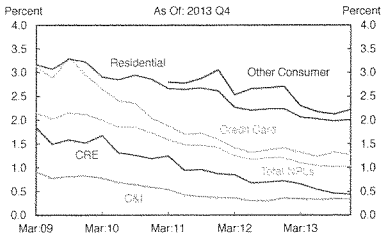
5.3.13 Consolidated BHC Liquidity Ratio



Source: FR Y-9C, SNL Financial, FSOC calculations

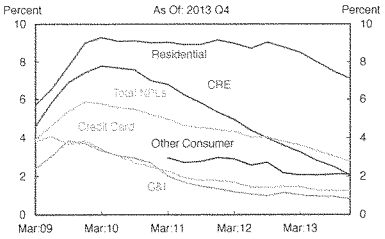
Note: Liquidity Ratio is the sum of Cash & Due From, FFS, Repos, U.S. Treasuries, U.S. Gov. Agencies and U.S. Gov. Sponsored Agencies divided by Total Assets. All top-tier BHCs included.

5.3.14 Nonperforming Loans (30-89 Days)



Source: SNL Financial

5.3.15 Nonperforming Loans (90+ Days and Nonaccrual)



Source: SNL Financial

Asset Quality

Asset quality also continued to improve in 2013. Nonperforming loans declined across all major categories **(Chart 5.3.14)**, led by declines in CRE. Residential loan delinquencies declined sharply during the year but remain elevated, as extended foreclosure timelines in many states keep longer dated delinquencies from being resolved **(Chart 5.3.15)**.

Net charge-offs (i.e., reductions to loan loss reserves) also declined significantly during the year, with declines across all loan categories, and in aggregate reached pre-crisis levels. As of the fourth quarter of 2013, the industry-wide net charge-off ratio was 63 basis points, a 37 basis point decline from the prior year **(Chart 5.3.16)**. Provisions (i.e., additions to loan loss reserves) as a share of loans also decreased to historical lows in 2013. Loan loss reserves have fallen since 2010, but remain slightly above pre-crisis levels. The ratio of loan loss reserves to annualized net charge offs has increased sharply over the past three years as net charge offs (ratio denominator) have declined much more significantly than loan loss reserves (ratio numerator) **(Chart 5.3.17)**.

DFAST and CCAR

In March, the Federal Reserve released the results of the 2014 annual Dodd-Frank Act stress tests (DFAST) and the CCAR. A total of 30 BHCs with $50 billion or more in total consolidated assets participated in the annual stress tests and CCAR, including 18 BHCs that participated in 2013.

DFAST is a forward looking exercise conducted by the Federal Reserve to evaluate whether the 30 BHCs have sufficient capital to absorb losses resulting from stressful economic and financial market conditions, using hypothetical supervisory scenarios designed by the Federal Reserve. In the nine quarters of the planning horizon covered in the stress test, the aggregate projected tier 1 common ratio for the 30 BHCs fell to a minimum level of 7.6 percent under the severely adverse scenario from 11.5 percent in

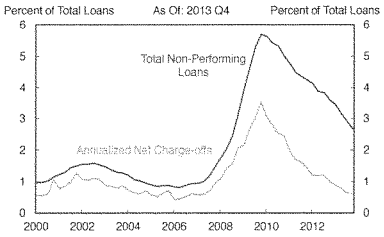
the third quarter of 2013 (**Chart 5.3.18**). The summary results showed that under the severely adverse scenario, projected minimum tier 1 common ratios for individual firms ranged from 0.7 to 8.1 percentage points lower than actual tier 1 common ratios in the third quarter of 2013.

Through CCAR, the Federal Reserve evaluates the capital planning processes and capital adequacy of the 30 BHCs, including the firms' proposed capital actions such as dividend payments and share buybacks and issuances. The Federal Reserve considers both qualitative and quantitative factors in analyzing a firm's capital plan. In 2014, the Federal Reserve did not object to the capital plans of 25 of the 30 BHCs and objected to the capital plans of five BHCs (**Chart 5.3.19**). Four of the objections were based on qualitative concerns about BHCs' capital planning processes. One of the objections was on quantitative grounds, as the firm's tier 1 common ratio fell below the 5 percent threshold under the severely adverse scenario. Following issuance of the initial CCAR results, Bank of America Corporation disclosed that it had incorrectly reported data used in the calculation of regulatory capital ratios in the stress tests. Based on these errors, the Federal Reserve determined that the firm must resubmit its capital plan and suspend planned increases in capital distributions. Bank of America must address the quantitative errors in its capital plan as part of the resubmission and undertake a review of its regulatory reporting to ensure there are no further errors.

Insured Commercial Banks and Savings Institutions

As of the fourth quarter of 2013, the banking industry was composed of 6,812 FDIC-insured commercial banks, savings institutions and BHCs with total assets of $14.7 trillion. There were 2,056 institutions with assets under $100 million and 666 institutions had assets over $1 billion. The number of institutions fell by 271 firms during 2013 due to failures and mergers. Failures of insured depository institutions

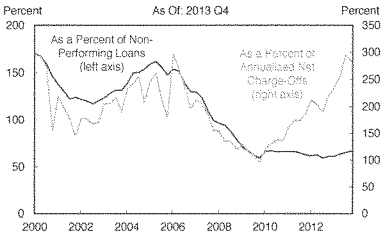
5.3.16 Credit Quality



Source: FRBNY Quarterly Trends Report

Note: For domestic BHCs and commercial banks.

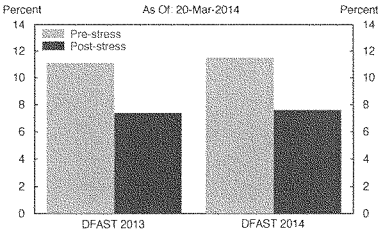
5.3.17 Loan Loss Reserves



Source: FRBNY Quarterly Trends Report, FSOC Calculations

Note: For domestic BHCs and commercial banks.

5.3.18 Initial and Stressed Tier 1 Common Capital Ratios



Source: Federal Reserve

Note: 2013 aggregate ratios are for 18 participants. 2014 aggregate ratios are for 30 participants. Stress ratios using severely adverse supervisory scenario.

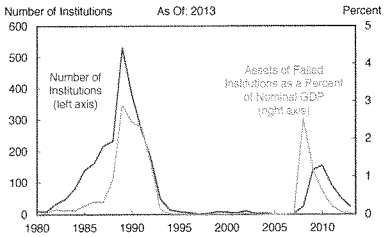
5.3.19 Federal Reserve's Actions in CCAR 2014

Non-Objection to Capital Plan		Objection to Capital Plan
Ally Financial	JPMorgan Chase	Citigroup
American Express	KeyCorp	HSBC North America
Bank of America*	M&T Bank	RBS Citizens Financial
Bank of New York Mellon	Morgan Stanley	Santander Holdings USA
BB&T	Northern Trust	Zions
BBVA Compass	PNC Financial	
BMO Financial	Regions Financial	
Capital One	State Street	
Comerica	SunTrust	
Discover Financial	U.S. Bancorp	
Fifth Third Bancorp	UnionBanCal	
Goldman Sachs*	Wells Fargo	
Huntington Bancshares		

Source: Federal Reserve

Note: Firms in blue are first-time CCAR participants. *Bank of America and Goldman Sachs resubmitted their capital plans after receiving results of DFAST. Bank of America is resubmitting its capital plan after incorrectly reporting regulatory capital.

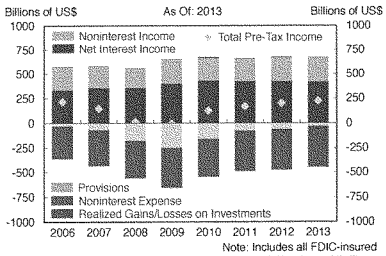
5.3.20 FDIC-Insured Failed Institutions



Source: BEA, FDIC, Haver Analytics

Note: No FDIC-insured institutions failed during 2005 and 2006.

5.3.21 Commercial Bank and Thrift Pre-Tax Income



Source: FDIC

Note: Includes all FDIC-insured commercial banks and thrifts.

continue to decline since the financial crisis, as 24 institutions with $6 billion in total assets failed in 2013 (**Chart 5.3.20**). This is the smallest number of failures since 2007.

As of December 31, 2013, 467 institutions, or 6.9 percent of all institutions, were on the FDIC's "problem bank" list, which includes institutions with financial, operational, or managerial weaknesses that require corrective action in order to operate in a safe and sound manner. That total is more than 45 percent lower than the most recent peak of 888 problem banks at the end of March 2011.

Pre-tax income for all U.S. commercial banks and savings institutions totaled $224 billion in 2013, representing a 12 percent increase from 2012. Continued improvement in credit quality, with an associated reduction in loan loss provisions and other expenses, has been the principal driver of the recovery in pretax net income since 2009 (**Chart 5.3.21**). The positive trend in asset quality indicators has been accompanied by a reduction in overall portfolio risk as evidenced by the post-crisis decrease in RWAs relative to total assets (**Chart 5.3.22**).

5.3.2 U.S. Branches and Agencies of Foreign Banks

Foreign banks also have a large presence in the United States. Together, assets of U.S. branches and agencies of foreign banks total $2.4 trillion. By comparison, FDIC-insured institutions—which do not include U.S. branches and agencies of foreign banks—hold $14.7 trillion in assets.

Cash and cash equivalents, particularly reserve balances at the Federal Reserve, have grown sharply since the crisis and continue to represent the largest asset category for foreign branches and agencies (**Chart 5.3.23**).

U.S. branches and agencies of foreign banks also dedicate a significant portion of their balance sheets to loans. Direct C&I loans outstanding by these banks typically constitute the largest portion of their loan portfolios.

The liability structures of U.S. branches and agencies of foreign banks also vary considerably. These U.S. branches lack access to the stable source of funds represented by households' checking, savings, and other transaction accounts, as they are not permitted to offer deposits insured by the FDIC. Instead, wholesale funding, particularly CDs issued primarily to institutional investors, provides the majority of funding for these institutions **(Chart 5.3.24)**.

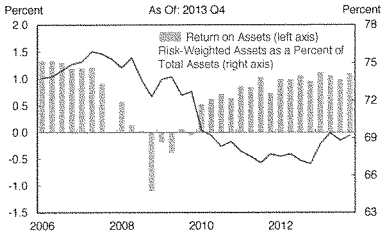
Pre-crisis, U.S. branches and agencies of foreign banks, in aggregate, obtained wholesale dollar deposits in the United States and used those deposits to provide dollar funding to their parent organizations and related affiliates, which in turn used the funds for lending and investment. Beginning in 2011, this trend reversed. For some institutions, flows from parent and related entities into U.S. branches and agencies served to stabilize U.S. branches experiencing deposit withdrawals stemming from European sovereign and banking sector concerns. More recently, dollar inflows to U.S. branches and agencies of foreign banks, in conjunction with an increase in U.S. deposit-taking (such as negotiable CDs) on the part of these institutions, have funded an accumulation of reserve balances at the Federal Reserve.

5.3.3 Credit Unions

Credit unions are member-owned depository institutions. As of the fourth quarter of 2013, there were 6,554 federally insured credit unions with aggregate assets of nearly $1.1 trillion. More than three quarters of credit unions (5,099) had assets under $100 million, while 426 credit unions had assets over $500 million.

Corporate credit unions—which provide critical services to the broader credit union system—continue to consolidate and deleverage as they refocus their business models on providing operational support to consumer credit unions, raising capital, and adjusting to the new regulatory environment. As of December 2013, there were 15 corporate credit unions with $18.5 billion in assets serving consumer credit

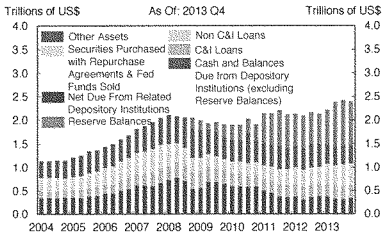
5.3.22 Risk-Weighted Assets and Return on Assets



Source: FDIC, Haver Analytics

Note: All FDIC-insured institutions.

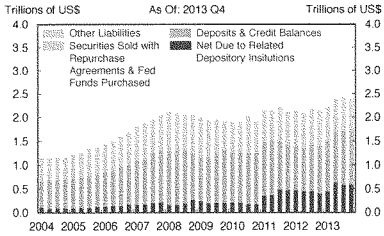
5.3.23 U.S. Branches and Agencies of Foreign Banks: Assets



Source: Federal Reserve, Haver Analytics

Note: Other assets includes government securities, asset-backed securities, and other trading assets.

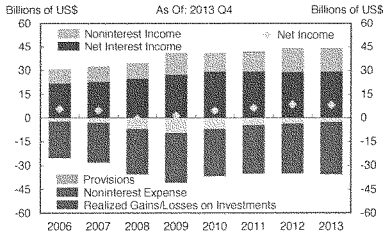
5.3.24 U.S. Branches and Agencies of Foreign Banks: Liabilities



Source: Federal Reserve, Haver Analytics

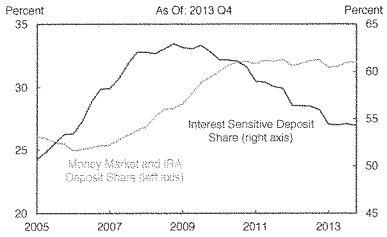
Note: Other liabilities includes transaction accounts, non-transaction accounts, and other borrowed money.

5.3.25 Federally Insured Credit Union Income



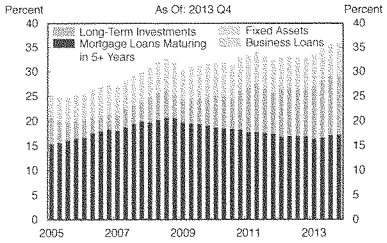
Source: NCUA

5.3.26 Credit Union Deposits



Source: NCUA

5.3.27 Credit Union Long-Term Assets



Source: NCUA

Note: Percent of net long-term assets.

unions—a decline from 27 corporate credit unions with $96 billion in assets in December 2007.

Annual net income at credit unions was about $8.14 billion in 2013 **(Chart 5.3.25)**, a decline of 3.8 percent from 2012. The amount of outstanding loans at credit unions increased by 8.0 percent (year-over-year) during 2013. This was an increase from 4.6 percent in 2012. The credit union system experienced return on average assets (ROA) of 78 basis points in 2013, a decrease from 85 basis points in 2012. The decline in ROA reverses a four-year period of rising ROA. In 2011 and 2012 ROA increased even as net-interest margin compressed. The ROA growth during this four-year period was primarily driven by reductions in provisions for loan losses. As provisions for loan losses have returned to their pre-crisis levels, the industry-wide trend of NIMs is more clearly reflected in earnings. NIMs declined to 2.8 percent in 2013 from 2.9 percent in 2012 and are down 45 basis points from 2010.

A key concern for the industry is ongoing challenges related to the low interest rate environment and the eventual transition process to a higher rate environment, potentially with a flatter yield curve. Although interest rate sensitive deposits continue to decline as a share of total liabilities, they remain well above pre-crisis levels and the share of money market accounts and individual retirement accounts continues to increase **(Chart 5.3.26)**. Net long-term assets continue to increase as a share of assets despite the decline in the share of mortgages maturing in five years or longer **(Chart 5.3.27)**. It appears that, having exhausted other sources of earnings growth, some credit unions are reaching for yield by lengthening their term of investments to boost near-term earnings.

Investments in total have increased, rising from 19 percent of assets in the fourth quarter of 2006 to over 28 percent in the second quarter of 2013. Total investments as a share of assets declined somewhat during the second half of 2013 to just under 27 percent. But over the year, investments with a maturity of less than three years fell 13 percent—a decline of almost $25 billion—while investments with a maturity of more than three years rose by 31 percent—a rise of $30 billion **(Chart 5.3.28)**. The slight increase in long-term interest rates in 2013 has already had a substantial effect on the market value of these investments. At the end of 2012, credit unions had an unrealized gain of $2.8 billion from held-to-maturity and AFS securities. By the end of 2013, this gain had reversed to an unrealized loss of $2.4 billion **(Chart 5.3.29)**. In addition to federally insured credit unions, there are 133 non-federally insured credit unions operating in nine states. These credit unions, which are insured privately and not backed by NCUA share insurance, had $13.4 billion in combined assets at the end of 2013 and served 1.2 million members.

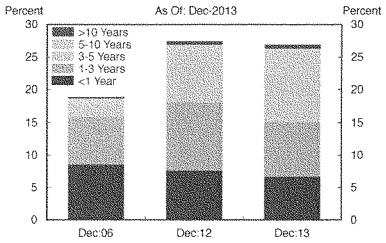
5.4 Nonbank Financial Companies

5.4.1 Securities Broker-Dealers

As of the fourth quarter of 2013, there were 4,378 domestic and foreign-owned securities broker-dealers registered with the SEC. The U.S. broker-dealer sector remains relatively concentrated, with about 60 percent of industry assets held by the top 10 broker-dealers at the end of 2013, the largest of which are affiliated with domestic BHCs or foreign banks. Aggregate annual revenues of broker-dealers increased by approximately 3.4 percent in 2013 to $71.2 billion, with increases in all categories, except in trading and other revenues related to the securities business **(Chart 5.4.1)**.

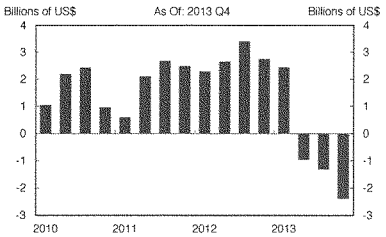
Assets held within the U.S. broker-dealer industry declined modestly in 2013 to $4.6 trillion **(Chart 5.4.2)**. Broker-dealer leverage similarly declined slightly in 2013, after decreasing markedly during the crisis to a level last seen in the early 1990s and remaining

5.3.28 Credit Union Investments by Maturity



Source: NCUA

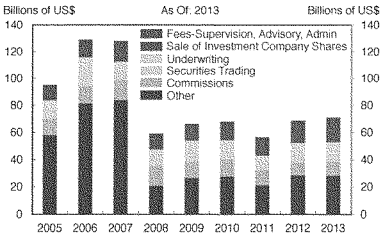
5.3.29 Credit Union Unrealized Gains on AFS and HTM Securities



Source: NCUA

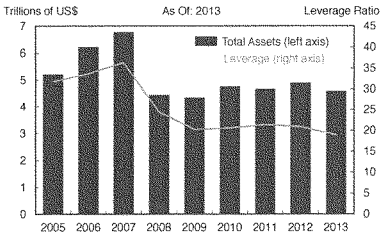
Note: AFS=Available for Sale and HTM=Held to Maturity

5.4.1 Broker-Dealer Revenues



Source: FINRA

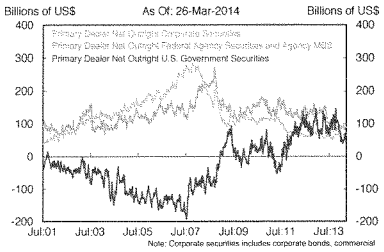
5.4.2 Broker-Dealer Assets and Leverage



Source: FINRA

Note: Leverage is the ratio of total assets to equity.

5.4.3 Primary Dealer Securities



Source: FRBNY

Note: Corporate securities includes corporate bonds, commercial paper, non-agency residential MBS, and other CMBS.

relatively stable since the crisis. Measured as total assets as a multiple of equity, broker-dealers operate at 19 times leverage in aggregate (well below the peak of 36 times in 2007); measured as total assets as a multiple of regulatory capital, broker-dealers operate at 13 times leverage in aggregate.

Dealer assets consist primarily of securities borrowed in securities financing transactions and trading inventory held for market-making and proprietary trading purposes. After the financial crisis, there were significant changes in the composition of net positions held by large dealers operating in the U.S. For example, primary dealers (dealers that have a trading relationship with the Federal Reserve) increased holdings of U.S. government securities and reduced holdings of corporate securities, including ABS, agency MBS and agency debt, reflecting changes in risk appetite and balance sheet capacity **(Chart 5.4.3)**.

In 2013, further changes occurred in the positions held by primary dealers, which pared net positions across rate-sensitive assets, such as Treasuries, agency MBS, and agency debt. Dealer holdings of Treasuries declined significantly in the second half of the year. These declines likely reflect a reduction in dealer risk appetite and adjustments to regulatory changes. It also appears that dealers were affected by events in May and June 2013 that caused uncertainty on the general direction of monetary policy, and concomitant volatility in bond prices and interest rates. In response to these developments, dealers sold off bonds to cut their risk exposures and reduce inventory **(see Box C)**.

5.4.2 Insurance Companies

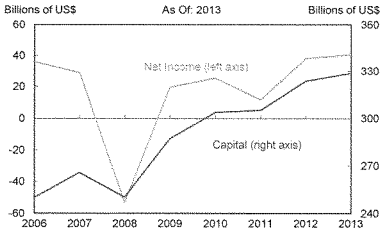
The U.S. insurance industry is composed of over 3,700 operating insurance companies, which are broadly defined by the insurance products they sell: Life insurers provide coverage for human life contingencies such as unexpected death and retirement savings products like annuities, while property and

casualty (P/C) insurers provide coverage on homes, cars, and businesses. All figures in this section are from statutory insurance filings, which only include operating insurance companies and underestimate the total size of the U.S. insurance industry because subsidiaries such as asset managers and foreign subsidiaries are excluded. According to statutory data, the U.S. life insurance industry has approximately $6.0 trillion in assets, which is more than three times those of P/C insurers who hold $1.7 trillion. Approximately 80 percent of life insurance assets are held in the 25 largest companies, compared to a 67 percent concentration for the P/C industry.

Life insurance revenue from insurance and annuity products decreased to $583 billion in 2013 from the record $645 billion set in 2012. Expanded product distribution channels and a more favorable interest rate environment led to higher fixed annuity sales, but a number of one-time transactions and increased reinsurance cession overcame the improved fixed annuity sales and led to the decrease in total revenues. Despite rising significantly in 2013, interest rates remained well below historical averages and continued to weigh on life insurance investment yields. Life insurers' investment portfolios turn over at a slow rate because they mostly hold long duration assets until maturity. Since market interest rates are still below the yield earned on maturing assets, life insurers' average portfolio yields continued to decline in 2013, albeit at a slower rate than in 2012. Nonetheless, the life sector's net income rose 6.8 percent to $41 billion, a record high (**Chart 5.4.4**). Rising equity markets benefited life insurers as customers paid higher fees on higher equity account balances.

P/C revenue from insurance products increased 3.9 percent to $544 billion in 2013, a record high. Rates charged by insurers to policyholders increased moderately in most commercial lines of business led by strong sales of workers' compensation and demand for personal auto insurance. Net income increased to a record level of $70 billion, or an increase of 91.5

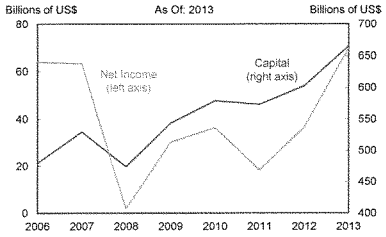
5.4.4 Life and Other Insurance: Capital and Net Income



Source: NAIC

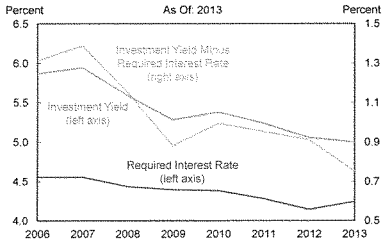
Note: Includes accident and health.

5.4.5 Property and Casualty Insurance: Capital and Net Income



Source: NAIC

5.4.6 Life Insurers: Impact of Low Rate Environment



Source: NAIC, SNL Financial

percent from 2012, as expenses and losses paid on claims declined and there were no major storms during the hurricane season in 2013 **(Chart 5.4.5)**. Improved profitability increased capital held by P/C operating insurance entities to $665 billion, or an increase of 10.4 percent over 2012.

As noted above, low interest rates present a challenge to insurers as net yield on invested assets continued to decline in 2013 **(Chart 5.4.6)**. Life insurance companies are more sensitive to interest rates than P/C companies because investment income accounts for a higher percentage of revenue (21 percent in 2013) than for the P/C sector (9 percent in 2013). In addition, many life insurance and annuity products are spread-based, and a protracted low interest rate environment may stress life insurers' profits as the spread between investment yields and the rate promised to policyholders compresses. Legacy products in particular (including annuities, long-term care, and universal life insurance with secondary guarantees) have been less profitable in the current interest rate environment, as they were originally priced and sold under differing market conditions. To adapt to current financial conditions as well as changing demographic trends, companies have redesigned offerings and discontinued product lines. The current low interest rate environment also may affect the use of captive reinsurance: the low rates affect the present value of insurers' contract obligations (increasing the present values of future obligations), and therefore may encourage use of reinsurance for insurance products with liability valuations that are interest-rate-sensitive **(see Box E)**.

BOX E: Concerns Related to Captive Reinsurance

Captive insurance entities were originally formed by corporations and non-profit organizations seeking to self-insure their own insurable business risks such as general liability, workers' compensation, employee benefits, and automobile coverage. Over time, commercial life insurance companies formed captive reinsurers to reinsure policyholder risks. As with primary insurers, captive reinsurers are regulated by their licensing state or country of domicile. However, because captive reinsurers originally only provided self-insurance coverage of business insurable risks as opposed to policyholder risks, state captive regulation originally developed separately from primary insurance regulation, which places more emphasis on solvency and policyholder protection. Although captive reinsurance transactions must be approved by both the captive and primary insurer's regulators, the opportunity for regulatory arbitrage arises because of state-by-state differences in oversight, accounting, and capital requirements for the two types of entities. In addition, in most instances, unlike primary insurers, reinsurance captives are required neither to file public statutory financial statements nor to follow the same regulatory accounting practices as primary insurers.

Some life insurance organizations have been using captive reinsurance companies for many years to, at least in part, obtain relief from certain regulatory requirements. Importantly, the use of captive reinsurance by a life insurer impacts results reported on a regulatory accounting basis rather than U.S. generally accepted accounting principles (GAAP) accounting. For example, life insurance captives became popular for reinsuring level premium term life insurance and universal life insurance with secondary guarantees. Both products have statutory liability reserve requirements that exceed the expected economic risks and the use of captive reinsurance transactions allow for the reduction of required regulatory capital. In the last decade, the use of captive reinsurance by life insurers has grown significantly and has expanded to other types of product risks, the full scope of which has yet to be determined. Of particular concern is the use of captives to reinsure insurance products with liability valuations that are volatile, cyclically sensitive, or interest rate sensitive, such as variable annuities with guaranteed living benefits and long-term care insurance.

In addition, captive reinsurers may hold riskier asset portfolios, including higher exposures to derivatives, than is generally permitted under state law for primary insurers. Also, instead of holding high-quality liquid collateral in trust to cover reserves reinsured to captives, insurance companies can sometimes collateralize a portion of the reserves held at captives with bank letters of credit that are guaranteed by their parent holding companies or, as allowed in some states, use a direct guarantee from the parent holding company in lieu of any third-party collateral. If the parent company providing a guarantee to a captive were to experience financial distress and become unable to properly capitalize the captive, the primary insurer could lose credit for the reinsurance on its statutory balance sheet and could experience a capital shortfall as a result. This could complicate the orderly resolution of a large insurance organization. Furthermore, an insurance organization could face funding rollover risk in a period of financial distress to the extent that its captive uses bank letters of credit to support longer-duration liabilities.

All of these factors can add complexity and reduce transparency around the financial condition and potential resolvability of certain life insurance companies. Regulators and rating agencies have noted that the broad use of captive reinsurance by life insurers may result in regulatory capital ratios that potentially understate risk. During times of financial market volatility when reserve and capital levels for some products should increase, an insurance company that uses captive reinsurance may not be required to hold higher reserves and capital. This could become a financial stability concern if a large, complex insurance organization were to experience financial distress.

Regulatory Developments

State insurance regulators are continuing work to address the challenges of state-by-state differences in the oversight of captives. Specifically, state regulators, through the National Association of Insurance Commissioners (NAIC), are seeking to develop and then implement consistent regulatory controls for reinsuring term life insurance and universal life insurance with secondary guarantees; proposing changes to the NAIC's accreditation program for state regulators which would require U.S. reinsurance captives to be subject to the U.S. solvency framework; and considering further refinements to collateral requirements for captive reinsurance transactions involving letters of credit. State regulators are also in the process of preparing for the implementation of a principles-based reserve valuation system, which would allow life insurers to "right-size" reserves based on credible insurance company experience data. The implementation of principles-based reserving may eliminate the need to use captive reinsurance for the purpose of reducing reserves that are significantly higher than expected losses.

In addition to the work being done by state insurance regulators, reports completed by Council members and member agencies including the Treasury's FIO and OFR have identified concerns regarding life insurers' use of captives. The Federal Reserve also recently issued a Supervision and Regulation Letter concerning the effects of risk transfer activities on capital adequacy, which would apply to captive reinsurance risk transfer transactions for insurance companies it supervises when they become subject to the Federal Reserve's risk-based capital framework. Further, the FIO is monitoring both the role and impact of captives in the sector and the potential for regulatory improvements at the state level.

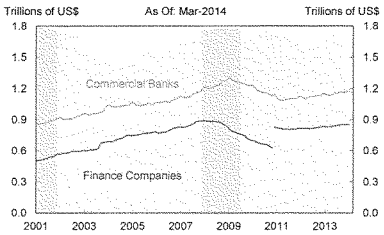
5.4.3 Specialty Finance Companies

Specialty finance companies provide credit to both consumers and businesses. Examples of consumer credit include revolving credit and student, mortgage, and auto loans, while examples of business credit include equipment leasing, accounts receivable factoring and other major capital asset financing. Specialty finance companies may be either independent companies, captives of vehicle or equipment manufacturers, or subsidiaries of financial holding companies. Credit activity in the specialty-lending sector continued to expand in 2013, yet still remains below pre-crisis levels. Overall, nonbank financial companies owned approximately $855 billion of consumer loans, $157 billion of real estate loans, and $402 billion of business loans at year end 2013 (**Charts 5.4.7, 5.4.8**).

The securitization market for these credit types originated by both bank and nonbank financial companies remained healthy in 2013, while overall issuance volume declined approximately 7.5 percent from 2012 due in part to a decrease in securitization of government guaranteed student loans. In the auto ABS market, which comprises the largest share of consumer ABS, many benchmark prime issuers reduced their securitization volumes, electing to tap alternate funding sources, such as corporate bond markets. Subprime auto ABS issuance increased moderately year-over-year. Student loan ABS issuance declined in 2013 as the amount of government-guaranteed issuance continues to dwindle after the elimination of the Federal Family Education Loan Program in 2010 (**Chart 5.4.9**).

Senior credit spreads on credit card and auto ABS are slightly wider than they were at the start of 2013, as the spread widening that occurred following the June 2013 selloff (**See Box C**) did not fully retrace due to more moderate demand in anticipation of changes to the interest rate environment. Subordinate tranche credit spreads tightened moderately during the second half of 2013, due to a combination of reach for yield by investors and

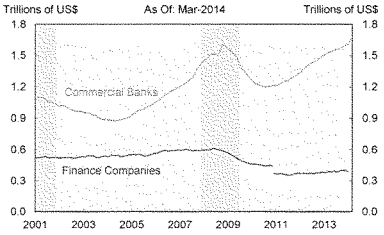
5.4.7 Consumer Loans Outstanding



Source: Federal Reserve, Haver Analytics

Note: Loans owned and securitized. Series break in December 2010 for consumer loans outstanding at finance companies due to change in data collection methodology. Gray bars signify NBER recessions.

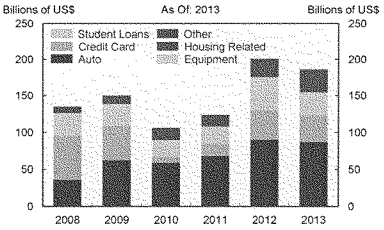
5.4.8 Business Loans Outstanding



Source: Federal Reserve, Haver Analytics

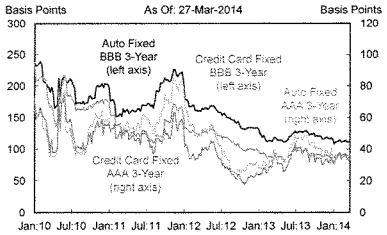
Note: Loans owned and securitized. Series break in December 2010 for business loans outstanding at finance companies due to change in data collection methodology. Gray bars signify NBER recessions.

5.4.9 ABS Issuance



Source: Thomson Reuters, SIFMA

5.4.10 Selected ABS Spreads



Source: Barclays

Note: Spreads to Treasury securities.

lower subordinate tranche supply relative to senior tranches (**Chart 5.4.10**).

5.4.4 Agency REITs

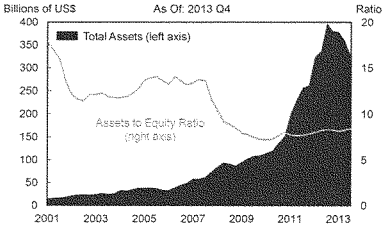
Agency MBS REITs use short-term debt, mainly in the form of bilateral repos, to fund the purchase of agency MBS. Most agency MBS REITs also use derivatives to hedge at least a portion of the inherent duration mismatch between their assets and liabilities. However, prepayment risk and basis risk limit the efficacy of hedging with interest rate derivatives. Consequently, agency MBS REITs' investment strategy exposes them to interest rate risk resulting from changes in the yield curve and convexity risks, or the risk of MBS prices falling at an increasing rate when rates rise. Convexity risk is particularly acute for agency MBS REITs since their use of leverage can magnify the negative effects of any material increase in interest rate volatility. Additionally, agency MBS REITs are exposed to rollover risk, or the risk of an increase in financing costs or a pullback in the willingness of lending counterparties to extend credit when their short-term repo matures.

On net, REITs earn the yield on the underlying MBS less the cost of financing and hedging the portfolio. REITs' earnings are not taxed at the corporate level. They are only taxed when equity holders receive the earnings in the form of a dividend. To maintain their REIT status, these entities must comply with various income and asset tests, as well as distribute at least 90 percent of their taxable income to equity holders. Given their tax status, dividend payout requirements and use of leverage, REITs are able to offer relatively high dividend yields which some institutional and retail equity investors find attractive.

The year 2013 proved to be a particularly challenging year for agency MBS REITs as rising interest rates and widening MBS spreads weighed heavily on their portfolios. The events that transpired throughout 2013 gave observers insight into how these entities would react to adverse market conditions. In the face

of declining asset values, many REITs sold a portion of their agency MBS holdings, reduced leverage and bolstered hedges **(Chart 5.4.11)**. The 12 largest publically traded agency MBS REITs reduced their agency MBS exposure by roughly $111 billion, or 28 percent of peak holdings. While it appears this REIT selling may have exacerbated negative price action in agency MBS, there were no major market disruptions. The heavy losses and aforementioned defensive portfolio positioning resulted in a significant reduction of net income, which in turn inhibited their ability to maintain dividend payouts. Correspondingly, shares of major agency MBS REITs declined notably, with many falling between 20 and 30 percent year-over-year **(Chart 5.4.12)**. The market value of equity for most REITs declined 10 to 20 percent below their corresponding book value, a rare occurrence for agency MBS REITs. When the market value of equity declines below the book value, agency MBS REITs will find it difficult to raise new equity capital and purchase additional agency MBS. On these occasions, REITs have an incentive to sell agency MBS holdings and repurchase shares in the open market, a trend that materialized and persisted throughout the second half of 2013. Lastly, despite heightened MBS price volatility in last years' selloff, agency MBS REITs did not report any material changes to funding conditions.

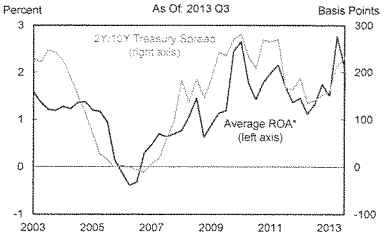
5.4.11 Total Agency REIT Assets and Leverage



Source: Bloomberg, L.P.

Note: Data for 12 largest publically traded agency MBS REITs. Assets to equity ratio is weighted by market capitalization.

5.4.12 Agency REITs: Return on Assets



Source: Bloomberg, L.P.

Note: *Weighted by market capitalization.

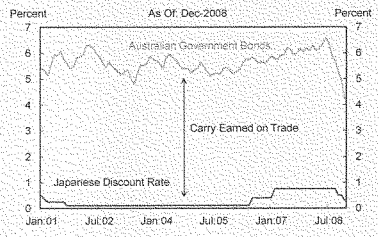
BOX F: Carry Trade Strategies and Susceptibility to Shocks

In recent years, carry trades have become an increasingly popular investment strategy. "Carry" broadly means the difference between the yield or return on a financial contract or asset and the cost of funds. If the yield or return is higher (lower) than the cost of funds, the investor is said to have positive (negative) carry. Volatile swings in asset prices or spikes in borrowing costs can quickly erase expected gains from positive carry. A sharp rise in volatility among seemingly uncorrelated assets can cause a forced exit of carry trades leading to market dislocations.

The carry trade is most often found in currency and fixed income markets. For example, in 2001, an investor could borrow Japanese yen (JPY), at funding costs close to zero, and invest in Australian (AUD) denominated government securities yielding over 5 percent. As long as the AUD/JPY exchange rate remained stable or the Australian dollar strengthened, the investor would maintain positive carry of about 5 percent or more **(Chart F.1)**. This trade persisted until global asset markets experienced significant volatility during the summer of 2008. When volatility increased, investors exited this trade, which strengthened the yen and exacerbated currency movements that negatively impacted this strategy **(Chart F.2)**.

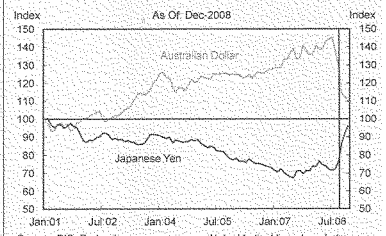
Periods of low market volatility, such as in recent years, make carry trades popular among investors. Persistently low interest rates can also incentivize a search for yield and a higher degree of risk taking in carry trades. These incentives can lead to a buildup of leveraged risks among market participants. Should risks become greater than expected, investors may exit carry trades on a "first out" basis. Such a scenario, especially in illiquid markets, could lead to forced selling in which one trade after another is exited. This could cause negative spillover effects with financial stability implications to markets and institutions.

F.1 Interest Rate on Government Bonds and Discount Rate



Source: IMF, Federal Reserve

F.2 Real Effective Exchange Rate Returns



Source: BIS, Federal Reserve

Note: Vertical line placed at September 2008. Jan-2001 = 100.

5.5 Investment Funds

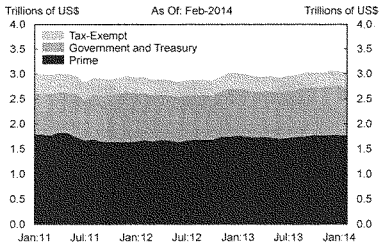
5.5.1 Money Market Funds

MMFs are a type of mutual fund that invests in certain high quality short-term securities as defined by the SEC. Subject to compliance with the investment restrictions, MMFs are permitted to use the amortized cost method of valuation and/or the penny-rounding method of pricing to facilitate a stable NAV, commonly $1 per share, for subscriptions and redemptions. There are three main categories of MMFs: prime funds, which invest primarily in corporate debt securities; government and Treasury funds, which invest primarily in U.S. federal government securities; and tax-exempt funds, which invest primarily in short-term, tax-exempt securities of local and state governments. Prime MMF assets increased slightly in 2013 from $1.76 trillion to $1.79 trillion, while government and Treasury MMF assets increased from $949 billion to $981 billion **(Chart 5.5.1)**. Tax-exempt MMFs declined from $299 billion to $281 billion. Taken together, MMFs held just over $3 trillion in assets as of December 2013, or about 18 percent of total mutual fund assets under management (AUM), according to the Investment Company Institute.

The last two years have been a period of persistent consolidation in the MMF industry, with the number of MMFs dropping from 629 at the start of 2012 to 555 at the end of 2013. In the sustained low-interest rate environment, competitive measures have led fund managers to offer fee waivers to MMF investors to prevent negative net yield, which contributed to fund consolidation.

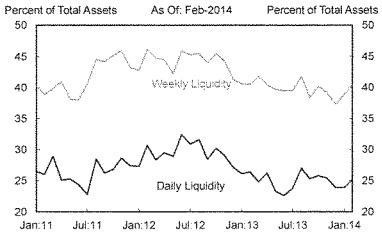
During 2013, MMFs decreased liquidity levels and increased the weighted-average life of their fund portfolios **(Charts 5.5.2, 5.5.3)**. In particular, the weighted-average life of non-traditional repo held in MMF portfolios lengthened from 17.7 days at the end of 2012 to 30.3 days at the end of 2013.

5.5.1 MMF Assets by Fund Type



Source: SEC

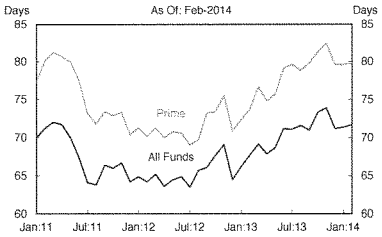
5.5.2 Liquidity of Prime MMFs



Source: SEC

Note: Weighted by fund size.

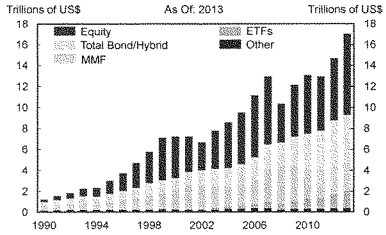
5.5.3 Weighted Average Life of MMFs



Source: SEC

Note: Weighted by fund size

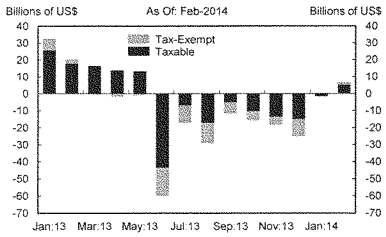
5.5.4 Growth in Assets of the Investment Company Industry



Source: ICI Factbook 2013, Flow of Funds, ICI, Haver Analytics

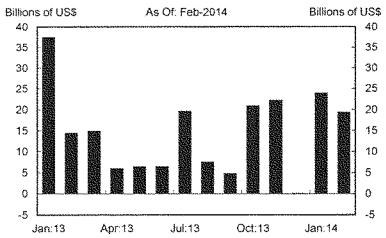
Note: Other = Unit Investment Trusts and Closed-End Funds.

5.5.5 Monthly Bond Mutual Fund Flows



Source: ICI, Haver Analytics

5.5.6 Monthly Equity Mutual Fund Flows



Source: ICI, Haver Analytics

While the ranking changed slightly from 2012 to 2013, prime MMFs continued to have the heaviest geographical exposures to the United States, Canada, Japan, France, and Australia/New Zealand. Notably, MMF exposure to Chinese banks has increased steadily since exposures first appeared in portfolios in November 2011. However, at $5.9 billion at the end of 2013, it is still a very small percentage of prime MMF assets (0.3 percent).

Another notable change for MMFs in 2013 was the introduction of the Overnight Fixed-Rate Capped-Allotment Reverse Repurchase Agreement Operational Exercise, which the Federal Reserve has undertaken as part of its effort to test potential tools for future implementation of monetary policy. As a consequence of this exercise, investors in short-term funding markets, including MMFs, now have an additional, albeit potentially temporary, high-quality liquid investment option. As of December 31, 2013, prime MMFs held 44 percent of these repos, and all MMFs together held over 78 percent.

5.5.2 Mutual Funds

The U.S. mutual fund industry has grown from AUM of approximately $1 trillion in 1990 to $17 trillion in December 2013 (Chart 5.5.4). Long-term (equity and bond/hybrid) funds, with assets of almost $12.3 trillion, made up 72 percent of total AUM as of December 2013.

In the wake of the 2008 financial crisis there was a significant flow of cash into bond funds, accompanied by a lesser but still significant flow of cash out of equity funds. From January 2009 to December 2012, approximately $1,044 billion of new cash flowed into bond funds while approximately $306 billion flowed out of equity funds **(Chart 5.5.4)**. This trend reversed in 2013 as taxable bond funds had net redemptions of $25 billion (compared to net inflows of $254 billion in 2012) while tax-exempt bond funds had net redemptions of $58 billion **(Chart 5.5.5)**. This contrasts with equity funds, which had a net inflow of $161 billion in 2013 (89 percent into international funds

and 11 percent into domestic stock funds) after recording a net outflow of $153 billion in 2012 (**Chart 5.5.6**). Equity funds had not had net inflows since 2007.

The month of June 2013 marked a turning point in bond fund flows. After taxable bond funds had net inflows of $87 billion from January through May 2013, they had net redemptions of $112 billion from June through December, as markets anticipated that the Federal Reserve would reduce its $85 billion-per-month bond buying program and economic conditions improved. Taxable bond funds had net inflows for every week from January through May and net outflows for all but three weeks from June through December.

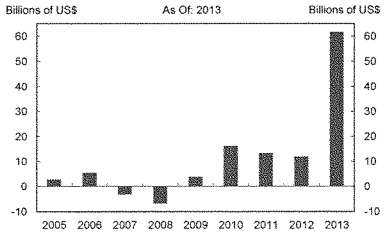
By far the most popular bond fund category in 2013 was corporate short-term bond funds. These funds, which primarily invest in lower-rated bank loans, had net inflows of $62 billion in 2013, or about five times the 2012 net inflow (**Chart 5.5.7**). With interest rates still near historical lows, investors who are reluctant to take on interest rate risk in the form of longer duration bonds have been attracted to this fund category.

5.5.3 Pension Funds

As of the third quarter of 2013, the combined AUM of private and public pensions, including federal pensions and defined contribution plans, were almost $16 trillion (**Chart 5.5.8**).

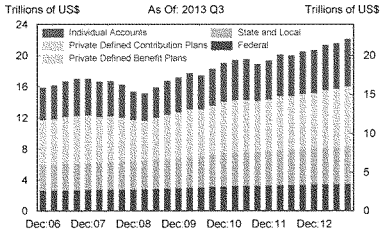
Corporate defined benefit funded status–the estimated share of fund liabilities covered by current assets-improved in 2013 (**Chart 5.5.9**). One estimate of the funded status of the 100 largest corporate pension plans reached 94 percent in November 2013, and some large plans reached full funding in 2013. The improvement of the aggregate corporate funded status resulted in part from the increase in the corporate pension liability discount rate over the course of 2013. Corporate pension discount rates are closely tied to corporate bond rates, which rose during the year in tandem with the rise in Treasury yields. Additionally,

5.5.7 Bank Loan Mutual Funds: Annual Flows



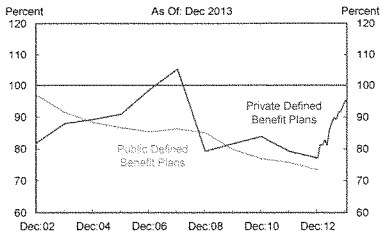
Source: Morningstar, Inc.

5.5.8 Retirement Fund Assets by Plan Type



Source: Flow of Funds, Haver Analytics

5.5.9 Public and Private Pension Funding Level



Source: Public Fund Survey, Milliman

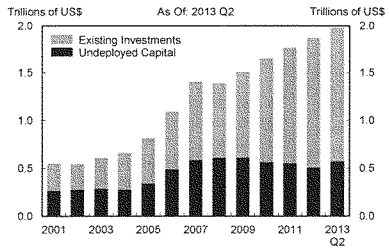
high returns in equities and alternative assets helped to improve funded status.

In contrast, based on 2013 data, several important multi-employer plans have low funding levels due to several causes, including the structure of the multi-employer pension system and changing demographics of plan participants. The Pension Benefit Guaranty Corporation multi-employer insurance fund also faces a projected inability to meet its obligations due in part to the combination of insufficient premium payments and critical funding status of a set of multi-employer plans.

U.S. public pension funds are also notably underfunded with a roughly 74 percent aggregate funding level. Of note, however, is that these estimates are based on 2012 data (the latest available) and do not include 2013 equity market gains. On the other hand, public pension funds generally use a different set of accounting rules than private pension funds, enabling them to assume a discount rate based on long-run returns. These estimated long-run returns are significantly higher than average post-crisis returns, and could result in an artificially high funding status.

Several localities and states, such as Detroit, Chicago, Vallejo, Puerto Rico, Connecticut, and Illinois currently face very low levels of public pension funding. States and municipalities may face important constraints in addressing pension funding gaps. Detroit's bankruptcy case could become a precedent for other cash-strapped municipalities **(see Section 4.3.2)**. Also, pension benefits may be protected by statute or constitutional law. Additionally, some attempts by public pensions to curtail benefits have been challenged in court, and related litigation is ongoing.

5.5.10 U.S. Private Equity AUM



Source: Preqin

5.5.4 Private Equity

U.S. private equity AUM increased to approximately $2 trillion in 2013 **(Chart 5.5.10)**. Sponsor-backed debt issuance remained strong in a historical context, with refinancing being the main use of proceeds in the first half of

2013, and debt related to new leveraged buyouts increasing notably in the latter half of 2013. The issuance of sponsor-backed payment-in-kind bonds, which are financing vehicles used by private equity firms that are typically viewed as highly risky for investors, spiked in the third quarter 2013. Nonetheless, both the volume of payment-in-kind bonds and their percentage of total issuance remain substantially below pre-crisis levels **(Chart 5.5.11)**.

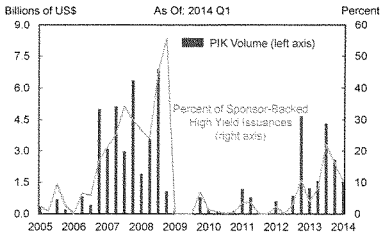
5.5.5 Hedge Funds

Hedge fund industry assets grew to an estimated $2.6 trillion in 2013, a 17 percent increase from 2012 **(Chart 5.5.12)**. The growth in 2013 was mainly driven by positive investment performance **(Chart 5.5.13)**. Large funds continued to receive the majority of aggregate net inflows in 2013 **(Chart 5.5.14)**. Meanwhile, funds of hedge funds continue to lose popularity relative to standalone funds, as 2013 was the sixth consecutive year of net capital outflows for these types of funds.

Responses to the Federal Reserve's Senior Credit Officer Opinion Survey on Dealer Financing Terms conducted in June 2013 indicated that hedge fund financial leverage was roughly halfway between the pre-crisis peak and post-crisis trough. The findings differed somewhat by hedge fund strategy: about one-fifth of dealers reported that equity-oriented and macro-oriented funds were utilizing levels of leverage near to or at the pre-crisis peak.

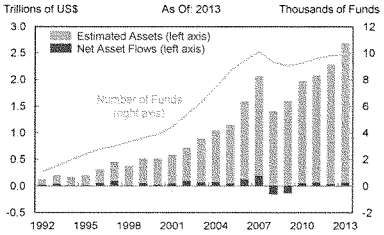
According to form PF data from year-end 2012, the mean financial leverage of the top 100 funds—measured by gross asset value divided by NAV—ranges from 1x to 18x for funds in the first and fourth quartile of the distribution of financial leverage, respectively. The source of this leverage is primarily repo transactions and prime broker financing. For gross leverage, defined as gross notional exposure divided by NAV, the corresponding measures range from 1x to 57x. Gross notional exposure includes synthetic leverage provided by derivatives, measured as the sum of absolute notional values of long and short positions.

5.5.11 Sponsor-Backed Payment-in-Kind Bonds



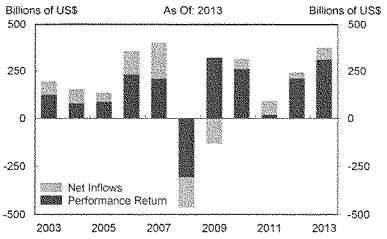
Source: S&P LCD

5.5.12 Hedge Fund Assets and Net Asset Flows



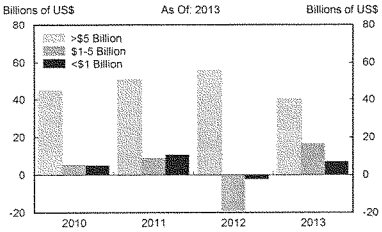
Source: Hedge Fund Research, Inc.

5.5.13 Change in Hedge Fund AUM



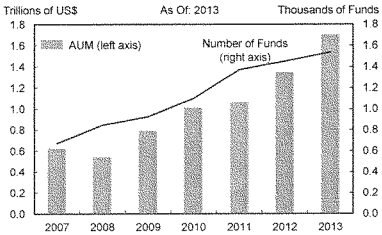
Source: Hedge Fund Research, Inc.

5.5.14 Hedge Fund Net Asset Flows by AUM



Source: Hedge Fund Research, Inc.

5.5.15 U.S.-Listed ETP AUM and Count



Source: Morningstar, Inc.

5.5.6 Exchange-Traded Products

Exchange-traded products (ETPs) include ETFs, exchange-traded notes and other investment vehicles. Since their creation, ETPs have expanded from primarily offering exposure to equity market indices to also investing in commodities, currencies, and other non-securities instruments, such as loans and precious metals. ETPs are often used as a means to achieve exposure to a market sector or index in a manner that is potentially more efficient and cost-effective than a traditional mutual fund, investment product, or financial instrument. Intra-day pricing and secondary markets for ETPs can provide higher levels of liquidity than other fund vehicles that price daily, such as mutual funds.

U.S.-listed ETP assets grew by 26 percent to $1.7 trillion in 2013 and the number of U.S.-listed ETPs grew to 1,536 **(Chart 5.5.15)**. U.S. equity ETP aggregate net inflows were $199 billion in 2013, up from $124 billion in 2012. U.S. bond ETPs, however, experienced net inflows of only $7.7 billion, down from a net inflow of over $55 billion in 2012. In contrast to equity and bond ETPs, commodity ETPs experienced aggregate net outflows of $30 billion in 2013.

ETFs referencing fixed income and EM assets underwent a period of increased volatility in the middle of 2013, reflecting in part changes in market participants' expectations for monetary policy. On June 20, 2013, amid elevated volatility in fixed income markets, some investors experienced temporary restrictions related to ETF redemptions. For example, one ETF sponsor opted to only allow standard, in-kind redemptions for certain ETFs—temporarily taking away an optional cash redemption—because the higher costs of liquidity would have been borne by ETF shareholders. Furthermore, rising interest rates in 2013 prompted fixed-income investors to reduce the duration of their investments. As a result, floating rate note ETFs experienced substantial inflows, and short-duration corporate credit ETFs saw robust inflows as well.

5.6 Derivatives Infrastructure

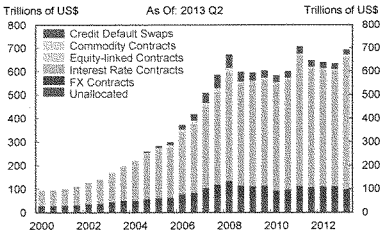
Global Derivatives Volumes

Between December 2012 and June 2013, the size of the global over-the-counter (OTC) derivatives market increased by 9 percent from $633 trillion to $693 trillion gross notional outstanding, according to the most recent Bank for International Settlements survey of global market activity (**Chart 5.6.1**). The composition by asset classes remained similar to previous surveys.

Since November 2013, the CFTC has been publishing weekly Swaps Reports that provide aggregate data on OTC derivatives volumes and notional amounts. The Swaps Report represents all OTC derivatives transactions reported to the CFTC-registered SDRs (i.e., CME, Depository Trust and Clearing Corporation (DTCC), Intercontinental Exchange, and Bloomberg) by entities subject to the CFTC's reporting rules, which are primarily U.S. market participants. As of January 31, 2014, the CFTC's Swaps Report showed $406 trillion in notional amount outstanding for OTC derivative transactions across all asset classes. Similar to the global market, U.S. interest rate derivatives accounted for around 85 percent of the activity at $343 trillion, followed by FX and credit derivatives with $31 trillion and $8 trillion, respectively.

Data reported in the credit derivatives market over the past few years reflect a significant move by market participants from single name activity to more index-based trading. Some of this movement may result from the significant reduction of new structured credit and tranche product activity that necessitated the use of many different single name CDS contracts, including entities that had no debt outstanding. Volume in single name CDS dropped significantly after the financial crisis because of the reduced demand from monoline insurance companies and the overall decline of complex products. In contrast, volume in index CDS has increased significantly in the post-crisis years (**Chart 5.6.2**). Market participants cite better

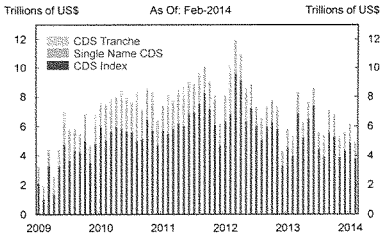
5.6.1 Global OTC Derivatives Market



Source: BIS, Haver Analytics

Note: Notional values.

5.6.2 Credit Derivatives Outstanding



Source: DTCC

Note: Gross notional includes the notional from the perspective of both swap counterparties.

execution and liquidity in indexes as compared to trading in individual single name CDS.

Central Clearing

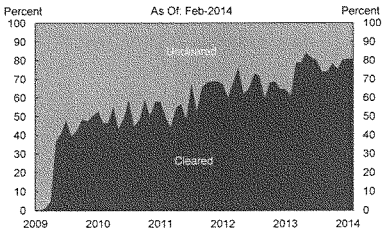
G-20 commitments and Dodd-Frank Act requirements to promote central clearing of certain OTC derivatives transactions have led to an increase in the number of transactions centrally cleared. A central counterparty (CCP) reduces risks to participants through multilateral netting of trades, imposing risk controls on clearing members, and maintaining financial resources commensurate with risks it carries. A CCP also has the benefit of establishing ex-ante procedures for managing a default and allocating losses that can provide the market with more certainty in the event of a clearing member default. Given the rise in activity of certain derivatives through CCPs, and their relevance to financial stability, it is important that they have robust capital and risk management standards in place.

In recognition of this shift to central clearing and the associated concentration of risks, the Dodd-Frank Act coupled the clearing mandate with a requirement for risk management standards, requiring the implementation of risk management standards for systemically important financial market utilities (FMUs), including CCPs that are designated systemically important by the Council, that take into consideration relevant international standards, such as those set forth in the Principles for Financial Market Infrastructures (PFMIs). Accordingly, U.S. regulators have prioritized implementation of revised regulations in line with these standards **(see Section 6.1.1)**.

The Seventh Progress Report on Implementation of OTC Derivatives Market Reforms published by the Financial Stability Board (FSB) indicates that of 15 FSB member jurisdiction dealers' gross notional outstanding in OTC interest rate derivatives products, as of end-February 2014, 53 percent of those products offered for clearing by a CCP are estimated to have been centrally cleared. For credit derivatives this number stood at 40 percent.

In the United States, mandatory central clearing began in 2013 with certain standardized derivatives on a phased-in schedule pursuant to CFTC rules. U.S. central clearing of credit derivatives has grown from zero percent in the beginning of 2009 to 81 percent in February 2014 **(Chart 5.6.3)**. Most market participants that are active in the swaps market, including dealers, were generally required to clear these products starting in March 2013, while other less active market participants were required to clear certain credit derivatives indices starting in June or September 2013. According to Depository Trust & Clearing Corporation data, centrally cleared credit derivatives remain heavily concentrated within the interdealer network with a few firms accounting for 49 percent of volumes over the period 2010 to present. While some dealer-to-dealer trades were being cleared on a voluntary basis before 2013, CFTC rules did result in a significant increase in clearing of client trades. The process of mandating additional products for central clearing is ongoing.

5.6.3 Growth of Credit Derivative Central Clearing



Source: DTCC

Swap Execution Facilities

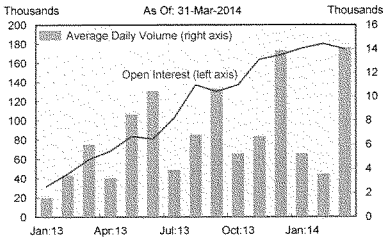
In the United States, there has been progress on the G-20 commitment for increased transparency in the OTC derivatives market through the introduction of swap execution facilities (SEFs) in 2013. A transition to organized platform trading increases pre-trade transparency and supports more efficient markets. The CFTC implemented its SEF rules in October 2013, and in February 2014 mandatory trading began for benchmark USD, euro, and sterling interest rate swap contracts as well as certain five-year CDS indices, with temporary relief granted for contracts involving contingent and simultaneous execution with another contract. The rules also require that SEFs report all transactions to SDRs and make market data publicly available through their website on a daily basis.

Swap Futures Products

Partially in response to the new requirements and the added costs of trading OTC derivatives in late 2012, U.S. futures exchanges began offering dollar-denominated futures contracts with similar cash flows and exposure profiles as some interest rate and credit OTC derivative contracts in December 2012 and June 2013 respectively. Euro-denominated interest rate swap futures launched in April 2014. Interest rate swap futures have lower initial margin requirements compared to those on similar OTC swaps, which is a potential driver for their use.

Since the third phase of the CFTC clearing mandate came into effect in September 2013, the market for interest rate swap futures has grown 34 percent measured by notional outstanding. In January 2014, average daily trading volume for interest rate swap futures products was $528 million and open interest at the end of the month was $18 billion, both measured by notional amount (**Chart 5.6.4**). However, the trading volume and size of the USD interest rate swap futures market still remains small relative to those of the comparable USD interest rate swap market. The notional amount of open interest in USD interest rate swap futures is about 0.02 percent of the notional outstanding USD OTC interest rate swaps cleared by LCH SwapClear. The trading volume and open interest for CDS index futures have declined since they were introduced in June 2013.

5.6.4 Interest Rate Swap Futures: Volume and Open Interest



Source: CME Group, Eris Exchange

Note: Number of contracts. Notional contract value is $100,000/contract.

6 Regulatory Developments; Council Activities

Since the Council's 2013 annual report, financial reform progress included further strengthening of capital, leverage, and liquidity standards for financial institutions and risk-management standards for FMUs; adoption of the Volcker Rule, which generally prohibits banking entities from engaging in proprietary trading and limits their investment in and sponsorship of private funds; refinements of periodic supervisory and company-run stress tests; further implementation of the OLA; regulation of the derivatives markets to reduce risk and increase transparency; new standards to protect mortgage borrowers and reduce risks in the mortgage market; and other measures to enhance consumer and investor protection.

In addition, the Council has continued to fulfill its mandate. In particular, the Council made determinations that three nonbank financial companies will be subject to Federal Reserve supervision and enhanced prudential standards, pursuant to Section 113 of the Dodd-Frank Act. The Council also continued to monitor potential risks to U.S. financial stability and served as a forum for discussion and coordination among the member agencies.

The following is a discussion of the significant financial regulatory reforms implemented by the Council and its member agencies since the Council's 2013 annual report. This section covers: (1) the safety and soundness of financial institutions; (2) financial infrastructure, markets, and oversight; (3) consumer and investor protection; (4) data standards; and (5) Council activities. A special topic in this section covers enhancements of the Council's governance and transparency.

6.1 Safety and Soundness

6.1.1 Enhanced Capital and Prudential Standards and Supervision

Capital, Leverage, and Liquidity Standards

The banking agencies have made significant progress over the last year in implementing capital, leverage, and liquidity standards.

In July 2013, the Federal Reserve, FDIC, and OCC issued new rules implementing the Basel III regulatory capital standards by establishing heightened minimum risk-based and leverage capital requirements for banking organizations, creating a mechanism for counter-cyclical capital buffers for periods of high credit growth, limiting capital distributions, and certain discretionary bonus payments if banking organizations fail to maintain a capital conservation buffer, and removing references to and reliance on credit ratings in capital calculations. These rules apply to all insured depository institutions and to BHCs and savings and loan holding companies, with certain exceptions. These rules include a new minimum ratio of common equity tier 1 capital to RWAs of 4.5 percent and a common equity tier 1 capital conservation buffer of 2.5 percent of RWAs. The rules also raise the minimum ratio of tier 1 capital to RWAs from 4 percent to 6 percent. The rules maintain a total risk-based capital ratio of 8 percent and a minimum tier 1 ratio to total on-balance sheet assets leverage ratio of 4 percent. For large, internationally active banking organizations, the rules establish a minimum supplementary leverage ratio of 3 percent that is based on the international leverage ratio standard and takes into account off-balance sheet exposures.

In July 2013, the SEC adopted amendments to the broker-dealer financial responsibility rules that, among other things, clarify that a broker-dealer providing securities lending and borrowing services is acting in a principal capacity for purposes of the net capital rule, and thus subject to increased capital charges, unless the broker-dealer takes certain steps to disclaim principal liability. The SEC has also proposed to increase the minimum net capital requirement of certain large broker-dealers and subject these firms to a monthly liquidity stress test to ensure that large broker-dealers have sufficient liquidity to survive a potential loss of funding in a liquidity stress event.

In addition, in October 2013, the banking agencies released a proposed rule that would establish a standardized liquidity requirement through a LCR for large financial institutions. The requirement would apply to BHCs and savings and loan holding companies without significant insurance or commercial operations and that are internationally active—generally those with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure. The rule would also apply to the consolidated insured depository institution subsidiaries of those companies with $10 billion or more in total consolidated assets. The rule would additionally apply to nonbank financial companies designated by the Council that do not have substantial insurance operations. The proposal also would apply a less stringent, modified LCR to BHCs and savings and loan holding companies without significant insurance or commercial operations that are not internationally active, but have more than $50 billion in total assets. The proposed requirement would be consistent with the international LCR standard. The proposed rule would require institutions to maintain highly liquid assets sufficient to withstand a severe short-term, standardized liquidity stress scenario, thereby promoting the resilience of their liquidity risk profile and improving the banking sector's ability to absorb shocks arising from financial and economic stress, as well as improvements in the measurement and management of liquidity risk.

In February 2014, the Federal Reserve issued a final rule implementing enhanced prudential standards for U.S. BHCs and FBOs with total consolidated assets of $50 billion or more. For a BHC with total consolidated assets of $50 billion or more, the rule incorporates previously issued capital planning and stress testing requirements and imposes enhanced liquidity requirements, enhanced risk-management requirements, and a debt-to-equity limit for companies that the Council determines pose a grave threat to U.S. financial stability. For a FBO with total consolidated assets of $50 billion or more, the rule implements enhanced risk-based and leverage capital requirements, liquidity requirements, risk-management requirements, stress-testing requirements, and a debt-to-equity limit for companies that the Council determines pose a grave threat to U.S. financial stability. In addition, the rule requires FBOs with U.S. non-branch assets of $50 billion or more to form a U.S. intermediate holding company and imposes capital, liquidity, and other requirements on that entity. The rule also implements stress-testing requirements for FBOs and foreign savings and loan holding companies with total consolidated assets of more than $10 billion. In addition, the rule establishes a risk-committee requirement for certain banking organizations.

In April 2014, the Federal Reserve, FDIC, and OCC issued a final joint rule to strengthen the supplementary leverage ratio requirements for the largest, most interconnected U.S. BHCs, those with total consolidated assets greater than $700 billion or assets under custody greater than $10 trillion, and insured depository institution subsidiaries of those BHCs. Under the rule, subsidiary insured depository institutions of these companies will be required to satisfy a 6 percent supplementary leverage ratio requirement to be considered well capitalized under the agencies' prompt corrective action regulations. U.S. top-tier holding companies will be required to maintain a leverage buffer of at least 2 percent above the minimum supplementary leverage ratio requirement of 3 percent, for a total requirement of 5 percent. The rule is intended to constrain the buildup of financial leverage at the largest banking organizations and place additional private capital at risk before the Deposit Insurance Fund or government resolution mechanisms would need to be called upon.

Foreign Bank Regulation

In February 2014, the Federal Reserve issued a final rule implementing enhanced prudential standards for FBOs to help increase the resiliency of their operations.

The Federal Reserve also issued an interim final rule clarifying how uninsured U.S. branches and agencies of foreign banks will be treated under Section 716 of the Dodd-Frank Act, also known as the "swaps push-out rule." The interim final rule provides that for purposes of Section 716, the term "insured depository institution" includes any uninsured U.S. branch or agency of a foreign bank. Following the Federal Reserve's interim final rule, the OCC notified uninsured branches and agencies of foreign banks that they may request a transition period under Section 716 from the OCC. The Federal Reserve finalized this rule in December 2013.

The FDIC issued a final rule regarding the treatment of deposits in foreign branches of U.S. banks. Currently, under the Federal Deposit Insurance Act, funds deposited in foreign branches of U.S. banks are not considered deposits unless the funds are payable both in the foreign branch and in the United States. A recent consultation paper issued by the U.K. Prudential Regulation Authority could result in some large U.S. banks changing their deposit agreements to make U.K. branch deposits payable in both the United Kingdom and United States. In response, the FDIC in September 2013 issued a rule that clarifies that deposits in foreign branches of U.S. banks are not eligible for FDIC deposit insurance, although they may qualify as deposits for the purpose of the national depositor preference statute enacted in 1993.

Emergency Lending Authority

In December 2013, the Federal Reserve issued proposed amendments to Regulation A implementing the Dodd-Frank Act's amendments to Section 13(3) of the Federal Reserve Act. The amendments are designed to ensure that any emergency extension of credit or emergency lending program or facility established by the Federal Reserve is solely for the purpose of providing liquidity to the financial system, and not to assist failing financial institutions.

Risk-Management Standards for Designated FMUs

As discussed in **Section 5.6**, the Dodd-Frank Act required the implementation of enhanced risk-management standards for designated FMUs, which take into consideration the relevant international standards. These international standards, the PFMIs, were issued in April 2012 by the Committee on Payment and Settlement Systems and IOSCO. The PFMIs harmonized, strengthened, and created new international risk management standards for systemically important payment systems, central securities depositories, securities settlement systems, CCPs, and trade repositories. The PFMIs include standards for governance, credit risk management, margin and collateral, liquidity risk management, settlement, clearing member default management, and business and operational risk, among others.

The Council has designated eight FMUs as systemically important, subjecting them to the enhanced regulatory and supervisory regime provided by Title VIII of the Dodd-Frank Act. The supervisory agencies for the currently designated FMUs (the Federal Reserve, CFTC, and SEC) are in various stages of rulemaking to implement enhanced risk-management standards for designated FMUs. The CFTC issued a final rule in November 2013 establishing enhanced risk management standards for derivatives clearing organizations designated as systemically important FMUs by the Council. The SEC's operational and risk-management standards for clearing agencies, including clearing agencies that clear security-based swaps, came into effect in January 2013. In March 2014, the SEC proposed additional standards that would be consistent with the PFMIs for clearing agencies designated as systemically important FMUs by the Council. The Federal Reserve proposed revisions to its risk-management standards for designated FMUs other than those for which the

SEC or the CFTC is the supervisory agency in January 2014. Each of the supervisory agencies' rules or rule proposals are, while not identical, based on and generally consistent with the PFMIs.

6.1.2 Volcker Rule

In December 2013, the Federal Reserve, OCC, FDIC, SEC, and CFTC issued final rules to implement section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule. The rulemaking was coordinated by Treasury. The final rules, which include a single, common regulatory text, generally prohibit banking entities from: (1) engaging in short-term proprietary trading in securities, derivatives, commodity futures, and options on these instruments for their own account, and (2) owning, sponsoring, or having certain relationships with hedge funds, private equity funds, and other covered funds. As required by section 619 of the Dodd-Frank Act, the final rules provide exemptions for certain activities, including market making-related activities, underwriting, risk-mitigating hedging, and trading in certain U.S. and foreign government obligations, among others. In accordance with the Dodd-Frank Act, the final rules prohibit any activity, even if it would otherwise be permitted, if it would involve a material conflict of interest, a material exposure to high-risk assets or trading strategies, or a threat to the safety and soundness of the banking entity or to U.S. financial stability.

6.1.3 Dodd-Frank Stress Tests and Comprehensive Capital Analysis and Review

Section 165(i) of the Dodd-Frank Act requires two types of stress tests. First, the Federal Reserve must conduct annual supervisory stress tests of BHCs with $50 billion or more in total consolidated assets and nonbank financial companies designated by the Council. Second, financial companies with more than $10 billion in total consolidated assets must conduct annual stress tests, and BHCs with $50 billion or more in total consolidated assets and nonbank financial companies designated by the Council must also conduct semi-annual company-run stress tests. In addition, the Federal Reserve conducts an annual CCAR.

The results of company-run, mid-year stress tests were released by certain banking organizations in September 2013. Also in September 2013, the Federal Reserve issued a rule providing a one-year transition period during which banking organizations with between $10 and $50 billion in total assets would not be required to reflect the Basel III capital rule in their stress tests.

In November 2013, the Federal Reserve, FDIC, and OCC issued the economic and financial market scenarios used in the 2013 to 2014 stress tests and capital planning program. A total of 30 BHCs and other financial institutions regulated by the Federal Reserve with consolidated assets of at least $50 billion participated in the 2013 to 2014 exercise, and the results of these stress tests were released in March 2014. The Federal Reserve approved the plans of 25 financial institutions in the CCAR, and objected to the plans of five firms—four based on qualitative concerns, and one due to its inability to meet a minimum post-stress capital requirement. Following the initial CCAR results, the Federal Reserve required Bank of America Corporation to resubmit its capital plan, as described in **Section 5.3.1**. All but two of the 30 CCAR participants are expected to build capital from the second quarter of 2014 through the first quarter of 2015. In the aggregate, the firms are expected to distribute 40 percent less than their projected net income during the same period.

Institutions with $50 billion or more that are subject to the Federal Reserve, FDIC, and OCC company-run stress test rules began their second stress test cycle in 2013. Institutions with $10 to $50 billion in assets began their first stress test cycle in 2013. These midsize institutions are not required to publicly disclose their 2013 to 2014 stress test results; public disclosures will begin in June 2015 with the results of the 2014 to 2015 stress tests.

In March 2014, the Federal Reserve published a final rule providing that no banking organization would be required to calculate its regulatory capital ratios using the Basel III advanced approaches until the 2015

to 2016 stress testing cycle. Also in March 2014, the Federal Reserve, FDIC, and OCC issued stress testing guidance for institutions with $10 to $50 billion in assets.

6.1.4 Resolution Plans and Orderly Liquidation Authority

Resolution Plans

Under the framework of the Dodd-Frank Act, bankruptcy is the preferred option in the event of the failure of a financial company. Section 165(d) of the Dodd-Frank Act requires nonbank financial companies designated by the Council for supervision by the Federal Reserve and BHCs (including FBOs that are, or are treated as, BHCs) with total consolidated assets of $50 billion or more to report periodically to the Federal Reserve, the FDIC, and the Council with plans—also referred to as living wills—for their rapid and orderly resolution under the U.S. Bankruptcy Code in the event of material financial distress or failure. The Federal Reserve and the FDIC must review each plan and may jointly determine that the plan is not credible or would not facilitate an orderly resolution of the company under the U.S. Bankruptcy Code. If the Federal Reserve and the FDIC make such a joint determination, then the company must resubmit its plan with revisions demonstrating that the plan is credible and would result in an orderly resolution under the Bankruptcy Code, including any proposed changes in business operations and corporate structure to facilitate implementation of the plan. In November 2011, the Federal Reserve and the FDIC published a joint final rule implementing the resolution plan requirement.

Eleven of the largest, most complex institutions submitted initial plans in 2012 and revised plans in 2013. During 2013, an additional 120 institutions subject to the rule at that time submitted initial plans. The public portions of each resolution plan were published on the Federal Reserve's and the FDIC's websites. In 2013, the Council designated three nonbank financial companies for Federal Reserve supervision, and these firms will submit initial resolution plans in 2014.

Following the review of the 11 plans submitted in 2012, the Federal Reserve and the FDIC issued guidance for those firms concerning information that should be included in their 2013 resolution plan submissions. The guidance identified significant obstacles to rapid and orderly resolution for the firms to consider and address, including delineating the actions or steps the company has taken or proposes to take to remediate or to otherwise mitigate each obstacle, and providing a timeline for proposed actions, as necessary.

The significant obstacles identified in the guidance were:

- Multiple competing insolvencies: The risk of discontinuity of critical operations, arising from operations in multiple jurisdictions.
- Global cooperation: The risk that lack of cooperation could lead to ring fencing of assets.
- Operations and interconnectedness: The risk that critical services provided by an affiliate or third party might be interrupted.
- Counterparty actions: The risk that derivative and other counterparty actions may lead to systemic market disruption.
- Funding and liquidity: The risk of having insufficient liquidity to maintain critical operations.

Orderly Liquidation Authority

In cases where resolution of a financial company under the Bankruptcy Code may result in serious adverse effects on financial stability in the United States, the OLA set out in Title II of the Dodd-Frank Act serves as the last resort alternative. Under the Dodd-Frank Act, the Federal Reserve, and another financial regulatory agency specified by the Dodd-Frank Act (either the FDIC, the SEC, or FIO) must make written recommendations to the Secretary of the Treasury, who must then make certain determinations in order to

invoke the OLA. These include determining that the company is in default or danger of default; that failure of the company and its resolution under other law, including bankruptcy, would have serious adverse effects on U.S. financial stability; and that no private sector alternative is available to prevent the default of the company.

The FDIC is developing a strategic approach, the SPOE, to carry out the OLA when resolving a financial company. Under SPOE, the FDIC would be appointed receiver only of the top-tier parent holding company of a financial group upon the completion of the recommendation, determination, and expedited judicial review process set forth in Title II. The FDIC would organize a temporary bridge financial company and transfer to it assets from the receivership estate—including the failed holding company's investments in and loans to subsidiaries. The FDIC would oversee operations of the bridge financial company and retain control over high-level key matters of its governance, impose losses on shareholders and unsecured creditors, and replace culpable senior management.

The FDIC would appoint a board of directors and nominate a new chief executive officer and other key managers to operate the bridge financial company under the FDIC's oversight. The company may be restructured by shrinking businesses, breaking the company into smaller entities, liquidating assets, or closing operations to ensure that the resulting entities could be resolved in bankruptcy.

During the operation of the bridge financial company, the healthy subsidiaries of the company would remain open, protecting against contagion in the financial system by maintaining continuity of services. At the same time, SPOE would protect against moral hazard by holding the failed company's shareholders, management, and creditors, accountable for its failure. In December 2013, the FDIC approved a Federal Register Notice for public comment that provides greater detail on SPOE.

International Coordination on Resolution under the OLA

Advance planning and cross-border coordination for resolution of G-SIFIs are essential to minimize disruptions to global financial markets. The FDIC and the BoE, in conjunction with prudential regulators in their respective jurisdictions, are developing contingency plans for the failure of a G-SIFI with operations in the United States and the United Kingdom. In December 2013, building on their joint policy paper on resolution strategies released in 2012, the FDIC and the BoE, in conjunction with the Prudential Regulation Authority, the Federal Reserve, and the FRBNY, held a tabletop exercise exploring cross-border issues and mitigating actions that regulators could take in case of a resolution.

The FDIC and the European Commission have established a joint working group to focus on resolution and deposit insurance issues. In 2013, the working group convened twice, and staff collaboration has been ongoing.

In 2013, the FDIC also collaborated with regulators in Switzerland, Germany, and Japan to discuss cross-border issues and impediments affecting the resolution of G-SIFIs. They will continue this work in 2014, with tabletop exercises.

In a demonstration of cross-border cooperation, the FDIC, the BoE, the Swiss Financial Market Supervisory Authority, and the German Federal Financial Supervisory Authority signed a November 2013 joint letter to the International Swaps and Derivatives Association (ISDA). This letter encouraged ISDA to revise derivatives contracts to authorize the short-term suspension of early termination rights and other remedies in the event of a G-SIFI resolution. Such changes are intended to permit the exercise of all applicable types of resolution powers without resulting in a disorderly termination of derivatives contracts.

6.1.5 Insurance

FIO, state regulators and, as of October 2013, the Federal Reserve, are members of the International Association of Insurance Supervisors (IAIS). FIO's director and two state regulators serve on the IAIS's Executive Committee.

Through service on the IAIS's Financial Stability Committee, FIO, the NAIC, and state regulators have participated extensively in the process of identifying global systemically important insurers (G-SIIs) and the policy measures to be applied to any such designated insurer. The FSB, which was tasked by the G-20 to identify G-SIIs, delegated the development of a methodology and policy measures for G-SIIs to the IAIS. On July 18, 2013, the FSB, in consultation with the IAIS, identified an initial list of nine G-SIIs that included three U.S.-based insurers; however, a decision on the G-SII status of major reinsurers was deferred until November 2014. In July 2013, the IAIS also published, and the FSB endorsed, a set of policy measures that will apply to G-SIIs, including enhanced group-wide supervision, recovery and resolution planning, and higher loss absorbency (HLA) requirements.

In the absence of an international capital standard for insurance companies, the FSB also called upon the IAIS to develop two separate capital measures. The first, straightforward backstop capital requirements (BCR), will serve as a foundation for HLA requirements for G-SIIs. The second is a quantitative insurance capital standard (ICS) that will be part of the IAIS's Common Framework for the Supervision of Internationally Active Insurance Groups. The IAIS's Technical Committee directs the development of this integrated, multilateral, and multidisciplinary framework for the group-wide supervision of internationally active insurance groups. FIO, state regulators (through the NAIC), and the Federal Reserve have been participating actively in the IAIS task force charged with developing and testing the BCR and ICS. The IAIS will develop and propose a BCR to the FSB by late 2014 and will propose HLA by the end of 2015, with implementation of both to begin January 2019. The ICS will be developed by the end of 2016, and will be field tested through 2018 in advance of implementation in 2019.

Title V of the Dodd-Frank Act established FIO and directed it to study and report on how to modernize and improve the system of insurance regulation in the United States. After extensive study and consultation, the report was released in December 2013 and concluded that the United States should build on the existing hybrid model of insurance regulation, incorporating state regulation with a federal role, where necessary. Accordingly, the report recommends how the U.S. system of insurance regulation can be modernized and improved by a combination of steps by the states and certain actions by the federal government. Specifically, the report highlights three areas of note where FIO concluded that federal involvement is warranted: development of international insurance regulatory standards; topics for which national uniformity is an appropriate standard and topics of national interest for which federal involvement is necessary; and oversight of mortgage insurance.

Since early 2012, FIO, state regulators (through the NAIC), the European Commission, and the European Insurance, and Occupational Pensions Authority have participated in a project to increase mutual understanding and enhance cooperation between the EU and the United States in order to promote business opportunity, consumer protection, and effective supervision. After focusing on gap analysis through 2012, the focus of the project shifted in 2013 to professional secrecy and confidentiality, solvency and capital requirements, and reinsurance and collateral requirements. With the IAIS developments and the finalization of the EU's oversight regime (Solvency II), new areas will be focused on in 2014.

State insurance regulators, through the NAIC, continue work on updating the insurance financial solvency framework and to refine existing accounting, reporting, valuation, and risk-based capital requirements. States continue to adopt various NAIC models or updated models related to the Solvency Modernization Initiative, including the revised Credit for Reinsurance Model Law and Regulation, the revised Model Insurance Holding Company System Regulatory Act (including the enterprise risk report), the Standard Valuation Law to implement principles-based reserving, and the Risk Management and Own Risk and Solvency Assessment Model Law, which was adopted by the NAIC in 2012 to establish the Own Risk and Solvency Assessment filing requirement. In addition, state insurance regulators continue to build on various aspects of these projects through implementation efforts at the NAIC. This includes the NAIC's approval of four international supervisory authorities as conditional qualified jurisdictions under the Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions, and the rollout of the NAIC's Reinsurance Financial Analysis (E) Working Group, which among other things coordinates multi-state efforts in reviewing and addressing issues related to certified reinsurers.

The Council also will continue to monitor relevant domestic and international financial regulatory proposals and developments involving insurance.

6.1.6 Mortgage-related Litigation and Settlements

Federal and state agencies reached several significant settlements in 2013 with financial institutions, including some relating to the sale of mortgage securities.

Beginning in January 2013, 15 mortgage servicing companies subject to enforcement actions for deficient practices in mortgage loan servicing and foreclosure processing reached settlements with the OCC and the Federal Reserve to provide approximately $3.9 billion in direct cash payments to borrowers and approximately $6.1 billion in other foreclosure prevention assistance, such as loan modifications and the forgiveness of deficiency judgments. For participating servicers, fulfillment of these agreements satisfies the foreclosure file review requirements of enforcement actions issued by the OCC, Federal Reserve, and Office of Thrift Supervision in 2011 and 2012. In addition, in December 2013, the CFPB, together with authorities in 49 states and the District of Columbia, entered into a settlement with the country's largest nonbank mortgage loan servicer, requiring it to provide consumer refunds and $2 billion in loan modification relief.

Since January 2013, there have been settlements totaling more than $17 billion in eight lawsuits filed by FHFA relating to financial institutions' sales of mortgage securities to Fannie Mae and Freddie Mac. The largest of these settlements were $9.3 billion by Bank of America, $4.0 billion by JPMorgan, $1.9 billion by Deutsche Bank, and $1.3 billion by Morgan Stanley.

Also, in October 2013, the Justice Department announced a $13 billion settlement with JPMorgan to resolve federal and state civil claims arising out of the packaging, marketing, sale, and issuance of residential mortgage-backed securities (RMBS) by JPMorgan, Bear Stearns, and Washington Mutual prior to January 1, 2009. Of the $13 billion, $9 billion will be paid to settle federal and state civil claims by federal agencies and several states related to RMBS. This $13 billion settlement also includes JPMorgan's settlement with the FHFA that requires it to pay out $4 billion in the form of relief to aid consumers harmed by the conduct of JPMorgan, Bear Stearns, and Washington Mutual.

In 2013, the SEC continued its pursuit of financial institutions that misled investors in connection with the sale of MBS. The SEC brought actions against large financial institutions such as Bank of America and the Royal Bank of Scotland for their roles in the issuance of RMBS. The SEC also filed charges against broker-dealers, collateral managers, and their principals for fraud in connection with the structuring and sale of billions of dollars of collateralized debt obligations.

6.2 Financial Infrastructure, Markets, and Oversight

6.2.1 Over-the-Counter Derivatives Reform

Title VII of the Dodd-Frank Act establishes a comprehensive new regulatory framework for swaps and security-based swaps. Among other things, the legislation: (1) provides for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants (MSPs), and major security-based swap participants; (2) imposes clearing and trade execution requirements on standardized derivatives products; and (3) creates robust recordkeeping and real-time reporting requirements with respect to swaps and security-based swaps. Title VII also provides for greater pre-trade and post-trade transparency in the swaps and security-based swaps markets. Under Title VII, the CFTC regulates "swaps," the SEC regulates "security-based swaps," and the CFTC and SEC jointly regulate "mixed swaps."

A number of elements of the CFTC's swaps regulatory regime became effective over the past year. The CFTC continued to phase in its implementation of the clearing mandate for certain standardized index CDS and interest rate swaps. The clearing requirement was implemented in March 2013 for swap dealers, MSPs, and private funds active in the swaps market; in June 2013 for entities including commodity pools and private funds other than active funds; and in September 2013 for all other entities. The CFTC also adopted a final rule in April 2013 exempting swaps between certain affiliated entities within a corporate group from the mandatory clearing requirement.

An important milestone for increased transparency in the swaps market was achieved in May 2013 when the CFTC adopted final rules implementing the core principles and other requirements for SEFs, where swap contracts may be listed for trading. At the same time, the CFTC also issued rules establishing the process by which a designated contract market or a SEF can submit a determination that a swap has been made available for trading for purposes of the trade execution mandate.

Over the past year, the CFTC also took significant actions to begin implementing the international regulatory framework for swaps. In July 2013, the CFTC and the European Commission announced a "Path Forward" regarding their joint understandings on a package of measures for how to approach cross-border derivatives. In the same month, the CFTC issued a final interpretive guidance and policy statement regarding the application of the CFTC's swap regulatory regime to cross-border activities. In December 2013, the CFTC issued broad comparability determinations, covering a range of Dodd-Frank Act requirements, for a number of foreign jurisdictions. These comparability determinations would permit eligible swap counterparties to comply with local requirements rather than the corresponding Dodd-Frank Act requirements in cases where substituted compliance is available.

Other significant CFTC actions include a final interpretive statement issued in May 2013 providing guidance on statutory provisions prohibiting certain disruptive trading, practices, or conduct. In November 2013, the CFTC issued final rules imposing requirements on swap dealers and MSPs with respect to the treatment of collateral posted by their counterparties to margin, guarantee, or secure uncleared swaps. Finally, in December 2013, the CFTC issued proposed rules to establish speculative position limits for 28 exempt and agricultural commodity futures and option contracts, and physical commodity swaps that are "economically equivalent" to such contracts.

The SEC also has begun the first major phase of security-based swap regulation. In May 2013, the SEC issued comprehensive proposed rules and proposed interpretations on cross-border security-based swap activities. This proposal covers registration requirements for security-based swap dealers and major security-based swap participants; transaction-related requirements such as the reporting, dissemination, clearing, and trade execution of security-based swaps; exceptions to registration requirements; and the re-proposal of Regulation

SBSR (for security-based swap reporting), which provides for the reporting and dissemination of security-based swap information. In addition, in April 2014, the SEC proposed rules for security-based swap dealers and major security-based swap market participants, as required by the Dodd-Frank Act. The proposed rules cover recordkeeping, reporting, and notification requirements for security-based swap dealers and major security-based swap participants and would establish additional recordkeeping requirements for broker-dealers to account for their security-based swap activities.

Finally, in September of 2013, the Basel Committee on Banking Supervision and IOSCO's working group on margin requirements released the final policy framework on minimum standards for margin requirements for non-centrally cleared derivatives. The framework is designed to reduce risks related to OTC derivatives markets and provide firms with appropriate incentives for central clearing while managing the liquidity impact of the requirements. The CFTC, SEC, Federal Reserve, FDIC, OCC, FHFA, and Farm Credit Administration are working to implement rules that are generally consistent with this policy framework and the Dodd-Frank Act.

6.2.2 Securitization Reform

In August 2013, the Federal Reserve, OCC, FDIC, FHFA, SEC, and HUD re-proposed a rule from 2011 to implement the requirement under the Dodd-Frank Act for securitizers to retain risk in the assets they securitize. The rulemaking is coordinated by Treasury. The risk-retention requirement is intended better to align the interests of securitizers and investors, and provide a strong incentive for securitizers to monitor the credit quality and underwriting of assets they securitize.

Under the Dodd-Frank Act, the rule must generally provide that securitizers must retain at least 5 percent of the credit risk for the assets collateralizing any ABS that they issue, unless the securitized assets or the transaction qualify for an exemption. Consistent with the statute, the reproposal would establish underwriting standards for QRMs, which would be exempt from the risk-retention requirements. The reproposal would provide sponsors of ABS with various options for meeting the risk retention requirements. The new proposal would provide for the QRM definition to equal the definition of "qualified mortgage" (QM) established by the CFPB in 2013. The reproposal also requested comment on an alternative definition of QRM that would include certain underwriting standards in addition to the QM criteria.

6.2.3 Money Market Mutual Fund Reform

In June 2013, the SEC proposed further reforms for the regulation of MMFs. The reforms were intended to make MMFs less susceptible to runs that could threaten financial stability and harm investors. The SEC's proposal includes two principal reforms that could be adopted alone or in combination. One alternative would require a floating NAV for prime institutional MMFs. The other alternative would allow the use of liquidity fees and redemption gates in times of stress. The proposal also includes additional diversification, disclosure, and stress testing measures that would apply under either alternative. The public comment period has closed, and the SEC is currently reviewing the comments and working to develop a final rule.

The SEC began evaluating the need for MMF reform after the Reserve Primary Fund "broke the buck" at the height of the financial crisis in September 2008. In 2010, the SEC adopted reforms enhancing the risk-limiting conditions on MMFs by reducing maturities, improving credit quality and imposing new liquidity requirements. The SEC's proposed rules would supplement the 2010 reforms. In November 2012, the Council issued for public comment a proposed recommendation that the SEC implement structural reforms to mitigate the vulnerability of MMFs to runs. The Council's proposed recommendation was issued under Section 120 of the Dodd-Frank Act. Under Section 120, if the Council determines that a financial activity or practice conducted by BHCs or nonbank financial companies could create or increase the risk of certain

problems spreading among financial companies or markets, the Council may, after seeking public comment, issue recommendations to the relevant regulator to apply new or heightened standards or safeguards.

6.2.4 Credit Rating Reforms

Section 939A of the Dodd-Frank Act requires each federal agency to modify its regulations to remove any reference to, or requirement of reliance on, credit ratings and to substitute in its regulations a standard of credit-worthiness that the agency determines is appropriate. In 2013, agencies including the FDIC, Federal Reserve, NCUA, OCC, SEC, and the Internal Revenue Service continued to implement this requirement by amending their rules. Previously, other agencies including the CFTC and FHFA had adopted rules implementing Section 939A.

6.2.5 Accounting Standards

In December 2012, the Financial Accounting Standards Board (FASB) issued for public comment a proposal to improve financial reporting by moving to an expected credit loss model for loans and other financial assets. The proposal, Financial Instruments—Credit Losses (Subtopic 825-15), is intended to require more timely recognition of credit losses, while also providing additional transparency about credit risk. Currently, under U.S. GAAP, credit losses are generally not reflected in financial statements until it is probable that the losses have been incurred. Under the proposal, a firm's balance sheet would reflect management's current estimate of expected credit losses at the reporting date (as an allowance for credit losses), and the income statement would reflect all changes in expected credit losses (as a provision for credit losses). The FASB's final standard is expected to be issued by the end of 2014. While the FASB's and the International Accounting Standards Board's (IASB) approaches on expected credit losses will not be converged, the final standards will represent a significant change from the current incurred loss credit impairment model.

In February 2013, the FASB issued for public comment a proposal to improve financial reporting by providing a comprehensive framework for classifying and measuring financial instruments. Under the proposal, the classification and measurement of a financial asset would be based on the asset's cash flow characteristics and the entity's business model for managing the asset. In November 2012, the IASB had proposed amendments to its financial instruments accounting standards that would also classify and measure financial assets based on cash flow characteristics and business model assessments, although some parts of the two boards' proposals differed. However, in December 2013 and January 2014, the FASB decided that it would not continue to pursue the proposed contractual cash flow characteristics and business model assessments. In March 2014, the FASB decided to retain the separate models in existing U.S. GAAP for determining the classification of loans and securities, but directed staff to analyze whether changes are needed to the current definition of a security. The FASB's final standard is expected to be issued by the end of 2014.

In May 2013, the FASB, jointly with the IASB, issued a revised proposal for public comment to increase transparency and comparability among organizations that lease assets (as lessor or lessee), updating a joint proposal from August 2010. The revised proposal would create a new approach to lease accounting, the core principle of which would be that both a lessee and a lessor organization should recognize assets and liabilities arising from a lease on the balance sheet. Existing lease accounting standards have been criticized for failing to meet the needs of financial statements users. In March 2014, the FASB and IASB began redeliberations on the revised proposal and reaffirmed that all leases would be recognized on the balance sheet by lessees, while current lessor accounting would remain substantially unchanged. However, based on the FASB's decisions, most existing operating leases would continue to have straight-line expense and most existing capital leases would continue to have accelerated lease expense. The boards will continue redeliberations during 2014 to try and reach a converged solution.

The FASB and the IASB also are in the process of finalizing standards on revenue recognition. U.S. GAAP comprises broad revenue recognition concepts and numerous requirements for particular industries or transactions that can result in different accounting for economically similar transactions. International Financial Reporting Standards have fewer requirements on revenue recognition. To resolve these inconsistencies, the FASB and the IASB initiated a joint project to develop a common revenue standard for U.S. GAAP and International Financial Reporting Standards. The initial proposal to amend revenue recognition rules was issued in June 2010. After receiving comments, an amended exposure draft was issued in November 2011, and proposed amendments to U.S. GAAP were released in January 2012. In November 2013, the FASB completed its discussions on revenue recognition, and a final standard is expected to be issued in the first half of 2014.

In June 2013, the FASB issued for public comment a proposal to improve the financial reporting of insurance contracts. The proposal would have required contracts that transfer significant insurance risk to be accounted for in a similar manner, regardless of the type of institution issuing the contract. In contrast, existing U.S. GAAP for insurance contracts only applies if the entity providing insurance is an insurance company. The IASB also issued an insurance proposal in June 2013 that is similar in some respects to the FASB proposal. The FASB began redeliberations on its proposal in February 2014 and, in light of feedback, decided to limit the scope of the project to insurance entities as described in existing U.S. GAAP and to focus on making targeted improvements to existing U.S. GAAP. A completion date for the project has not been established.

6.3 Consumer and Investor Protection

6.3.1 Mortgage Transactions and Housing

In December 2013, the CFPB published a final rule and forms that combine several federal disclosures that a consumer receives in connection with applying for and closing on a mortgage loan under Regulation Z (which implements the Truth in Lending Act (TILA)) and Regulation X (which implements the Real Estate Settlement Procedures Act (RESPA)).

For more than 30 years, federal law has required a lender to provide different sets of disclosures to a consumer who applies for and closes on a mortgage loan: one under TILA and the other under RESPA. Two different federal agencies separately had developed the required disclosures. The information on the TILA and RESPA disclosure forms is overlapping and the language is inconsistent. Pursuant to a mandate in the Dodd-Frank Act, the CFPB integrated the mortgage loan disclosures required under TILA and RESPA. After engaging in extensive consumer and industry outreach and testing and considering the comments on the proposed rule, the CFPB issued the integrated disclosures in a final rule.

The final rule also provides a detailed explanation of how the forms should be filled out and used. The first new form, called the Loan Estimate, is designed to provide information to a consumer when the consumer applies for a mortgage loan so that the consumer can understand the key features, costs, and risks of the loan. The Loan Estimate form must be sent to the consumer no later than three business days after the creditor receives the consumer's application. The second new form, called the Closing Disclosure, is designed to provide information to a consumer to understand all of the costs of the mortgage loan transaction, and must be provided to the consumer no later than three business days prior to closing on the loan.

In developing the Loan Estimate and Closing Disclosure forms, the CFPB reconciled the differences between the existing TILA and RESPA disclosures, and combined several other mandated disclosures, including an appraisal notice under the Equal Credit Opportunity Act and a servicing application disclosure under RESPA. The rule also makes certain changes to reduce the risk that consumers will be surprised at the

closing table. These changes include requiring that closing information be provided three days in advance and placing certain further restrictions on increases in charges disclosed on the Loan Estimate. The final rule is effective on August 1, 2015, and applies to transactions for which the creditor or mortgage broker receives an application on or after that date, subject to certain exceptions.

In January 2013, the CFPB issued several rules implementing new consumer protections for the mortgage market as mandated in the Dodd-Frank Act. First, the CFPB issued a final rule, known as the ability-to-repay/QM rule, implementing a requirement of the Dodd-Frank Act that creditors make a reasonable, good-faith determination at the time of consummation that a consumer has a reasonable ability to repay a mortgage. The ability-to-repay/QM rule is designed, in part, to promote the stability of the financial system by aligning the consumer's interest in obtaining a loan that he or she can afford with the lender's interest in originating a loan that is a viable asset. The ability-to-repay requirements contained in the CFPB's Regulation Z generally prohibit a creditor from using unverified information about a consumer's income and debt and from underwriting a loan based only on low "teaser" rates. Certain mortgages, called QMs, that meet specific criteria set forth in the rule are entitled to a presumption of compliance with the ability-to-repay requirements. A QM that is a higher-priced mortgage loan is subject to a rebuttable presumption of compliance, while a QM that is not higher priced receives a safe harbor from a claim alleging a violation of the ability-to-repay requirements.

The CFPB rules generally require that a consumer's backend debt-to-income (DTI) ratio may not exceed 43 percent for a QM, with some exceptions. In particular, to help ensure access to credit while the market adjusts to the new regulations, the CFPB rules provide that for the next several years, certain loans that are eligible for purchase, guarantee, or insurance by the government sponsored entities and certain federal agencies shall be deemed QMs even if the DTI ratio exceeds 43 percent.

The CFPB subsequently amended the ability-to-repay rule in 2013, so as to exempt certain creditors and lending programs from the ability-to-repay requirements, facilitate compliance by and to preserve access to credit from small creditors, and modify the requirements regarding the inclusion of loan originator compensation in the QM 3 percent points and fees cap. In particular, the CFPB adopted exemptions from the ability-to-repay requirements for creditors designated by certain federal government agencies under specified community development lending programs, as well as for creditors designated as nonprofit organizations that extend credit secured by a dwelling no more than 200 times annually, provide credit only to low-to-moderate income consumers, and follow their own written procedures to determine that consumers have a reasonable ability to repay their loans.

Among other amendments designed to preserve access to credit for customers of small creditors, the CFPB raised the threshold for determining when a QM is deemed to be a higher-priced mortgage. This amendment expands the ability of small creditors to receive the safe harbor under the ability-to-repay requirements. The amendments also exempt a small creditor from the 43 percent DTI requirement for QMs the creditor holds in its portfolio, so long as the creditor considers DTI ratios or residual income according to its own internal criteria. Finally, in October 2013 the CFPB, Federal Reserve, FDIC, NCUA, and OCC issued interagency guidance to address issues regarding fair lending risks associated with offering only QMs.

Under the new rules, certain loans eligible for purchase by Fannie Mae and Freddie Mac will be deemed QMs under the temporary QM category described above. These loans need not meet the 43 percent DTI ratio cap. However, a jumbo loan generally may receive QM status only if that loan meets the 43 percent DTI requirement, and a loan with certain product features or with points and fees in excess of the general

3 percent cap is not eligible for QM status. In response to the CFPB's rules, FHFA directed Fannie Mae and Freddie Mac to refrain from purchasing a loan that is subject to the "ability to repay" rule if the loan is not fully amortizing, has a term of longer than 30 years, or includes points and fees in excess of 3 percent of the total loan amount generally. Effectively, this means that Fannie Mae and Freddie Mac may not purchase interest-only loans, loans with 40-year terms, or those with points and fees exceeding the thresholds established by the rule.

The CFPB's rules also address concerns with regard to servicers' policies and procedures regarding recordkeeping, servicing transfers, loss mitigation, and other topics. The new rules generally require that servicers provide consistent monthly statements, expand and improve their information request and error resolution procedures, and provide certain disclosures to consumers before imposing force-placed insurance. The new rules also direct servicers to improve communications with borrowers who are having difficulty repaying their loans. Servicers must reach out to troubled borrowers within 36 days of delinquency, provide continuity of contact with trained personnel, and process applications for loan modifications and other foreclosure relief consistent with specified timelines and procedures.

In January 2013, the CFPB also issued mortgage servicing rules to implement several protections mandated by the Dodd-Frank Act. Over the course of 2013, the CFPB amended certain provisions of the mortgage servicing rules to clarify the scope and application of the rules. Small servicers are exempt from several of the provisions. In January 2013, the CFPB also issued rules to implement requirements under the Dodd-Frank Act concerning mortgage loan appraisals, loan originator compensation and training, high-cost mortgage loans, the use of agreements requiring arbitration of disputes concerning mortgage loans, mandatory escrow accounts for certain higher priced mortgage loans, and various other topics. The CFPB made some minor clarifications and adjustments to these rules over the course of 2013.

In January 2013, the Federal Reserve, FDIC, OCC, FHFA, CFPB, and NCUA jointly issued a final rule that established new appraisal requirements for higher-priced mortgage loans. Under the Dodd-Frank Act, mortgage loans are higher-priced if they are secured by a consumer's home and have annual percentage rates above certain thresholds. In December 2013, the agencies approved a supplemental rule that exempts a subset of higher-priced mortgage loans from certain appraisal requirements. As mandated by the Dodd-Frank Act, in March 2014 these agencies issued a proposed rule that would implement minimum requirements for state registration and supervision of appraisal management companies.

The FHFA and CFPB also have continued their work on the construction of a National Mortgage Database, the core of which consists of a nationally representative rolling 5 percent sample of originated mortgages, matched with credit bureau data and supplemented by survey data. This database is intended to provide regulators with an unprecedented understanding of mortgage market dynamics.

6.3.2 Consumer Protection

Among its authorities, the CFPB may supervise certain nonbank entities, including mortgage companies, private education lenders, payday lenders, "larger participants" of a market for other consumer financial products and services, and any nonbank covered person that the CFPB has reasonable cause to determine is engaging or has engaged in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services. In July 2013, the CFPB issued a rule to establish procedures by which the CFPB would bring a nonbank covered person under the CFPB's supervisory authority because the person's conduct poses risks to consumers. The CFPB's procedural rule is designed to establish a consistent framework applicable to all affected entities, and thereby provide transparency regarding the procedures the CFPB would use prior to commencement of a proceeding to notify and give an affected entity an opportunity to respond to the CFPB's proposed order to supervise the entity.

In December 2013, the CFPB issued another in its series of rules to define "larger participants" of specific markets for purposes of establishing, in part, the scope of the CFPB's nonbank supervision program. The CFPB's larger-participant rule defines a market for "student loan servicing" activities, which covers the servicing of both federal and private student loans. The rule provides that a person who engages in student loan servicing would be a larger participant, and thus subject to the CFPB's supervisory authority, if the account volume of the person and its affiliates exceeds one million.

6.3.3 Investor Protection

The SEC issued a final rule in July 2013 implementing Section 926 of the Dodd-Frank Act, prohibiting directors, officers, and other covered persons from relying on the exemption under Rule 506 under the Securities Act of 1933 for a securities offering if any of these individuals are subject to criminal convictions, disciplinary orders, or other administrative proceedings for wrongful acts, false representations, or other disqualifying events.

In addition, in July 2013, the SEC adopted rule amendments to strengthen the audit requirements for broker-dealers and enhance oversight of the way broker-dealers maintain custody of their customers' assets. Among other things, the amendments require that broker-dealer audits be conducted in accordance with standards of the Public Company Accounting Oversight Board as provided by the Dodd-Frank Act. In addition, broker-dealers are required to file a new form that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and non-customers so that regulators can better monitor custody practices and oversee security of customer assets.

In September 2013, the SEC adopted rules establishing a permanent registration regime for municipal advisors, as required by the Dodd-Frank Act. The new rules require a municipal advisor to permanently register with the SEC if it provides advice on the issuance of municipal securities or about certain investment strategies or municipal derivatives. As a result of these rules, municipal advisors will be subject to a comprehensive regulatory regime when they provide advice to municipalities.

6.4 Data Standards

Data standards improve the clarity and quality of data by providing an unambiguous and universally accepted meaning, thus increasing confidence in the data, and enabling comparison, aggregation, sharing, and exchange. Adoption of data standards also reduces the need for costly conversion when exchanging data. Building, adopting, and using standards for financial data will promote financial stability monitoring and both better risk management and lower-cost regulatory reporting by firms.

The financial industry, the Council, and the Council's members are increasingly focused on the need for data standardization. Many industries have found that sector-wide standardization can reduce costs and improve efficiency. The OFR works on behalf of the Council to participate as appropriate in industry standards-making bodies, such as the Mortgage Industry Standards Maintenance Organization, to ensure that regulatory needs are satisfied in data standard design. The SEC's new Market Information Data Analytics System (MIDAS), introduced in 2013, is an example of regulators' response to increasing amounts of data generated by financial markets. On a typical trading day, MIDAS collects roughly a billion price quotes and trades from 13 U.S. stock exchanges. Tools like MIDAS require significant data standardization.

6.4.1 Legal Entity Identifier

The progress of the global LEI is evidence of the Council and the international community recognizing the need for data standards. The LEI is a code that uniquely identifies parties to financial transactions instantly and precisely. It is the first non-proprietary global unique entity identifier. The LEI is expected to reduce

regulatory reporting burden and generate considerable cost savings for the financial industry in collecting, cleaning, and aggregating data. The LEI is a key identifier for enabling better monitoring of risks in the financial system.

To date, 13 organizations have issued more than 250,000 codes in 178 countries. Council member agencies have played a key role throughout the LEI development process, leading work streams, and working with other regulators and industry to provide recommendations to the G-20 to guide the governance, development, and implementation of the global LEI system. The OFR's Chief Counsel currently serves as the Chair of the LEI's Regulatory Oversight Committee, and representatives of the Federal Reserve, SEC, CFTC, OCC, and FDIC sit on this committee. The Global LEI Foundation is being established in Switzerland to oversee the system. The foundation's board of directors was nominated in December 2013 and was endorsed by the FSB in January 2014. It will have authority over a global federation of local operating units to ensure adherence with LEI governing principles.

Mandatory reporting uses of the LEI will facilitate the rapid deployment of the LEI. LEIs are already required for counterparty identification in the CFTC's and the European Securities and Markets Authority's swap data reporting requirements and are optional for reporting by private fund investment advisers on the SEC's Form PF. The European Banking Authority has decided to recommend the use of LEIs as unique identification codes for supervisory purposes for every credit and financial institution in the EU. The Council's Data Committee is evaluating how to expand the use of the LEI in U.S. regulatory and reporting requirements.

6.4.2 Mortgage Industry

Regulators are working to adopt data standards in the mortgage industry. As with LEIs, adoption of such standards offers the benefits of improved data quality, increased efficiency and effectiveness of data sharing among regulators, and decreased costs for regulatory reporting by the industry. The Dodd-Frank Act amended the Home Mortgage Disclosure Act to allow the CFPB to require a UMI, if deemed appropriate. The CFPB convened a Small Business Review panel in March 2014 to consider a number of issues in Home Mortgage Disclosure Act reporting, including the use of both the LEI and a UMI.

Given the size, complexity, and fragmented nature of the mortgage system, regulators need a clear and con¬sistent identifier of each mortgage. The Mortgage Industry Standards Maintenance Organization created placeholders in its standards for the LEIs of financial institutions involved in each loan, from origination through servicing and securitization of mortgages. A recent OFR working paper described how a universal mortgage identi¬fier could improve aggregation, comparability, and analysis in the U.S. mortgage industry. During the financial crisis, the lack of a mortgage identifier made it difficult for lenders and regulators to have a consistent understanding of trends in originations, underwriting standards, performance, and loan modifications. A unique mortgage identifier designed to protect individual privacy has the potential to be beneficial in this regard.

The Uniform Mortgage Data Program is an ongoing initiative implemented by the FHFA and the GSEs to improve the consistency, quality, and uniformity of data collected at the beginning of the lending process, as well as for servicing data. Developing standard terms, definitions, and industry standard data-reporting protocols will decrease costs for originators and appraisers, reduce repurchase risk, and also allow new entrants to use industry standards rather than having to develop their own proprietary data systems.

6.4.3 Swap Data Repositories

Promoting standardization and transparency in the OTC derivatives or swaps market is a priority for the Council and the international regulatory community. At the 2009 Pittsburgh summit, G-20 leaders

committed to several reforms to strengthen the OTC derivatives markets and improve transparency and regulatory oversight. One of the main elements of these reforms was the mandated reporting of OTC derivative transactions. OTC derivatives products have historically been among the least-standardized financial instruments. The Dodd-Frank Act established a new regulatory framework for OTC derivatives, under which all swap transactions must be reported to new entities known as SDRs or SBSDRs.

The CFTC has issued rules identifying specific fields that must be reported for every swap and for classes of swaps. Those rules require the use of the LEI as well as the Unique Product Identifier, which categorizes swaps according to certain underlying information, and the Unique Swap Identifier, which identifies individual swaps, where available.

SDRs for interest rate, credit, equity, FX, and other commodity asset classes under the CFTC's jurisdiction are required to publicly disseminate real-time swap transaction data for these swap transactions, such as transaction prices and sizes, "as soon as technologically practicable" after the SDR receives such data, unless the transaction is subject to a time delay. Additionally, all trades are subject to delays during the phase-in of the CFTC reporting rules. The CFTC has begun reporting aggregated swap data (such as aggregate numbers of trades and aggregate gross notional amounts) in weekly reports that combine data from the SDRs. These reports have recently estimated gross notional amounts reported at over $390 trillion.

There are four SDRs in the United States. In an effort to reduce burden, the CFTC required the SDRs to report transactions, but did not specify reporting standards regarding data definitions or formats. However, data standards are essential to enable data aggregation across SDRs and across asset classes. The CFTC, with support from other Council member agencies, is working to improve and harmonize data reporting by SDRs.

Legislation in several key jurisdictions has led to a proliferation of trade repositories (internationally, SDRs are referred to as trade repositories). However, in many jurisdictions, the legal framework for reporting derivatives transactions limits authorities' ability to obtain access to the information. In the United States, authorities (other than the CFTC or SEC, as applicable) face obstacles obtaining access to data reported to and maintained in registered SDRs without agreeing to confidentiality requirements and to indemnify the SDR and the CFTC or SEC for litigation expenses relating to the information provided. This and other obstacles restricting authorities' access to trade repository data run counter to the G-20's goals of practical and effective access for authorities and enhanced market transparency. With limited access to data, authorities, including certain Council members and member agencies, are unable to carry out fully their mandates to monitor systemic risk and identify potential emerging threats.

The FSB, Committee on Payment and Settlement Systems, and IOSCO have recognized the importance of standards in derivatives data reporting and the challenges posed by the fragmentation of derivatives data across global trade repositories. Disparate reporting rules, a lack of uniform data standards, and varying rules for authorities' access to data across jurisdictions makes analysis of the global derivatives market difficult. To fulfill their mandates, authorities may need to combine data from trade repositories within and across jurisdictions. In 2013, the FSB called for the creation of the Aggregation Feasibility Study Group to study how to ensure that data reported to trade repositories can be effectively used by authorities and options for producing and sharing global aggregated trade repository data. The Aggregation Feasibility Study Group includes representatives of the CFTC, Federal Reserve, FRBNY, and Treasury. The FSB published a consultative report in February 2014, and a final report is expected to be published in mid-2014.

6.4.4 Other Interagency Data Initiatives

Interagency Data Inventory

In January 2014, the OFR published an excerpt of its interagency data inventory for describing data that the Council member agencies collect from financial institutions. The inventory described almost 500 separate forms currently used in regulatory oversight by Council member agencies. The inventory is intended to help the OFR and member agencies identify potential gaps in data collection, with the goal of enabling an evaluation of what, how, and by whom data is being reported. The inventory may also facilitate identification of any overlaps in collections.

Private Fund Data

In July 2013, the SEC released a report on the use of data and records on private investment funds derived from the new Form PF. The SEC has received a complete set of initial filings from registered investment advisers on the form. As of mid-2013, private funds were reporting on more than $7 trillion in regulatory AUM with Form PF. The Council and OFR are using certain Form PF data to evaluate potential risks to financial stability. The OFR published preliminary results from analysis of Form PF data in its 2013 annual report, including analysis of leverage and VaR. SEC staff has begun to assess the quality of the data collected—including evaluating the consistency of filer responses and differences in approaches or assumptions made by filers—and has used the data to obtain information regarding certain private funds. The SEC also has identified a number of uses of the information, including incorporating Form PF data into SEC analytical tools, using Form PF information to monitor the risk-taking activities of investment advisers to private funds, conducting pre-examination due diligence and in risk identification, and providing certain aggregated Form PF data to IOSCO regarding large hedge funds to offer a more complete overview of the global hedge fund market.

6.5 Council Activities

6.5.1 Determination of Nonbank Financial Companies to be Supervised by the Federal Reserve

One of the Council's statutory authorities is to determine that a nonbank financial company will be subject to supervision by the Federal Reserve and enhanced prudential standards if the company's material financial distress—or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities—could pose a threat to U.S. financial stability. The Council's authority to make these determinations is an important tool to help mitigate potential threats posed by these companies to U.S. financial stability. The Dodd-Frank Act sets forth the standard for the Council's determinations regarding nonbank financial companies and requires the Council to take into account 10 specific considerations when evaluating those companies. To further inform the public of the Council's framework and processes for assessing nonbank financial companies, the Council issued a rule and interpretive guidance, beginning with the release of an advance notice of proposed rulemaking at its first meeting in October 2010.

The Federal Reserve issued a final rule in April 2013 establishing the requirements for determining if a company is "predominantly engaged in financial activities." A company that falls within this definition is eligible for a determination by the Council that the company could pose a threat to U.S. financial stability and will be supervised by the Federal Reserve and subject to enhanced prudential standards. For the purposes of Title I of the Dodd-Frank Act, a company is predominantly engaged in financial activities if 85 percent or more of its revenues or assets are derived from or related to activities that are "financial in nature" under the Bank Holding Company Act.

In 2013, the Council made its first determinations regarding nonbank financial companies. The Council voted in July to make final determinations regarding American International Group (AIG) and General

Electric Capital Corporation. In September, the Council voted to make a final determination regarding Prudential Financial. The basis for each final determination is available on the Council's website.

The Council's three determinations in 2013 followed the process laid out in the Council's rule and guidance. Each of the nonbank financial companies subject to a Council determination received a letter in June 2013 informing it that the Council had made a proposed determination and providing it with an explanation of the basis of the Council's proposed determination. Each company then had 30 days to request a hearing to contest the Council's proposed determination. Neither AIG nor General Electric Capital Corporation requested a hearing. The Council conducted a hearing for Prudential Financial in July 2013.

6.5.2 Risk Monitoring and Regulatory Coordination

The Dodd-Frank Act charges the Council with responsibility to identify risks to U.S. financial stability, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. The Council also has a duty to facilitate coordination among member agencies and other federal and state agencies regarding financial services policy and other developments. The Council regularly examines significant market developments and structural issues within the financial system. For example, over the past year, the Council has considered issues such as market volatility, the government shutdown and debt ceiling impasse, interest rate risk, economic developments in Europe and emerging economies, housing finance reform, the NASDAQ trading halt in August 2013, and risks to financial stability arising from cybersecurity vulnerabilities. The Council will continue to monitor potential threats to financial stability, whether from external shocks or structural weaknesses, and to facilitate coordination among federal and state agencies.

To facilitate this risk monitoring process, the Council established the Systemic Risk Committee (SRC), composed primarily of member agency staff in supervisory, monitoring, examination, and policy roles. The SRC serves as a forum for member agency staff to identify and analyze potential risks that may extend beyond the jurisdiction of any one agency.

The OFR plays an important role in the activities of the Council. In 2013, the OFR reported regularly to the SRC on developments in financial markets. In its 2013 annual report, the OFR issued a prototype Financial Stability Monitor that assesses risks to the financial system based on five areas of risk: macroeconomic, market, credit, funding and liquidity, and contagion.

6.5.3 Study on Asset Management and Financial Stability

In September 2013, the OFR released a report requested by the Council that provided an overview of the asset management industry and an analysis of how asset management firms and their activities could introduce vulnerabilities into the financial system. The Council had requested the report to inform its analysis of potential threats asset management activities or firms might pose to financial stability.

The OFR's report noted that asset management activities and firms differ from commercial banking and insurance activities in that asset managers act primarily as agents, managing assets on behalf of clients as opposed to investing on the managers' behalf. Nonetheless, the report stated that some asset management activities could give rise to threats to financial stability if improperly managed or accompanied by the use of leverage, liquidity transformation, or funding mismatches. For example, the report discussed risk-taking in separately managed accounts and the reinvestment of cash collateral in securities lending transactions. The report also noted that significant data gaps hamper analysis of the industry. The Council is considering potential next steps with regard to asset management.

6.5.4 Operations of the Council

The Dodd-Frank Act requires the Council to convene no less than quarterly. In 2013, the Council met 10 times. The meetings bring Council members together to discuss and analyze market developments, threats to financial stability, and financial regulatory issues. While the Council's work frequently involves confidential supervisory and sensitive information, the Council is committed to conducting its business as openly and transparently as practicable. Consistent with the Council's transparency policy, the Council opens its meetings to the public whenever possible. The Council held a public session at two of its meetings in 2013.

Approximately every two weeks, the Council's Deputies Committee, which is composed of senior representatives of Council members, convenes to discuss the Council's agenda and to coordinate and oversee the work of the SRC and the five other functional committees. The other functional committees are organized around the Council's ongoing statutory responsibilities: (1) identification and consideration of nonbank financial companies for designation; (2) identification and consideration of FMUs and payment, clearing, and settlement activities for designation; (3) making recommendations to primary financial regulatory agencies regarding heightened prudential standards for financial firms; (4) consultation with the FDIC on OLA and review of the resolution plan requirements for designated nonbank financial firms and the largest BHCs; and (5) the collection of data and improvement of data-reporting standards.

The ability to share data among Council members with confidence that the data will be maintained securely is important to the Council. To help accomplish this objective, the Council's Data Committee developed a framework that builds on existing standards and agreements to enable the secure sharing of data among Council member agencies. Each agency retains the discretion to determine how to apply the framework internally, based on the unique nature of that agency's organization or mission.

In 2013, the Council adopted its fourth budget. In addition, the Council fulfilled its obligations under the Freedom of Information Act (FOIA) by responding to FOIA requests in accordance with the Council's FOIA regulation, and complied with the Council's transparency policy by conducting its business in an open and transparent manner whenever possible.

6.5.5 Section 119 of the Dodd-Frank Act

Section 119 of the Dodd-Frank Act provides that the Council may issue non-binding recommendations to member agencies on disputes about the agencies' respective jurisdiction over a particular BHC, nonbank financial company, or financial activity or product. (Certain consumer protection matters, for which another dispute mechanism is provided under Title X of the Act, are excluded.) To date, no member agency has approached the Council to resolve a dispute under Section 119.

BOX G: Governance and Transparency

The Council seeks to maximize transparency and accountability while also protecting the market-sensitive and confidential information that it regularly considers. Achieving this balance has been a priority for the Council since its first meeting in October 2010, when it adopted its publicly available bylaws and transparency policy. The Council opens its meetings to the public whenever possible and will continue to seek opportunities for public engagement. For example, in December 2013, for the first time, a representative from the private sector presented at a public meeting of the Council.

The Council undertook a review of its governance and transparency policies in 2013 and early 2014 to help ensure that these policies remain appropriate. The review included consideration of the practices of other organizations with similar structures, memberships, or responsibilities as the Council. As a result of this work, the Council is considering several enhancements to its transparency policy and the adoption of bylaws for its Deputies Committee. These efforts are intended to help the Council achieve its goal of maximizing transparency and accountability, while continuing to protect the confidentiality of sensitive information. Some of the changes would formalize or expand on existing practices of the Council, such as providing public notice at least seven days before all regularly scheduled Council meetings and releasing a brief summary of the topics discussed immediately after each meeting, in order to provide the public with information about Council proceedings well in advance of the release of the official minutes for each meeting.

The Deputies Committee bylaws would further clarify the purpose, duties, and composition of the committee.

Information about the Council's governance is available at www.fsoc.gov.

7 Potential Emerging Threats

7.1 Risk of Reliance Upon Short-Term Wholesale Funding

The risk of fire sales continues to be a major source of financial instability in the tri-party repo market. This instability is particularly acute because of the large size of the tri-party repo market and the potential vulnerability emanating from liquidity pressures that could force many investors to sell assets simultaneously.

Repos and securities borrowing transactions provide a means for participants to enter into short sales and broker-dealers to meet their settlement obligations. The tri-party repo market is used by broker-dealers to finance their securities inventories and client securities. Funding in this market is primarily provided by MMFs, securities lenders, and other institutional cash investors such as mutual funds, insurance companies, corporate treasurers, and state and local government treasurers.

There are two types of fire-sale risk: Pre-default fire sales occur when a dealer begins to lose access to market sources of funding and must sell its securities quickly. Post-default fire-sales occur when a dealer defaults and its investors receive its repo collateral in lieu of cash repayment, and sell that collateral in an uncoordinated and rapid manner.

Large broker-dealers' tri-party repo books range between $100 and $150 billion. The collateral is mainly government securities, but the size of these positions can dwarf the amount a single investor could expect to sell without pushing prices lower on a given day. The liquidation risk is even greater for less-liquid, lower quality collateral.

MMFs and securities lenders constitute more than half of the investor base in tri-party repo. These firms are vulnerable to same-day calls for liquidity, creating strong pressure to sell assets quickly if needed to generate that liquidity. MMFs can experience runs when perceived by shareholders to have worrisome risk exposures. This vulnerability was evident following the bankruptcy of Lehman Brothers, when investors withdrew approximately $300 billion (10 percent of assets) from prime MMFs in a couple of days. Lenders of securities typically include mutual funds, pensions, insurers, and other asset managers that own securities and can enhance returns by lending securities. Because most securities lending is done against cash collateral, securities lenders, or their agent often hold large pools of cash collateral, which they reinvest to enhance their return. Most securities lending is done on an open maturity basis, which means that the lender of a security has to return the cash collateral as soon as the borrower returns the security, and can face the need to generate liquidity quickly to make that return.

Pre- and post-default fire sales require different risk mitigants. Regulators of broker-dealers can examine firms to assess their management of rollover risk, the maturity of their repo books, their single-day concentrations, and their capital and liquidity resources. But no single regulator has an ability to impose a coordination mechanism to support orderly liquidations across all investors in the market. Market participants will be critically important in defining a solution to this collective action problem.

7.2 Developments in Financial Products, Services, and Business Practices

The financial system is constantly evolving. New products, services, and business practices are being developed, and existing products are undergoing changes or being used in new ways or with greater frequency. These changes can occur for a variety

of reasons, including improvements in technology that make new practices possible, new or changing regulations, and competition between financial institutions for customers.

Financial evolution provides a number of benefits to the financial system. Investors and consumers gain access to new products. New products and services also may serve the needs of financial institutions. Along with these benefits come new challenges to supervisors and regulators. For example, as regulators institute new regulations, products or services are often developed that attempt to weaken the effectiveness of these regulations. In other cases, activities may move outside of the regulatory perimeter or move from a heavily regulated entity to an entity that is less regulated. Still, other innovations may result in products or services where the interests of the provider are not aligned with the interests of the consumer.

While at times it is possible to evaluate the benefits of an innovation early on, more often than not it is difficult to determine whether an innovation will be beneficial to the financial system. As a result, authorities are confronted with the need to make a judgment about the potential net benefits of a new practice. Because it is impossible to foresee how even seemingly beneficial innovations will ultimately be utilized, that judgment can be very difficult.

An example may shed some light on this difficult determination. CDS were introduced in the early 1990s. CDS allow the buyers of the contracts to transfer the credit risk associated with fixed income products to the sellers of the contracts. The ability to set a market price for the credit risk of a fixed income product was an important, positive change for financial markets, and when the market was relatively small, few questioned the product. The market grew and evolved until the notional value of CDS contracts outstanding was over $60 trillion in 2007, and CDS were being written on increasingly complex structured products. Concerns arose about lack of transparency, flaws in record keeping, and the misjudgment of risk that some market participants appeared to have with respect to their CDS positions. Ultimately, some of these issues contributed to the problems that led to the federal bailout of AIG during the financial crisis.

The changing landscape of the post-financial crisis world has fostered many innovations. What follows are examples of developments in products, services, and business practices that Council member agencies are currently aware of and are monitoring so as to understand the potential benefits and risks. We list these in order to illustrate the many ways in which innovation is manifested in the current financial landscape and the need for Council member agencies to remain vigilant.

- MSRs are increasingly being transferred to nonbank mortgage servicing companies. While the CFPB and state regulators have some authority over these companies, many of them are not currently subject to prudential standards such as capital, liquidity, or risk management oversight. Further, in many cases, mortgage investors' ability to collect on mortgages is dependent on a single mortgage servicing company, where failure could have significant negative consequences for market participants.

- Banks are building in optionality to the money market instruments they issue to raise funding. Some instruments give investors the option to put paper back to the bank ahead of the maturity date. Others allow the bank to call the paper prior to its scheduled maturity. These options satisfy investors' needs for liquidity, but they serve other purposes as well. For example, some institutions have been issuing debt with an embedded call option, despite the additional cost. The willingness to bear this cost appears to be driven by these institutions' belief that they do not need to hold liquid assets against these liabilities provided they call them 30 or more days prior to maturity. However, to the extent that this practice creates expectations of future callbacks, a deviation from this practice can be interpreted as a negative signal by market participants.

- High demand for single-family rental properties and low price-to-rent ratios appear to have

attracted new investors to the single-family rental property market. Late last year, the first securitization of income from single-family rental properties was issued. However, since developments in this area are new, there is uncertainty about how they will impact the housing finance market, renters, and investors.

- In the insurance industry, life insurance companies have increasingly used affiliated captive reinsurers to address perceived redundancies in statutory reserves, and for other reasons. However, some state insurance regulators have expressed concern about this practice and how it affects the overall reserve and capital levels of the company.

- Pension plans are transferring their exposure to longevity risk to the insurance industry. In some instances, both the asset risk and the longevity risk are transferred to an insurance company. In other instances, pension plans are keeping the asset risk but transferring the longevity risk outright to the insurance industry. This business migration moves risk between spaces with different regulations. While this migration has the potential to provide significant benefits to pension plan participants as well as the insurance industry, it also has the potential of transferring significant amounts of risk to the insurance industry.

- Some asset managers are now providing indemnification to securities lenders as part of their securities lending business. There are likely benefits for asset managers from combining indemnification provision with securities lending, but there also is the potential for enhanced risks. Unlike banks, asset managers are not required to set aside capital when they provide indemnification. Also, although asset managers have access to management fees, they do not have access to banks' stable deposit funding base. Consequently, the indemnification that asset managers provide may be a source of stress on their own balance sheets, while at the same time resulting in lower protection for the lenders relative to indemnities provided by banks.

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

Historically, when large, complex, interconnected financial institutions became distressed, the official sector often intervened to maintain financial stability. In the financial crisis of 2008, the official sector, including the Federal Reserve, Treasury, and FDIC, provided liquidity and solvency support to some of the largest U.S. financial institutions. Past support can engender expectations of future support, and such expectations provide incentives for further increases in size, interconnectedness, and complexity. When market participants, including bond investors, uninsured depositors, and other counterparties, expect institutions to receive support, they will not correctly price risk when lending to and transacting with these institutions. This will incentivize large institutions to take on excessive risk, and put pressure on competing firms to do likewise.

The Dodd-Frank Act explicitly addresses and attempts to mitigate the incentives and abilities of large, complex, interconnected financial institutions to engage in excessive risk-taking through a combination of policies.

1. The Act limits the ability of the Federal Reserve to provide extraordinary support to individual institutions.

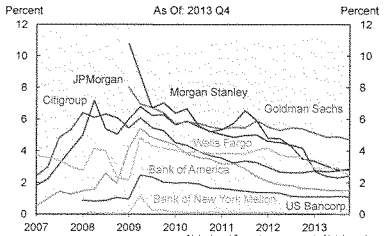
2. The Act requires the Federal Reserve to adopt enhanced prudential standards for the largest BHCs and designated nonbank financial companies (**see Section 6.1.1**). The stringency of these requirements must increase with the size and complexity of the firm. In addition, the Dodd-Frank Act requires the Federal Reserve to impose a debt-to-equity limit on companies the Council has determined pose a grave threat to financial stability. On February 18, 2014, the Federal Reserve adopted final rules establishing enhanced prudential standards for large BHCs and FBOs. The final rule also requires a FBO with a significant U.S. presence to establish an intermediate holding company over its U.S. subsidiaries. The Federal Reserve is continuing

to develop single counterparty credit limits and early remediation requirements for both large BHCs and FBOs.

3. Title I of the Act requires certain companies to develop and submit to the Federal Reserve and the FDIC their own plan for rapid and orderly resolution under the Bankruptcy Code in the event they experience material financial distress or failure. Title II of the Act authorizes the FDIC to resolve financial companies whose failure and resolution under otherwise applicable law would have serious adverse effects on U.S. financial stability. The FDIC is developing a strategic approach, referred to as SPOE, to carry out its OLA for resolving a financial company. On December 10, 2013, the FDIC Board approved a Federal Register notice for public comment that provides greater detail on the SPOE strategy and discusses key issues that will be faced in a financial company's resolution **(see Section 6.1.4)**. Additionally, the Federal Reserve is considering adopting a proposal that would require the largest, most complex U.S. banking firms to maintain a minimum amount of long-term unsecured debt outstanding at the holding company level.

During 2013, the largest U.S. financial institutions continued to reduce their complexity. For example, they now hold fewer assets where fair value measurement is based on unobservable inputs (level 3 assets), one of the measures used to identify global systemically important banks **(Chart 7.3.1)**. Similarly, they continued to reduce their interconnectedness, as measured by the estimated size of the fire-sale externalities they would impose on the rest of the system if they were subject to an adverse shock to their assets or equity capital **(Chart 7.3.2)**. Some of them increased their size further, but at a slower pace than during the pre-crisis period. Additionally, since the passage of the Dodd-Frank Act, certain rating agencies have lowered their assessments of the likelihood of government support. Moody's assessment of the probability that a bank will

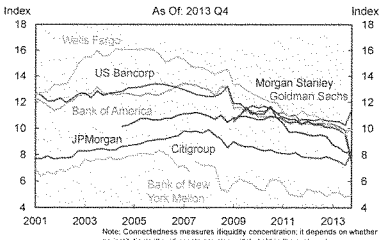
7.3.1 Level 3 Assets



Note: Level 3 assets as a percent of total assets. Level 3 assets are assets whose fair value cannot be determined by using observable inputs.

Source: FRBNY

7.3.2 Connectedness



Note: Connectedness measures illiquidity concentration; it depends on whether an institution's illiquid assets are also widely held in the system. Lower connectedness implies smaller fire-sale externalities when banks suffer shocks. The Bank of New York merged with Mellon Financial in 2007, hence the break.

Source: FRBNY

receive support from the official sector or the parent corporation in times of stress has declined for most of the largest banks after the passage of Dodd-Frank Act **(Chart 7.3.3)**. Fitch's assessment of the likelihood that a bank will receive support from the official sector in times of stress depicts a similar picture **(Chart 7.3.4)**.

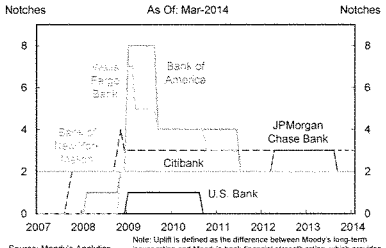
However, both rating agencies are still of the opinion that there is some chance that the official sector will provide support to the largest banks if they become financially distressed **(Charts 7.3.3, 7.3.4)**.

It is possible that these remaining expectations of official sector support reflect the incomplete state of Dodd-Frank Act implementation. To the extent that this is the case, the full implementation of the orderly resolution facility and the phasing in of enhanced prudential standards in coming years should help reduce remaining perceptions of government support to large, complex, interconnected financial institutions.

7.4 Reliance upon Reference Rates as a Vulnerability

As discussed in the Council's 2013 annual report, the problems with USD LIBOR reflect several interrelated structural factors including the decline in unsecured interbank markets, the incentives to manipulate rates submitted to reference rate panels owing to the vast scale of derivatives tied to the reference rate, and the dominance of instruments tied to LIBOR in terms of market liquidity. Reliance on USD LIBOR creates vulnerabilities that could pose a threat to market integrity, the safety and soundness of individual financial institutions, and to U.S. financial stability. First, a reference rate that is not anchored in observable transactions or that relies overly on transactions in a relatively low-volume market increases the incentives and potential for manipulative activity. Second, the current and prospective levels of activity in unsecured interbank markets raise the risk that continued production of LIBOR might not be sustainable. The cessation

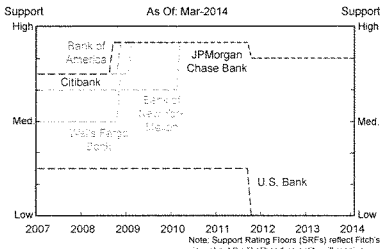
7.3.3 Moody's Systemic Support Uplift



Source: Moody's Analytics, FRBNY calculations

Note: Uplift is defined as the difference between Moody's long-term issuer rating and Moody's bank financial strength rating, which provides an estimate of the effect of implicit guarantees and external support.

7.3.4 Fitch Support Rating Floors



Source: Fitch Ratings

Note: Support Rating Floors (SRFs) reflect Fitch's view about the likelihood an entity will receive extraordinary government support in case of need.

of such a heavily used-reference rate would pose substantial legal risks and could cause substantial disruptions to and uncertainties around the large gross flows of LIBOR-related payments and receipts between financial institutions.

Manipulative Activity in Interest Rate Benchmarks

Since the Council's 2013 annual report, the CFTC issued orders bringing and settling charges of manipulation, attempted manipulation, and false reporting against Rabobank and ICAP, an interdealer broker. In total, five financial institutions have now settled with the CFTC over charges of benchmark interest rate manipulation, paying fines and penalties of nearly $3 billion. Globally, penalties paid related to benchmark interest rate manipulation exceed $6 billion.

Reform Efforts in Interest Rate Benchmarks

Since the Council's 2013 annual report, official sector efforts to strengthen financial market benchmarks have made substantial progress.

The IOSCO Task Force on financial market benchmarks published its final report in July 2013 establishing principles of governance, quality, and accountability for all financial benchmarks. IOSCO intends to review the extent to which benchmark administrators, within an 18-month timeframe, have implemented the principles.

In June 2013, the FSB established an Official Sector Steering Group (OSSG) comprised of relevant central banks and regulatory agencies including the Federal Reserve and CFTC. The OSSG was tasked with coordinating reviews of existing interest rate benchmarks, encouraging the identification of robust alternative benchmarks by the private sector, and proposing strategies for transitioning to a new benchmark. The OSSG is scheduled to provide its analysis and recommendations to the FSB in June 2014.

The OSSG's work has focused on LIBOR, the EURIBOR and the Tokyo Interbank Offered Rate (TIBOR). While some alternative to these rates could include bank credit risk, other alternative rates would be largely risk-free and potentially more appropriate for use in derivatives transactions or other products where credit risk plays a smaller role. Using largely risk-free rates for these transactions would lower the risks to financial institutions and to financial stability from a further decline in the unsecured interbank market, consistent with the Council's recommendations. Separating the reference rate used for most derivatives from the interbank market would also remove one of the significant incentives to manipulate LIBOR and would allow some users to select a reference rate that is more appropriate for their purpose than the current system in which the vast majority of contracts reference LIBOR.

Concerns about Other Reference Rates

Since the Council's 2013 annual report, concerns about other financial benchmarks, including swap rates and FX rates, have increased. These benchmarks are used for valuing numerous contracts and portfolios of assets. In various countries, agencies, including the Department of Justice in cooperation with U.S. financial regulators, have begun to investigate charges of manipulation of exchange rate benchmarks. Authorities are also investigating charges of manipulation of ISDAfix, a leading set of benchmarks for interest-rate-swap rates produced by the ISDA.

These investigations serve as a reminder of the prevalence of benchmark rates across financial markets and of their integral importance to the financial system. IOSCO intends to review the extent to which its principles have been implemented across a wide set of financial markets. In addition, the FSB created a subgroup to undertake a review of exchange rate benchmarks and market practices in relation to their use. Conclusions and recommendations from this review will be transmitted by the FSB to the G-20 in November 2014.

7.5 Financial System Vulnerability to Interest Rate Volatility

The prolonged period of low interest rates and low volatility has led financial institutions and investors to search for yield. Low interest rates weigh on earnings of banks, credit unions, broker-dealers and insurance companies, thereby incenting companies

to seek higher-yielding investments. The ability of pension and retirement funds to meet their long-term liabilities is also under pressure, incenting them to seek more yield.

Investors have responded to the low interest rate environment in different ways. Some have extended maturities or invested in lower-quality credit, or sought ways to further enhance returns with leverage. While some leveraged strategies and investment vehicles have nearly disappeared since the end of the financial crisis, others have witnessed a large growth or resurgence. Among fixed income mutual funds, high yield and leveraged loan funds have experienced record inflows. In equity markets, agency mortgage REITs experienced substantial inflows of funds in the years after the crisis. Furthermore, hedge fund products such as risk parity funds—which hold a leveraged position in fixed income and an unlevered position in equities so as to achieve the same total volatility in each of those two asset classes—have continued to be popular. Issuance of CLOs is at record highs. Additionally, higher yields and stronger economic growth have fueled investments in EM bonds, pushing flows between 2009 and early 2013 to record high levels. While each of these developments is likely due to a range of factors, including the economic recovery and an increase in risk appetite, low interest rates have probably played a role.

Financial institutions also have responded to the low interest rate environment. Some banks have extended their portfolios' durations, and eased their loan underwriting standards, discounting risk when setting interest rates, and reducing the incidence of covenants. Banks also have increased the volume of leveraged loans **(see Section 5.1.1)**. Insurance companies have adjusted their investment portfolios by moderately increasing the duration of their portfolio and investing in lower quality credit. MMFs also have modestly increased the duration of their fund portfolios **(see Section 5.5.1)** in order to obtain higher yields.

Since the 2013 annual report, yields in fixed-income markets increased significantly and volatility surged during the summer **(see Box C)**. During the May to September 2013 period, there was a significant repricing of long-duration fixed-income assets. The sharp rise in rates and volatility triggered losses across fixed income investment strategies and vehicles. Bond mutual funds experienced large outflows; the agency mortgage REIT share price index lost 25 percent; risk parity funds posted record losses; and EMs' financial assets sold off broadly. While the rise in rates last year was large by historical standards, it did not create any disruptions to the intermediation function of the financial system, or more broadly to the banking and insurance sectors. However, investors did suffer sizeable losses. In addition, as explained in section 5.1.4, the weakening in housing starts in the latter part of 2013 has largely been attributed to the rise in mortgage rates last year.

Despite the relatively benign impact on financial stability of last year's increase in long-term interest rates, a sharp increase in interest rate volatility still poses some potentially important threats to financial stability. The first threat is that a bigger interest-rate shock might still occur. While a larger shock is less likely, given the normalization of rates that we have seen so far, it can certainly not be ruled out. Moreover, the leveraged strategies highlighted above leave investors potentially exposed to sizable losses should a sharp jump in yields materialize, and such losses could force institutions to liquidate positions, pushing yields yet higher.

A second concern with interest rate volatility risk relates to the recent growth in floating rate loans and the loosening of underwriting standards. Since most leveraged lending is done with floating rate instruments and borrowers have high levels of debt, a sharp rise in short term interest rates could also have significant adverse effects to these borrowers' credit risk and possibly their credit holders. In addition, since the crisis, some banks have combined floating rate lending with market-based pricing, whereby they tie loans' credit spreads to borrowers' CDS spreads. This practice has the potential to create an amplifying mechanism for interest-rate shocks that may ultimately have significant effects on borrowers' credit risk and by extension on their creditors.

A continued low rate environment has additional risks. It will continue to drain earnings of financial institutions. Pension and retirement funds historically relied on rate of return assumptions based on earlier periods when interest rates were between 5 and 10 percent. Therefore, pension and retirement liabilities that were based on assumptions of such higher returns will reduce the earnings of these companies, as their assets will yield substantially less in a low-interest rate environment. For insurance companies, low rates affect policyholder behavior in a way that reduces earnings. In addition, low rates may make it difficult to sell new policies for some products at a profit. In Japan, a country that has experienced a prolonged period of low rates for nearly 25 years, a number of insurers went bankrupt, although low interest rates were only one contributing factor in a complex process.

7.6 Operational Risks

Cybersecurity: Vulnerabilities to Attacks on Financial Services

Cyber incidents can impact the confidentiality, integrity, and availability of the information and technologies essential to the provision of services, resulting in financial, compliance, and reputation risk. Moreover, cyber incidents that disrupt, degrade, or impact the integrity and availability of critical financial infrastructure could have consequences on operations and efficiency. Such incidents can undermine the confidence of consumers and investors, and ultimately, threaten the stability of the financial system.

In the past two years, several financial institutions sustained distributed denial-of-service attacks to their public-facing websites. The frequency of such incidents declined over much of 2013. Other types of cyber incidents have engendered public concern, in part because of their increasing magnitude. For instance, the recent theft of customer information at Target and other retailers showed how skilled cyber thieves could gain access to significant amounts of credit and debit cardholder data. It also highlighted the potential risks posed by the financial sector's interconnectedness with other major sectors of the economy. Indeed, cyber criminals exploited vulnerabilities at certain third-party and retailer IT networks in order to gain access to customer information that could be used illegally throughout the broader retail payment system. Similar attacks against other non-financial sector networks may continue to pose threats to customers of financial institutions.

Mitigating the evolving cyber threats, effectively managing incidents, and promoting recovery efforts are critical to maintaining public confidence and reducing financial risk. These actions require a close partnership between the public and private sectors. In 2013, the Federal Financial Institutions Examination Council established a cyber-related working group to review cyber-related activities. Financial institutions have been investing in ways to protect their systems and infrastructure and to design their core information and transaction systems to make it harder for intruders to gain access to valuable data. Financial services industry associations have similarly been focused on bolstering resilience. The Financial Services Sector Coordinating Council, and the Financial Services Information Sharing and Analysis Center are the private sector's principal representatives on cybersecurity matters. Over the last year, these two groups have collaborated with the Treasury and members of regulatory, law enforcement, and intelligence communities to identify measures and best practices for disseminating timely and actionable information.

The President's Executive Order 13636 on Improving Critical Infrastructure Cybersecurity should help strengthen these activities. Among its core provisions is the establishment of a new cybersecurity framework to encourage private institutions to strengthen cybersecurity practices as well as an expedited process for obtaining security clearances so that qualified employees at these firms can gain access to sensitive information and technical assistance from the government.

In addition, the Department of Justice and the Federal Trade Commission in April 2014 released an antitrust policy statement on the sharing of cybersecurity information among industry, which is designed to reduce uncertainty for those who want to share ways to prevent and combat cyber attacks.

The financial sector is increasingly dependent on many other industry sectors, including energy, transportation, and telecommunications. As a result, a cyber event that disrupts or destroys any critical infrastructure organizations in these areas could have significant spillover effects on the financial sector.

Market Infrastructure and Market Continuity

A number of different operational issues affected the U.S. securities markets in 2013, including network connectivity and hardware failures, software changes and configuration management errors, and human operational errors. These issues led to the suspension of trading on the affected exchanges for up to several hours, the disruption of trade and quote publication for stocks, the display of erroneous trading data, broken trades, the execution of expired orders, and the publication of inaccurate quotes. Although none of these incidents rose to the level of posing a threat to financial stability, they do serve as important reminders of the need to address operational risks. Some notable events include:

- On August 20, 2013, an internal error in Goldman Sachs's trading systems caused the firm's non-actionable indications of interest in certain options symbols to be treated as actual orders to buy and sell options with unintended limit prices. These orders were sent to the options exchanges just prior to the opening of trading. Some of the resulting trades were cancelled according to the obvious error rules of the options exchanges, but Goldman Sachs took net losses on the trades that were not cancelled.

- On August 22, 2013, NASDAQ halted trading in all NASDAQ-listed securities for more than three hours after the Unlisted Trading Privileges Securities Information Processor, the single source of consolidated market data for Nasdaq-listed securities, was unable to process quotes from the exchanges for dissemination to the public. Once the halt was lifted, trading resumed and the markets held a normal end-of-day close for NASDAQ-listed securities.

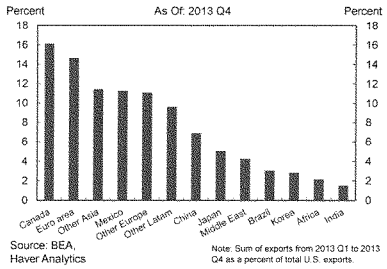
The importance of system integrity in highly interconnected markets is critical. When systems do not operate as intended, there are consequences for all market participants. Significant and frequent system failures that impact financial markets can potentially erode investor confidence and may threaten market stability. During 2013 regulators took steps to address such infrastructure concerns as well as continue to address automated-trading system issues. In March 2013, the SEC proposed Regulation Systems Compliance and Integrity to strengthen the automated systems of important participants in the securities markets. Additionally, in September 2013 the CFTC published "Concept Release on Risk Controls and Systems Safeguards for Automated Trading Environments" which requested information about market practices relating to the use of automated trading systems and possible regulations that would have a direct impact on a wide variety of market participants.

7.7 Foreign Economic and Financial Developments

Foreign risks can threaten U.S. financial stability and economic activity. The nature of these risks has shifted over the past year with many EMEs experiencing considerable market stress, stemming from a number of domestic challenges and changes in expectations for U.S. monetary policy. EMEs have generally stronger macroeconomic fundamentals and structural buffers compared to previous crisis periods. China's ability to reform its economy while avoiding an abrupt slowdown in growth remains critical for the global economy and EMEs in particular. In the past year, potential risks in the euro area and Japan have declined. Still, the potential for negative shocks to the U.S. economy from strains abroad remain significant.

There are a number of channels through which international developments could spill over to the U.S. economy and financial system. For example, weakness in foreign growth and asset prices may translate into lower demand for U.S. exports, weighing on U.S. growth. In aggregate, EMEs import the largest share of U.S. goods

7.7.1 Destination of U.S. Exports of Goods and Services



Source: BEA, Haver Analytics

Note: Sum of exports from 2013 Q1 to 2013 Q4 as a percent of total U.S. exports.

7.7.2 Country Exposures of All U.S. Banks

As Of: Sep-2013

	Total Exposure (Billions of US$)	Cross-Border Claims (Billions of US$)	Foreign Office Claims (Billions of US$)	Total Exposure Relative to Tier 1 Capital (Percent)	Memo: Unused Commitments (Billions of US$)
Europe	1686	955	513	150%	246
- Euro area	906	701	76	80%	134
Japan	377	134	225	33%	31
Total EME	786	387	378	70%	87
- China	88	53	33	8%	5

Source: FFIEC Country Exposure Report

Note: EME exposures exclude financial centers. Euro area does not include data for Cyprus, Estonia, Latvia, Malta, or Slovenia, which are not publicly available

and service exports, with the largest importers being Mexico and China. In addition to its direct trade ties to the United States, China also stands out for its significant contribution to global growth—roughly one-quarter since 2010. Trade links with Japan and the euro area are sizeable as well (**Chart 7.7.1**).

Another channel for spillover is through U.S. banks' country exposures (**Chart 7.7.2**). Exposures to EMEs totaled $786 billion, including sovereign and private sector exposures, as of the third quarter 2013 weighted toward private sector borrowers in investment-grade rated countries, with the largest exposures to Brazil, Mexico, Korea, India, and China. U.S. banks' total exposure to Europe is even greater at $1.7 trillion, while Japanese exposure totals $377 billion. Indirect exposures are also important; some European banking systems, including ones in the euro area periphery, have larger exposures to EMEs than do the U.S. banking system banks.

Emerging Markets

U.S. economic and financial linkages with the emerging world in aggregate are sizeable, but links with any one country appear limited. While EME growth has decelerated in recent years, and external vulnerabilities have increased, risks of a broad EME crisis appear contained. Past EME crises have often come in clusters, reflecting changes in the global environment, shared vulnerabilities, and common external funding sources. The downside risk is that conditions deteriorate, reducing growth, which spurs further reductions in capital flows to EMs and increases global financial strains.

In some countries, market confidence in the trajectory of domestic policy or politics has declined, contributing to financial pressures. Additionally, there are signs of increasing vulnerability in the corporate sector in some EMEs stemming from significant borrowing and deteriorating profitability in the context of weaker growth. However, the level of vulnerability across the EMEs

appears materially lower than in the run-up to past crisis episodes. This reflects improved policy frameworks, including flexible exchange rate regimes, independent central banks, and generally lower levels of government indebtedness. Moreover, existing foreign reserves can cover years of maturing debt in most EMEs, providing scope to ride out periods of increasing market volatility and reduced funding. Additionally, while foreign portfolio inflows have surged since the global financial crisis, the relative importance of stable foreign direct investment flows in EMEs' external funding has also increased. Finally, EME banks generally have stronger capital and liquidity positions and are better managed and supervised than has historically been the case.

China

Recent Chinese economic data suggest that activity is decelerating, in line with the government's desire to slow credit expansion **(see Section 4.4.2)**. Given the difficulty in achieving a well-timed and calibrated rebalancing, authorities will encounter significant challenges in their attempts to shift growth away from inefficient investment and exports towards consumption. Authorities also face a challenge in addressing liquidity risks and rapid growth in off-balance sheet liabilities in the financial sector, which contributed to elevated volatility in the interbank money market in the second half of 2013. China is set to gradually undertake a host of difficult structural reforms, such as interest rate and capital account liberalization. China's strong external position, however, provides an important buffer against shocks.

Euro Area

Public sector debt burdens, at the periphery, are projected to stabilize at high levels, leaving that part of the euro area vulnerable to policy setbacks, shifts in market sentiment, and eventually, rising interest rates. The announcement of the ECB's outright monetary transactions (OMT) program effectively served as a backstop to peripheral sovereign debt markets and contributed to the sharp reduction in peripheral spreads since June 2012. However, the OMT itself is now subject to some uncertainty following the decision by Germany's constitutional court to refer its case on the program's legality to the European Court of Justice, indicating that it views the current program as non-compliant with the EU Treaty.

Financial fragmentation within the euro area also persists. The ECB's comprehensive assessment of the largest euro area banks will be an important test for the new regulatory and supervisory framework with implications for the credibility of the ECB and confidence in euro area's banks. Ensuring adequate credibility and transparency regarding methodology, risk exposures and results, given limited clarity regarding available national and regional backstops to address identified capital shortfalls, will be important for the success of the exercise.

7.8 Data Gaps and Data Quality

More than five years after the financial crisis, regulators have made significant progress in addressing financial data gaps. Regulators collect real-time data from derivatives markets, detailed loan- and position-level financial data from banks, and data from MMFs and private funds.

However, gaps remain in the data that are available, both to regulators and market participants. The Council remains concerned about the risks of funding runs and fire sales in wholesale funding markets. Council members have highlighted weaknesses in the scope and availability of data that are available to regulators concerned with monitoring these risks, particularly around repo and securities lending activities. U.S. banking regulators now have access to fairly detailed data on tri-party repo and GCF repo transactions through the two clearing banks that conduct all of the domestic matching and settlement activity and have this information for all of their customers. However, regulators and policymakers currently have no reliable, ongoing information on bilateral repo market activity, which is more difficult to collect because activity in this segment does not flow through a settlement agent like tri-party and GCF repo transactions do.

There are similar data gaps regarding the securities lending activities of financial institutions. Regulators are still unable to fully monitor securities lending transactions and the reinvestment of cash collateral. It is difficult to know the depth of securities lending in a particular issue, the counterparty exposures, or the number of times that an issue has been re-lent. The Dodd-Frank Act requires the SEC to adopt rules increasing the transparency of information about securities lending available to broker-dealers and investors.

The lack of data standards governing legal entities, instruments, and transactions continues to create challenges for financial analysis, risk management, supervision, and financial stability monitoring. There has been important progress in rolling out the LEI to precisely identify parties to financial transactions. However, more work remains. Working closely with Council member agencies, the OFR is tasked with promoting financial data standards and has taken a lead role in the rollout of the LEI. Although the mandating of the LEI in the CFTC's SDR rules initially spurred the implementation of the LEI, other regulators have only recently begun to establish the LEI in regulatory reporting and rulemakings.

An important development in 2014 is the continued creation of SDRs and SBSDRs, which collect and maintain confidential information about transactions and make those data available to regulators. However, under current rules the repositories have significant discretion in how they report the data. Without strong and common standards, the data collected by repositories are unlikely to bring the desired benefits to counterparty analysis and financial stability monitoring. The CFTC is working to improve data quality and data standards in swaps data reporting with input from the OFR. However, some U.S. authorities' access to these data remains a challenge due to legal and other obstacles.

Abbreviations

ABCP	Asset-Backed Commercial Paper
ABS	Asset-Backed Securities
AFS	Available-for-Sale
AIG	American International Group
AUM	Assets Under Management
BCR	Backstop Capital Requirements
BHC	Bank Holding Company
BoE	Bank of England
BoJ	Bank of Japan
C&I	Commercial and Industrial
CCAR	Comprehensive Capital Analysis and Review
CCP	Central Counterparty
CDS	Credit Default Swap
CDs	Certificates of Deposit
CFPB	Bureau of Consumer Financial Protection
CFTC	Commodity Futures Trading Commission
CLO	Collateralized Loan Obligation
CMBS	Commercial Mortgage-Backed Security
CoVaR	Conditional Value-at-Risk
CP	Commercial Paper
CRE	Commercial Real Estate

CSP	Common Securitization Platform
DFAST	Dodd-Frank Act Stress Tests
DTCC	Depository Trust and Clearing Corporation
DTI	Debt-to-Income
ECB	European Central Bank
EM	Emerging Market
EME	Emerging Market Economy
ETF	Exchange-Traded Funds
ETP	Exchange-Traded Product
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FASB	Financial Accounting Standards Board
FBO	Foreign Banking Organization
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FICO	Fair Isaac Corporation
FIO	Federal Insurance Office
FMU	Financial Market Utilities
FOIA	Freedom of Information Act
FOMC	Federal Open Market Committee
FRBNY	Federal Reserve Bank of New York
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council

FX	Foreign Exchange
G-20	The Group of Twenty
GCF	General Collateral Finance
GDP	Gross Domestic Product
GSE	Government-Sponsored Enterprise
G-SIFI	Global Systemically Important Financial Institution
G-SII	Global Systemically Important Insurer
HLA	Higher Loss Absorbency
HUD	U.S. Department of Housing and Urban Development
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICS	Insurance Capital Standard
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
JGB	Japanese Government Bond
LCR	Liquidity Coverage Ratio
LEI	Legal Entity Identifier
LIBOR	London Interbank Offered Rate
MBS	Mortgage-Backed Securities
MIDAS	Market Information Data Analytics System
MMF	Money Market Fund
MPC	Monetary Policy Committee
MSPs	Major Swap Participants

MSR	Mortgage Servicing Rights
NAIC	National Association of Insurance Commissioners
NAV	Net Asset Value
NFIB	National Federation of Independent Businesses
NIM	Net Interest Margin
OCC	Office of the Comptroller of the Currency
OFR	Office of Financial Research
OLA	Orderly Liquidation Authority
OMT	Outright Monetary Transactions
OSSG	Official Sector Steering Group
OTC	Over-the-Counter
P/C	Property and Casualty Insurance
PFMI	Principles for Financial Market Infrastructures
QM	Qualified Mortgage
QRM	Qualified Residential Mortgage
REIT	Real Estate Investment Trusts
Repo	Repurchase Agreements
RESPA	Real Estate Settlement Procedures Act
RMBS	Residential Mortgage-Backed Securities
ROA	Return on Average Assets
RWA	Risk-Weighted Assets
S&P	Standard and Poor's
SBSDRs	Security-Based Swap Data Repositories
SBSR	Security-Based Swap Reporting

SDRs	Swap Data Repositories
SEC	Securities and Exchange Commission
SEF	Swap Execution Facilities
SES	Systemic Expected Shortfall
SLOOS	Senior Loan Officer Opinion Survey
SPOE	Single Point of Entry
SRC	Systemic Risk Committee
TIBOR	Tokyo Interbank Offered Rate
TILA	Truth in Lending Act
U.S. GAAP	Generally Accepted Accounting Principles
UMI	Unique Mortgage Identifier
UPB	Unpaid Balance
USD	U.S. Dollar
VaR	Value-at-Risk
VIX	Chicago Board Options Exchange Volatility Index
WMP	Wealth-Management Products

Glossary

Asset-Backed Commercial Paper (ABCP)	Short-term debt that has a fixed maturity of up to 270 days and is backed by some financial asset, such as trade receivables, consumer debt receivables, securities, or auto and equipment loans or leases.
Asset-Backed Security (ABS)	A fixed income or other security that is collateralized by any type of self-liquidating financial asset that allows the holder of the security to receive payments that depend primarily on cash flows from the assets.
Available-for-Sale (AFS)	An accounting term for debt and equity securities that are accounted for at fair value on firms' balance sheets and are not classified as trading securities or as held-to-maturity securities. Changes in fair value for AFS securities are recognized in stockholders' equity as part of accumulated other comprehensive income.
Base Money	The sum of currency in circulation and reserve balances.
Basel III Common Equity Tier 1 ratio	A ratio which divides common equity Tier 1 by Basel III risk-weighted assets.
Bilateral Repo	Bilateral repos are repos between two institutions where settlement typically occurs on a "delivery versus payment" basis. More specifically, the transfer of the collateral to the cash lender occurs simultaneously with the transfer of the cash to the collateral provider.
Carry Trade	An investment strategy involving borrowing at low interest rates to purchase assets that yield higher returns.
Central Counterparty (CCP)	An entity that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the performance of open contracts.
Clearing Bank	A BHC subsidiary that facilitates payment and settlement of financial transactions, such as check clearing, or facilitates trades between the sellers and buyers of securities or other financial instruments or contracts.
Collateral	Any asset pledged by a borrower to guarantee payment of a debt.

Collateralized Loan Obligation (CLO)	Securitization vehicles backed predominantly by commercial loans.
Collateralized Mortgage Obligation (CMO)	An obligation of a bankruptcy remote special purpose vehicle with claims to specific cash flows from a pool of MBS. The streams of principal and interest payments on the MBS underlying loans are distributed to the different classes of CMO interests, known as tranches, according to a deal structure. Each tranche may have different principal balances, coupon rates, prepayment risks, and maturity dates.
Collateral Transformation	In securities lending on a non-cash collateral basis, a party usually swaps, or temporarily exchanges their lower quality assets, by posting them as collateral for higher quality assets, such as Treasury securities.
Commercial Mortgage-Backed Security (CMBS)	A security that is collateralized by a pool of commercial mortgage loans and makes payments derived from the interest and principal payments on the underlying mortgage loans.
Commercial Paper (CP)	Short-term (maturity of up to 270 days), unsecured corporate debt.
Common Securitization Platform (CSP)	A common securitization infrastructure between Freddie Mac and Fannie Mae for RMBS.
Comprehensive Capital Analysis and Review (CCAR)	An annual exercise by the Federal Reserve to ensure that institutions have robust, forward-looking capital planning processes that account for their unique risks and sufficient capital to continue operations throughout times of economic and financial stress.
Conditional Value-at-Risk (CoVaR)	The value-at-risk (VaR) of the financial system conditional on institutions being in distress.
Consumer Price Index (CPI)	A monthly index containing monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.
Convexity Event Risk	Risk that an initial increase in long-term interest rates can be significantly amplified by many MBS investors actively hedging the duration of their MBS. Convexity events can result in rapid changes in long-term interest rates, sharp increases in interest rate volatility, and reduced liquidity in fixed income markets. See Duration Hedging.

Credit Default Swap (CDS)	A financial contract in which one party agrees to make a payment to the other party in the event of a specified credit event, in exchange for one or more fixed payments.
Credit Rating Agency	A private company that evaluates the credit quality of debt issuers as well as their issued securities and provides ratings on the issuers and those securities. Many credit rating agencies are Nationally Recognized Statistical Rating Organizations, the largest of which are Fitch Ratings, Moody's Investors Service, and Standard & Poor's.
Debt-to-Income (DTI) Ratio	The ratio of debt payments to income for a borrower.
Defined Benefit (DB) Plan	A retirement plan in which the cost to the employer is based on a predetermined formula to calculate the amount of a participant's future benefit. In DB plans, the investment risk is borne by the plan sponsor.
Defined Contribution (DC) Plan	A retirement plan in which the cost to the employer is limited to the specified annual contribution. In DC plans, the investment risk is borne by the plan participant.
Distress Insurance Premium (DIP)	A measure of systemic risk that integrates the characteristics of bank size, default probability, and interconnectedness.
Dodd-Frank Act Stress Tests (DFAST)	Annual stress tests required by Dodd-Frank for national banks and federal savings associations with total consolidated assets of more than $10 billion.
Duration	The sensitivity of the prices of bonds and other fixed-income securities to changes in the level of interest rates.
Duration Hedging	A process of dynamically changing portfolio allocation to fixed income instruments—such as Treasury securities or futures, or interest rate swaps or swaptions—so as to limit fluctuation of the portfolio interest rate duration.
Euro Interbank Offered Rate (EURIBOR)	The rate at which Euro interbank term deposits are offered by one prime bank to another prime bank within the euro area.
Exchange Traded Product (ETP)	An investment fund whose shares are traded on an exchange. ETPs offer continuous pricing, unlike mutual funds which offer only end-of-day pricing. ETPs are often designed to track an index or a portfolio of assets.

Federal Funds Rate	The interest rate at which depository institutions lend balances to each other overnight. The FOMC sets a target level for the overnight federal funds rate, and the FRBNY then uses open market operations to influence the overnight federal funds rate to trade around the policy target rate or within the target rate range.
FICO Score	A measure of a borrower's creditworthiness based on the borrower's credit data; developed by the Fair Isaac Corporation.
Financial Market Infrastructure (FMI)	A multilateral system among participating financial institutions, including the operator of the system, used for the purposes of recording, clearing, or settling payments, securities, derivatives, or other financial transactions. Under the Dodd-Frank Act, certain FMIs are recognized as FMUs.
Financial Market Utility (FMU)	A Dodd-Frank defined entity, which, subject to certain exclusions, is "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person."
Fire Sale	The disorderly liquidation of assets to meet margin requirements or other urgent cash needs. Such a sudden selloff drives down prices, potentially below their intrinsic value, when the quantities to be sold are large relative to the typical volume of transactions. Fire sales can be self-reinforcing and lead to additional forced selling by some market participants that, subsequent to an initial fire sale and consequent decline in asset prices, may also need to meet margin or other urgent cash needs.
Fiscal Consolidation	Changes in government policy pertaining to taxes and spending intended to reduce deficits and slow the pace of debt accumulation.
Fiscal Year	Any 12-month accounting period. The fiscal year for the federal government begins on October 1 and ends on September 30 of the following year; it is named after the calendar year in which it ends.
Future	A standardized contract traded over exchanges to buy or sell an asset in the future.
General Collateral Finance (GCF)	An interdealer repo market in which the Fixed Income Clearing Corporation plays the role of intraday CCP. Trades are netted at the end of each day and settled at the tri-party clearing banks. See Tri-party Repo.

Government-Sponsored Enterprise (GSE)	A corporate entity that has a federal charter authorized by law, but that is a privately owned financial institution. Examples include the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).
Gross Domestic Product (GDP)	The broadest measure of aggregate economic activity, measuring the total value of all final goods and services produced within a country's borders during a specific period.
Haircut	The discount, represented as a percentage of par or market value, at which an asset can be pledged as collateral. For example, a $1,000,000 bond with a 5 percent haircut would collateralize a $950,000 loan. The purpose of a haircut is to provide a collateral margin for a secured lender.
Held-to-Maturity	An accounting term for debt securities held in portfolio and accounted for at cost less any impairment, under the proviso that the company has no intent to sell and it is more likely than not that it will hold those securities to maturity.
Home Equity Line of Credit (HELOC)	A line of credit extended to a homeowner that uses the home as collateral.
High-Quality Liquid Asset	Assets such as government bonds that are considered eligible as liquidity buffers in Basel III's LCR. High-quality liquid assets should be liquid in markets during times of stress and, ideally, be central bank eligible.
Household Debt Service Ratio	An estimate of the ratio of debt payments to disposable personal income. Debt payments consist of the estimated required payments on outstanding mortgage and consumer debt.
Interest Rate Risk Management	The management of the exposure of an individual's or an institution's financial condition to movements in interest rates.
Interest Rate Swap	A derivative contract in which two parties swap interest rate cash flows on a periodic basis, referencing a specified notional amount for a fixed term. Typically one party will pay a predetermined fixed rate while the other party will pay a short-term variable reference rate that resets at specified intervals.
Large-Scale Asset Purchases	Purchases by the Federal Reserve of securities issued by the U.S. government or securities issued or guaranteed by government-sponsored agencies (including Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Banks) in the implementation of monetary policy.

Legal Entity Identifier (LEI)	A 20-digit alpha-numeric code that connects to key reference information that enables clear and unique identification of companies participating in global financial markets. The LEI system is designed to facilitate many financial stability objectives, including: improved risk management in firms; better assessment of microprudential and macroprudential risks; expedition of orderly resolution; containment of market abuse and financial fraud; and provision of higher-quality and more accurate financial data.
Level 3 Assets	Assets where fair value measurement is based on unobservable inputs.
Leveraged Buyout	An acquisition of a company financed by a private equity contribution combined with borrowed funds, with debt comprising a significant portion of the purchase price.
Leveraged Loan	Loans extended to a borrower who already has significant amounts of debt or whose debt is not rated investment-grade by credit rating agencies.
London Interbank Offered Rate (LIBOR)	The interest rate at which banks can borrow unsecured funds from other banks in London wholesale money markets, as measured by daily surveys. The published rate is a trimmed average of the rates obtained in the survey.
Liquidity Coverage Ratio (LCR)	A Basel III standard to ensure that a bank maintains adequate unencumbered, high-quality liquid assets to meet its anticipated liquidity needs for a 30-day horizon under a liquidity stress scenario specified by supervisors.
Loan-to-Value Ratio	The ratio of the amount of a loan to the value of the asset that the loan funds, typically expressed as a percentage. This is a key metric when considering the level of collateralization of a mortgage.
Major Security-Based Swap Participant	A person that is not a security-based swap dealer and maintains a substantial position in security-based swaps, creates substantial counterparty exposure, or is a financial entity that is highly leveraged and not subject to federal banking capital rules.
Major Swap Participant (MSP)	A person that is not a swap dealer and maintains a substantial position in swaps, holds outstanding swaps that create substantial counterparty exposure, or is a highly leveraged financial entity which is not otherwise subject to capital requirements.
Maturity Gap	The weighted-average time to maturity of financial assets less the weighted-average time to maturity of liabilities.

Money Market Mutual Fund (MMF)	A type of mutual fund that invests in short-term, liquid securities such as government bills, CDs, CP, or repos.
Mortgage Servicing Company	A company that acts as an agent for mortgage holders by collecting and distributing mortgage cash flows. Mortgage servicers also manage defaults, modifications, settlements, foreclosure proceedings, and various notifications of borrowers and investors.
Mortgage Servicing Rights (MSRs)	The right to service and collect fees on a mortgage.
Mortgage-Backed Security (MBS)	ABS backed by a pool of mortgages. Investors in the security receive payments derived from the interest and principal payments on the underlying mortgages. This term typically applies to MBS issued or guaranteed by the GSEs; these securities can also be called "agency MBS."
Municipal Bond	A bond issued by states, cities, counties, local governmental agencies, or certain nongovernment issuers to finance certain general or project-related activities.
Net Asset Value (NAV)	An investment company's total assets minus its total liabilities.
Net Interest Margin (NIM)	Net interest income as percent of interest-earning assets.
Open Market Operations	The purchase and sale of securities in the open market by a central bank to implement monetary policy.
Option	A financial contract granting the holder the right but not the obligation to engage in a future transaction on an underlying security or real asset. The most basic examples are an equity call option, which provides the right but not the obligation to buy a block of shares at a fixed price for a fixed period, and an equity put option, which similarly grants the right to sell a block of shares.
Outright Monetary Transactions (OMT)	An ECB program under which secondary market purchases of sovereign bonds can be made, with the aim of safeguarding appropriate monetary policy transmission and the singleness of the monetary policy. A necessary condition for OMT is a support agreement under which the European Financial Stability Facility or European Stability Mechanism program can make primary market purchases of sovereign debt. Such an agreement would include a range of policy conditions.
Over-the-Counter (OTC)	A method of trading that does not involve an organized exchange. In OTM markets, participants trade directly on a bilateral basis, typically through voice or computer communication and often with certain standardized documentation with counterparty-dependent terms.

Prudential Regulation	Regulation aimed at ensuring the safe and sound operation of financial institutions, set by both state and federal authorities.
Public Debt	All debt issued by Treasury and the Federal Financing Bank, including both debt held by the public and debt held in intergovernmental accounts such as the Social Security Trust Funds. Not included is debt issued by government agencies other than the Department of the Treasury.
Purchasing Managers Index	An index based off a survey of manufacturing companies, which asks questions about new orders, inventory levels, production, supplier deliveries and the employment environment.
Qualified Mortgage (QM)	A mortgage loan that meets certain underwriting criteria announced by the CFPB. An originator of a QM is provided with certain protections from borrower lawsuits alleging that the originator failed to fulfill its duty under the Dodd-Frank Act to make a good faith and reasonable determination of the borrower's ability to repay the loan.
Qualified Residential Mortgage (QRM)	A mortgage loan that is exempt from the Dodd-Frank Act's securitization risk retention rule requiring securitization issuers to retain a portion of securitized risk exposure in transactions that they issue.
Qualitative and Quantitative Easing	A program introduced by the BoJ in April 2013 to achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI at the earliest possible time, with a time horizon of about two years. The program will double the monetary base and the amounts outstanding of JGBs as well as ETFs in two years, and more than double the average remaining maturity of JGB purchases.
Real Estate Investment Trust (REIT)	An operating company that manages income-producing real estate or real estate-related assets. Certain REITs also operate real estate properties in which they invest. To qualify as a REIT, a company must have three-fourths of its assets and gross income connected to real estate investment and must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends.
Receiver	A custodian appointed to maximize the value of the assets of a failed institution or company and to settle its liabilities.
Repurchase Agreement (Repo)	The sale of a security combined with an agreement to repurchase the security, or a similar security, on a specified future date at a prearranged price. A repo is a secured lending arrangement.

Residential Mortgage-Backed Security (RMBS)	A security that is collateralized by a pool of residential mortgage loans and makes payments derived from the interest and principal payments on the underlying mortgage loans.
Revolving Credit	A lending arrangement whereby a lender commits to provide a certain amount of funding to a borrower on demand. The borrower may generally draw funds and repay the committed funding at any time over the term of the agreement.
Risk-Based Capital	An amount of capital, based on the risk-weighting of various asset categories, that a financial institution holds to help protect against losses.
Risk-Weighted Assets (RWA)	A risk-based concept used as the denominator of risk-based capital ratios (common equity tier 1, tier 1 risk-based, and total risk-based) with respect to Basel capital guidelines for banking organizations. The RWA is a weighted total asset value calculated from assigned risk categories or modeled analysis. Broadly, total RWA are determined by calculating RWA for market risk and operational risk, as applicable, and adding the sum of RWA for on-balance sheet, off-balance sheet, counterparty, and other credit risks. Details vary, in part, depending upon the version(s) of Basel capital guidelines that may apply to the banking organization.
Rollover Risk	The risk that as an institution's debt nears maturity, the institution may not be able to refinance the existing debt or may have to refinance at less favorable terms.
Run Risk	The risk that investors lose confidence in an institution—due to concerns about counterparties, collateral, solvency, or related issues—and respond by pulling back their funding.
Securities Information Processor	A system that consolidates and disseminates equity prices.
Securities Lending/Borrowing	The temporary transfer of securities from one party to another for a specified fee and term, in exchange for collateral in the form of cash or securities.
Securitization	A financial transaction in which assets such as mortgage loans are pooled, securities representing interests in the pool are issued, and proceeds from the underlying pooled assets are used to service and repay securities issued via the securitization.

Security-Based Swap Dealer	A person that holds itself out as a dealer in security-based swaps, makes a market in security-based swaps, regularly enters into security-based swaps with counterparties, or engages in any activity causing it to be known as a dealer or market maker in security-based swaps; does not include a person entering into security-based swaps for such person's own account.
Short-Term Wholesale Funding	Short-term funding instruments not covered by deposit insurance that are typically issued to institutional investors. Examples include large checkable and time deposits, brokered CDs, CP, Federal Home Loan Bank borrowings, and repos.
Sponsor-backed payment-in-kind (PIK) bond	A bond that compensates the holder with other bonds rather than cash.
Swap	An exchange of cash flows with defined terms and over a fixed period, agreed upon by two parties. A swap contract may reference underlying financial products across various asset classes including interest rates, credit, equity, commodity, and FX.
Swap Data Repository (SDR)	A person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for swaps. In certain jurisdictions, SDRs are referred to as trade repositories. The Committee on Payment and Settlement Systems and IOSCO describes a trade repository as "an entity that maintains a centralized electronic record (database) of transaction data."
Swap Execution Facility (SEF)	A term defined in the Dodd-Frank Act as a trading platform which market participants use to execute and trade swaps by accepting bids and offers made by other participants.
Swap Dealer	A person that holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties, or engages in any activity causing it to be known as a dealer or market maker in swaps; does not include a person entering into swaps for such person's own account.
Swap Future	A futures contract that mimics the economic substance of a swap.
Systemic Expected Shortfall (SES)	A systemic risk indicator that estimates the extent to which the market value equity of a financial firm would be depleted by a decline in equity prices.
Swaption	An option granting the right to enter into a swap. See Option and Swap.

Tri-Party Repo Infrastructure Reform Task Force	A task force formed in September 2009 under the auspices of the Payments Risk Committee, a private sector body sponsored by the FRBNY. The Task Force membership included representatives from multiple types of market participants in the tri-party repo market, as well as relevant industry associations.
Tier 1 Capital	A measure that includes common stock, preferred stock, and retained earnings
Tier 1 Common	Tier 1 capital less non-common elements, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities.
Time Deposits	Deposits which the depositor, generally, does not have the right to withdraw before a designated maturity date without paying an early withdrawal penalty. A CD is a time deposit.
Tri-Party Repo	A repo in which a clearing bank acts as third-party agent to provide collateral management services and to facilitate the exchange of cash against collateral between the two counterparties.
Underwriting Standards	Terms, conditions, and criteria used to determine the extension of credit in the form of a loan or bond.
Value-at-Risk (VaR)	A tool measuring the risk of portfolio losses. The VaR projects the probability and maximum expected loss for a specific time period. For example, the VaR over 10 days and with 99 percent certainty measures the most one would expect to lose over a 10-day period, 99 percent of the time.
Wealth-Management Products (WMPs)	Products sold to investors as higher-yielding alternatives to time deposits. WMPs are largely off-balance sheet investment vehicles offered by banks, trusts, and securities companies.
Weighted-Average Life	A weighted average of the time to each principal payment in a security.
Weighted-Average Maturity	A weighted average of the time to maturity on all mortgages in a mortgage-backed security.
Yield Curve	A graphical representation of the relationship between bond yields and their respective maturities.

List of Charts

Chart 4.1.1 Change in Real Gross Domestic Product 15
Chart 4.1.2 Change in Real Personal Consumption Expenditures 15
Chart 4.1.3 Private Housing Starts 15
Chart 4.1.4 Net Change in Nonfarm Payroll Employment 16
Chart 4.1.5 Civilian Unemployment Rate 16
Chart 4.1.6 Labor Force Participation Rate 16
Chart 4.1.7 Long-Term Unemployment 17
Chart 4.2.1 Debt to Assets for Nonfinancial Corporations 17
Chart 4.2.2 Bank Business Lending Standards and Demand 17
Chart 4.2.3 Nonfinancial Corporate Bond Default Rate 18
Chart 4.2.4 Noncurrent Commercial and Industrial Loans 18
Chart 4.2.5 Noncorporate Assets 18
Chart 4.2.6 Net Borrowing by Nonfinancial Noncorporate Businesses 19
Chart 4.2.7 Bank Business Lending Standards and Demand 19
Chart 4.2.8 Small Businesses' Difficulty Obtaining Credit 19
Chart 4.2.9 Household Debt as a Percent of Disposable Personal Income 20
Chart 4.2.10 Private Nonfinancial Debt 20
Chart 4.2.11 Household Debt Service Ratio 20
Chart 4.2.12 Share of Household Debt by Delinquency Status 21
Chart 4.2.13 Household and Nonprofit Balance Sheets 21
Chart 4.2.14 Owners' Equity as Share of Household Real Estate 21
Chart 4.2.15 Components of Consumer Credit 22
Chart 4.2.16 Applications for Credit 22
Chart 4.2.17 90+ Day Delinquency Rate by Loan Type 22
Chart 4.3.1 Federal Unified Budget Surplus/Deficit 23
Chart 4.3.2 Projected Spending in Major Budget Categories 23
Chart 4.3.3 Federal Debt Held by the Public as a Percent of GDP 23
Chart 4.3.4 Interest Outlays and Average Maturity of U.S. Public Debt 24
Chart 4.3.5 State and Local Government Tax Revenues 24
Chart A.1 Treasury Bill Yields: 2011 vs 2013 25
Chart A.2 Treasury Collateralized Borrowing Rate 26
Chart 4.3.6 Growth of State and Local Government Employment 27
Chart 4.3.7 Municipal Bond Issuance 27
Chart 4.3.8 Municipal Bond Spreads 27
Chart B.1 Weekly Municipal Bond Fund Flows and Yields 28
Chart 4.4.1 Real GDP Growth 29

Chart 4.4.2 Advanced Economies Real GDP Growth 29
Chart 4.4.3 Euro Area Real GDP Growth 30
Chart 4.4.4 Peripheral Europe: Gross Public Debt 30
Chart 4.4.5 Peripheral Merchandise Exports 30
Chart 4.4.6 Euro Zone: Consumer Price Inflation 31
Chart 4.4.7 Japan: Consumer Price Inflation 32
Chart 4.4.8 Emerging Economies Real GDP Growth 33
Chart 4.4.9 EME Contributions to Global Growth 33
Chart 4.4.10 China Real GDP Growth 34
Chart 4.4.11 China: Credit to the Private Sector 34
Chart 4.4.12 China: Annual Increases in Credit and GDP 35
Chart 5.1.1 Treasury Yields 37
Chart 5.1.2 Slope of the Treasury Yield Curve 37
Chart 5.1.3 Implied Volatility 37
Chart 5.1.4 Agency MBS and Treasury Yields 38
Chart 5.1.5 Outstanding Agency MBS by Holders 38
Chart 5.1.6 U.S. Corporate Bond Option-Adjusted Spreads 39
Chart 5.1.7 U.S. Corporate Bond Issuance 39
Chart 5.1.8 Institutional Loans Issuance and Market Size 39
Chart 5.1.9 CLO and Leveraged Loan Spreads 40
Chart 5.1.10 Annual CLO Issuance 40
Chart C.1 Bid-Ask Spreads on U.S. Treasury Notes 41
Chart C.2 Price Impact of Trades Increases during the Selloff 41
Chart C.3 Quoted Treasury Market Depth 41
Chart C.4 Change in Broker-Dealers' Long Vs. Short Positions 42
Chart C.5 Broker-Dealer's VaR and Net Leverage 42
Chart C.6 Capital Constrained Broker-Dealers Are Associated with Less Selling 42
Chart 5.1.11 Publically Held Federal Debt Outstanding 43
Chart 5.1.12 Foreign Holders of U.S. Federal Debt 43
Chart 5.1.13 Euro Area 10-Year Yield Spreads to German Debt 44
Chart 5.1.14 Emerging Market Bond Spreads 44
Chart 5.1.15 EM Assets and U.S. Treasuries: Performance Since May 1, 2013 44
Chart 5.1.16 Cumulative Changes in 5-year Government Yields 45
Chart 5.1.17 Gross Capital Flows to EMEs 45
Chart 5.1.18 EME Gross Global Bond Issuance 45
Chart 5.1.19 EME Corporate Debt Securities Outstanding 46
Chart 5.1.20 U.S. Dollar Trade Weighted Index 46
Chart 5.1.21 Currency Implied Volatility 46
Chart 5.1.22 U.S. Dollar Exchange Rates 47
Chart 5.1.23 Change in Exchange Rates (April 2013-March 2014) 47

Chart D.1 Advanced Economy Base Money....48
Chart D.2 Central Bank Assets....48
Chart D.3 Market Volatility....49
Chart 5.1.24 Selected Equities Indices....50
Chart 5.1.25 S&P 500 Key Ratios....50
Chart 5.1.26 Returns in Selected Equities Indices....50
Chart 5.1.27 Market Volatility....51
Chart 5.1.28 Commodities....51
Chart 5.1.29 National Repeat Sales Home Price Indices....52
Chart 5.1.30 Monthly Originations by Purchase and Refinance....52
Chart 5.1.31 Mortgages with Negative Equity....53
Chart 5.1.32 Mortgage Delinquency and Foreclosure....53
Chart 5.1.33 Purchase Origination Volume by Credit Score....53
Chart 5.1.34 Servicing Growth: Banks vs. Nonbanks....54
Chart 5.1.35 Mortgage Originations by Program....54
Chart 5.1.36 Issuance of RMBS....55
Chart 5.1.37 GSE Net Income....55
Chart 5.1.38 Commercial Property Price Indices....56
Chart 5.1.39 CMBS New Issuance....56
Chart 5.1.40 CMBS Senior Debt Spreads....56
Chart 5.2.1 Composition of Bank Short-Term Funding....57
Chart 5.2.2 Commercial Paper Outstanding....57
Chart 5.2.3 Commercial Paper Outstanding....57
Chart 5.2.4 U.S. MMF Holdings of European Entities' CP, CD, and Repos....58
Chart 5.2.5 Premium for Borrowing U.S. Dollars for 3 Months....58
Chart 5.2.6 Value of the Repo Market....59
Chart 5.2.7 Primary Dealer Repo Agreements....59
Chart 5.2.8 Collateral in Tri-Party Repo....59
Chart 5.2.9 Share of Securities Lending by Lender Type....60
Chart 5.2.10 Value of Securities on Loan....60
Chart 5.2.11 Composition of Securities Lending by Security Type....60
Chart 5.2.12 Securities Lending Cash Reinvestment....61
Chart 5.3.1 Aggregate BHC Pre-Tax Income....62
Chart 5.3.2 Return on Average Assets for BHCs > $10B....62
Chart 5.3.3 Annualized Net Interest Margin....62
Chart 5.3.4 Total Residential Mortgage Originations....63
Chart 5.3.5 U.S. Mortgage Spread....63
Chart 5.3.6 Maturity Gap at Large Banks....63
Chart 5.3.7 Maturity Gap at Small Banks....64
Chart 5.3.8 KBW Bank Index and Implied Volatility....64

Chart 5.3.9 Average P/B and P/E Ratios of 6 Large Complex BHCs 64
Chart 5.3.10 CDS Spreads of 6 Large Complex BHCs 65
Chart 5.3.11 Systemic Risk Measures 65
Chart 5.3.12 Change in Tier 1 Common Ratios for Aggregate U.S. BHCs 65
Chart 5.3.13 Consolidated BHC Liquidity Ratio 66
Chart 5.3.14 Nonperforming Loans (30-89 Days) 66
Chart 5.3.15 Nonperforming Loans (90+ Days and Nonaccrual) 66
Chart 5.3.16 Credit Quality 67
Chart 5.3.17 Loan Loss Reserves 67
Chart 5.3.18 Initial and Stressed Tier 1 Common Capital Ratios 67
Chart 5.3.19 Federal Reserve's Actions in CCAR 2014 68
Chart 5.3.20 FDIC-Insured Failed Institutions 68
Chart 5.3.21 Commercial Bank and Thrift Pre-Tax Income 68
Chart 5.3.22 Risk-Weighted Assets and Return on Assets 69
Chart 5.3.23 U.S. Branches and Agencies of Foreign Banks: Assets 69
Chart 5.3.24 U.S. Branches and Agencies of Foreign Banks: Liabilities 69
Chart 5.3.25 Federally Insured Credit Union Income 70
Chart 5.3.26 Credit Union Deposits 70
Chart 5.3.27 Credit Union Long-Term Assets 70
Chart 5.3.28 Credit Union Investments by Maturity 71
Chart 5.3.29 Credit Union Unrealized Gains on AFS & HTM Securities 71
Chart 5.4.1 Broker-Dealer Revenues 71
Chart 5.4.2 Broker-Dealer Assets and Leverage 72
Chart 5.4.3 Primary Dealer Securities 72
Chart 5.4.4 Life and Other Insurance: Capital and Net Income 73
Chart 5.4.5 Property and Casualty Insurance: Capital and Net Income 74
Chart 5.4.6 Life Insurers: Impact of Low Rate Environment 74
Chart 5.4.7 Consumer Loans Outstanding 77
Chart 5.4.8 Business Loans Outstanding 77
Chart 5.4.9 ABS Issuance 77
Chart 5.4.10 Selected ABS Spreads 78
Chart 5.4.11 Total Agency REIT Assets and Leverage 79
Chart 5.4.12 Agency REITs: Return on Assets 79
Chart F.1 Interest Rate on Government Bonds and Discount Rate 80
Chart F.2 Real Effective Exchange Rate Returns 80
Chart 5.5.1 MMF Assets by Fund Type 81
Chart 5.5.2 Liquidity of Prime MMFs 81
Chart 5.5.3 Weighted Average Life of MMFs 81
Chart 5.5.4 Growth in Assets of the Investment Company Industry 82
Chart 5.5.5 Monthly Bond Mutual Fund Flows 82

Chart 5.5.6 Monthly Equity Mutual Fund Flows 82
Chart 5.5.7 Bank Loan Mutual Funds: Annual Flows 83
Chart 5.5.8 Retirement Fund Assets by Plan Type 83
Chart 5.5.9 Public and Private Pension Funding Level 83
Chart 5.5.10 U.S. Private Equity AUM 84
Chart 5.5.11 Sponsor-Backed Payment-in-Kind Bonds 85
Chart 5.5.12 Hedge Fund Assets and Net Asset Flows 85
Chart 5.5.13 Change in Hedge Fund AUM 85
Chart 5.5.14 Hedge Fund Net Asset Flows by AUM 86
Chart 5.5.15 U.S.-Listed ETP AUM and Count 86
Chart 5.6.1 Global OTC Derivatives Market 87
Chart 5.6.2 Credit Derivatives Outstanding 87
Chart 5.6.3 Growth of Credit Derivative Central Clearing 89
Chart 5.6.4 Interest Rate Swap Futures: Volume and Open Interest 90
Chart 7.3.1 Level 3 Assets 116
Chart 7.3.2 Connectedness 116
Chart 7.3.3 Moody's Systemic Support Uplift 117
Chart 7.3.4 Fitch Support Rating Floors 117
Chart 7.7.1 Destination of U.S. Exports of Goods and Services 122
Chart 7.7.2 Country Exposures of All U.S. Banks 122

Notes on the Data

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House Committee on Financial Services
Questions for the Record for Secretary Jacob J. Lew
June 24, 2014 Hearing on the Annual Report of the Financial Stability Oversight Council

Submitted by Chairman Hensarling

Question 1:
In order to designate a nonbank financial company as a systemically important financial institution (SIFI), the FSOC must determine that either (1) material financial distress at the nonbank financial company or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company could pose a threat to the financial stability of the United States. Although the Dodd-Frank Act also sets forth eleven factors that the FSOC must consider in designating SIFIs, the FSOC's regulations and guidance have done little to give non-bank financial institutions notice of the standards that will be applied to them, whether they are likely to be designated as SIFIs, and what changes they could make in their structure and operations to avoid designation. The FSOC has not defined "systemic risk" or indicated what level of risk is sufficient to justify a non-bank firm's designation as SIFI. Nor has the FSOC defined "interconnectedness" or explained how "interconnectedness" is to be measured. In May 2014, administrative law expert Eugene Scalia testified before the House Financial Services Committee that "[m]arket participants need fair notice of the legal standards that will be applied to them. Ultimately, constitutional due process requires this. [The] FSOC has failed to provide this notice to date."

- **What steps is the FSOC taking to ensure that the criteria it uses to designate SIFIs are objective and clearly communicated to market participants to satisfy constitutional due process requirements?**
- **What steps is the FSOC taking to ensure that the criteria it uses are objective and clearly stated in order to limit the FSOC's discretion and avoid unnecessary subjectivity in its decisions?**
- **What steps is the FSOC taking to ensure that the criteria it uses are objective and clearly stated in order to provide market participants with fair notice that their size or activities may subject them to heightened prudential standards and supervision by the Federal Reserve?**
- **What steps is the FSOC taking to ensure that the criteria it uses are objective and clearly stated in order to provide market participants with adequate notice such that they can change their business models, activities, size, or structure in order to avoid designation as a SIFI?**

Answer:
The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) establishes the standards for whether the FSOC may designate a nonbank financial company, and also includes a list of factors that the FSOC must consider in its designations. Under the statute, the FSOC may designate a nonbank financial company only if the FSOC determines that the firm's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to U.S. financial stability. Factors the FSOC must consider include, among others, leverage, size, interconnectedness, and existing regulatory scrutiny.

In 2012, after soliciting public comment three separate times, the FSOC voluntarily published in the Federal Register a final rule and interpretive guidance regarding its nonbank designations process. These documents are also available on the FSOC's website[1]. The guidance describes how the FSOC intends to apply the statutory standards and considerations and lists examples of the types of metrics that the FSOC would assess as part of its analysis.

In light of the nature, size, and complexity of companies under consideration and as directed by the Dodd-Frank Act, the FSOC conducts its analysis on a company-specific basis in order to take into account the potential risks and mitigating factors unique to each company.

Before the Council makes any proposed designation, a company under review has the opportunity to submit arguments and information as to why it should not be designated and has other extensive opportunities to engage with and provide information to staff of FSOC members and member agencies. In addition, if the FSOC makes a proposed designation regarding a nonbank financial company, it provides the company a detailed, company-specific explanation, setting forth the FSOC's basis for the proposed designation. These company-specific bases can be hundreds of pages in length. Pursuant to the Dodd-Frank Act, any company subject to a proposed designation can request a hearing before the FSOC to contest the proposed determination and submit additional information in support of its position

The FSOC has published explanations of the basis for each of its final designations of nonbank financial companies, available on its website.

The FSOC has also published a set of frequently asked questions on the nonbank financial company designations process, available on its website.

On November 20, 2014, the Government Accountability Office (GAO) released its findings from a year-long review of the Council's nonbank designations process, which included an extensive review of public and nonpublic materials and interviews with member agencies, designated companies, and others. The report noted that the Council has followed its process, including the Council's application of the analytic framework, and that companies that had been designated told GAO they were largely satisfied with the Council's communication with them during the evaluation process. The report also highlights that member agency staff who contributed to company evaluations held a variety of roles and responsibilities across different agencies and contributed a range of expertise, including from the primary regulators, and that member agency officials generally indicated that their agency's expertise was well utilized.

In recent months, the FSOC has received a number of suggestions regarding its process for evaluating nonbank financial companies for potential designation. The FSOC is always interested in reviewing its processes, and has been engaged in efforts to seek input from stakeholders regarding potential changes to the process. As part of this most recent review, on February 4, 2015, the FSOC adopted a number of changes to its process that include opportunities for engagement with companies earlier in the process.

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[1] www.fsoc.gov

House Committee on Financial Services
Questions for the Record for Secretary Jacob J. Lew
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Question 2:
Although an institution can appeal its designation if it disagrees with the FSOC's determination that it poses a systemic risk, the appeals process is not robust. The first appeal is to the FSOC itself – an appeal that seems meaningless, given that the institution is not appealing to an independent arbiter but to the same body that made the designation itself. The institution is effectively making an "appeal" to the same group of regulators that ruled against it and will naturally be predisposed to ratify, rather than reverse, their own prior judgment. The second appeal is to the courts, but that appeal also seems unavailing, for two reasons. First, because the FSOC has never set forth objective standards to guide its discretion, a court cannot effectively review the FSOC's designations—the court essentially must accept the FSOC's judgment because there are no objective standards that the court can apply in reviewing the FSOC's determinations. Second, the institution will be inhibited from challenging the regulators' judgment because if the institution loses, those same regulators will have an opportunity to seek their revenge against the institution in the supervisory process.

- **Given these substantial flaws in the appeals process, does the designation process really give institutions a meaningful opportunity to challenge their designations?**
- **Given these flaws, should the FSOC or Congress establish an independent arbiter or ombudsmen to hear a designated company's initial appeal, rather than expecting that company to appeal to the same group of regulators that made the designation in the first place?**

Answer:
Section 113 of the Dodd-Frank Act sets forth the standards by which the FSOC must evaluate a company under consideration for designation as well as the process for a company to appeal the FSOC's determination. The nonbank designations process has been implemented consistently with the statutory requirements set forth by Congress, which provides companies under consideration significant opportunity to provide information and analyses relevant to the FSOC's determinations.

During its robust three-stage process described in its final rule and interpretive guidance, the FSOC evaluates whether a company meets these statutory standards for designation. This process includes extensive interaction with the company and concludes with a detailed, company-specific basis for designation. For example, for one of the companies that has been designated, the FSOC spent almost a year conducting its analysis after beginning its engagement with the company, and the FSOC considered more than 200 data submissions from the company that totaled over 6,000 pages. Staff of FSOC members and member agencies engaged with the company at least 20 times. The FSOC's evaluation, which considered the company's views and information, culminated in a detailed and lengthy analysis (over 200 pages) that the FSOC shared with the company following the proposed designation and before a vote on a final designation.

Pursuant to the Dodd-Frank Act, any company subject to a proposed designation can request a hearing before the FSOC to contest the proposed determination. A company has a right to a

written hearing, in which it submits information and arguments to the FSOC. In addition, the FSOC has stated that it expects that it generally will grant a timely request for an oral hearing. For the two firms so far that have requested oral hearings, the FSOC granted their requests, and the FSOC heard directly from the companies' representatives. The FSOC voluntarily published hearing procedures, which are available in the Federal Register and on the FSOC website, explaining the process for hearings. As part of its supplementary procedures related to nonbank financial company designations, the Council will also provide each company subject to a determination an opportunity for an oral hearing before the Council once every five years at which the company can contest the determination.

Question 3:
In your written testimony, you stated that "there has been continued progress towards achieving an international minimum standard that would allow national authorities in the majority of the world's largest economies to wind down failing global banks without the use of taxpayer money." You also stated that the FSOC "anticipates progress on a framework for cross-border cooperation in the future resolutions of global banks." By contrast, in a May 2014 speech, Christine Lagarde, the Managing Director of the International Monetary Fund, decried the lack of an agreement on how to resolve large banks that operate across international borders, calling it a "gaping hole in the financial architecture right now." Given that five years have passed since the financial crisis, the fact there is still no regime in place for the cross-border resolution of a large, complex financial institution is extremely troubling. What specific steps are you, as Secretary of the Treasury and the Chairman of the FSOC, taking to address this failure? What steps is the FSOC taking to address this failure?

Answer:
On November 10, 2014, the Financial Stability Board (FSB) issued for public consultation a proposal for a common international standard on total loss-absorbing capacity (TLAC) for global systemically important banks (G-SIBs). The TLAC standard reflects the collective determination of G-20 countries to help protect taxpayers from bearing the costs of a G-SIB's failure. Building on our work to bolster bank capital and liquidity, this TLAC standard will help authorities resolve failing global banks in a more orderly manner. The United States encourages the FSB to finalize this important standard by the end of 2015.

Treasury and U.S. regulatory agencies have made progress on international cooperation in cross-border resolution a high priority. For example, in December 2012, the Federal Deposit Insurance Corporation (FDIC) and the Bank of England published a joint strategy paper for resolving globally active, systemically important financial institutions. In December 2013, I highlighted the need for home and host authorities to work out international arrangements that establish how home and host authorities will cooperate to wind down a globally active financial institution in an orderly way. In October 2014, U.S. and UK officials participated in an exercise designed to enhance understanding among the principals of these countries regarding G-SIB resolution strategies under U.S. and UK resolution regimes, aspects of those strategies requiring coordination between U.S. and UK authorities, and key challenges to the successful resolution of U.S. and UK G-SIBs. Participants included the heads of the Treasuries and leading financial

regulatory agencies from both countries. Treasury, along with U.S. regulatory agencies, will continue to work with our international counterparts to develop viable strategies for effectively resolving failing global banks without exposing U.S. taxpayers to losses.

Question 4:
The Financial Services Committee has held two hearings this year on the effects that the Volcker Rule will have on capital markets. It seems inevitable that the Volcker Rule will significantly reduce liquidity in the corporate bond market, which will make it more expensive for businesses to raise funds, which in turn will make it harder for these businesses to grow and create jobs. The Volcker Rule's effect on liquidity in the corporate bond market is so troubling that this Committee has asked the regulators to report on the effect that the Volcker Rule is having on liquidity in the corporate bond market, but they have yet to do so. The *Financial Times* has reported that the Federal Reserve staff is concerned that the Volcker Rule will spark mass redemptions in the corporate bond market because investors are afraid that liquidity for these bonds will dry up. In fact, the *Financial Times* reported that the Fed staff is so concerned about this "fire sale" scenario that they have proposed that investors be required to pay an exit fee when they sell a corporate bond.

- **Is the FSOC be examining the threat to financial stability that the Volcker Rule poses—a risk that the Federal Reserve has identified and thinks is so real that it has proposed a solution that would force investors to hold bonds they don't want?**
- **Would the FSOC's mission of maintaining financial stability be better served if the FSOC focused on real fire-sale risks, like that posed by the Volcker Rule, rather than speculative ones, like those identified in the OFR's asset management report?**

Answer:
The Volcker Rule is an important part of the Dodd-Frank Wall Street Reform and Consumer Protection Act and limits the ability of banks that have access to the federal safety net to make risky trading bets and invest in speculative funds with their own capital. Regulators were deliberate and thorough in drafting rules to implement the Volcker Rule, taking into account 18,000 comments received on the proposed rule. Since issuing a final rule, the regulators have acted quickly to consider and address issues raised by affected institutions. The final rules became effective on April 1, 2014.

Since that time, the Federal Reserve has granted several extensions of the conformance period for the final rules.

The FSOC routinely monitors for potential threats to financial stability as part of its ongoing mission. To the extent that market developments or other macroeconomic factors result in a potential threat to financial stability, the FSOC would assess that threat, including as part of its annual report to Congress.

House Committee on Financial Services
Questions for the Record for Secretary Jacob J. Lew
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Question 5:
In your testimony, you stated that the FSOC did not conduct a cost-benefit analysis in its designation decisions because the Dodd-Frank Act does not impose such a mandate on the FSOC.

- **Notwithstanding the lack of an explicit cost-benefit mandate in the Dodd-Frank Act, should the FSOC nonetheless consider the relative costs and benefits of heightened prudential standards and supervision by the Federal Reserve on designated non-bank financial institutions, financial markets, and the broader economy? If not, why not?**
- **Should the Dodd-Frank Act be amended to require the FSOC to explicitly consider the costs that heightened prudential standards and supervision by the Federal Reserve will have on designated financial institutions, financial markets, and the broader economy relative to the benefits of these heightened standards and supervision by the Federal Reserve? If not, why not?**

Answer:
The FSOC's statutory authority to designate firms is distinct from the Federal Reserve's subsequent responsibility to develop enhanced prudential standards for designated firms. The FSOC conducts an extensive analysis prior to any designation of a nonbank financial company, and with respect to the four companies that have been designated, the Council determined that the material financial distress of each company could pose a threat to U.S. financial stability. The Federal Reserve is responsible for establishing the enhanced prudential standards to which designated companies will be subject. The Federal Reserve may consider the capital structure, riskiness, complexity, financial activities, size, and other risk-related factors in prescribing enhanced prudential standards for companies designated by the FSOC.

Question 6:
The FSOC SIFI designation process is incomplete. It gives extraordinary weight to the possible harm that might result if a financial institution fails, but it does not require the FSOC to assess the likelihood of that failure, or the effectiveness of the existing regulatory regimes in preventing that failure. Moreover, it does not require the FSOC to consider the costs that designation will have on the designated financial institutions, on the financial system, or on the economy.

- **Should the FSOC be required to conduct an explicit cost-benefit analysis as part of the designation process?**
- **And if the supposed benefit is avoiding failure, shouldn't the FSOC be required to discount that benefit by the probability of that failure occurring?**

Answer:
Under the Dodd-Frank Act, the FSOC may designate a nonbank financial company only if the FSOC determines that the firm's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to

U.S. financial stability. Factors the FSOC must consider include, among others, leverage, size, interconnectedness, and existing regulatory scrutiny.

The FSOC's statutory authority to designate firms is distinct from the Federal Reserve's subsequent responsibility to develop enhanced prudential standards for designated firms. The FSOC conducts an extensive analysis prior to any designation of a nonbank financial company, and with respect to the four companies that have been designated, consistent with the standard set forth in the Dodd-Frank Act, the Council determined that the material financial distress of each of those companies could pose a threat to U.S. financial stability. The Federal Reserve is responsible for establishing the enhanced prudential standards to which designated companies will be subject. The Federal Reserve may consider the capital structure, riskiness, complexity, financial activities, size, and other risk-related factors in prescribing enhanced prudential standards for companies designated by the FSOC.

Question 7:
The FSOC is dominated by the heads of the bank regulatory agencies—the Chairman of the Federal Reserve, the Comptroller of the Currency, the Chairman of the National Credit Union Administration, and the Chairman of the Federal Deposit Insurance Corporation. Not surprisingly, these regulators have a "bank-centric" view of the world.

- **Why should the expertise and judgment of bank and credit union regulators be substituted for that of the SEC in the case of asset managers or state insurance regulators in the case of insurance companies when determining how these firms should be regulated?**

Answer:
The FSOC is composed of 15 members that act as one body to fulfill its statutory responsibilities. Except for the vote of the Chairperson in certain instances required by statute, the vote of each of the FSOC's 10 voting members counts equally. Before the creation of the FSOC, no agency had responsibility for identifying and responding to potential risks to financial stability. Based on the lessons from the financial crisis, the FSOC was established by the Dodd-Frank Act with a clear statutory mission to identify potential risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the U.S. financial system. When the FSOC identifies potential risks within the existing jurisdiction of a regulator, the regulator is often best positioned to take action to mitigate those risks, and the FSOC works closely with all the federal financial regulators. At the same time, the FSOC has the unique statutory responsibility under the Dodd-Frank Act to look across the financial system and to prevent risks to financial stability from slipping through the cracks.

As SEC Chair Mary Jo White noted on December 11, 2014, "truly tackling systemic risk in any area, obviously, demands a broader program than one agency can execute. Systemic risks cannot be addressed alone – they are, after all, 'systemic.' Risks that could cascade through our financial system could have an impact on a range of market participants, many of which we do not oversee. The Financial Stability Oversight Council (FSOC) is an important forum for studying and identifying systemic risks across different markets and market participants."

With respect to the FSOC's evaluations of nonbank financial companies for potential designation, members with expertise relevant to a particular company often provide important insights, and they work together with other FSOC members to reach decisions regarding designations. As the GAO found in its recent report on the designations process, all of the voting and non-voting members of the FSOC can participate in the evaluation of all nonbank financial companies. The report also highlights that member agency staff who contributed to company evaluations held a variety of roles and responsibilities across different agencies and contributed a range of expertise, including from the primary regulators, and that member agency officials generally indicated that their agency's expertise was well utilized. Analytical teams composed of staff of FSOC members and member agencies work closely with each company under review. These analyses are guided by the FSOC's Deputies Committee and Nonbank Financial Company Designations Committee, both of which include representatives of all the FSOC members. Ultimately, proposed and final designations are made by the affirmative vote of at least two-thirds of the voting members of the FSOC then serving.

Question 8:
Under the Dodd-Frank Act, only the heads of the financial regulatory agencies are FSOC Members—the other Commissioners or Board Members of the agencies are not FSOC Members. In fact, the FSOC has refused to allow SEC Commissioners to attend FSOC meetings, even though the Federal Reserve is allowed to seat not only its Chair but another Governor and the President of the New York Federal Reserve Bank. Why has the FSOC accorded special privileges to the Federal Reserve on the FSOC?

Answer:
By statute, FSOC is a body of 15 specific members. Aside from public meetings, attendance at FSOC meetings is generally limited to FSOC members designated by statute plus one additional individual from their agencies. Our practice is to defer to individual FSOC members as to who accompanies them to meetings. Generally, FSOC members have chosen members of their staffs as their "plus one."

Question 9:
Mutual funds and insurance companies are among the most heavily regulated participants in the financial services industry. Yet the Office of Financial Research's Asset Management Report largely ignored the extensive regulation of mutual funds and focused on dozens of hypotheticals about remote risks that are extremely unlikely ever to happen. The FSOC's designation of Prudential also gave short shrift to the extensive regulation of insurance companies by state insurance commissioners that already exists. The Dodd-Frank Act requires the FSOC to consider the extent to which an industry is already regulated when it designates SIFIs. Yet there is no evidence that this analysis was conducted before Prudential received its designation.

- **Should the FSOC be required to demonstrate how and where the current set of regulations has come up short before it designates an institution for heighted prudential supervision?**
- **Should the FSOC be required to demonstrate how supervision by the Federal Reserve would be an improvement over the current regulatory regime, given the Fed's failures in supervising bank-holding companies in the run-up to the financial crisis?**

Answer:
Under the Dodd-Frank Act, if the FSOC determines that a nonbank financial company's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to U.S. financial stability, the FSOC may designate the company for consolidated supervision by the Federal Reserve and enhanced prudential standards. Factors the FSOC must consider include, among others, the company's leverage, size, interconnectedness, and existing regulatory scrutiny.

As required by the Dodd-Frank Act, the FSOC consults with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for designation, before the FSOC makes any final designation.

The FSOC's statutory authority to designate firms is distinct from the Federal Reserve's subsequent responsibility to develop enhanced prudential standards for designated firms. For companies that the FSOC has designated, the Federal Reserve is responsible for establishing the enhanced prudential standards to which designated companies will be subject. The Federal Reserve may consider the capital structure, riskiness, complexity, financial activities, size, and other risk-related factors in prescribing enhanced prudential standards for companies designated by the FSOC.

Question 10:
In May, former Assistant Secretary Treasury Michael Barr testified before the Committee that we should not be overly concerned about the qualifications of agency heads to vote on regulatory matters that they had neither the expertise nor the experience to opine upon because these agency heads "were confirmed by the Senate."

- **Does the bare fact of Senate confirmation qualify the Chair of the NCUA or the Director of the FHFA to opine on the regulation of mutual funds?**
- **Does Senate confirmation alone make the Fed Chair an expert on insurance regulation?**
- **If Senate confirmation is sufficient, doesn't that mean that the other agency members should also be allowed to participate in the designation process, given that they too were confirmed by the Senate?**

Answer:
The FSOC is composed of 15 members that act as one body to fulfill its statutory responsibility. Except for the vote of the Chairperson in certain instances required by statute, the vote of each of the FSOC's 10 voting members counts equally. Before the creation of the FSOC, no agency had responsibility for identifying and responding to potential risks to financial stability. Based on the lessons from the financial crisis, the FSOC was established by the Dodd-Frank Act with a clear statutory mission to identify potential risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the U.S. financial system. When the FSOC identifies potential risks within the existing jurisdiction of a regulator, the regulator is often best positioned to take action to mitigate those risks, and the FSOC works closely with all the federal financial regulators. At the same time, the FSOC has the unique statutory responsibility under the Dodd-Frank Act to look across the financial system and to prevent risks to financial stability from slipping through the cracks. The participation on the FSOC by regulators of diverse parts of the financial system strengthens the FSOC and helps ensure that risks do not slip through the cracks.

Question 11:
Roy Woodall, the FSOC Member with Insurance Expertise, dissented from the FSOC's decision to designate Prudential as a SIFI. In his dissent, he said that the FSOC's analysis relied on "scenarios antithetical to a fundamental and seasoned understanding of the business of insurance and the insurance regulatory environment."

- **Should the FSOC show greater deference to an industry's primary regulators in making designation decisions about firms in the primary regulator's jurisdiction?**
- **Should the opinion of a regulator who has little experience in a particular industry be given the same weight as that of the primary regulator?**
- **Should the vote of the chair of the Commodity Futures Trading Commission count as much as that of the Member with Insurance Expertise when designating an insurance company?**

Answer:
The FSOC is composed of 15 members that act as one body to fulfill its statutory responsibility. Except for the vote of the Chairperson in certain instances required by statute, the vote of each of the FSOC's 10 voting members counts equally. Before the creation of the FSOC, no agency had responsibility for identifying and responding to potential risks to financial stability. Based on the lessons from the financial crisis, the FSOC was established by the Dodd-Frank Act with a clear statutory mission to identify potential risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the U.S. financial system. When the FSOC identifies potential risks within the existing jurisdiction of a regulator, the regulator is often best positioned to take action to mitigate those risks, and the FSOC works closely with all the federal financial regulators. At the same time, the FSOC has the unique statutory responsibility under the Dodd-Frank Act to look across the financial system and to prevent risks to financial stability from slipping through the cracks.

As SEC Chair Mary Jo White noted on December 11, 2014, "truly tackling systemic risk in any area, obviously, demands a broader program than one agency can execute. Systemic risks cannot be addressed alone – they are, after all, 'systemic.' Risks that could cascade through our financial system could have an impact on a range of market participants, many of which we do not oversee. The Financial Stability Oversight Council (FSOC) is an important forum for studying and identifying systemic risks across different markets and market participants."

With respect to the FSOC's evaluations of nonbank financial companies for potential designation, members with expertise relevant to a particular company often provide important insights, and they work together with other FSOC members to reach decisions regarding designations. As the GAO found in its recent report on the designations process, all of the voting and non-voting members of the FSOC can participate in the evaluation of all nonbank financial companies. The report also highlights that member agency staff who contributed to company evaluations held a variety of roles and responsibilities across different agencies and contributed a range of expertise, including from the primary regulators, and that member agency officials generally indicated that their agency's expertise was well utilized. Analytical teams composed of staff of FSOC members and member agencies work closely with each company under review in Stage 3. These analyses are guided by the FSOC's Deputies Committee and Nonbank Financial Company Designations Committee, both of which include representatives of all the FSOC members. Ultimately, proposed and final designations are made by the affirmative vote of at least two-thirds of the voting members of the FSOC then serving.

As required by the Dodd-Frank Act, the FSOC consults with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for designation, before the FSOC makes any final designation, and also considers the degree to which the company is already regulated by a primary regulator. In addition, the FSOC may consider in Stage 2 of its analysis information available from the company's primary financial regulatory agency or home country supervisor, as appropriate. The FSOC's interpretive guidance notes that as part of that process, the FSOC intends to consult with the primary financial regulatory agency, if any, of each significant subsidiary of the nonbank financial company, to the extent the FSOC deems appropriate. For example, for the three insurance companies that the FSOC has designated, the FSOC consulted with multiple state insurance regulators of the companies' insurance subsidiaries.

Question 12:
Last May, administrative law expert Eugene Scalia testified before this Committee that one of the problems with the FSOC's designation of Prudential was that it relied on "unsubstantiated conjecture; a subjective, standardless notion of excessive risk; and repeated disregard . . . for the existing system of insurance regulation by the states."

- **How can the FSOC fix these flaws in its designation process?**
- **Should Congress rewrite the statute to require the FSOC to consider not only the consequences of failure but the likelihood of failure as well, rather than allowing the FSOC to base its designation decisions on extremely unlikely and purely speculative scenarios, as it did in the Prudential case?**

- **Should Congress rewrite the statute so that the FSOC must do more than simply consider the extent to which an institution is regulated?**
- **Should Congress require the FSOC to make an affirmative determination that the current regulatory regime governing a prospective non-bank SIFI is defective?**

Answer:
Under the Dodd-Frank Act, if the FSOC determines that a nonbank financial company's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to U.S. financial stability, the FSOC may designate the company for consolidated supervision by the Federal Reserve and enhanced prudential standards. Factors the FSOC must consider include, among others, the company's leverage, size, interconnectedness, and existing regulatory scrutiny.

As required by section 113 of the Dodd-Frank Act, the FSOC considers the degree to which a company under review for potential designation is already regulated by a primary regulator. For the three insurance organizations that the FSOC has designated, the FSOC consulted with multiple state insurance regulators of the companies' insurance subsidiaries before making its final determination.

In light of the nature, size, and complexity of companies under consideration and as directed by the Dodd-Frank Act, the FSOC conducts its analysis on a company-specific basis in order to take into account the potential risks and mitigating factors unique to each company.

Before the Council makes any proposed designation, a company under review has the opportunity to submit arguments and information as to why it should not be designated and has other extensive opportunities to engage with and provide information to staff of FSOC members and member agencies. In addition, if the FSOC makes a proposed designation regarding a nonbank financial company, it provides the company a detailed, company-specific explanation, setting forth the FSOC's basis for the proposed designation. These company-specific bases can be hundreds of pages in length. Pursuant to the Dodd-Frank Act, any company subject to a proposed designation can request a hearing before the FSOC to contest the proposed determination and submit additional information in support of its position.

The FSOC has published the public basis for each of its final designations of nonbank financial companies on its website. The FSOC has also published a set of frequently asked questions on the nonbank financial company designations process, available on its website.

On November 20, 2014, the Government Accountability Office (GAO) released its findings from a year-long review of the Council's nonbank designations process, which included an extensive review of public and nonpublic materials and interviews with member agencies, designated companies, and others. The report noted that the Council has followed its process, including through the Council's application of the analytic framework, and that companies that had been designated told GAO they were largely satisfied with the Council's communication with them during the evaluation process. The report also states that member agency staff who contributed to company evaluations held a variety of roles and responsibilities across different agencies and

contributed a range of expertise, including from the primary regulators, and that member agency officials generally indicated that their agency's expertise was well utilized.

Question 13:
In its efforts to build a case that asset managers can pose a risk to financial stability, the FSOC directed the Office of Financial Research to study the asset management industry and issue a report. The OFR is not an independent agency, but an office within the Treasury Department that exists to do the FSOC's bidding. In fact, the OFR seems to be a captive agency, whose only purpose is to torture the data to support conclusions that the FSOC has already made.

- **Given that the OFR exists as an arm of the Treasury Department, can it be expected to generate unbiased, objective research to support FSOC designations?**
- **Is that kind of research better done by the independent agencies?**

Answer:
The FSOC asked the OFR to study potential threats to financial stability presented by the activities of asset managers, but did not preconceive of or direct any particular outcome. The OFR published its report after extensive collaboration with experts from other FSOC member agencies. The study made no recommendations concerning what policy actions, if any, the Council should take.

Before the financial crisis, the U.S. financial regulatory framework was focused on individual firms and markets. No single regulator had responsibility for comprehensively monitoring and addressing risks to financial stability. The Dodd-Frank Act addressed this weakness partly through the creation of the FSOC, whose mission is to identify potential risks to U.S. financial stability, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. In addition, the Dodd-Frank Act established the OFR within the Treasury Department to improve the quality of financial data available to policymakers and to facilitate more robust and sophisticated analysis of the financial system. The OFR supports the FSOC and its member agencies by collecting and standardizing data, performing research, and developing tools for measuring and monitoring risk. With the exception of its Director—who is appointed by the President, confirmed by the Senate, serves a six-year term, and is a non-voting member of the FSOC —the OFR is composed of career government staff and experts on financial research. The OFR performs analysis independent from the financial regulators. Maintaining "independent analytical capabilities" is OFR's statutory duty. The OFR is required to report annually to Congress on potential threats to U.S. financial stability, similar to the Council's obligation, with one important difference: the OFR's annual report represents the work of the Office, as opposed to the FSOC, and is signed only by the OFR Director, who must also testify annually before Congress.

Question 14:
The OFR's asset management study achieved instant notoriety here in Washington, criticized by almost everyone. Better Markets—which is not normally thought of as a

bastion of deregulatory zeal—pointed out the "inexplicably and indefensibly poor quality of the work presented in the Report." Georgetown University finance professor James Angel said that the OFR report "provides a brief overview of the asset management industry, comparable to a chapter in an introductory textbook, along with a generic list of things that could go wrong."

- **Does the poor quality of the report show that the OFR is simply unqualified, lacking the necessary expertise and experience to put together a useful report?**
- **Does the poor quality of the report show that the OFR is so beholden to the FSOC and its regulatory agenda that it wasn't about to let the facts and the data get in the way of an outcome that was predetermined—that asset managers pose risks to financial stability?**

Answer:
The OFR's asset management study was intended to provide a "brief overview" of potential risks, while noting the need for additional data and analysis regarding an industry that has more than $55 trillion in assets under management and encompasses investments for a broad cross-section of individuals and institutions. The study made no recommendations concerning what policy actions, if any, the FSOC should take. Instead, the report highlighted areas within the asset management industry that needed further study. The Council has since taken additional steps to inform its review of the asset management industry, including hosting a public conference on May 19, 2014, and focusing on identifying and evaluating any potential risks arising from the products and activities of asset managers.

The OFR's report and its conclusions were not directed by the FSOC. The FSOC did not ask the OFR to determine whether the FSOC should designate asset management firms, and the OFR's study did not contain any such recommendations. Instead, the study was intended to provide the FSOC with objective information in the early stages of the FSOC's consideration of whether asset management activities or firms could pose risks to financial stability. The OFR is staffed by career economists and analysts. The principal staff working on the study had experience in asset management from both the private and regulatory sectors. In preparing the study, the OFR conducted a careful analysis that included discussions with a number of market participants and industry experts, both private and public sector. In particular, throughout the process of writing the study, the OFR engaged in an extensive and meaningful collaboration with FSOC member agencies.

Question 15:
The rationale for the OFR has always seemed dubious, given that each of the regulatory agencies already has economists and staff dedicated to identifying and managing systemic risk. The SEC, for example, has a Division of Economic and Risk Analysis. Among the army of economists that the Federal Reserve employs is a group known as the "Office of Financial Stability Policy and Research." The FDIC has an Office of Complex Financial Institutions, whose mission is to "monitor and address risks in the largest, systemically important financial institutions."

- **Given that each agency already has the resources to do what the OFR is supposed to do and the experience and the expertise that the OFR does not, would it be better public policy for the FSOC to delegate its research projects to the regulatory agencies, rather than parcel them out to its in-house captive agency?**
- **Wouldn't doing that increase the credibility and the quality of the research?**

Answer:
The financial crisis revealed deficiencies in our understanding of the financial system, and showed that the data necessary to fully understand and monitor the system were often unavailable or not available in a useful format.

Consistent with its statutory mandate under the Dodd-Frank Act, the OFR works to fill the gaps in data and in knowledge about the financial system, thus complementing the work of the FSOC member agencies, which continue to collect the data they need to monitor the specific individual financial institutions or discrete markets they regulate.

Question 16:
SEC Chair White testified before this Committee that the SEC has all the authority it needs to regulate the asset management industry. The OFR Asset Management Report, however, ignores the extensive SEC regulation that already exists, as well as the authority that the SEC already has to do more, and instead focuses on extremely remote possibilities that something *might* go wrong.

- **Does the SEC have all the authority it needs to regulate asset managers?**
- **If the SEC's regulation is adequate, and it has the authority to do more, why has the FSOC and the OFR taken up this issue?**

Answer:
The OFR's asset management report was an initial study of asset management activities intended to help the FSOC determine whether these activities could create, transmit, or amplify stress through the financial system. The OFR released its study following a careful analysis that included discussions with a number of market participants and extensive input from FSOC member agencies with relevant expertise, including the SEC.

The report was intended to inform the Council about the activities and potential risks arising from the asset management industry. It did not contain any recommendations.

Since the publication of the report, as the FSOC stated in its readout from its July 31, 2014, meeting, the FSOC has directed staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry. This includes a recent request for public comment to gather public input on potential risks associated with asset management products and activities. This request for comment will enable the FSOC to engage in a targeted manner with the public to provide greater insight into whether and how asset management products and activities could create risks to U.S. financial stability.

As the FSOC continues to review this industry, it is important to note that there are no predetermined outcomes. When the Council identifies potential risks within the existing jurisdiction of a regulator, the regulator is often best positioned to take action to mitigate those risks, and the Council works closely with all the federal financial regulators. At the same time, the Council has the unique statutory responsibility under the Dodd-Frank Act to look across the financial system and to prevent risks to financial stability from slipping through the cracks.

As SEC Chair Mary Jo White noted on December 11, 2014, "truly tackling systemic risk in any area, obviously, demands a broader program than one agency can execute. Systemic risks cannot be addressed alone – they are, after all, 'systemic.' Risks that could cascade through our financial system could have an impact on a range of market participants, many of which we do not oversee. The Financial Stability Oversight Council (FSOC) is an important forum for studying and identifying systemic risks across different markets and market participants. The market perspective that the SEC brings is an essential component of FSOC's efforts. And FSOC's current review of the potential risks to the stability of U.S. financial system of asset managers is a complement to the work we are now undertaking."

Question 17:
Georgetown University finance professor James Angel wrote that the OFR's report does not "attempt to assess the likelihood of these different things that could, can, or may go wrong, or to provide a careful quantitative analysis to guide policy. . . . [A]n asteroid could wipe out the planet and thus threaten the financial stability of the United States, but how likely is that? Does that imply that the Fed should regulate NASA to make sure it can find and deflect dangerous asteroids?"

- **Should the FSOC and the OFR be required to explicitly consider the likelihood that an institution might fail, rather than constructing extremely unlikely scenarios in which failure does occur?**

Answer:
Based on the lessons from the financial crisis, the FSOC was established by the Dodd-Frank Act with a clear statutory mission to identify potential risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the U.S. financial system. As we saw during the financial crisis, a number of large financial companies that may not have been considered likely to experience material financial distress did so quickly, and the contagion from their distress spread throughout the financial system. While no two financial crises are exactly the same, and because the precise origin of another financial crisis cannot be predicted with certainty, that example illustrates the importance of evaluating whether a company's financial distress could pose a threat to U.S. financial stability.

Under the Dodd-Frank Act, if the FSOC determines that a nonbank financial company's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to U.S. financial stability, the FSOC may designate the company for consolidated supervision by the Federal Reserve and enhanced prudential standards.

Question 18:
Many experts believe that the insurance industry poses much less of a systemic risk than other financial institutions, because policyholders can't run on an insurance company the way depositors and short-term creditors can run on a bank, and because insurance companies invest in assets that are less risky than those typically held by other kinds of financial institutions.

- **Given that insurance companies are fundamentally different from other kinds of financial institutions, should they be held to the same capital standards that were developed for banks?**
- **What is the FSOC doing to ensure that insurance companies are not subjected to "bank-centric" capital standards and other regulatory requirements that simply do not fit their business model?**
- **Does the FSOC plan to recommend that the Federal Reserve Board tailor the prudential standards to different types of companies, including insurance companies?**
- **Does the Obama Administration support legislation recently passed by the Senate and pending in the House to clarify that the Fed should not be imposing bank-centric capital standards on insurance companies?**

Answer:
Following a final designation, a nonbank financial company is subject to consolidated supervision by the Federal Reserve and enhanced prudential standards, which the Federal Reserve has stated that it intends to tailor, as appropriate, based on the specific business structures, activities, and other factors that may distinguish the designated companies from bank holding companies and foreign banking organizations.

On December 18, 2014, President Obama signed into law the Insurance Capital Standards Clarification Act of 2014, which makes it clear that the Federal Reserve is not required to apply the risk and leverage capital requirements of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to a person engaged in the business of insurance regulated by a state insurance regulator, to the extent that such person "acts in its capacity as a regulated insurance entity."

Question 19:
Has the FSOC conducted any analysis to determine how applying risk-based capital standards to insurers will affect the amount of coverage that insurers can offer? Is it possible that the cost of insurance could rise to prohibitive levels? Or that there may come a time when it is impossible to obtain certain kinds of insurance coverage because insurance companies that have been subjected to bank-like capital standards simply won't be able to afford to offer it?

Answer:
Following a final designation, a nonbank financial company is subject to consolidated supervision by the Federal Reserve and enhanced prudential standards, which the Federal Reserve has stated that it intends to tailor, as appropriate, based on the specific business structures, activities, and other factors that may distinguish the designated companies from bank holding companies and foreign banking organizations.

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Question 20:
In addition to bank-like prudential standards, SIFI designation also means supervision by the Federal Reserve. Does the Federal Reserve have the ability and the expertise to supervise insurance companies?

Answer:
The Federal Reserve is well-positioned in terms of its ability and expertise to supervise and develop enhanced prudential standards for designated nonbank financial companies.

Question 21:
Designated insurance companies will continue be supervised by their state regulators. Will the Federal Reserve simply follow the lead of the state regulators, who have the expertise and experience necessary to regulate insurance companies? If so, does Federal Reserve supervision add anything other than another layer of bureaucracy and another source of compliance costs?

Answer:
Designated nonbank financial companies are subject to consolidated supervision by the Federal Reserve and enhanced prudential standards, which the Federal Reserve has stated that it intends to tailor, as appropriate, based on the specific business structures, activities, and other factors that may distinguish the designated companies from bank holding companies and foreign banking organizations.

Question 22:
Because insurance companies try to match their long-term liabilities with long-term assets, they have emerged as one of the most significant sources of long-term investment funds, which are crucially important for funding investment in infrastructure. How will applying bank-centric risk-based capital standards to insurers affect their ability to supply capital

for infrastructure and other long-term projects? And what are the implications for long-term economic growth?

Answer:
Any capital standards for an insurance company should take into account insurance business models and risk metrics, including the fact that insurance companies attempt to match their long-term liabilities with long-term assets. On December 18, 2014, President Obama signed into law the Insurance Capital Standards Clarification Act of 2014, which makes it clear that the Federal Reserve is not required to apply the risk and leverage capital requirements of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to a person engaged in the business of insurance regulated by a state insurance regulator, to the extent that such person "acts in its capacity as a regulated insurance entity."

Question 23:
SIFI designation would impose substantial costs on asset managers. These costs include the costs of complying with Fed supervision as well as the privilege of helping to fund the OFR's so-called "financial research" and the Fed. These costs would be borne by the fund's investors—people saving for their retirement and their children's college tuition. In trying to concoct an argument for designating asset managers, the OFR seems willing to consider every possible way an asset manager could fail and every possible way that failure could affect the financial system, no matter how implausible or remote. Shouldn't the OFR or the FSOC also consider the costs that designation would have on investors and capital markets?

Answer:
The FSOC has a responsibility to consider whether any sector of the financial system creates potential risks to U.S. financial stability. The FSOC would not be doing its job if it ignored an entire sector or activity, including one as vital as the asset management industry. At its meeting on July 31, 2014, the FSOC directed staff to undertake an analysis of industry-wide products and activities to assess potential risks associated with the asset management industry. This includes a recent request for public comment to gather public input on potential risks associated with asset management products and activities. This request for comment will enable the Council to engage with the public to provide targeted insight into whether and how asset management products and activities could create risks to U.S. financial stability.

It is important to note that there are no predetermined outcomes for the FSOC's review of asset management products and activities. In general, the FSOC has a number of tools available to address potential risks to U.S. financial stability it identifies, including:

- highlighting potential emerging threats in the FSOC's annual reports to Congress;
- making recommendations to existing primary regulators to apply heightened standards and safeguards;
- designating certain nonbank financial companies and financial market utilities for heightened supervision and prudential standards, and

- collecting and facilitating the sharing of information to assess threats to U.S. financial stability.

Question 24:
"Bank-like prudential standards" could mean that the Federal Reserve will require asset managers to maintain higher liquidity ratios—in other words, asset managers might be required to hold more cash and more securities that could be easily converted to cash. How would higher liquidity ratios affect investors? How would higher liquidity ratios affect someone who is investing for retirement? Or to pay for a child's education?

Answer:
It is premature to speculate about a specific measure, such as a liquidity ratio, as applied to asset managers.

It is important to note that there are no predetermined outcomes for the FSOC's review of asset management products and activities. In general, the FSOC has a number of tools available to address risks to U.S. financial stability it identifies, including:

- highlighting potential emerging threats in the FSOC's annual reports to Congress;
- making recommendations to existing primary regulators to apply heightened standards and safeguards;
- designating certain nonbank financial companies and financial market utilities for heightened supervision and prudential standards, and
- collecting and facilitating the sharing of information to assess threats to U.S. financial stability.

Question 25:
Douglas Holtz-Eakin, the former Director of the Congressional Budget Office, has estimated that designating asset management firms as SIFIs could cost investors as much as 25% of the return on their investments over the long-term. That is $108,000 per investor. What would investors get in return for that $108,000? Will the financial system be any safer? And how will giving up $108,000 affect an investor's plans for retirement? For sending children to college?

Answer:
It is important to note that there are no predetermined outcomes for the FSOC's review of asset management products and activities. In general, the FSOC has a number of tools available to address risks to U.S. financial stability it identifies, including:

- highlighting potential emerging threats in the FSOC's annual reports to Congress;
- making recommendations to existing primary regulators to apply heightened standards and safeguards;
- designating certain nonbank financial companies and financial market utilities for heightened supervision and prudential standards, and

- collecting and facilitating the sharing of information to assess threats to U.S. financial stability.

Question 26:
SIFI designation may signal to market participants that the U.S. government has decided that a firm is "too big to fail" and will be bailed out if it fails. After all, the reason a firm is designated is that the FSOC has decided that the failure of the firm would have significant effects on the U.S. financial system, and the lesson that market participants learned during the financial crisis was that government officials won't let that happen. In fact, AIG's Chairman celebrated AIG's designation by noting that "when we go out and say we're strong, we'll have them as a voice of the good housekeeping seal that says they are strong." Doesn't designation permanently entrench the "too big to fail" mentality in financial markets?

Answer:
As a matter of law, Dodd-Frank ended too big to fail. Importantly, the designation of a nonbank financial company does not create any new ability or obligation for the government to bail out a designated nonbank financial company. Instead, the FSOC's work to designate nonbank financial companies is a critical tool to reduce the likelihood of failure of large, complex firms, and to mitigate their effects on financial stability if they do fail. Designation subjects a firm to enhanced prudential standards, a requirement to submit a living will to regulators, and supervision by the Federal Reserve.

Question 27:
Last year, the President of the Americas Division of MetLife testified at a Financial Institutions Subcommittee hearing that "whether a SIFI designation is a help or a hindrance . . . naming a handful of insurance companies as 'too big to fail' will needlessly distort the competitive landscape and misallocate capital in the insurance sector."

- **Will designation help some firms by giving them a competitive advantage?**
- **Or will the regulatory burdens and duplicative supervision imposed by designation drive up costs for these firms?**
- **Regardless of which scenario unfolds, doesn't designation distort the competitive landscape?**

Answer:
Designated nonbank financial companies are subject to consolidated supervision by the Federal Reserve and enhanced prudential standards, which the Federal Reserve has stated that it intends to tailor, as appropriate, based on the specific business structures, activities, and other factors. The designation of a nonbank financial company is a critical tool to reduce the likelihood of failure of large, complex firms, and to mitigate their effects on financial stability if they do fail.

On December 18, 2014, President Obama signed into law the Insurance Capital Standards Clarification Act of 2014, which makes it clear that the Federal Reserve is not required to apply

the risk and leverage capital requirements of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to a person engaged in the business of insurance regulated by a state insurance regulator, to the extent that such person "acts in its capacity as a regulated insurance entity."

Question 28:
Last January, the Financial Stability Board published a consultation document in which it proposed designating investment funds as Global SIFIs. Notably, the only investment funds that met the FSB's criteria were U.S.-registered investment companies.

- **Has the Treasury Department conducted any analysis of the implications for the competitiveness of the U.S. financial services sector of a regime in which only U.S. firms must comply with bank-like capital requirements and other heightened prudential standards?**
- **Why has the Treasury Department acquiesced to an action by the FSB that seems to be directly contrary to U.S. interests?**

Answer:
The FSB-IOSCO methodologies for identifying potentially global systemically important non-bank non-insurer financial institutions are still being developed. FSB-IOSCO published a consultative document in January 2014 and received over 75 comment letters. The group has also met with industry and received further feedback. Reflecting these discussions and dialogue, the FSB and IOSCO are in the process of revising the methodologies and plan to release a second public consultation document around the end of the year.

The draft methodologies published in January, sought public comment on the appropriate level of focus for assessing the systemic importance of asset management entities, The FSB-IOSCO draft thresholds were merely an initial screen to be used to filter entities before the national authorities conduct a deep-dive analysis and assessment of potential systemic importance. Exceeding the initial threshold does not indicate the entity is global systemically important.

According to the draft methodologies, national authorities will identify the global systemically important entities in their jurisdictions. The FSB has not yet proposed policy measures.

House Committee on Financial Services
Questions for the Record for Secretary Jacob J. Lew
June 24, 2014 Hearing on the Annual Report of the Financial Stability Oversight Council

Submitted by Rep. Bill Huizenga

Thank you for your appearance before the June 24, 2014, House Financial Services Committee hearing to discuss the annual report of the FSOC. To follow up on the discussion, I would like to submit the below background and questions to the aforementioned witness and have the answers included in the official hearing record.

Question 1:
I have concerns about the approach you have taken to impose economic sanctions on Russia. In particular, I am troubled by your apparent willingness to use U.S. based companies as the "tip of the spear" without having built consensus from our European allies. While I certainly do not question the need for action against Russia, I do question your response and the effectiveness of your approach.

- **What concrete evidence do you have that our economic sanctions have been effective?**
- **Have you considered any of the long-terms impacts that these economic sanctions could have on U.S.-based companies that do business in Russia?**
- **In hindsight, do you believe that greater consensus from our European allies and a more comprehensive approach that leverages the strength and reach of multiply sectors could have bolstered the effectiveness of these sanctions?**

Answer:
Since the start of the Ukraine crisis, the United States has built a strong international coalition to counter Russian actions. Our close and continuing collaboration with EU and G-7 partners on the development and implementation of sanctions ensures both that our sanctions have maximum impact on Russia and that U.S. companies are not disproportionately affected by prohibitions on transactions with sanctioned Russian companies.

Together with our EU and G-7 partners, we have implemented a powerful set of measures that balance spillover risks and costs to our companies with the need to provide an appropriate response to Russia's destabilization of eastern Ukraine. We have imposed export and service-related prohibitions in coordination with the EU on frontier oil projects in Russia, which are areas that non-U.S. and –EU firms are not able to backfill. We have targeted Russia's largest state-owned financial institutions, including Sberbank, prohibiting transacting in new equity and new debt with a maturity of more than 30 days. Furthermore, we have imposed prohibitions on transactions in new debt of specific maturities in the Russian state-owned defense and energy sectors. The EU and our other partners have taken similar actions. Furthermore, we have repeatedly and forcefully engaged other countries to ask that they discourage their companies from exploiting the business opportunities forgone by our and European companies due to sanctions.

Most recently, on December 19, 2014, the President issued Executive Order (E.O.) 13685 to impose a ban on trade in goods, technology, or services with Crimea and on new investment in Crimea, a step taken in conjunction with substantially similar EU measures. In addition, E.O.

13685 provides authority to impose further sanctions on individuals and entities operating in Ukraine. Ongoing discussions with our European partners will include how to utilize these authorities and to ensure that backfill issues do not unduly disadvantage U.S. and EU companies.

The sanctions we have put in place on Russia since July 16, 214 are having an impact on Russia's already-vulnerable economy and key members of Putin's inner circle. The IMF currently projects that Russia's GDP grew by only 0.2 percent in 2014, and its latest forecast is for a 3 percent contraction in 2015. Inflation in Russia is also running well above target and is expected to exceed an annual rate of 10 percent for the rest of this year. The ruble depreciated 43 percent against the dollar in 2014 amid heavy capital outflows, which exceed $150 billion, and the currency is expected to remain under pressure over the medium term. The sharp depreciation of the ruble has taken place despite substantial market intervention by the Central Bank of Russia, which spent approximately $80 billion to stabilize the currency in 2014 and increased its key policy rate from 5.5 percent to 17.5 percent. Russia's sovereign credit rating has also been downgraded on multiple occasions over the past year (many private analysts expect it to be lowered to "junk" status in the coming months), and government and corporate borrowing costs have risen significantly.

By their nature, we would expect the economic and financial costs of our debt and equity prohibitions to increase over time. We may see accelerated capital outflows and further dampening of investor confidence as banks and corporates struggle to rollover maturing external debt next year. Furthermore, as we have seen in recent weeks, the cumulative impact of multiple rounds of U.S. and European sanctions will continue to be exacerbated by low oil prices.

Question 2:
In recent months, leaders of the Federal Reserve including Fed Chairman Yellen, Governor Tarullo and others have stated that insurance companies have unique business models that make them different from banks, and that a bank-centric regulatory model would not work for insurance companies.

At the same time, international bodies in Europe including the Financial Stability Board and the International Association of Insurance Supervisors (bodies that have U.S. representation) have begun the process of preparing quantitative international capital standards that could potentially apply to U.S. insurance companies, including insurers that have not been designated systemically important financial institutions under Dodd-Frank and were not among insurance groups designated as Global Systemically Important Insurers last year by the FSB.

- **Given the Treasury Department's important role as a member of the FSB, can you share your perspective on this move toward bank-like capital standards for U.S. insurance groups, and tell us what steps the Treasury and other U.S. regulators can take to make sure that a quantitative capital standard does not become the regulatory reality for U.S. insurers?**

- **I would also be interested in your thoughts on how such standards could be implemented without disruption to the U.S. state-based system of regulation and if it is the position of the Treasury at the FSB to promote the United States state-based system?**

Answer:
The United States plays a leadership role in developing international standards at the FSB and at the international standard setting bodies, including the International Association of Insurance Supervisors (IAIS). International standards have been developed in the insurance sector for nearly 20 years. International standards support robust, high-quality oversight that promotes global financial stability, promotes a level playing field, offers consistent supervisory approaches for regulators around the world, and leads to reduced compliance costs for global firms.

The United States is represented at the IAIS by Treasury's Federal Insurance Office (FIO), the 56 insurance commissioners of the states and other jurisdictions of the United States, staff from the National Association of Insurance Commissioners (NAIC), and the Federal Reserve. We are engaged in developing international standards that will serve U.S. consumers, industry, and economy. This important work is occurring at the IAIS, a forum for technical insurance experts.

The work on a comprehensive supervisory framework for internationally active insurance groups (IAIGs) has been ongoing since 2009 and is shaped by the input of the U.S. federal and state participants. As part of these discussions, Treasury agrees that any capital standards for insurers should be based on insurance business models and risk metrics. In addition, prior to implementation, the international capital standards will be tested directly with U.S.-based insurers. A market analysis will be conducted to determine whether and, if so, how the standard, and related provisions, would affect both individual insurance firms and the U.S. insurance market. The testing and the study will allow for the implementation of international standards that account for the impact in the United States.

As has always been true in the insurance sector, international standards are not self-executing. Only U.S. state or federal authorities may impose a standard or requirement on a U.S. insurance organization. In the case of the United States, for firms that operate as part of a bank or savings and loan holding company or nonbank financial company designated by the Financial Stability Oversight Council (FSOC), the Federal Reserve has the authority to implement the standard. For firms not subject to oversight by the Federal Reserve, the state insurance regulators would have authority to implement the standard.

House Committee on Financial Services
Questions for the Record for Secretary Jacob J. Lew
June 24, 2014 Hearing on the Annual Report of the Financial Stability Oversight Council

Submitted by Rep. Robert Hurt

Question 1:
Secretary Lew, during the hearing I asked you about your views on the trend of consolidation in our banking industry, as the number of community banks continues to decline from 18,000 in 1984 to less than 7,000 today. Are you concerned with these statistics? What do you believe are the potential impacts for the U.S. economy if this trend continues?

Additionally, FSOC's primary objective is to identify risks to our financial stability. Do you believe that significant consolidation in the banking industry constitutes a risk to our financial stability? If so, what is the FSOC doing in response?

Finally, some note that one of the major causes of this consolidation is the significant increase in regulatory compliance costs. What immediate steps are you and the appropriate member agencies of FSOC taking to ensure that community banks are not paying disproportionate regulatory costs that will further increase bank consolidation?

Answer:
Community banks have long filled a vital role in meeting the needs of families and small businesses in communities across the country. Banks of all sizes are operating in a very competitive environment, not just community banks. Yet banks today are generally in much better shape than they were in the years before the financial crisis. Net income for the industry is stable, capital levels are robust, and loan performance is strong for most banks, large and small.

Industry consolidation is a long-term trend that predates the financial crisis and any regulatory response. In recent years, we have seen the pace of consolidation slow. Banks have had to adapt in various ways to a changing business and regulatory environment following the crisis, and we will continue our regular exercise of financial sector monitoring.

The vast majority of new regulations do not apply to community banks. We will continue to be attentive, however, to the importance of tailoring regulations as may be appropriate with respect to smaller financial institutions.

Question 2:
The Financial Stability Board (FSB), in which the U.S. is represented by the U.S. Department of the Treasury, the Federal Reserve Board and the Securities and Exchange Commission, is increasingly engaged in insurance regulatory matters and has issued directives to the International Association of Insurance Supervisors to come up with global capital standards for insurers, with the apparent agreement of Treasury.

What data and other empirical evidence did the Treasury and FSB rely upon to determine that global capital standards are necessary for the insurance sector and benefit consumers more than our current system? What cost benefit analysis was performed before the

directive was issued by the FSB? Please provide any information and data used to make these determinations.

Answer:
At the Pittsburgh Summit in 2009, the Group of 20 (G-20) Leaders committed to develop internationally consistent approaches to evaluating global systemically important financial firms "to help mitigate the disruption of financial institution failures and reduce moral hazard in the future." In response, the Financial Stability Board (FSB) developed a framework and called on the technical experts in the relevant international standard-setting bodies to develop methodologies for identifying global systemically important financial institutions (G-SIFIs) in each sector. The International Association of Insurance Supervisors (IAIS) developed the methodology for global systemically important insurers (G-SIIs) and the FSB called on the IAIS to develop a quantitative capital standard for internationally active insurers. The United States is represented at the IAIS by Treasury's Federal Insurance Office (FIO), the 56 insurance commissioners of the states and other jurisdictions of the United States, staff from the National Association of Insurance Commissioners (NAIC), and the Federal Reserve. The technical work and recommendations developed at the IAIS have formed and will continue to form the basis for any FSB determinations on insurance matters.

The United States has made strong commitments in the G-20 to these international efforts, which reflect the globally connected economy and are important to safeguarding the U.S. financial system from threats resulting from weaker regulation elsewhere. Treasury supports the technical work undertaken at the IAIS in order to support financial stability and to promote a level playing field for U.S. firms that operate internationally. This ongoing work is informed by FIO, the states, and the Federal Reserve.

Prior to implementation, the international capital standards will be tested directly with U.S.-based insurers. A market analysis will be conducted to determine whether and, if so, how the standard, and related provisions, would affect individual insurance firms and the U.S. insurance market.

House Committee on Financial Services
Questions for the Record for Secretary Jacob J. Lew
June 24, 2014 Hearing on the Annual Report of the Financial Stability Oversight Council

Submitted by Rep. Blaine Luetkemeyer

Question 1:
The Dodd-Frank Act gives Treasury, through the Federal Insurance Office (FIO), some limited authority to represent U.S. interests in international insurance regulatory discussions but also makes clear that the states continue to be the primary regulators of insurance in an effort to ensure that the policies of individual states continue to govern insurance regulation in the United States. Yet, FIO has taken positions different from and even contrary to, the positions advocated by our state regulators, including the need for a global insurance capital standard that could reduce the relative competitiveness and consumer focus of the U.S. insurance market.

Do you believe that, while FIO has the authority to engage in representation of the United States, it should advocate for positions that are consistent with the positions of the state officials who have the primary regulatory responsibility of insurance? Do you believe that failure to properly represent the positions of these state officials runs afoul of Congressional intent?

Answer:
In Title V of the Dodd-Frank Act, Congress established the Federal Insurance Office (FIO) within the Treasury Department. In addition to advising the Secretary of the Treasury on major domestic and prudential international insurance policy issues and having its director serve as a non-voting member of the Financial Stability Oversight Council (FSOC), FIO is authorized, pursuant to the Dodd-Frank Act, to coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors (IAIS).

The United States is represented at the IAIS by FIO, the 56 insurance commissioners of the states and other jurisdictions of the U.S., staff from the National Association of Insurance Commissioners (NAIC), and the Federal Reserve. We are engaged in developing international standards that will serve the best interests of the United States,.

As has always been true in the insurance sector, international standards are not self-executing. U.S. state or federal authorities, not international standard-setters, may impose a standard or requirement on a U.S. insurance organization. In the case of the United States, for insurance organizations that operate as part of a bank or savings and loan holding company or nonbank financial company designated by the FSOC, the Federal Reserve has the authority to implement the standard. For those insurance organizations not subject to oversight by the Federal Reserve, the state insurance regulators would have authority to implement the standard.

House Committee on Financial Services
Questions for the Record for Secretary Jacob J. Lew
June 24, 2014 Hearing on the Annual Report of the Financial Stability Oversight Council

Submitted by Rep. Steve Stivers

The recent FSOC annual report had very little negative to say about the U.S. property and casualty insurance industry and its regulation. Yet, there are many developments in which Treasury is participating that could harm that market and its regulation, including the wrong global capital standards that could create systemic risk that clearly doesn't exist today.

Question 1:
What direction have you given to Treasury's representatives in international discussions, including FIO, to avoid harming the competitiveness and quality of the U.S. property and casualty insurance market and its state regulation?

Answer:
FIO will continue to contribute constructively in support of international standards that, when implemented, will benefit U.S. consumers and U.S. insurers, promote competition and consumer choice, and safeguard policyholder protection and financial stability. Working together, U.S. participants are already leading developments in international standard-setting activities. Absent the participation and leadership of U.S. participants, international standard-setting activities would continue without reflecting the unique features of the U.S. market and regulatory structure.

Capital standards for insurers should take into account insurance business models and risk metrics. In addition, prior to implementation, the international capital standards will be tested directly with U.S.-based insurers. A market analysis will be conducted to determine whether and, if so, how the standard, and related provisions, would affect both individual insurance firms and the U.S. insurance market.

As has always been true in the insurance sector, international standards are not self-executing. U.S. state or federal authorities, not international standard-setters, may impose a standard or requirement on a U.S. insurance organization. In the case of the United States, for firms that operate as part of a bank or savings and loan holding company or nonbank financial company designated by the Financial Stability Oversight Council (FSOC), the Federal Reserve has the authority to implement the standard. For those firms not subject to oversight by the Federal Reserve, the state insurance regulators would have authority to implement the standard.

Treasury's FIO regularly works with other federal agencies and state insurance regulators to promote a coordinated and effective approach to prudential aspects of international insurance matters. Treasury officials, representatives of other federal agencies, and state regulators jointly attend and participate in discussions in multiple fora regarding international insurance matters. The United States plays a leadership role in developing international standards at the IAIS that promote the best interests of the United States. U.S. state regulators, individually and through NAIC staff, participate in and often lead international workstreams at the IAIS in which FIO and the FRB staff also participate. For instance, all 56 insurance commissioners of the states and other jurisdictions of the United States and the NAIC are represented in the IAIS. The international insurance standards under development at the IAIS are important to promote global

financial stability, promote a level playing field, offer consistent supervisory approaches for regulators around the world, and lead to reduced compliance costs for global firms. International insurance supervisory standards have been developed and adopted by the states in the United States for nearly 20 years, and state regulators have been actively involved in the IAIS since its inception in 1994.

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