STATEMENT OF

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on

OVERSIGHT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

December 8, 2015

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Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify today on the work being undertaken by the Financial Stability Oversight Council (FSOC). My testimony will discuss the FSOC's efforts to identify and address systemic risk, and the designation of entities as systemically important financial institutions (SIFIs).

Background and Mission of the FSOC

The financial crisis that began in 2007 exposed a number of serious vulnerabilities in the U.S. financial system. In the years leading up to the crisis, misaligned incentives, excessive leverage and risk taking, and gaps in regulation all contributed to a serious and, at the time, unrecognized increase in systemic risk. The crisis that followed resulted in the most severe economic downturn since the Great Depression. While some risks affecting individual products and institutions had been recognized, neither the financial markets nor the regulatory community was able to see the whole picture.

The FSOC was established in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to address this gap in the regulatory framework. Its key functions are to facilitate information sharing among its member agencies, to identify and respond to emerging risks to financial stability, and to promote market discipline. The FSOC is also responsible for designating nonbank SIFIs for heightened supervision by the Board of Governors of the Federal Reserve System (FRB). By statute, the FSOC is composed of 10 voting members and 5 nonvoting members, and its structure allows the member agencies to work together while preserving the ability of the independent regulators to fulfill their statutory mandates.

Specific Authorities

Identification of emerging risks that can have a systemic impact is among the key responsibilities of the FSOC. This work is carried out and documented primarily through the development of the FSOC's Annual Reports. This year the FSOC issued its fifth such report, and as in previous years, a significant portion of the report is devoted to describing emerging risks to financial stability.

The FSOC is also responsible for determining whether a nonbank financial company should be designated as a SIFI based on the statutory factors in Section 113 of the Dodd-Frank Act. A firm that is designated as systemic is subject to FRB supervision and enhanced prudential standards, including the requirement to file a resolution plan to demonstrate how the company would be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of its material financial distress or failure.

FDIC's Role

The FDIC has as its primary mission the maintenance of public confidence in our nation's financial system, which is the foundation of financial stability. It performs that mission in three important ways. First, it insures deposits held in our nation's banking system. Second, it examines and supervises banks for safety and soundness and compliance with laws and regulations. Finally, it is responsible for the resolution of failed banks and, under the Dodd-Frank Act, for the resolvability of large and complex financial institutions. These authorities give the FDIC a valuable perspective on markets and market participants that it brings to bear on FSOC deliberations and actions.

Systemic Risk Identification and Monitoring

One of the primary responsibilities of the FSOC is to identify risks to the financial stability of the United States financial system and to respond to these risks. Through the work of its standing committees and its principal-level meetings, the FSOC monitors: the U.S. macroeconomic environment; developments in financial markets, firms and products; the regulatory environment; and international trends and other potential exogenous shocks to financial stability. This is a continuous process the FSOC engages in throughout the year, culminating in the assessment of potential threats to the financial system published in the FSOC Annual Report.

The FSOC Annual Report provides an evaluation of the current macroeconomic environment and financial developments and a progress report on regulatory developments that form the basis of an analysis of potential emerging risks to U.S. financial stability. Moreover, the FSOC Annual Report contains a set of recommendations intended to address those potential threats. We now have the benefit of five annual reports, which together outline the key systemic risks facing the financial system – and how they have evolved over time - and provide a framework to formulate policies to address these risks.

The first Annual Report, published in 2011, described a still fragile financial system recovering slowly from the deepest financial crisis since the Great Depression. At that time, much of the regulatory agenda intended to improve the resilience of the financial system as a whole — and of the financial institutions that make up the financial system — had yet to be completed. Rulemakings and reforms in areas like capital, liquidity, resolution planning, derivatives, tri-party repos, and money market funds, among others, were not complete, and in some cases, not yet underway. In contrast, the most recent 2015 FSOC Annual Report describes a more stable, though still recovering macro economy and broad-based improvement in most financial markets and market participants. Three broad areas of risk which the FSOC has been following closely, and which are of particular consequence to the FDIC, are interest rate risk, credit risk, and cybersecurity.

The five annual reports have been prepared against the backdrop of prolonged low interest rates and have accordingly addressed potential risks to market participants and the financial system of a sharp rise in interest rates as well as the implications of increased risk taking in a low-rate environment (so-called “reach for yield” behavior). We have identified industry trends that highlight the importance of careful management of sensitivity to interest rate risk. Nationally, a number of institutions report a significantly liability- sensitive balance sheet position, meaning that a rise in short-term interest rates may cause funding costs to rise at a faster rate than long-term asset yields. For a number of institutions, the potential exists for material securities depreciation relative to capital in a rising interest rate environment. Significant, unmitigated levels of interest rate or market risk can lead to losses and liquidity constraints when prevailing rates change significantly. Effectively managing interest rate risk is part of the business of banking, and many institutions have effectively measured, monitored, and controlled exposures to achieve earnings goals. However, we expect the FSOC will continue to closely review interest rate risk in the industry.

In addition to problems related to maturity mismatch, we have seen an increase in credit risk caused by easing of lending standards, and other forms of increased risk-taking. The past two annual reports describe a sharp increase in high-yield and leveraged lending markets as some market participants reach for yield, and accordingly, strong activity in the secondary markets for these credits. The FDIC, along with the other banking agencies, issued guidance in 2013 to the institutions we supervise that sets forth prudent underwriting and risk management standards for these types of credits. The banking agencies published results of the 2015 SNC review on November 5th. The review found that the level of risk in the SNC portfolio is increasing, with elevated levels of credit risk centered mainly in loans to leveraged borrowers as well as weaknesses in leveraged loan underwriting practices and oil and gas sector credit exposures. The agencies will continue to closely monitor the leveraged lending activities of insured depository institutions and will continue to stress the need to conform to 2013 leveraged lending guidance.

Cybersecurity has been cited as a risk in each of the five FSOC annual reports, and in 2015, rose to the top of the list of potential emerging threats and vulnerabilities as a result of the increase in the number and severity of cyber incidents and the real costs this issue presents in terms of risk assessment and mitigation. Given the deliberate and increasingly sophisticated attempts to disrupt institutions and markets, and given the increasing reliance on complex and interconnected technologies, it is clear these incidents will continue and will require heightened attention in the years to come. This year's report addresses the importance of the public/private partnership in information sharing, developing strong best practices to enhance the security and resilience of the nation's critical infrastructure – including the portions that are not within the financial system, but upon which financial companies rely, and solid plans for response and recovery.

The FSOC Annual Report recommends enhancements to existing information sharing between government and industry, including increasing the speed of information exchange by automating the sharing of technical data where possible. The FSOC has been supportive of the ongoing work done through the Federal Financial Institutions Examination Council (FFIEC), which includes release of a Cybersecurity Assessment Tool to help institutions identify their risks and level of cybersecurity preparedness. If there is a significant cyber incident, a coordinated, nationwide response will be essential. The FSOC encourages the establishment of a national plan for cyber incident response for the financial sector that includes identifying and articulating the role of law enforcement, the Department of Homeland Security, and financial regulators.

In the coming year, the FSOC will continue its ongoing process of monitoring these risks and others as we begin to prepare our sixth annual report in 2016.

Nonbank Designation

As previously noted, Section 113 of the Dodd-Frank Act authorizes the FSOC to designate a nonbank financial company if the FSOC determines that material financial distress at the company, or 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. Rather than relying on any one specific factor, or using a strictly quantitative approach, the Dodd-Frank Act requires the FSOC to evaluate both quantitative measures and qualitative factors. It also ensures significant engagement between FSOC staff and representatives of the companies being evaluated and provides due process rights to financial companies being considered for designation. Designated companies are subject to enhanced supervision by the FRB and are required to develop and submit resolution plans as noted above.

The Designation Process

After three opportunities for public comment, the FSOC issued a Final Rule and Interpretive Guidance (Rule and Guidance) outlining the process it uses in carrying out the requirements of section 113 of the Dodd-Frank Act. The FSOC received significant feedback on the procedures from a wide range of commenters, and considered their recommendations. The Guidance lays out a 3-stage process, with each stage involving a more in-depth evaluation and analysis of the financial company. This approach allows the FSOC to engage in a flexible company-specific analysis that reflects the unique risks posed by each company and is appropriate for the company's size, scope, and complexity.

In the first stage of the nonbank financial company designation process, FSOC compares all nonbank financial companies to public "threshold" quantitative standards. The Stage 1 thresholds are based on public information and are readily calculable by nonbank financial companies and market participants. They are:

- $50 billion in total consolidated assets;
- $30 billion in gross notional credit default swaps (CDS) outstanding for which a nonbank financial company is the reference entity;
- $3.5 billion of derivative liabilities;
- $20 billion in total debt outstanding;
- 15 to 1 leverage ratio; and
- 10 percent short-term debt ratio.

Generally, in order to be further evaluated, a company would have to meet or exceed at least 2 of these thresholds. Only a small subset of nonbank financial companies will exceed the threshold standards and receive additional analysis. These thresholds, adopted by notice and comment as part of the Rule and Guidance, add significant transparency to the designation process. Earlier this year, FSOC staff published guidance on its website that provides additional details explaining how the Stage 1 thresholds are calculated. Publication of these thresholds and the related guidance allows nonbank financial companies to assess, from the outset of the process, whether they would likely be subject to additional FSOC review.

In stages 2 and 3 of the process, the FSOC considers all the statutory factors set forth in Section 113 of the Dodd-Frank Act. These factors include the following:

- leverage, off-balance sheet exposures, and financial assets;

- transactions/relationships with other significant nonbank financial companies and significant bank holding companies;
- importance as a credit source for households, businesses, State/local governments, and U.S. financial system, and as a credit source for low-income, minority, or underserved communities, and impact failure would have on credit for such communities;
- extent to which it manages rather than owns assets, and whether ownership of assets under management is diffuse;
- nature, scope, size, scale, concentration, interconnectedness, and mix of activities;
- degree to which it is already regulated by 1 or more primary financial regulatory agencies;
- liabilities, including reliance on short-term funding; and
- any other risk-related factors the FSOC deems appropriate.

In the second stage of review, FSOC analyzes each nonbank financial company using public information, and nonpublic information from regulators, if provided, to determine whether the company could pose a threat to U.S. financial stability. An analytical team, made up of staff members from the FSOC and FSOC member agencies, reviews these information sources to analyze these risk factors and to consider the mechanisms through which risk can be transmitted to the rest of the financial system. After the analysis in Stage 2, the Council votes on whether to conduct additional analysis in Stage 3. As was noted in this year's Annual Report, to date, four nonbank financial companies have been subject to final designation by the FSOC, and the FSOC has voted not to advance five nonbank financial companies beyond Stage 2 because the analyses indicated that the firms were unlikely to be systemic.

In the third stage, FSOC notifies in writing each nonbank financial company that the FSOC believes merits further review to collect directly from the company information that was not available in prior stages. Each nonbank financial company reviewed at this stage is provided an opportunity to submit written materials related to the FSOC's analysis.

During this time, a company may have extensive contact with FSOC staff and the analytical team. Although not required by the statute, the FSOC encourages meetings between company representatives and members of the analytical team to discuss details of the company's operations and financing and to hear the company's views. Based on the results of the analyses conducted in Stage 3, the FSOC may make a proposed determination regarding designation of the nonbank financial company, which requires a vote of at least two-thirds of the FSOC's voting members then serving, including an affirmative vote by the FSOC Chairperson. If a proposed designation determination is made, the FSOC will provide the nonbank financial company with a written explanation of the basis of the proposed determination. Any company that receives a proposed designation may submit a written response and request an oral hearing before the FSOC. The FSOC has adopted hearing procedures, clarified in response to industry comment, to ensure that any company that wishes to contest a proposed designation can fully and fairly present its views before the FSOC principals.

After a hearing, or if none is requested, the FSOC will vote on a final determination with respect to the designation of the nonbank financial company. If two-thirds of the members then serving, including the FSOC Chairperson, vote in favor of the determination to subject the company to FRB supervision, the firm is designated. The FSOC provides any nonbank financial company that receives such a vote with written notice of its final determination, including a detailed explanation of the basis of its decision. Ultimately, the FSOC's close adherence to the requirements of the statute and the Rule and Guidance is intended to ensure a consistent, fair, and transparent designation process for nonbank financial companies.

The FSOC annually reevaluates each designation and will rescind a designation if it determines that the company no longer meets the statutory standards. In connection with this annual reevaluation, the company has the opportunity to meet with FSOC staff to discuss the review and to present information regarding changes that may be relevant to the threat the company could pose to financial stability, such as restructuring efforts, regulatory developments, or market changes. A company also has the opportunity to contest its designation at an oral hearing before the FSOC once every five years.

Companies designated by the FSOC for FRB supervision are subject to a number of authorities designed to reduce systemic risk. The Dodd-Frank Act requires the FRB to apply enhanced prudential standards and early remediation requirements to these companies and authorizes the FRB to tailor the application of these standards and requirements to different companies on an individual basis or by category. Prudential standards include capital standards, stress testing requirements, and the submission of resolution plans to the FDIC and the FRB.

Designated companies, as well as large bank holding companies, are required to submit resolution plans identifying how the company could be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of its material financial distress or failure. The FDIC and the FRB review each resolution plan. Under Section 165(d) of the Dodd-Frank Act, if the FDIC and the FRB jointly determine that the resolution plan is not credible or would not facilitate an orderly resolution of the firm under the Bankruptcy Code, then the company must resubmit the plan with revisions, including, if necessary, proposed changes in business operations or corporate structure. If the company fails to resubmit a credible plan that would result in orderly resolution under the Bankruptcy Code, the FDIC and the FRB may jointly impose more stringent capital, leverage, or liquidity requirements; as well as growth, activities, or operations restrictions. In addition, if the company fails to resubmit a credible plan after two years, the FDIC and FRB, in consultation with the FSOC, may impose divestiture requirements.

FSOC transparency and process

FSOC policies and procedures were crafted to ensure a robust exchange of information throughout the designation process. As the process has evolved, opportunities for additional transparency both within the operations and the designation process were identified by the FSOC and in comments by external parties. As a result, the FSOC undertook several initiatives over the past year and a half to improve both transparency and engagement with financial companies.

These include:

- providing no less than seven days' advance notice of regularly scheduled meetings, including information about the agenda for both open and closed meetings;
- publication of minutes of Council meetings, including all votes of Council members;
- publication of answers to frequently asked questions about designation;
- publication of guidance that provides additional details explaining the calculation of Stage 1 thresholds; and
- the adoption of supplemental procedures related to its nonbank designations process.

The supplemental procedures, adopted in February of 2015, address a number of suggestions made by industry stakeholders as well as members of Congress. These supplemental procedures require, among other things, notification to companies that they have been advanced to Stage 2 and that they are being evaluated by the FSOC, opportunities for the company to submit information to the FSOC for review by the analytical team, opportunities in Stage 2 for the company to meet with the analytical team, notice if the Council votes not to advance to Stage 3, and if the Council votes to advance a company to Stage 3, notification if specific aspects of the company's operations or activities were identified as the primary focus for the evaluation. Additionally, the supplemental procedures provide clarification that the FSOC intends to grant any timely request for an oral hearing from a company subject to a proposed designation and for any such hearing to be conducted by the FSOC members. If a company is designated, the designation must be reevaluated annually and the supplemental procedures provide that the company may submit new information, meet with FSOC staff, and get feedback on the review as part of the reevaluation process. The procedures provide an opportunity for a designated company to have an oral hearing before the FSOC once every five years. These steps reflect an ongoing commitment to good governance and transparency, and the FSOC will continue to look for opportunities to improve both.

Conclusion

Thank you for the opportunity to share with the Committee some details of the work that the FDIC has done with the FSOC to identify and address systemic risk in the financial system. The FSOC fills a significant gap in the regulatory framework that existed prior to its creation. The FDIC is committed to the ongoing work of the FSOC and supports the cooperative approach to identifying and responding to risks along with other FSOC members.