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PROMOTING FINANCIAL STABILITY: ASSESSING THREATS TO THE U.S. FINANCIAL SYSTEM

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCIAL INSTITUTIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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PROMOTING FINANCIAL STABILITY: ASSESSING THREATS TO THE U.S. FINANCIAL SYSTEM

Wednesday, September 25, 2019

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION
AND FINANCIAL INSTITUTIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:07 a.m., in room 2128, Rayburn House Office Building, Hon. Gregory W. Meeks [chairman of the subcommittee] presiding.

Members present: Representatives Meeks, Scott, Velazquez, Heck, Foster, Lawson, Tlaib, Porter, Wexton; Luetkemeyer, Posey, Barr, Tipton, Williams, Loudermilk, Kustoff, and Riggleman.

Ex officio present: Representatives Waters and McHenry.

Also present: Representatives Cleaver, and Garcia of Illinois.

Chairman MEEKS. The Subcommittee on Consumer Protection and Financial Institutions will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee are authorized to participate in today's hearing.

I now recognize myself for 4 minutes to give an opening statement.

Today's hearing is entitled, "Promoting Financial Stability: Assessing Threats to the U.S. Financial System." This committee considers many important issues that impact the lives of American families and households, but I would argue that no issue cuts across every district, every ZIP code, and impacts every American like a financial crisis.

While 10 years may seem like a long time ago, it frankly feels like yesterday when it comes to the financial crisis and the Great Recession. I was here and recall vividly, in 2008, when Secretary Paulson came to the House Floor and told us that we literally had just a few days to save the entire American economy and financial system from total collapse.

I was here, as Chair of the International Monetary Policy Subcommittee, and a member of the Conference Committee, when we drafted the Dodd-Frank Wall Street Reform and Consumer Protection Act. I know that documentaries and movies have been made about it, but there is frankly no way to describe or fully capture the deep, sinking feeling of being told that the greatest economy in

the world is days away from a collapse, dragging the rest of the world with us.

Today, the U.S. economy is slowing. Global trade is in turmoil. Chinese growth is stalling. European economies are slowing, with some entering recession and a hard Brexit poses a potential shock to global markets. Big sections of Latin America are in turmoil, oil markets are literally under attack, and I could go on.

We are entering a period that may prove to be the first real test of the new regulatory framework put in place following the financial crisis. I fear that some actors in the economy, and even in government, suffer from a worrisome form of amnesia or selective memory. As they say, history may not repeat itself, but it certainly rhymes.

There are echoes, not just of the last financial crisis, but of elements of previous crises in the state of the economy and markets today which cause me great concern. There are also new emerging threats, and I question whether the Administration, the Financial Stability Oversight Council (FSOC), or the Office of Financial Research (OFR) and regulators are taking seriously enough the potential risk to the economy. I hope so.

Among those, I would include high equity valuations that appear well above fundamentals, seizures in short-term funding markets, leveraged lending that burdens companies with high debts and creates new complex securitization schemes, and an economy meant to be the best in 50 years propped up nearly entirely by consumers while 40 percent of American households barely make ends meet and can't afford a $400 emergency expenditure. Also, rapid concentration of the banking sector and disappearance of community banks and minority banks, creating expanding banking deserts and exposing a growing share of the population to predatory actors, and leaving many financially disenfranchised. Cyber-attacks and data breaches, and again, I could go on.

So I am here, and we are here today, and I urge the regulators, FSOC, and, in particular, the Office of Financial Research, to invest in required resources to monitor, map, and quantify existing and emerging systemic risk. We owe it to every American family, worker, and homeowner to take an intellectually honest approach to monitoring and regulating markets to prevent the fallout of yet another financial crisis.

The Chair now recognizes the ranking member of the subcommittee, Mr. Luetkemeyer, for 4 minutes for an opening statement.

Mr. LUETKEMEYER. Thank you, Chairman Meeks. A decade after the financial crisis, all signs are pointing towards a healthy U.S. financial system that is vastly safer and more resilient. According to FDIC Vice Chairman of Supervision Randy Quarles, every time we go through this analysis we conclude that financial stability risks are not meaningfully above normal because there is so much capital in the banking sector. Financial institutions across the nation are injecting capital into their communities and supporting American consumers, homeowners, and business owners through increased lending.

This is not to say that we cannot improve. The stranglehold of regulatory burdens continues to affect financial institutions across

the nation. The Trump Administration has been a strong partner in easing overly burdensome regulations, and together we can do more to free up additional capital. It is our responsibility, on this committee, to support pro-growth policies and responsible regulations that ensure the continued safety and stability of our financial system.

When the CEOs of America's largest banks testified before this committee in April, they were asked to cite the biggest threat that their institutions faced. Many identified cybersecurity as a major threat, with Bank of America CEO Brian Moynihan going as far as to say thagt we are effectively in a war on cybersecurity.

At a House Financial Services markup last year, I lamented that at some point there will be another major breach, and without a comprehensive solution, our constituents will pay the price for our inaction. Fast forward a year, and we have seen numerous data breaches spanning every industry from financial services to retailers to social media companies.

Data security is a challenging and constantly evolving issue that, unfortunately, doesn't get the attention it deserves until there is yet another breach affecting millions of Americans. We need clear rules of the road surrounding data security and breach notification across the nation. Unfortunately, this committee has not had any data security hearings this year. Current data security notification standards leave millions woefully unprotected, and the American people deserve more than a deafening silence on this critical issue.

In addition to data security, I have been raising alarms with regard to the threat posed by the Financial Accounting Standards Board's (FASB's) Current Expected Credit Losses (CECL) standard. While FASB will vigorously argue that CECL has been years in the making, members of the Board have also admitted that there has not been, nor will there be an economic impact study performed, despite repeated warnings that the procyclical nature of CECL could exacerbate a downturn.

JPMorgan Chase CEO Jamie Dimon, in this very committee, went as far as to say that CECL would put smaller institutions in a position that when a crisis hits, they will virtually have to stop lending, because putting up those reserves would be too much at precisely the wrong time.

It is irresponsible for Congress to stand by and allow short-sighted, hastily implemented standards to threaten the ability of our financial institutions to continue lending. I welcome today's witnesses and I look forward to a robust discussion on how to support continued financial stability in the United States.

With that, Mr. Chairman, I yield back.

Chairman MEEKS. Thank you. The gentleman yields back the balance of his time.

I now recognize the gentleman from Georgia, Mr. Scott, for one minute.

Mr. SCOTT. Thank you very much, Chairman Meeks, and it is really good to have Governor Brainard and Director Falaschetti here with us, because this is an incredibly important and timely hearing. We find ourselves now 10 years out from the collapse of our financial system. Our economy has come a long way. I think we have done a good job. The passage of Dodd-Frank took impor-

tant steps to expose the cracks in the foundation of our financial structure and mitigate the damage that was done by decades of financial recklessness.

Now, as we hear from our top regulatory experts, we must evaluate not only our efforts to correct past missteps, but we also must find ways to remain vigilant against new threats to our great financial stability and our great financial industry.

So I look forward to the insights of my colleagues, and those of my colleagues on the subcommittee, and from our distinguished panelists.

Thank you, Mr. Chairman.

Chairman MEEKS. The gentleman's time has expired.

I now recognize Mr. Luetkemeyer for a unanimous consent request.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Ranking Member McHenry wanted to be here and had a statement that he was going to read, but in his absence, I will just ask the subcommittee, without objection, to add it to the record.

Chairman MEEKS. Without objection, it is so ordered.

Today, we welcome the testimony of two witnesses.

First, Fed Governor Lael Brainard took office as a member of the Board of Governors of the Federal Reserve System on June 16, 2014, to fill an unexpired term ending January 31, 2026. Prior to her appointment to the Board of Governors, Dr. Brainard served as Under Secretary of the U.S. Department of the Treasury from 2010 to 2013, and as Counsel to the Secretary of the Treasury in 2009.

During this time, she was the U.S. representative to the G-20 finance deputies and the G-7 deputies, and was a member of the Financial Stability Board. She received the Alexander Hamilton Award for her service.

Dr. Brainard was also previously assistant and associate professor of applied economics at the Massachusetts Institute of Technology's Sloan School of Management. She received a BA with university honors from Wesleyan University in 1983. She received an MS and a Ph.D. in economics in 1989 from Harvard University, where she was awarded the National Science Foundation fellowship. She is also the recipient of a White House fellowship.

Welcome, Governor Brainard.

Also testifying is OFR Director Dino Falaschetti. Mr. Falaschetti was confirmed by the U.S. Senate and sworn in as Director of the Office of Financial Research in June 2019. He started his career by leading financial statement audits and managing at Fortune 100 corporate financial departments. Subsequently, he served as a professor of law, economics, and finance, where he leveraged professional experiences in business, policy, and law with firmly grounded data analytics to build a top-ranked research program. He earned tenure in both law and economics, an endowed Chair in finance, and research appointments at Stanford University and the University of California at Berkeley.

Prior to joining OFR, he served as the Chief Economist for the U.S. House Financial Services Committee, so he is really coming back home. He has also served as a Senior Economist for the White House Council on Economic Advisors, and contributed in leadership roles at policy research institutions. He earned a doctorate degree

in economics from Washington University in St. Louis, an MBA with high honors from the University of Chicago Booth School of Business, and a bachelor of science degree with distinction from the Indiana University Kelley School of Business.

I remind the witnesses that your oral testimony today will be limited to 5 minutes, and without objection, your written statements will be made a part of the record.

Governor Brainard, you are now recognized for 5 minutes to give your oral presentation.

STATEMENT OF THE HONORABLE LAEL BRAINARD, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. BRAINARD. Thank you, Chairman Meeks, Ranking Member Luetkemeyer, and members of the subcommittee. I appreciate the opportunity to be here today, along with my colleague from OFR, Dino Falaschetti.

Following the financial crisis, Congress created the FSOC and assigned financial stability responsibilities to domestic regulators. The Federal Reserve Board, in turn, created a new board, the Committee on Financial Stability, which I Chair, and the Division of Financial Stability, which provides a financial stability assessment each quarter to the Board and to the Federal Open Market Committee (FOMC), and I just want to acknowledge Andreas Lehnert, who has led that Division. We now publish a Financial Stability Report semi-annually in order to increase transparency and accountability, and I brought a copy today.

Because the build-up of financial imbalances in good economic times has the potential to lead to disruptions in credit that can amplify a subsequent downturn, we assess financial vulnerabilities as well as mitigants that build resilience. Let me briefly run through these.

First, overall household borrowing has come down in recent years and is now growing more slowly than the economy overall. While much of the increase before the crisis reflected borrowing that proved unsustainable, more recently it has been concentrated among households with stronger credit profiles. In addition, there has been an increase in student debt in recent years, which deserves attention.

Second, far-reaching reforms have made the regulated financial sector more resilient. Insurers appear generally well-capitalized and broker-dealers have lower leverage. Banks increased capital buffers following the crisis, although the ratio of capital relative to risk assets at the largest banks has moved down somewhat as payouts have exceeded earnings over the past couple of years. Financial reforms have also importantly reduced funding risks. Large banks subject to liquidity regulation have stronger liquidity buffers and are less reliant on unstable short-term wholesale funding.

There are, however, two areas that I am monitoring closely. First, a range of asset prices are high relative to historical benchmarks. Relative to Treasury yields, spreads on high-yield corporate bonds remain somewhat narrow, relative to historical norms. Spreads on leveraged loans remain in the bottom half of their

range since the crisis, and capitalization rates on commercial real estate have been low.

Declines in those valuations could make it more challenging for firms to obtain or extend financing, which could be amplified by high levels of risky corporate debt, and that is the second area of note. Business borrowing has risen more rapidly than GDP for much of the current expansion and now sits near its historical peak. It appears that firms with high leverage, high interest expense ratios, and low earnings and cash holdings have been increasing their debt loads the most.

While the share of high-yield bonds rated "deep junk" has stayed well below the financial crisis peak within the investment-grade segment, half of those corporate bonds are now rated at the lowest level, and that is a near record. Widespread downgrades of those low-rated investment-grade bonds to speculative-grade ratings could induce some investors to sell them rapidly, and this bears watching, as total assets under management and bond mutual funds have more than doubled in the past decade and they now hold about one-tenth of the corporate bond market.

In addition, net issuance of leveraged loans grew rapidly last year. The total is now over a trillion, although the pace of issuance has slowed as the interest rate environment has shifted. Covenants issued for the loans issued in the last few years have weakened notably, and they often include terms that increase opacity and risk. A substantial share of those are packaged in CLOs and many large banks originate leveraged loans with an intent to distribute. While the direct exposures of the banking system in the form of loan portfolios and warehousing exposures are being monitored, there are indirect exposures, including through investments and CLOs and credit lines, and, of course, non-bank exposures are hard to monitor.

Overall, corporate credit conditions have been favorable. However, history points to the risk that excesses in corporate debt markets could amplify negative shock.

That brings me to the final point, recognizing that we must be especially vigilant to fortify financial system resilience in good times. Our toolkit includes a countercyclical capital buffer (CCyB) that is intended to be on top of strong through the cycle requirements. The CCyB is simple, predictable, and slow-moving. It applies equally across all large banks. The criteria for implementing it were released in September 2016. The Board voted to set it at zero earlier this year, but many other jurisdictions have raised their countercyclical buffers above zero.

Thank you. I look forward to any questions.

[The prepared statement of Governor Brainard can be found on page 40 of the appendix.]

Chairman MEEKS. I now yield 5 minutes to Mr. Falaschetti for his oral testimony.

STATEMENT OF THE HONORABLE DINO FALASCHETTI, DIRECTOR, OFFICE OF FINANCIAL RESEARCH, U.S. DEPARTMENT OF THE TREASURY

Mr. FALASCHETTI. Chairman Meeks, Ranking Member Luetkemeyer, and members of the subcommittee, thank you for inviting

my testimony on behalf of our Office of Financial Research (OFR). I am honored to appear with the Governor and look forward to discussing the productive role that OFR plays in our government's financial stability framework.

Throughout my career, I have enjoyed developing firmly grounded perspective on important financial and economic matters, and I have especially enjoyed doing so through public service on the President's Council of Economic Advisors, this committee, and now, as Director of our office.

Before starting my testimony, I want to recognize our staff. Prior to my appointment, our office extensively reexamined its mission, culture, and structure. Throughout, our staff never let go of a mission that they and I support. I am grateful to each and every one of you for your dedicated service as individuals and a team. I begin my testimony today by acknowledging you all. My priority in commitment to them is a safe, collegial, and fulfilling workplace so that they can thrive personally and professionally by furthering our important mission of serving FSOC and its member agencies.

When it comes to economic opportunity, our United States stands as the world's leader. A resilient financial sector is vital to every American. While the great financial crisis is sometimes characterized as a perfect storm, credible warnings were available. For example, the President's Economic Report in 2006 highlighted the importance of financial services for upward mobility. In doing so, it also called on regulators to "mitigate the likelihood of systemic events." Despite their accessibility and timeliness, such warnings could not mitigate, let alone stop the crisis that was to come.

Reflecting on this history, a prominent economist rejected calls for increased regulation of an already heavily regulated sector. Instead, he highlighted opportunities for data analysis and monitors to increase transparency for inter-institution exposures and concentrations of risk.

OFR was established to increase the likelihood that future warnings will be more credible when grounded on economic fundamentals and informed by high-quality data and careful research. OFR supports FSOC and its member agencies with data and research services that work toward this important end.

Our office's latest Annual Report to Congress was published in November 2018. It saw financial stability risks in the medium range while indicating relatively high market and cybersecurity risks. Credit risk appeared moderate overall, with increased risk from leveraged lending tempered somewhat by lower risk from consumer credit. Risk from solvency and leverage remain low, in general, while funding and liquidity risk was low overall. However, these risks can change quickly.

Cybersecurity risk continued to warrant attention. Our office first discussed risks from cybersecurity in the inaugural 2012 annual report. Our 2018 annual report also highlights how network analysis could provide increased transparency for cyber risks.

Our office expects publication of its 2019 annual report later this year. That report remains a work in progress so I cannot speak to details. Based on currently available data, however, our overall risk assessment will remain in the medium range.

American economic opportunity is the envy of the world. The OFR plays an important role in fortifying financial stability for the world's greatest economy. I am honored to lead our office and proud of our good people who wake up every day to advance its important mission.

Thank you for your invitation to testify. I look forward to your questions.

[The prepared statement of Director Falaschetti can be found on page 49 of the appendix]

Chairman MEEKS. Thank you. I now recognize myself for 5 minutes for questions.

Let me start with you, Governor Brainard. The Fed has done a rapid pivot to cutting rates, just last week, and I asked this question yesterday to the members of the SEC Commission—they are intervening aggressively in the repo market, short-term lending. And I get those echoes, as I talked about in my opening statement, about, "I don't ever want to be back where we were in 2008," and Secretary Paulson. And then I look at what is happening with Brexit and the situation with China slowing down, et cetera.

You mentioned in your opening one of the key risks you worry about, and I think I heard "leveraged lending." Would you also expand on leveraged lending, why that may be a potential risk, and any other factors that you think we should be really paying attention to?

Ms. BRAINARD. Thank you for your question. First of all, with regard to leveraged lending, we really saw very rapid increases in leveraged lending over the past several years, although some of that has slowed as the interest rate environment has made bond issuance again more attractive.

The thing that is notable, apart from the very large increase in leveraged loan issuance that we saw, is just that the covenants on those leveraged loans have weakened quite notably, relative to what they would have looked like historically, and there are features that make them less secure, and more opaque, for some of the investors. Now, they are being securitized, many of them, in CLO structures.

And so what is important, I think, going forward, is to be able to have as much visibility as we can into those structures and who is holding those loans through those structures. We look at banking system exposures, but, of course, there is a very large component, which is non-bank, that I think bears attention.

I don't know if you wanted me to also turn to repo—

Chairman MEEKS. Yes, please.

Ms. BRAINARD. —but I am happy to do that.

Just to take a brief moment to separate how the FOMC looked at the economy, so with the interest rate decision, the Federal funds rate decision that was made at the September FOMC meeting, that was really a traditional kind of monetary policy lens, where looking at the economy, looking at downside risks from trade policy uncertainty, in particular, from slowing growth abroad, in an environment of muted inflation, the Committee, or at least in my view, was wise to take out some insurance against downside risks to the economy.

What is separate from that is the pipes of the short-term money markets, which is really what we are talking about in the repo markets, and what we saw was that a number of events—there was a confluence of both increased supply of Treasury Securities that needed to be funded at the same time as we also had some of the suppliers of cash in that market withdrawing because they had large corporate tax payments that they were taking care of.

So, it was a confluence of factors that led to an imbalance of supply and demand in the pipes of the system. I would really say that the New York Fed is very focused. They have been providing ample operations to relieve those temporary frictions. But the operations that they undertook were not for purposes of monetary policy. It was to address those technical issues in the pipes in the system.

Chairman MEEKS. Thank you very much.

Let me ask the Director, I noticed that you had a staff reduction of more than 43 percent, and a budget cut of 25 percent. So I am really concerned about OFR having the ability to have the personnel necessary to do what you were charged to do.

Can you tell us how you are committed to, and how you plan on rebuilding the OFR team to ensure that it is clearly focused on the monitoring and mapping and qualifying systemic risk wherever it might be, so regulators are well-equipped to do their work?

Mr. FALASCHETTI. Thank you for your question, Mr. Chairman. I just lost my nametag, but you know who I am.

We are in the process right now of—and thank you for the meeting yesterday—our head count right now is in the neighborhood of 100 employees at our shop. We are building—we are recruiting vigorously. We are interviewing and we are retaining the people that we are bringing on. We are making good progress on that.

In addition, with our staff, I have a mission which is well on its way to meet with every staff member in our building. I host lunches twice a week with our staff members. I want to hear everything that is going on within our organization, and I think, going forward, as we fill out that team, it will not only be a larger team but it will be a more collegial and effective team.

Chairman MEEKS. Thank you. My time has expired. I now yield 5 minutes to the ranking member of the subcommittee, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Mr. Falaschetti, you and I had a conversation last week, I believe, with regards to your ability to do a study that would give us some idea of the impact of CECL. And I think you indicated to me that you need to have some sort of directive from one of the members of the FSOC or FSOC itself, is that correct?

Mr. FALASCHETTI. That is correct, sir.

Mr. LUETKEMEYER. So exactly what is the process to be able to get a study? In other words, if Governor Brainard asked you to do that today, would that be sufficient?

Mr. FALASCHETTI. It is the members of the FSOC who would make that decision, and they are regularly briefed on issues like this. But I understand that has not come up in our FSOC meetings.

Mr. LUETKEMEYER. What would the typical study look like? What are the factors you would examine?

Mr. FALASCHETTI. On CECL per se?

Mr. LUETKEMEYER. Yes. Do you look at the macroeconomic effect of it? Is that what you do, I assume?

Mr. FALASCHETTI. Sure. Yes. Whether it is countercyclical, procyclical, those sorts of issues could come up.

Mr. LUETKEMEYER. Have you taken into account the other industry reports that I have seen that show the amount of money they are going to have to have, the additional reserves, the cost that it would incur that would have to be passed on to consumers? All of that would be part of it, I assume?

Mr. FALASCHETTI. Cost-benefit analysis would certainly be in that report, yes.

Mr. LUETKEMEYER. Okay. Thank you.

Governor Brainard, I have discussed this issue with every single member of the Federal Reserve Board. I think I have even discussed it with you in the past. This is, obviously, something that is very concerning to me, because of the impact I think it would have on our economy, on the financial services industry, and on our consumers, to be able to have access to affordable home loans. And so, this is really a big deal to me.

You have heard Mr. Falaschetti's concern, and I think you know enough about CECL to be willing to—would you be willing to go to your Board members and ask them to do a study for us?

Ms. BRAINARD. Thank you, Ranking Member Luetkemeyer. First, I will say that I have heard from many banks that they don't understand, especially small banks, how CECL might impact them. Now, of course, CECL is a standard that is put in place by an independent standard-setting body, so it is really something that we are simply obligated to accept. It is not something that we make determinations on.

Mr. LUETKEMEYER. But now you are going to have to enforce it. If you have to enforce a rule that is going to be detrimental to our economy, to the industry that you oversee, don't you think you ought to push back on that a little bit?

And before you answer that, let me read you what—I don't normally put credence in any of these political rags around here, but this one, as of last Thursday, The Hill, is quoting Chairman Powell directly. And the Chairman said, in response to a question, "The Fed has no role in the formulation of trade policy, but we do take into account anything that can materially affect the economy relative to our employment and inflationary goals."

When you look at the impact of this, that has direct and material effects on employment and inflationary goals. You are not going to consider that?

Ms. BRAINARD. Just to continue, there have been a number of quantitative studies that have been undertaken. Of course, we have looked at those very carefully. They do not conclusively suggest that there would be a negative impact. That said, I am not, as you know, a representative to FSOC.

Mr. LUETKEMEYER. Yes, but you are on the Board, Governor, and you have nput. I have files from credit union folks, I have the testimony from the bankers who were in this committee not too long ago, of billions and billions of additional dollars that are going after

reserve. Those costs have to be passed on. That should be a concern.

Ms. BRAINARD. Absolutely, and to the extent that FSOC wants to ask OFR to do a study, that is certainly something that—

Mr. LUETKEMEYER. Would you be willing to help push for that?

Ms. BRAINARD. I would certainly be happy to convey these concerns to the Chair in his role as our representative to—

Mr. LUETKEMEYER. Yesterday, I relayed a story, an analogy of what is going on here, and the analogy goes like this. A few months ago, we celebrated the 50th anniversary of putting a man on the moon. Imagine yourself in a lunar module on top of a rocket, knowing that the last market, i.e., mark to market, that was done without a study of cost-benefit analysis, blew up on the launching pad. And now you are sitting on top of another rocket called CECL, that has not had a cost-benefit analysis or a study on it. Would you be willing to light that rocket?

Ms. BRAINARD. Again, I think it is very important to understand—

Mr. LUETKEMEYER. Would you be willing to light that rocket, without a study or a cost-benefit analysis, knowing that the last one just blew up?

Ms. BRAINARD. I think that there have been a fair amount of quantitative studies done, and, of course, I am always interested—

Mr. LUETKEMEYER. You are the only one who would be willing to send that rocket—to light it and let it go. Everybody else, every regulator I have talked to said, no way. They need to be sure that it is tested, to be sure that—you are willing to put the economy at risk without a cost-benefit analysis study, that this gentleman is ready to do. That is not very responsible, Governor. Thank you.

Chairman MEEKS. The gentleman's time has expired. I now recognize the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. Governor Brainard, let me start with you. In recent weeks, the Fed has had to take extraordinary steps to maintain liquidity in short-term debt markets and repo markets, including the actions of the New York Fed earlier this week. It injected almost $50 billion for overnight repurchase agreements, or repo, to relieve funding pressure in money markets. The last time that this happened was back in 2008, as you probably know, during the financial crisis. Why is this happening now?

Ms. BRAINARD. Thank you for your question. We certainly recognize that we have important pipes in the short-term money markets, which the repo market is part of, and we want to make sure there is ample liquidity so that we don't see these kinds of frictions. And it is important to understand exactly where these frictions are arising.

Now, market participants did anticipate that there would be an increased need for repo.

Mr. SCOTT. Let me ask you this: What are the risks? That is what I am after. What are the risks to our financial institutions that they may become unwilling to lend to each other, as happened in 2008?

Ms. BRAINARD. From what our market discussions and surveys are able to tell, this is a very different episode, a different set of

frictions than in 2007–2008. In 2007–2008, we had counterparties pulling away from each other because there were concerns about the underlying quality of collateral and the creditworthiness of those counterparties. Today, we are in a different environment, and we believe that what we saw was a simple imbalance between those who were willing to supply and those who needed to finance repo. I believe that we have said, the committee has said that we are operating in an ample reserves regime, and it may simply be that we are close to the lowest level of reserves that are necessary for the contact of monetary policy.

But the kind of intervention that the New York Fed too, that is a pretty standard open-market operation, and my own inclination would be to look at mechanisms like allowing the balance sheet to continue organic growth in order to make sure there are enough reserves in the system so we don't see those kinds of frictions.

Mr. SCOTT. Okay. Now all of this is happening at the same time that there is an upcoming transition from LIBOR (London Inter-Bank Offered Rate) to what could be SOFR (Secured Overnight Financing Rate). I think that this poses one of the greatest potential disruptions to our financial system ever, and this is why: uncertainty. It has a large part to play in how smoothly this transition plays out. We are talking about $400 trillion on contractors, worldwide, $200 trillion in contracts here, and this massive change between these benchmark rates.

And so, we are after a smooth transition in terms of how this new reference rate will perform, particularly with what we call these transition legacy contracts. So are you concerned about this volatility and how it may add to the uncertainty associated with this rate change? This is a big issue. Can you explain it to us, and share with me and the audience and C-SPAN, how serious this issue is?

Ms. BRAINARD. Thank you. I think the transition away from the reference rate that was shown to be subject to manipulation and is becoming increasingly fragile, as fewer participants provide input into that rate, that transition to a more market-based rate that is going to be more resilient, and not subject to manipulation, is a very important transition, and it is a transition that I think we should all be paying a lot of attention to, and financial institutions prime among those who should be paying attention.

Chairman MEEKS. Thank you. The gentleman's time has expired. I now recognize the gentleman from Florida, Mr. Posey, for 5 minutes.

Mr. POSEY. Thank you very much, Mr. Chairman. I appreciate your and the ranking member's leadership in holding this hearing today. We are here today to examine the role of our regulatory community in monitoring and ameliorating the systemic stability of our financial institutions. I welcome the witnesses and thank them both for being here today.

The current framework for responding to systemic risk in our financial system centers on the Financial Stability Oversight Council's, or FSOC's, as we refer to it, role in identifying and designating non-bank financial companies as posing systemic risk. Identifying such a company as posing this kind of risk makes the com-

pany subject to enhanced supervision by the Federal Reserve Board.

We recall that one of the big interventions during the financial crisis recently was rescuing the American International Group (AIG). Assuming FSOC had been in place prior to the crisis, can you give the committee and the public a description of how FSOC would have worked to prevent the outcome we had with AIG?

Governor, you can go first, and then the Director.

Ms. BRAINARD. I think the intention of the designation—again, I am not a member of FSOC so I can't speak to the designation process. But I think the intention certainly of that designation authority was to be able to take institutions that were not supervised banks and subject them to consolidated supervision across all of their activities. And so, of course, for institutions that had a lot of derivatives exposures that were not well risk-managed, and that the company was not prepared to make good on in periods of stress, that kind of designation authority would have shown the full scope of activity to the supervisors and put in place resolution planning, liquidity requirements, and capital buffers against the full scope of activities, as opposed to the more narrow pieces that were under regulation.

But again, I am currently not on the FSOC so I can't speak to the current system.

Mr. POSEY. Thank you. Director Falaschetti?

Mr. FALASCHETTI. Sure, and thank you for your question. The Council is pursuing an activities-based approach to designations for non-bank financial determinations, and what this will do, the benefits that this brings is it will enhance analytical rigor and transparency in the process that the Council pursues. Some of the activities, or the characterizations of these activities are complex or opaque activities, those conducted without effective risk management practices, those that are significantly correlated with other financial products, or either highly correlated or significant and widespread.

Mr. POSEY. I guess, more specifically, how would they have identified AIG's threat to systemic stability? What metrics would have disclosed this threat? How would it be different today?

Mr. FALASCHETTI. The activities that I outlined here, we would work through each of those and size up any particular firm that might be subject to this consideration.

Mr. POSEY. So, you think now that FSOC would do the job that the regulators did not do before?

Mr. FALASCHETTI. Yes. And again, the transparency and the accountability of this proposal is what is attractive.

Mr. POSEY. Give me an example of how they would identify derivatives as being dangerous.

Mr. FALASCHETTI. With this list of the proposed guidance you have, measure it out. Is it complex? What is the degree of opaqueness in this market? Is there effective risk management? Each of these considerations would guide the FSOC.

Mr. POSEY. But they should have had those same considerations before, shouldn't they?

Mr. FALASCHETTI. They should have, but this wasn't the way that it used to be implemented, that the conversation went. And

when you designate a firm, one firm, and you have some other firms in the same sector that—

Chairman MEEKS. The gentleman's time has expired. I now recognize the gentlewoman from New York, Ms. Velazquez, for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Governor Brainard, as you know, earlier this summer there was a cybersecurity breach at Capital One. At the time of the event, Capital One relied on Amazon Web Services (AWS) for its cloud storage needs and has continued to rely on AWS, even following the incident.

In its 2018 annual report, the FSOC specifically highlights the growing reliance of financial institutions on third-party service providers, like Amazon, as creating risks to the financial system. Can you explain the risks that are created by banks' increasing dependence on third-party service providers for their data storage needs?

Ms. BRAINARD. Thank you for the question. A lot of financial institutions, like large institutions that have tremendous needs for processing data, across the economy, including government entities, are looking at questions about how much of their infrastructure, how much of their core systems versus their software services should they hold in-house, on-premise, or move to cloud providers? So, this is the beginning, or the middle of a trend that I think will continue.

What authorities we have, as bank supervisors and examiners, come to us through the Bank Service Company Act, which does provide the Federal Financial Institutions Examination Council (FFIEC), the bank regulators, some ability, under circumstances where providers are significant providers, to examine some of the third-party providers.

There is also a lot of work on this issue because of the concentration of some of the cloud provisions in international force. So this is also an area that we are looking at in the Financial Stability Board internationally, but it is certainly something that we are very focused on.

Ms. VELAZQUEZ. So is it fair to say that an event like the one that occurred at Capital One earlier this summer has the potential to pose a serious threat to the financial system?

Ms. BRAINARD. The particulars of that breach have to do with both the institution as well as its cloud migration. I think we do recognize that migrating to the cloud mitigates some risks, and adds other risks, and so we need to hold our institutions accountable for making that risk assessment in a very well-informed way, and taking that migration very seriously.

Ms. VELAZQUEZ. Thank you. Director Falaschetti, the OFR's 2018 report identifies cybersecurity as a continuing concern. Can you explain how the potential impacts of cyber risks are compounded by banks' own operational practices?

Mr. FALASCHETTI. Thank you for that question. I would put the cloud question with cyber risk. What we are really worried about here are the interconnections. If we have a cyber-attack on a particular organization, that organization has channels of transmission of that risk to other organizations. And our researchers are developing a network analysis that would help bring transparency to understand, okay, well, if this particular organization finds itself

in difficulty from a cyber attack, who else is downstream, and share that information with FSOC to take appropriate action.

Ms. VELAZQUEZ. Thank you. This question is for both of you. While crypto assets remain relatively small, they are growing fast in size, numbers, adoption, and applications. As you are both aware, earlier this year we held a hearing on Libra, which is the cryptocurrency being developed by Facebook and its association members. What risks to financial stability does the Libra cryptocurrency pose? Governor, let's start with you.

Ms. BRAINARD. Thank you. I think the advent of Libra really sharpened the set of questions that regulators, officials need to think about in terms of stable coins, their potential adoption for payments, what does this mean in terms of, if you are a consumer, your social media platform having information on payments? Will they keep your data private? Will they keep it secure?

For regulators such as the Fed, the potential for this to be across many jurisdictions, and the potential to have very incomplete regulatory authorities.

Ms. VELAZQUEZ. Yes-or-no answer, do you have the regulatory authority that you need to monitor this?

Chairman MEEKS. The gentlelady's time has expired.

Ms. VELAZQUEZ. It was to you, Governor.

Chairman MEEKS. I now recognize the gentleman from North Carolina, the ranking member of the full Financial Services Committee, Mr. McHenry, for 5 minutes.

Mr. MCHENRY. I appreciate the chairman for yielding.

So, Governor, let's go to this question of cybersecurity. On balance, a well-regulated migration to the cloud can be a better decision for financial institutions. Is that correct, in your view, in the Fed's view?

Ms. BRAINARD. I think each individual institution is going to make that assessment. They just need to do it—

Mr. MCHENRY. No, I am asking for your assessment on it.

Ms. BRAINARD. It can be.

Mr. MCHENRY. It can be. Director, is that your view, in terms of research?

Mr. FALASCHETTI. I'm sorry. Can you repeat the question?

Mr. MCHENRY. Never mind. We will just keep moving.

So, Governor, about cyber, currently we don't have any reportage from the Fed to this committee and policymakers on the Hill about what your institution is doing to protect itself from cyber threats. Do you see any reason why the Fed shouldn't report this information to policymakers on the Hill?

Ms. BRAINARD. I think this is a critically important issue. We do, of course, get assessed at the Federal level, like any other Federal agency. But, of course, we agree this is critically important.

Mr. MCHENRY. And you have a strong IG that reviews this too, so we do get independent reporting.

So about the repo market, back to the chairman's question, I think there is real interest on both sides of the aisle about what happened in the repo market. And what you report is very similar to what I have read in the Financial Times, and in the Wall Street Journal, so in terms of your outline, it is very clear.

The question is, what does it mean, and what does it mean for average, everyday investors? Just distill that.

Ms. BRAINARD. Because we do have the ability to provide that liquidity, at moments like this it is a very standard set of procedures. At the moment, it really doesn't have implications. But going forward, it does pose questions about whether reserves in the system do need to be allowed to grow again, and whether there is that demand for reserves, to make sure that we don't see this kind of volatility, because it is very disruptive.

Mr. MCHENRY. What does it mean, reserves? What does that effectively mean?

Ms. BRAINARD. My inclination is we are in an ample-reserve regime. That is the monetary framework that the committee adopted. Ample reserves means there are enough reserves in the system that you don't see this kind of short-term volatility. So, one of the things it may mean—

Mr. MCHENRY. So the assumption is, because of ample reserves, that this shouldn't happen. Okay. This is then the question for the Fed: How long are we going to continue open-market operations?

Ms. BRAINARD. I think for the foreseeable future, the New York Fed has provided sufficient liquidity, and they have done it on a term basis, for anticipating needs at quarter ends, which tend to be periods of higher demand.

Mr. MCHENRY. Or coming to a quarter end, as well, right? So this is a quirk that is happening outside of that tighter timeframe.

Let's move on to China. The assessment here, what we know from public reporting is that reserve ratio was reduced by 50 basis points. This basically injects $126 billion into Chinese institutions.

What does that mean? What is your assessment? This signifies an economic slowdown in China, clearly, and there are ramifications for that. We are seeing outflows of capital to the United States in recent weeks, especially. Could such a slowdown affect the U.S. economy, and how?

Ms. BRAINARD. China is a really important part of the global economy. We are in a global economy. Many of our firms are interacting on international markets. China affects the economies that it trades with, commodity producers. Exports from Germany have gone down. So yes, when China slows, it is a drag on the global economy and it can hurt our producers here.

Mr. MCHENRY. What is your view on modern monetary theory?

Ms. BRAINARD. Modern monetary theory really goes to the fiscal kind of framework that the country operates in, which is outside of our monetary policy frameworks. I will say—

Mr. MCHENRY. But the intent with modern monetary theory is to control inflation through taxation rather than the Federal Reserve interest rate-setting. So what is your view of modern monetary theory?

Ms. BRAINARD. My general sense is we are a well-tested, effective institutional framework for monetary policy, separate from fiscal policy. Currently, that has worked well for us over many decades. And my general assessment is that this is also an institutional framework that has worked pretty well around the world.

Mr. MCHENRY. What is your view of the economy right now? Is the economy strong?

Ms. BRAINARD. When you look at the economy, you see strong consumers. You see a continued, pretty strong labor market, with payrolls continuing to grow above the pace needed to absorb new entrants.

Mr. MCHENRY. Wages growing.

Ms. BRAINARD. You see wages growing above the rate of inflation. But you also see business sitting on the sidelines, CapEx is flattening out a lot of uncertainty out there. And, of course, you see a global environment, that you alluded to earlier, which could be a drag on our economy. So we are watching that very closely. In my own view, it poses downside risks, and that is why it made sense to soften the path of monetary policy.

Mr. MCHENRY. Thank you, Mr. Chairman.

Chairman MEEKS. The gentleman's time has expired. I now recognize the gentleman from Illinois, Mr. Foster, for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman, and thank you to our witnesses.

Governor Brainard, the Capital One hack was essentially a failure by, I believe, the firm itself, what is called a server side request forgery, due to a misconfigured firewall, and not the cloud provider. And so, this is an example of something that I think will continue forever. If a company does something dumb, whether they are in the cloud or not, that is a problem.

There is a second class of things having to do with, if you are completely dependent on one cloud provider and that cloud provider goes down. And so my question here is, has the Fed specifically looked at this risk, and is there a merit to potentially requiring major financial firms to connect to more than one cloud provider so they can fail over to the second one, in the case that one of them goes down? Has that been looked at, both from a cost point of view and a feasibility point of view?

Ms. BRAINARD. Thank you for your question. I think the principle of resiliency through redundancy is well-established, particularly for systemic infrastructures. Certainly, there is work internationally that we are participating in, thinking about precisely this question that you raise about the ability to fail over, and I think there are some technologies that are out there, or developing, that would provide mechanisms for being able to do so, so that that lock-in is less of a risk.

Mr. FOSTER. And there is also the possibility of a completely correlated risk. For example, last year's Spectre and Meltdown bugs that allowed processors to see into essentially arbitrary memory locations, called into question the whole concept of cloud computing and having multiple processes, potentially from other companies working on the same processor.

Moreover, that bug, it is my understanding, was applied to a range of hardware, so that it worked—the bug was applied to Intel x86 and ARM processors and IBM POWER processors, and everything. So there was no—even using different hardware did not protect you from that bug.

And what you saw there was a correlated risk, where one bug can be uncovered that applies to all cloud hardware as well as all non-cloud hardware. How do you evaluate that correlated risk and how do you defend the financial system against it?

Ms. BRAINARD. I certainly believe there are a variety of different ways that we could see threats to the system of our financial institutions, whether they are in the cloud or whether they are on-premise, or whether they are in their private cloud. So, it is a constantly evolving, I think, set of dynamic challenges, and the best that we can do is seek to understand them ourselves, and—

Mr. FOSTER. Well, do you believe that the Fed examiners have enough technical horsepower to identify this kind of risk? You are talking about very skilled people who could earn big paychecks elsewhere in industry.

Ms. BRAINARD. My own perspective has been to fortify our own internal technical resources, and that is going to be a continued area of high priority for me.

Mr. FOSTER. Okay. Let's see. Another completely unrelated question is, many of your positive comments about financial stability had to do with the relative quality of debt ratings, and all of these debt ratings still rely on the issuer-pays model, which was pointed to by many people as one of the core failings that led to the financial crisis. And to my belief, it has not really been solved.

Are there solutions to this that are potentially workable, that maybe Congress should start thinking about?

Ms. BRAINARD. It is a good question. I know there are a variety of initiatives that have been kind of looked at in this space. There is not one in particular that I would say I would put my strong support against. But as was true going into the crisis, we also wouldn't want institutions to be overly reliant on a set of ratings alone. We want institutions to be making risk assessments using additional mechanisms.

Mr. FOSTER. Yes, but even in your comments on financial stability you were using implicitly the ratings of the debt instrument.

Ms. BRAINARD. Obviously, when we do our aggregate assessments, to some degree we are looking at patterns in the overall data, so we need public sources of data to do that, but then we drill down. So to the extent that we have individual or multiplicity of balance sheets, we do some drilling down, and we describe that more qualitatively, particularly when it relies on data sources that are not public.

Mr. FOSTER. And are you worried about the rebirth of mortgage-backed securities, which has been the subject of several—

Chairman MEEKS. The gentleman's time has expired.

Mr. FOSTER. Thank you. I yield back.

Chairman MEEKS. I now recognize the gentleman from Kentucky, Mr. Barr, for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman. And Director Falaschetti and Governor Brainard, thank you for your service and for your valuable insights on financial stability today.

I want to drill down a little bit on this issue of leveraged lending, and I want to draw an important distinction between credit risk and systemic risk. Credit risk, of course, is the cost of doing business for investors. There is a possibility, of course, that a borrower might default. That possibility is priced into the product, and investors are aware of potential downsides.

But just because a product is risky does not mean that it is a contagion that will spread to other parts of the financial system

and bring down our economy. That is what systemic risk. Leveraged loans are, of course, not without risk, but that is the idea. Risk is how investors earn returns and how businesses access credit to finance their operations.

During yesterday's Full Committee hearing, SEC Chairman Clayton testified that he believes leveraged lending does not pose a systemic threat. Other regulators, including the Chairman of the Fed and the Vice Chairman of Supervision, have made similar statements. However, many of my Democratic colleagues maintain that leveraged lending poses a systemic threat to our financial system.

At approximately $1.2 trillion, leveraged loans represent only about 4 percent of the entire U.S. fixed income market. That is compared to $15.2 trillion in non-financial business debt like commercial loans and bonds, $10.3 trillion in household mortgage debt, $4 trillion in consumer debt, and $1.6 trillion in student loan debt.

Director Falaschetti, can you speak to this distinction between credit risk and systemic risk, in reference to leveraged lending, and can you also talk about the features of CLOs (collateralized loan obligations), namely that these are long-only, non-mark-to-market, term-financed, actively managed funds in senior-secured commercial and industrial loans, and can you speak to whether or not those features of CLOs enhance financial stability or undermine it?

Mr. FALASCHETTI. Thank you for the question, and I know you have done a lot of good work on this particular issue.

Before I was confirmed, the FSOC had this issue before then. This was in March of 2019, and there was a really nice presentation during that FSOC meeting. On one side, we had an OFR economist, and we also had an economist from the Federal Reserve, and each one of them took different sides of the balance sheet, which I think is where you are going with this.

On the other side, you are looking at really risky assets, and if that is the only thing that you are looking at, you are going to say, "Hey, you know what? This is a lot of trouble." But on the right-hand side, what you heard from this brief to the FSOC, is exactly what you are alluding to, is that there is patient capital on the right-hand side, and so patient capital doesn't run at a sign of smoke and the tiering of the losses locks people in to mitigate that risk.

Mr. BARR. Governor Brainard, a question for you on this. With a collateralized loan obligation, the risk of loss is held mostly by insurance companies, asset management firms, hedge funds, and other similar non-banks that are better able to absorb it. If there are larger than expected losses they won't impair the banking system or banks' critical role in managing the payment system and credit availability that is crucial for a healthy economy.

AAA CLOs are empirically risk-free—not low-risk but risk-free—based on their structure and absence of defaults in the 30-year history of the market. Now, I am just talking about the AAA tranche here—zero defaults, zero impairments in the 30-year history of the market. So, it does seem a bit misplaced to point to AAA CLOs as a source of concern.

Does the Fed agree or disagree that having banks fund loans indirectly through owning AAA CLO bonds, which have a 35 to 45

percent loss of absorption cushion below them, and have never been impaired in the 30-year history of the market, is better and safer for the banking system than having banks fund loans directly and taking 100 percent of that credit risk?

Ms. BRAINARD. Thank you. I think you are making very important distinctions, and, of courses, we do think very much about individual assets and the credit risk embodied in them quite differently than we try to track what might happen if a number of investors behaved the same way under stress circumstances. And so that is really kind of the spirit of our financial stability work, to think about what might happen during very stressed conditions that might lead what looks like a set of very secure investments, investors to behave in a kind of run dynamic, in a fire sale dynamic.

For instance, there are a large amount of leveraged loans sitting in loan funds, and we had a little mini stress test event back in the fourth quarter of last year. And what we saw is that there was a lot of redemptions in those funds, which worked out pretty well. On the other side of that we had a lot of CLOs picking up those leveraged loans that were coming out of those structures.

Chairman MEEKS. The gentleman's time has expired. I now recognize the gentleman from Florida, Mr. Lawson, for 5 minutes.

Mr. LAWSON. Thank you, good morning, and welcome to the committee. Thank you, Mr. Chairman, and I thank the ranking member as well for today's hearing.

My question to both of you is centered around—and it is important—what impact does a trade war have on the health of our economy, and what would the long-term effects be on our financial market?

Mr. FALASCHETTI. As noted, we addressed this in our 2018, our most annual report. And there is some uncertainty surrounding trade policy. That said, our economy continues to be strong, and our job is really to monitor these kinds of events on the stability of our financial sector, and that is continually ongoing in our shop.

Ms. BRAINARD. Thank you for the question. We, in terms of our monetary policy assessments of the economy, one of the factors that I think you will see cropping up most frequently in the minutes of our meetings, for instance, is that we are hearing from business contacts all over the country, in all of our districts, from businesses who are saying that the uncertainty about the rules of the game on trade are really leading them to sit by the sidelines. They are rethinking supply chains, global supply chains, but they are not quite sure how to reconfigure them. And so we do see it in the business investment numbers. We do see it in CapEx, in particular, which has flatlined and looks like it is softening further.

We have some of our independent research that was recently released suggesting that trade policy uncertainty itself, just the uncertainty about what trade policy will look like, does actually have a material negative impact on the health of the economy.

And so it is something that I think has been one of those prominent downside risks that has led the committee to reassess the path of the economy.

Mr. LAWSON. And one of the reasons why I asked that question is I also sit on the Agriculture Committee, and we realize all of the

problems that we have with a lot of our farmers, what is going on with China and so forth. And from a budgetary standpoint, we have been subsidizing the farmers in this country on a regular basis, either because of natural disasters or because of the downturn in the economy.

And so I wanted you all to—and I know you probably confront this from time to time in your deliberation—comment on what effects this is having on the economy with our agricultural industry in the United States?

Ms. BRAINARD. We talk a lot about the pain that is being felt in the farm economy in the FOMC. Of course, we have a lot of agricultural represented on our boards of directors at our reserve banks, and I certainly hear a lot as I travel around the country, about just how difficult conditions have been. Trade is clearly a big piece of that picture, but as you know, for some parts of the country, weather has been a huge factor as well. So it is something that I think has been prominent in our discussions.

Mr. LAWSON. Are you going to comment, Director?

Mr. FALASCHETTI. Sure. The OFR has a very narrow remit, and so with trade, you look at—we have a monitor for market risk, and that would fall under that market risk monitor. And our researchers would dig down and consider, okay, well, what are the growth effects of this issue and how might that impact our financial sector, and we would communicate that to the FSOC principals.

Mr. LAWSON. Okay. Thank you. Mr. Chairman, I yield back.

Chairman MEEKS. The gentleman yields back. I now recognize the gentleman from Colorado, Mr. Tipton, for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman. Director Falaschetti, I wanted to give you an opportunity to talk about some of the LIBOR transition that has been going on. What is OFR looking at? What type of plans do you have in terms of some of that transition to SOFR?

Mr. FALASCHETTI. Thank you for the question. The LIBOR transition is, in a lot of people's eyes, a critical risk. I would put it under contracting risk. You can think of Brexit as a contracting risk issue as well. If everything works smoothly, great, but recontracting at such large scales is very difficult. And if I recall my figures correctly, the notional value of contracts that are now indexed to LIBOR are an order of magnitude higher than for SOFR.

So, we have 2 years to pull the switch on this, and people are developing fallback language, but, as you and I discussed in your office, my fallback language might not jive with your fallback language, and so, how long does that process take place and where does that settle? There is a lot of work to be done there, and we are monitoring the potential implications for systemic risk from that issue.

Mr. TIPTON. It does create somewhat of a challenge because some of the LIBOR securities cannot be amended without 100 percent investor consent. That has to be creating some real challenges for transition.

Mr. FALASCHETTI. Oh, absolutely.

Mr. TIPTON. Did you have a comment on that, Governor?

Ms. BRAINARD. No. I entirely agree with Director Falaschetti's comments there. It is a very big issue. The International Swaps

and Derivatives Association (ISDA) obviously has put out some protocols. The more sophisticated players in this space are recontracting, but there are a lot of frictions in doing that, as you say, which creates risk.

Mr. TIPTON. Governor Brainard, while I have you there, you mentioned earlier in your testimony regarding LIBOR, that financial institutions should be paying attention. Of particular interest to me are some of our smaller banks, our regional banks, as well. I am concerned whether or not they are going to be less prepared, potentially, for that transition. Do you have any comments?

Ms. BRAINARD. We always try to provide as much technical assistance and education as we can through our examiner kind of interactions with our smaller institutions, recognizing that they don't have the same kind of resources. And in many cases, they may not have the same kinds of exposures. But we want to make sure that they are well-equipped to deal with these transitions. So, we try to do that through our educational materials, through examinations, discussions, and, of course, we do that in conjunction with the other banking agencies, through the FFIEC.

Mr. TIPTON. Great. I appreciate you talking about some of the collaborative efforts through the other agencies. Another issue that we have with a lot of our regional banks, and community banks as well, is the Community Reinvestment Act (CRA). It is being substantially updated. Do you believe that modernizing the CRA—do you foresee the Federal Reserve joining your fellow regulators in terms of that pursuit?

Ms. BRAINARD. We have been working really diligently with the OCC and the FDIC, and it would be my preferred outcome that we all find an approach that is responsive to the comments that we received on the OCC's ANPR and really does strengthen the ecosystem around CRA. I wouldn't want to do anything that would harm that ecosystem, because I think our community banks, our community development organizations, our large banks, they all generally are really committed to the CRA and want to see it improved, but not disrupted in a kind of way that might lead to uncertainty about their ratings.

Mr. TIPTON. I think we can certainly agree, though, that uncertainty can create some real problems in terms of that compliance, in terms of some of the reviews that are going to be going on. Would you agree?

Ms. BRAINARD. Yes.

Mr. TIPTON. Great. I wanted to also follow up just a little bit, Governor Brainard, if we can, just in terms of the ability of some of our banks to be well-capitalized. Do you agree with the Fed report that came out, substantially, at least, the Federal Reserve Report stating that banks appear well-positioned to exposures related to leveraged banking?

Ms. BRAINARD. Are you talking about the supervision report?

Mr. TIPTON. Yes.

Chairman MEEKS. The gentleman's time has expired. I now recognize the gentlelady from California, the Chair of the full Financial Services Committee, Chairwoman Maxine Waters, for 5 minutes.

Chairwoman WATERS. Thank you very much, Mr. Chairman. This is a very, very important hearing that you have organized.

Under the Trump Administration, financial regulators have been advancing a number of deregulatory proposals rather than addressing financial stability concerns. For example, the Financial Stability Oversight Council (FSOC) plans to make it harder to designate large, non-bank financial companies like AIG for enhanced oversight. In response, former Fed Chairs Bernanke and Yellen, along with former Treasury Secretaries Geithner and Lew warned, "Though framed as procedural changes, these amendments amount to a substantial weakening of the post-crisis reforms. These changes would make it impossible to prevent the build-up of risk in financial institutions whose failure would threaten the stability of the system as a whole."

Furthermore, additional concerns have been raised about weakening rules regarding capital, leverage, stress testing, and living wills for banks. These efforts, in the words of former Federal Reserve Governor Dan Tarullo, were "a kind of low-intensity deregulation consisting of an accumulation of nine headline-grabbing changes and an opaque relaxation of supervisory rigor."

Mr. Chairman, as you know, I have said to some of our biggest banks and financial institutions that they had a big win with, I believe it was H.R. 2155. There was gross deregulation. I asked them, and even warned them, not to come to the Financial Services Committee seeking other deregulatory efforts. And what has happened is there has been an end run around this committee, going straight to the regulators to do the bidding of those who are all focused on continuing to get deregulation in any shape or form.

And I am concerned about stress testing and living wills and capital and all of that. So, this is an opportunity, rather than ask a question, to say to regulators, don't keep doing that. Don't keep being used to promote deregulation based on the fact that this committee has decided that we are going to do everything that we can to protect consumers, we are going to do everything that we can to stop the deregulation efforts of our major institutions in this country that has been a detriment to the people that we are serving.

So, no matter how they frame it, the Chair is not happy with what has been going on, and, of course, in the event that this keeps up, we are going to have to deal with some legislation that would limit the ability of our deregulatory agencies to do that.

With that, I yield back the balance of my time.

Chairman MEEKS. The gentlelady yields back the balance of her time. I now recognize the gentleman from Texas, Mr. Williams, for 5 minutes.

Mr. WILLIAMS. Thank you, Mr. Chairman, and before I go into my questions, I just wanted to confirm something with both of you. This will be the 20th hearing that I have asked this question, and so far I have gotten the same answer from every single witness.

Given both of your positions I assume I know the answer, but I still must ask, starting with you, Governor Brainard, are you a capitalist or are you a socialist?

Ms. BRAINARD. Thank you for your question. I certainly have viewed markets that are well-regulated, that are competitive, as

providing really important benefits in terms of innovation and dynamism.

Mr. WILLIAMS. Well, are you a capitalist or a socialist?

Ms. BRAINARD. Again, I would say that markets that are well-regulated—

Mr. WILLIAMS. It is 20 to nothing right now—

Ms. BRAINARD. —where we have seen strong competition—

Mr. WILLIAMS. Okay.

Ms. BRAINARD. —I certainly have seen important benefits.

Mr. WILLIAMS. Are you a capitalist or a socialist?

Ms. BRAINARD. And—

Mr. WILLIAMS. Okay.

Ms. BRAINARD. —I don't really think—

Mr. WILLIAMS. Okay. All right.

Ms. BRAINARD. —about it in those terms.

Mr. WILLIAMS. All right. Director Falaschetti, are you a capitalist or are you a socialist?

Mr. FALASCHETTI. Capitalist.

Mr. WILLIAMS. Okay. Thank you.

When Dodd-Frank was signed into law it created new agencies and departments that greatly expanded the reach of the Federal Government. During the previous Administration, some of these entities drifted away from their core missions that were granted to them in Dodd-Frank. While some of the most serious examples of government overreach have come out of the Consumer Financial Protection Bureau (CFPB), I am still concerned about this practice in other areas of the government.

So, Director Falaschetti, can you please tell us the core mission that was granted to the Office of Financial Research in Dodd-Frank, and will you commit to working within these granted perimeters while you are the Director?

Mr. FALASCHETTI. Absolutely, sir. We have a narrow remit, and that narrow remit allows us to do very good work. We collect data to inform the FSOC, and we create research products to inform FSOC, period. And that narrow remit lets us be a trusted advisor to the FSOC. We don't have people pulling us one way and the other way. It is data and research.

Mr. WILLIAMS. I know we have touched on this briefly in the hearing already, but I think it is important to reiterate. There has been instability in the repo markets for over a week now. The Fed has injected $278 billion to meet the liquidity needs of Wall Street. This is the first time that the Fed has had to intervene in the repo market since 2008.

So, Governor Brainard, what is causing this cash crush in the short-term interest rate markets, and do you believe this to be an indicator of future financial instability?

Ms. BRAINARD. Thanks for the question. I think we are still making sure that we fully understand whether, in fact, there are some factors that we have not yet heard about. What we have heard about is an unexpected mismatch between the supply and demand, which would suggest that maybe we are in a period where reserves are more scarce than we intended with our monetary policy framework being one of ample reserves. And so, among other things, it may simply suggest that it is time to allow the balance sheet to

start growing again, to supply the amount of reserves that the short-term funding markets are demanding.

Mr. WILLIAMS. In OFR's 2018 annual report, it states that the migration of IT systems from local servers to the cloud should be completed by 2019, which will ultimately save $2 million annually, moving forward. I am happy to see these modernization and cost-saving efforts take place, but I am always concerned about the cybersecurity implications.

So, Director Falaschetti, can you give us a status update on this initiative, the benefits you see from the transition, and how OFR will ensure that the data stored in this new system is protected from bad actors?

Mr. FALASCHETTI. Yes, sir. We take cybersecurity very seriously, and the protection of our data very seriously. We collect data from our regulators, and we do so, again, with the goal of providing good research insights to the FSOC. And we take that data and we provide it to the FSOC.

Every time that we collect a dataset from one of the regulators, we have to protect that data at the level or higher than the protection that they give those data.

Mr. WILLIAMS. Okay. Thank you, and I yield back.

Chairman MEEKS. The gentleman yields back. I now recognize Chairwoman Waters for a unanimous request.

Chairwoman WATERS. Thank you very much, Mr. Chairman. I would like to enter into the record a letter from myself and Sherrod Brown, relative to swaps margins, and then a press statement regarding the FDIC's proposal to eliminate inter-affiliate swaps. I would appreciate entering these into the record.

Chairman MEEKS. Without objection, it is so ordered.

Chairwoman WATERS. Thank you.

Chairman MEEKS. I now recognize the gentlewoman from Virginia, Ms. Wexton, for 5 minutes.

Ms. WEXTON. Thank you, Mr. Chairman. Director Falaschetti, you spoke in your remarks a little bit about the history of the creation of the OFR. In particular, you said that "a prominent economist and former central banker issued calls for increased regulation of an already heavily regulated sector. Instead, he focused on opportunities for data analysis and monitors to increase transparency for inter-institution exposures and concentrations of risk in the financial system."

Is that correct?

Mr. FALASCHETTI. That is correct.

Ms. WEXTON. And, thus, OFR was kind of created to advise the regulators about those risks. Is that correct?

Mr. FALASCHETTI. That is correct. It was sort of a prescient call for the services that OFR actually delivers today.

Ms. WEXTON. Okay. And you speak a lot, or some, in your remarks about personnel and workforce issues, and I appreciate that, especially at a time when so many in the Administration are targeting our civil servants. So, I want to dig in a little bit more on this.

Mr. FALASCHETTI. Sure.

Ms. WEXTON. Under Treasury Secretary Mnuchin, the Office of Financial Research was downsized significantly. Is that correct?

Mr. FALASCHETTI. It was.

Ms. WEXTON. Okay. The 2017 budget estimated that OFR would employ a full-time staff of 255 full-time employees. Is that correct?

Mr. FALASCHETTI. I believe—I mean, that sounds right. I don't know the exact number.

Ms. WEXTON. And the 2020 budget estimates OFR will only employ 145 full-time employees. Does that sound right to you?

Mr. FALASCHETTI. That is correct.

Ms. WEXTON. Okay. So how many current full-time employees does OFR have at this time?

Mr. FALASCHETTI. We have about 100 right now, and again, earlier—I am not sure if you were on the dais yet—I said that we are vigorously recruiting. As we sit here today, the folks over at OFR right now are looking for our new IT director.

Ms. WEXTON. So that is about a 60 percent reduction from 255 to 100. Is that correct? Doing the math.

Mr. FALASCHETTI. Okay. I will trust—

Ms. WEXTON. It is less than half.

Mr. FALASCHETTI. It sounds right.

Ms. WEXTON. Okay. And I know that this report precedes you, but I took a look at it and there doesn't seem to be any justification in here, or any sort of footnoting of why such a drastic cut was necessary, even from 255 to 145. Can you explain the rationale behind gutting the OFR in this way, or reducing the workforce in this way?

Mr. FALASCHETTI. I cannot; I wasn't there. It was well before I was confirmed. But I can make this commitment to this chamber today, is that the way Dodd-Frank works is that the Director consults with the Treasury Secretary at the end of each year to re-evaluate what resources we need, how is the office working, and, you can see in my opening statement that I am very serious about the good work that our people do in that building, in making sure that they have everything they need.

I strongly agree with Mr. Meeks. I don't want to see 2008 again. I grew up on the south side of Chicago. The S&L crisis—I thought that was the worst thing in the world. I don't want to go through that again. I taught money and banking, and the S&L crisis blew our undergraduates' heads open on how bad that was. We don't want to do that again. So I promise that I will ask for the resources that we need going forward.

Ms. WEXTON. OFR is not taxpayer-funded, though, is it?

Mr. FALASCHETTI. It is not taxpayer-funded. It is funded by an appropriation, or from the large banks.

Ms. WEXTON. So are you committing to this committee—are you telling us here today that if you anticipate that you will need additional resources, you will go to the Administration and advocate vociferously for those resources?

Mr. FALASCHETTI. Absolutely. We are about 100 strong, as we sit here today. We are looking to expand to 150. When we get to 150, or when we start approaching 150, I should say—I mean, 145, 150—we will re-evaluate, see where we are, and make that determination then.

Ms. WEXTON. Okay. But as far as the reductions that you have seen so far, you don't have any analysis or study or anything like that which would justify the current staffing level. Is that correct?

Mr. FALASCHETTI. I am unaware of how the one—again, it was well before I was confirmed that the 145 number—I wasn't part of those conversations.

Ms. WEXTON. Okay. Thank you very much. I have no further questions. I will yield back the remainder of my time.

Chairman MEEKS. The gentlelady yields back the balance of her time. I now recognize the gentleman from Georgia, Mr. Loudermilk, for 5 minutes.

Mr. LOUDERMILK. Thank you, Mr. Chairman. I do have some questions I would like to ask, but first of all I want to follow up on something that my good friend, Mr. Luetkemeyer, brought up regarding CECL and moving forward with an untested rule or regulation that could have a significant impact on our nation, on our banking system, and on our economy. I think it is imperative that we do some research and studies, and it seems like, with several that we bring in, it is like banging your head against a brick wall. I don't understand what is the problem with looking into this before we launch it, and it seems like there is a lot of hesitation on that.

Since we have covered CECL, I don't want to go down that path anymore, but I would hope, Governor Brainard, that you will encourage Chairman Powell and the FSOC to do exactly what we are talking about. For some reason, I don't know why, we want to rush forward with something that is unproven. All we are asking is, let's do a little bit more research on the economic impacts of CECL.

With that, I will move on to something that, even though CECL is important, I still believe that the most dangerous, the most important issue facing our nation's economic system is cybersecurity, and it seems to be something that doesn't always rise to the top of the list of concerns. And because it is a significant impact on our financial system, or a threat to our economy, it is a significant threat to every American business, to our government, to our military, and to every individual.

Mr. Falaschetti, you and I have had a recent conversation, and you told me that you thought that this is the biggest threat to our nation's financial system. So could I get your thoughts on what you think needs to be done to address this growing cybersecurity risk that we have?

Mr. FALASCHETTI. Sure, and thank you for the question. I enjoyed our conversation. You noted that the long history that we have been studying this issue at the OFR, the first annual report that we published in 2012, evaluated this risk and put it at top of mind. Going forward, we are making progress. We have some really good researchers that look at network analysis. And so to bring some transparency to, if your organization is subject to an attack, what other firms are connected to your organization, and how could that metastasize into something that could potentially be a systemic risk?

This is a new monitoring tool that we are developing as we sit here today, and it will really give us a lot more transparency on the nature and the magnitude of this risk.

Mr. LOUDERMILK. There are two other elements that I think are important that don't seem to get a whole lot of attention. One, as I brought up to the Securities and Exchange Commission yesterday, in discussing my grave concerns with the consolidated audit trail, is—basically, I have spent 30 years in information technology, including Intelligence in the Air Force, where we closely guarded America's secrets—you don't have to secure what you don't have. So unless you absolutely need the data, don't collect it. Don't store it. That is a concern that I have.

We are in this age where we just want to obtain more data, and then we are responsible for securing it. And my thought is, if the government wasn't immune from lawsuits against them for data breaches, maybe they would think a little differently about not only obtaining the data but requiring others to obtain it.

The other part of that, which I would like for you to briefly comment on is the patchwork of conflicting State data security breach notifications. This is problematic. It leaves gaps in the system that those who are seeking to do harm can exploit. And I think that we need some type of uniform national standard that is flexible enough to keep up with technology.

Mr. Falaschetti, could you comment briefly on that?

Mr. FALASCHETTI. On the data security, we don't collect data to collect data. That is the wrong way to do financial, or, literally, any research. You have a question that you want to answer, and then you ask yourself, well, what data could help me address this question? So, we are very careful about that process.

Mr. LOUDERMILK. Thank you.

Chairman MEEKS. The gentleman's time has expired. I now recognize the gentlewoman from Michigan, Ms. Tlaib, for 5 minutes.

Ms. TLAIB. Thank you so much. My district—and I am not sure what others talked about, but I do want to talk about specifically my district, which is probably the most polluted district in the State of Michigan.

We have some of the highest levels of asthma and respiratory issues among some of our residents, and dozens of polluting facilities that are hurting residents, like Dr. Dolores Leonard in my district, and Emma Lockridge, who just recently testified at a field hearing in my district, just a couple of weeks ago. She constantly lives in fear that an explosion or toxic chemical could claim her life. She even went on to tell us, in committee, that she couldn't sleep without being interrupted with gagging and coughing, due to the toxic smell of fumes that enter her home.

Emma is one of countless Americans fighting for their lives. So the financial institutions that continue to ignore the lives that they are putting at stake with their fossil fuel investments while just causing instability to our financial market is a concern of mine.

Many energy analysts see a significantly negative performance outlook for the fossil fuel industry in the coming years, particularly given the past decade of bankruptcies in the coal industry, as the world transitions to clean energy sources. Yet, financial institutions continue to invest in unstable fossil fuel companies that continue to expand their dirty energy production.

This question is for Dr. Falaschetti, if there was a sudden urgency to sell off stranded fossil fuel assets, what impact would that have on our financial system?

Mr. FALASCHETTI. Taking your assumption, I suspect having to do something on such a large scale, and so quickly, could create some risks.

Ms. TLAIB. How would such a sudden urgency impact the shareholders and clients of financial institutions, which include pension funds that everyday Americans rely on for their retirement savings?

Mr. FALASCHETTI. Right. And again, I am taking your assumptions, and I haven't really—

Ms. TLAIB. I am not making this stuff up. It is actually happening.

Mr. FALASCHETTI. Right. But the assumption that you are going to have this quick break, if that were to happen, sitting here today I can't think about how that would not create some downstream effects.

Ms. TLAIB. Looking for a moment at the coal industry, the recent example which went from King Coal to widespread bankruptcy in the span of just a few years as the world transitioned to alternative and cheaper forms of energy, which were the financial entities hardest hit? Who took the losses?

Mr. FALASCHETTI. I'm sorry. Can you repeat that please?

Ms. TLAIB. Looking, for a moment, you know, the King—so basically when the coal industry, as a recent example, as they—you saw bankruptcy, obviously, in the industry, who was hit the most?

Mr. FALASCHETTI. Right now, I don't know. I would be happy to work with you and your staff to dig into this.

Ms. TLAIB. Okay. Two questions for Governor Brainard. Most financial institutions continue to invest heavily in fossil fuels, as I talked about. Is your agency conducting stress testing for climate risk?

Ms. BRAINARD. I think the kinds of valuation impacts that you are talking about are important ones for us to understand. I will say that we have a variety of research that is being undertaken by economists at the Federal Reserve, to think about what is the long-run impact on our economy from climate change, what could be the impact on our financial system. There is very interesting work that is being done internationally. I have certainly, in conversations with my colleagues at the Bank of England, who are undertaking a stress test over the next 2 years of their financial systems, to look at climate exposures. It is something, certainly, that I want to learn about and see whether it is something that we might want to look at.

And we are actually hosting a conference out at our San Francisco Federal Reserve Bank in a few weeks on this set of issue.

Ms. TLAIB. I appreciate that. Thank you so much. This is my last question and we can follow up, but why are banks and insurers and other financial institutions in Europe taking more of an aggressive action on climate change than many of our U.S. counterparts?

Mr. FALASCHETTI. In the annual report that I believe that you have from 2018, we do address the risk to financial systems from climate.

Ms. TLAIB. Okay. Thank you, Mr. Chairman.

Chairman MEEKS. The gentlelady yields back. I now recognize the gentleman from Virginia, Mr. Riggleman, for 5 minutes.

Mr. RIGGLEMAN. Thank you, Mr. Chairman. I appreciate it. Thank you for calling this hearing today and thank you to both of our witnesses for being here today.

Dr. Falaschetti, thank you for your service. As the OFR Director, while it might not be as well-known of an agency as the Federal Reserve, it is certainly important in maintaining and improving our robust economy. Thank you for that.

As you are charged with the data collection and analyses that FSOC uses to make designation decisions, I would say that it is a job that we in Congress are appreciative that you are doing. So, thank you for that.

My first question for you is simple: Do you want to see United States go through another financial crisis?

Mr. FALASCHETTI. Absolutely not, and I think I mentioned that before, that you and I are of a similar age. We both remember the S&L crisis. We thought that was the worst that it could get, and it got worse still.

Mr. RIGGLEMAN. I think you look younger than I do. And thank you, and I am glad to hear that.

Prior to your appointment, OFR had previously only had one Director. Is that correct?

Mr. FALASCHETTI. That is correct. We had a confirmed Director, and then we had an acting Director in an interim period.

Mr. RIGGLEMAN. Okay. And as I understand it, under previous leadership, OFR had been criticized for taking a unilateral or a one-dimensional approach to risk assessment that sometimes worked counterintuitive to your agency's mission. This was most explicit in OFR's 2013 Asset Management Report, which was widely criticized by individuals from varying political viewpoints as arbitrary, vague, and of little value. And, by the way, I thank you for the 2018 report you sent me. I started to read it and you are correct, it is a little bit easier. So, here we go.

What changes do you think, can you make on your own, and what changes should Congress work on to ensure that you have the necessary but appropriate methods to execute your mission?

Mr. FALASCHETTI. We are subject to the oversight of Congress. That is why we are sitting here today. In terms of—I'm sorry—you had a little bit more there and I—

Mr. RIGGLEMAN. Right, and what I am talking about is actually process. What do you think, as far as Congress, do you have the necessary but appropriate methods to execute your methods, when you were talking about your analysis, when we talked a little bit earlier about what you are looking at as far as oversight. What changes should Congress make for you to help with methods to execute your mission?

Mr. FALASCHETTI. I am reluctant to opine on what Congress should do, having sat on the other side of this dais previously. I am dedicated, and I know our staff are, to follow the rules that we

are given and the mandates that we are given here. We will dutifully execute on this.

Mr. RIGGLEMAN. And as far as your background, I would like to just ask you a couple of the background questions, and I know we went through this before. What things have you done to make you qualified for this position right now, sir?

Mr. FALASCHETTI. Sure. I mentioned in my opening statement the President's 2006 Economic Report. I was at the Council of Economic Advisors at that time. I co-authored a couple of chapters in that report, and we were thinking about how important the financial sector is to everyday Americans and how systemic risks could really put a big dent into those opportunities. We raised the flag, but as I mentioned in my opening statement, there were some really credible warnings about 2008, and for one reason or another those flags were not chased down.

Mr. RIGGLEMAN. Thank you. And, Governor Brainard, I also want to thank you for your amazing transparency, coming to see me and talking to me. You know where I stand on some things, so I do appreciate everything that you are doing.

I had some questions here and I want to talk about ubiquity. And there was something that I had read, and I do read a lot, talking about that the Board—and we are talking about the Fed Board—and we are going to talk about faster payments quickly, and the FedNow service, and as that were a private sector service.

In the November 2018 FRB notice, you stated that it is possible that the Reserve Bank entry could add to market fragmentation and lower the prospects for ubiquitous, faster payments in the United States, especially in the short run. I know a lot of this is a conversation based on what we continued, and I know we only have 20 seconds. So right now, based on the Fed's own publication, ubiquity will be chilled, especially in the short run, and it means thousands of institutions considering signing on to the private sector platform, could be waiting to see how FedNow works, effectively cut off millions of consumers from real-time payments. That is something I would like to follow up with you on, and I am probably going to have to do questions for the record, so I apologize for that.

So, anyhow, I guess my time has expired, so I yield back to the Chair.

Chairman MEEKS. The gentleman's time has expired. I now recognize the gentleman from Illinois, Mr. Garcia, for 5 minutes.

Mr. GARCIA OF ILLINOIS. Thank you, Mr. Chairman, and I want to thank both of our witnesses here today. I would like to talk a little bit about FSOC and shadow banks in my comments and questions.

The 2008 financial crisis was a painful reminder that it is not just commercial banks that can make risky choices, threatening the stability of our entire financial system. Hedge funds, insurance giants, and asset managers are all closely connected to basic financial stability.

My constituents cannot afford another crash, for many of them are still recovering from the last one. Many people in my immediate neighborhood, throughout my congressional district, and throughout the City of Chicago lost the equity in their homes, they lost their jobs, many became underemployed, and many had to dou-

ble up in apartments, and in homes throughout the area. Buildings became vacant throughout neighborhoods in Chicagoland. As a matter of fact, we had to establish a foreclosure mediation court in the County of Cook, in the metro area. People fell behind on utilities, car payments, and there were more repossessions. Retail business strips had higher vacancy rates. There were empty storefronts throughout the commercial areas in the district. The informal economy increased as people took to the streets to peddle food, fruits, and on and on. There was real, real pain.

Yet, during Secretary Mnuchin's tenure, the FSOC has voted to remove systemic risk designation from AIG and Prudential. FSOC has also voted to drop the appeal of the district court's decision in the MetLife lawsuit. Taken together, these decisions remove protections from non-bank financial companies with a combined $2 trillion in assets.

There are no longer any non-banks designated as systemically important. I am worried that we failed to learn the lessons of 2008 and are making the same mistakes. Large financial non-banks like Prudential and AIG were central to the last crisis. In fact, during the 2008 crash, AIG became the recipient of the largest government bailout in American history.

Governor Brainard, do you think it is appropriate that Prudential, a company with over $800 billion in assets, has, as its chief regulator, the New Jersey Department of Banking and Insurance?

Ms. BRAINARD. Thank you for your question. I certainly have traveled around your district and other places in the country where I think the effects of the foreclosure crisis are still evident.

With regard to the designation authority under FSOC, personally I thought it was a very important authority. I am no longer close to it. I am not the Board's representative to the FSOC so I can't speak to any particular decisions, but I certainly believe that non-bank activities were important, and could be, in the future, important sources of systemic risk.

Mr. GARCIA OF ILLINOIS. The Fed's Financial Stability Report warned about leveraged loans to corporations, and noted that, "the more risky tranches are primarily held by asset managers, insurance companies, hedge funds, and structured credit funds." In light of these findings, do you really believe that there is not a single insurance company, asset management firm, hedge fund, finance company, or standalone investment bank whose failure could threaten financial stability today?

Ms. BRAINARD. I certainly would feel more confident if we had greater lines of sight into where some of those non-bank, non-supervised entity holdings are sitting, and that is why we supported work through the Financial Stability Board (FSB), because, of course, this is an international market, to better understand where those holdings are sitting.

Mr. GARCIA OF ILLINOIS. And on the subject of leveraged loans, I will skip my introduction to the question, and let me cut to the chase, if I may. Do you think that it makes sense for Congress to act and restore risk retention or arrangers of CLOs?

Ms. BRAINARD. I think that issue is one for you in Congress to decide. I think risk retention has been shown to be an important risk mitigant.

Mr. GARCIA OF ILLINOIS. Thank you. I yield back, Mr. Chairman.

Chairman MEEKS. The gentleman's time has expired. I now recognize the gentleman from Missouri, Mr. Cleaver, who is also the Chair of our Subcommittee on National Security, International Development and Monetary Policy, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman. I would like to ask either of you, are you members of the Federalist party or the Whigs or the anti-Federalist party?

Mr. FALASCHETTI. No.

Ms. BRAINARD. No.

Mr. CLEAVER. It is critical to this hearing, but I just thought I needed to find out. We have found out, whether we have subversives, people with subversive opinions in here. So I will get to that non-subversive stuff.

I am wondering if there is a policy, Mr. Falaschetti, that the OFR would—do you have a deadline for letters to be answered to Members of Congress, particular the committee of jurisdiction?

Well, that is okay. I sent a letter on August 27th that I considered to be extremely important to me, asking for information I sought, and I just—I was actually mayor of a large city and we always said, I said get deadlines for the City Hall stuff in Kansas City to respond to members of the council.

Mr. FALASCHETTI. Right, and we are. We have received your letter and it is being considered as we speak by our FSOC.

Mr. CLEAVER. I appreciate it. I appreciate you doing that.

Here is the other issue. I am sure that you believe that your role at the OFR is critical. I was here—

Mr. FALASCHETTI. I agree.

Mr. CLEAVER. —during the last financial crisis, sitting right over here, and it was a tough time. I don't ever want to see that again. And so with the value that I place in your department and the value that you do, I am trying to understand why we would cut staff from the monitoring of systemic risk.

Mr. FALASCHETTI. Per my previous testimony, it was well before my confirmation.

Mr. CLEAVER. I didn't hear you make that comment.

Mr. FALASCHETTI. I commit, going forward, to get the resources that we need to be effective. Your colleague just left. I grew up in south Chicago. I know what it is like to be underbanked. I take this job very seriously. We have a fantastic team of employees back at the OFR who are watching us right now. They are doing great work, and I am dedicated to fulfilling the letter of the law here.

Mr. CLEAVER. Well, I like your answer, sir, and I appreciate that. It would seem to me—and you didn't make the decision—but it would just seem to me that if there is any place we are going to have some economic leniency, it ought to be in the prevention of us repeating what happened in 2008. I was in here when Ben Bernanke, Christopher Cox, Sheila Bair, and Henry Paulson walked in to tell us that the financial system of this country was going down the drain by Monday. This was on a Friday. I don't want to do that again, so I appreciate your answer.

To both of you, as my time runs down, do you believe that financial regulators should be aggressive in regulating? For example, Facebook, should we wait until they come to an agency or should

we be aggressive and go and say, if you are getting ready to do something significant, run some kind of new program, some kind of product, do we wait until they do it? I have a letter from David Marcus, head of Calibra, and he doesn't want to launch this project until regulators have looked at it, and it appears that the regulators are saying, "Well, we will wait until Facebook comes to us." And it is just kind of confusing, Ms. Brainard, Mr. Falaschetti, either of you?

Ms. BRAINARD. I—

Chairman MEEKS. The gentleman's time has expired. I thank the gentleman for his questions.

[laughter]

Chairman MEEKS. And now, I am going to recognize the ranking member for a one-minute closing statement.

Mr. LUETKEMEYER. I just want to thank the chairman for having this hearing today. I think this is extremely important to our mission here, and for he and I, as the leaders of our parties, to be able to assess the threats to the system that we basically oversee, the financial services system, and the constituents that we serve and the customers and consumers who take advantage of those services.

Today, we heard a lot of testimony with regards, and questions with regards to what is going on, different threats, and there are a lot of threats to our system. Our changing financial services environment is under a threat constantly, and we appreciate your direct responses to those questions. But obviously, you are going to have to continue to assess those threats in order to be able to thwart them.

And there are two things that I hope you continue to do. Number one, listen to and watch what is going on in the industry that you oversee, and commit to do the work of finding the solutions, and get all the information and then act on it. Don't give me the "Fed twostep." Act on what is going on. Don't give me a "may," "might," or "could," because after each one of those words, I can say, "may not," "might not," or "could not." I want you to be able to—don't couch those terms to defend your inaction, but I want you to take action when you need to.

Recently, in the past 2 or 3 weeks here, you have taken quick action to solve the liquidity problem in the markets. I commend you for that. But I brought up an issue today that I think is extremely important that needs your action. I hope that you take those kinds of actions.

I appreciate you being here today, and we will certainly follow up and watch what goes on.

Thank you. I yield back.

Chairman MEEKS. Thank you. I now recognize myself for one minute for a closing statement.

Governor and Director, I recognize that the work you do is especially complex, and the challenges faced in anticipating risk and crises that have yet to manifest. As you have heard today, Members of Congress from both sides of the aisle are genuinely concerned about repeating mistakes of the past. It is no exaggeration to say that our experience living through the financial crisis was

traumatic, not only for us in government but for the American public.

The Fed and the OFR are meant to rise about politics and partisanship, and focus truly on the financial stability and well-being of the American economy at large. Ultimately, every American family expects you and your organizations to take your responsibilities seriously, and I believe that you do, to approach them with intellectual honesty, rigor, and discipline, and to hold accountable those financial firms that have the potential to fundamentally disrupt our economy and those of our economic partners.

So please, I implore you to staff your organizations to the level needed to fulfill your missions, fight for the necessary budgets required to do your job well, on behalf of the American families, and provide us with the data and information necessary to force a strong, resilient, stable economy going forward.

Again, thank you for your work and your admirable careers of public service, and my colleagues and I look forward to continuing to work with the both of you.

I would now like to thank, again, our witnesses for your testimony.

The Chair notes that some Members may have additional questions for this panel, 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 these witnesses and to place their 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 is now adjourned.

[Whereupon, at 12:07 p.m. the hearing was adjourned.]

A P P E N D I X

September 25, 2019

Opening Statement: Financial Institutions Subcommittee hearing entitled "Promoting Financial Stability: Assessing Threats to the U.S. Financial System."
Date: September 25, 2019
Congressman: Patrick McHenry (NC-10)
Time: Approx. 1.4 Mins (201 Words)

Thank you, Mr. Chairman, for holding today's hearing. The work this committee does to examine systemic risk and overall financial stability is one of our most important responsibilities.

Today, we will hear from two independent federal officials on the risks facing our financial system and its stability.

There is no doubt that issues such as cybersecurity and global political and economic uncertainty pose real threats to our financial system. In fact, yesterday, I introduced the Cybersecurity and Financial System Resilience Act of 2019 directing the Federal Reserve to provide an annual

report and briefings to this Committee and the Senate Banking Committee on their cybersecurity efforts.

Congress must provide effective oversight to deal with these critical issues.

I would like to take a brief second to thank the Chair for attaching this bill to today's hearing so that we can have a robust discussion on cyber security oversight.

I look forward to hearing our witnesses' assessments and recommendations to ensure the financial system can withstand any market stress it may encounter.

I yield back.

For release on delivery
10:00 a.m. EDT
September 25, 2019

Statement by

Lael Brainard

Member

Board of Governors of the Federal Reserve System

before the

House Financial Services Subcommittee on Consumer Protection and Financial Institutions

U.S. House of Representatives

September 25, 2019

Thank you, Chairman Meeks, Ranking Member Luetkemeyer, and members of the subcommittee. I appreciate the opportunity to be here today to discuss financial stability.

The Federal Reserve's Role in Promoting Financial Stability

Safeguarding financial stability is integral to achieving the Federal Reserve's objectives of full employment and price stability. We need only look back a decade to see the dramatic damage from financial vulnerabilities that increased unchecked: millions of Americans lost their livelihoods and their homes, businesses failed, and the government had to provide extraordinary support. We learned from this experience that we must be especially vigilant to fortify the resilience of our financial system in good times when vulnerabilities may be building.

Following the financial crisis, the Congress assigned important responsibilities for safeguarding the stability of the financial system to domestic regulators. The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Financial Stability Oversight Council (FSOC) to identify, coordinate and respond to emerging threats to the financial system. The Federal Reserve was assigned responsibility for enhanced supervision of systemic firms, and we have placed great emphasis on strengthening our approach to promoting financial stability. Safeguarding financial stability is a shared responsibility, requiring cooperation across U.S. regulatory agencies, as well as with foreign regulators and central banks. Chair Powell represents the Federal Reserve in the FSOC, where we participate alongside other domestic regulators and the Treasury, and I am pleased to be joined today by Dino Falaschetti of the Office of Financial Research. We also participate in a variety of international forums, including the Financial Stability Board, which Vice Chair Randal Quarles chairs, and where I serve as the Federal Reserve representative.

The Board instituted a new organizational framework to carry out our responsibilities on financial stability. We created the Division of Financial Stability to strengthen our cross-disciplinary approach to the analysis of potential risks to the financial system and to support macroprudential supervision of large financial institutions. I serve as chair of the Committee on Financial Stability, which was created to guide staff work and make recommendations to the Board.[1] We develop a financial stability assessment four times per year that is discussed by the Board and the Federal Open Market Committee.

We have also taken steps to ensure transparency and accountability. Last year, I was pleased that the Board accepted my recommendation to publish a public *Financial Stability Report* twice a year.[2] The report provides an account of our assessment of vulnerabilities as well as a summary of market participants' views on potential risks to the financial system. Through this public communication, we hope to gain feedback from the broader financial stability community and the public on threats to the financial system.

How the Federal Reserve Approaches Financial Stability

Our approach to financial stability recognizes that the financial system and the broader economy are intertwined. The buildup of financial imbalances in good economic times has the potential to amplify shocks in a downturn and push the economy away from full employment and price stability. When financial vulnerabilities build, adverse developments can lead to disruptions in credit and other financial services, potentially amplifying declines in employment and economic activity. Our goal is to promote a resilient financial system that is able to continue

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[1] Federal Reserve Board https://www.federalreserve.gov/aboutthefed/bios/board/default.htm.
[2] Board of Governors of the Federal Reserve, *Financial Stability Report* (Washington: Board of Governors), https://www.federalreserve.gov/publications/financial-stability-report.htm.

meeting the demands of households and businesses for financial services when faced with adverse events.

Accordingly, we have developed a systematic forward-looking approach to assessing financial vulnerabilities that could amplify negative shocks, transmitting damage more broadly. The historical record here and abroad points to several key areas of vulnerability. Vulnerabilities can build when there is excessive or poorly underwritten borrowing across many households, such that incomes are not keeping up with debt payments. Similarly, elevated levels of corporate debt can create problems not only for the borrowers, but also for lenders, when the business cycle turns, and debt servicing obligations or refinancing prove challenging, leading businesses to pull back on investment and employment. Vulnerabilities historically have often been associated with conditions where asset prices are higher than what economic fundamentals support, often because of elevated risk appetite, potentially leading to much larger-than-expected losses should a sharp correction occur. Separately, we track leverage in the financial system for signs that banks and other financial intermediaries potentially have inadequate buffers of capital to absorb adverse shocks, increasing the risk of their distress and possible spillovers to the financial system. We also monitor funding risk in the financial system. Where banks or nonbank financial intermediaries fund long-term lending through potentially flighty short-term borrowing, it may pose the risk of a loss of confidence, precipitating a withdrawal of short-term funding and strains on institutions as they try to meet withdrawals.

To illustrate, I will provide my brief assessment in each of these areas. In contrast to the years preceding the crisis, when household borrowing was growing at a pace far above that of gross domestic product (GDP), it has since come down and is now growing more slowly than the economy overall. Moreover, while much of the increase before the crisis reflected borrowing

that proved unsustainable, more recent borrowing has been concentrated among households with strong credit profiles. That said, the increase in student debt in recent years deserves attention, although not primarily through the prism of financial stability.

The regulated financial sector is more resilient, owing to far-reaching reforms as well as favorable conditions. Insurers appear generally well capitalized, and broker-dealers, including those not affiliated with large bank holding companies, have reduced their leverage in recent years. In contrast, there has been some evidence of rising use of leverage by hedge funds over the past couple of years. Large banks increased both the size and quality of their capital buffers following the crisis, although the risk-weighted capital ratio at the largest banks has moved down somewhat as payouts have exceeded earnings over the past couple of years.

Financial reform has reduced funding risks associated with banks and money market funds. Large banks subject to liquidity regulation are less reliant on unstable short-term wholesale funding and have thicker liquidity buffers. Money market reforms have also reduced funding risks.

A range of asset prices remain high relative to historical benchmarks, even with the recent financial market volatility. In particular, yields on high-yield corporate bonds relative to Treasury securities remain somewhat narrow on a historical basis despite recent increases. Similarly, although they have moved up in recent months, spreads on leveraged loans remain in the bottom half of their range since the financial crisis, which is notable given the evidence of weakening protections. Finally, capitalization rates on commercial real estate properties, which measure annual income relative to prices for recently transacted properties, have been low relative to Treasury yields. In addition to generating losses for investors, declines in valuations

could make it more challenging for firms to obtain or extend financing—especially among risky, indebted firms—which in turn could be amplified by the high levels of risky corporate debt.

Finally, business borrowing has risen more rapidly than GDP for much of the current expansion and now sits near its historical peak. The run-up in corporate debt has brought the ratio of debt to assets close to its highest level in two decades on an overall basis, and this is also true for speculative-grade and unrated firms. And whereas previously, mostly high-earning firms with relatively low leverage were taking on additional debt, analysis of detailed balance sheet information indicates that firms with high leverage, high interest expense ratios, and low earnings and cash holdings have been increasing their debt loads the most. Historically, high leverage has been linked to elevated financial distress and retrenchment by businesses in economic downturns.

Regarding corporate bonds outstanding, recent years have witnessed little change in the relative shares of investment-grade bonds and high-yield bonds. Credit quality has deteriorated within the investment-grade segment, where the share of bonds rated at the lowest investment-grade level has reached near-record levels. As of mid-2019, just over half of investment-grade corporate bonds outstanding were at the lowest end of the investment-grade segment. In comparison, the share of high-yield bonds outstanding that are rated "deep junk" has stayed flat at about one-third over the past few years, well below the financial crisis peak of 50 percent.

In an economic downturn, widespread downgrades of these low-rated investment-grade bonds to speculative-grade ratings could induce some investors to sell them rapidly—for instance, because lower-rated bonds have higher regulatory capital requirements or because bond funds have limits on the share of non-investment-grade bonds they hold. This concern may be higher now than in the past, since total assets under management in bond mutual funds have

more than doubled in the past decade, and these funds now hold about one-tenth of the corporate bond market. The redemption behavior of investors in these funds during a market correction is unclear.

Further down the credit quality ladder, there has been sizable growth in leveraged lending, accompanied by a notable deterioration in underwriting standards. Net issuance of leveraged loans to risky borrowers grew rapidly last year and boosted leveraged loans outstanding to a level exceeding $1 trillion overall, although the pace of issuance has slowed more recently as the interest rate environment has shifted. While leveraged loans have traditionally had important investor protections, covenants for leveraged loans issued in the past few years have weakened dramatically, and they often include features that increase opacity and risk. A substantial share of the leveraged loans are packaged in collateralized loan obligations (CLOs) whose issuance increased sharply in 2018 and has since moderated somewhat. Many large banks originate leveraged loans with an intent to distribute, often to CLOs. While the direct exposures of the banking system in the form of loan portfolios and warehousing exposures can be monitored, there are also indirect exposures, including through bank investments in CLOs and credit lines, which bear vigilance. By contrast, nonbank exposures are harder for us to track. To date, the default rate on leveraged loans has been at the low end of its historical range, and corporate credit conditions have been favorable, with low interest expenses and low expected default rates. However, if spreads rise sharply or economic conditions deteriorate significantly, we could see downgrades, refinancing challenges, rising delinquencies and defaults, and losses to investors.

Recognizing that financial imbalances played a key role in each of the past three U.S. downturns, policy should seek to moderate financial vulnerabilities when they are likely to

materially exacerbate an economic downturn, leading to deeper declines in output and higher levels of unemployment. Both economic theory and econometric evidence point to the risk that excesses in corporate debt markets could amplify adverse shocks and contribute to job losses. Over-indebted businesses may face payment strains when earnings fall unexpectedly, and they may respond by pulling back on employment and investment. The slowdown in activity lowers investor demand for risky assets, thereby raising spreads and depressing valuations. As business losses accumulate, and delinquencies and defaults rise, banks are less willing or able to lend. This dynamic feeds on itself, potentially amplifying downside risks into more serious financial stresses or a downturn.

Recognizing this feedback loop between financial imbalances and the macroeconomy, in addition to strong through-the-cycle regulatory requirements, our toolkit includes a countercyclical capital buffer (CCyB). The CCyB is intended to require the nation's largest banks to build capital when conditions are favorable to sustain resilience for times when there is elevated risk of above-normal losses, which often follows periods of rapid asset price appreciation or credit growth. CCyB requirements are intended to lean against rising risks at a time when the degree of monetary tightening needed to achieve the same goal could be inconsistent supporting full employment and target inflation. And they build resilience, unlike monetary policy. Second, when conditions are favorable, the covered banks could build the modest additional buffer simply by moderately reducing payouts. Third, the CCyB is a simple, predictable, and slow-moving tool that applies equally across all large banks. It does not single out shortfalls in particular banks or result in volatility in individual banks' stressed capital requirements. Finally, the additional capital can be released when conditions deteriorate to ensure the ability of large banks to lend into a downturn.

The criteria for implementing the CCyB described in the Board's framework of September 2016 are calibrated so that the CCyB will be above its minimum value of zero about one-third of the time, when financial vulnerabilities are assessed to be in the upper one-third of their historical distribution.[3] The Board votes once a year on the level of the CCyB. The Board voted to set the CCyB at zero earlier this year.[4] Many other jurisdictions have raised their CCyB above zero.[5]

Going forward, we will continue to monitor financial vulnerabilities closely, recognizing the potential for such vulnerabilities to amplify any negative developments. We plan to share our assessment with you in our next *Financial Stability Report* later in the year and look forward to hearing from you about any issues that warrant further monitoring.

Thank you and I look forward to your questions.

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[3] Board of Governors of the Federal Reserve, "Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer," September 8, 2016, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908b1.pdf.

[4] Board of Governors of the Federal Reserve, "Federal Reserve Board Votes to Affirm the Countercyclical Capital Buffer (CCyB) at the Current Level of 0 Percent," press release, March 6, 2019, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190306c.htm

[5] See the Basel Committee on Banking Supervision, updated August 21, 2019, https://www.bis.org/bcbs/ccyb/index.htm#table.

Testimony of Dino Falaschetti
Director of the Office of Financial Research
U.S. Department of the Treasury
House Financial Services Subcommittee on Consumer Protection and Financial Institutions
Hearing on "Promoting Financial Stability: Assessing Threats to the U.S. Financial System"
September 25, 2019

The views expressed in this testimony are those of Dino Falaschetti, Director of the Office of Financial Research, and do not necessarily represent the views of the President.

Introduction

Chairman Meeks, Ranking Member Luetkemeyer, and members of your subcommittee, thank you for inviting me to testify this morning on behalf of our Office of Financial Research (OFR, the Office). I enjoyed meetings with a number of members on this dais, and look forward to working with each of you during my service in this position.

I am honored for the opportunity to share my testimony with you today, and look forward to discussing the productive role that OFR offers to our government's financial stability framework.

Throughout my career in business, education, and public service, I enjoyed developing and sharing firmly grounded perspectives on important financial and economic matters. And I have especially enjoyed doing so through my public service, first at the President's Council of Economic Advisors, then the House Financial Services Committee, and now as Director for our Office of Financial Research.

As you requested, my testimony today will cover the OFR's 2018 Annual Report to Congress. But first, I would like to take a minute to recognize our staff.

Prior to my appointment as OFR's Director, our Office underwent an extensive reexamination of mission, culture, and structure. Throughout this period of uncertainty, our staff members never let go of a mission that they

and I enthusiastically support. I am grateful to each and every one of you for your dedicated service as individuals and as a team. I begin my testimony today by acknowledging your service – thank you!

My priority and commitment to them going forward is providing for a safe, collegial, and fulfilling workplace so that they are able to thrive personally and professionally by furthering our important mission of serving the Financial Stability Oversight Council (FSOC, Council) and its member agencies.

To that end, I am meeting with each and every member of our staff, with the objective of better understanding what our ground truth looks like. This program will promote greater communication, collaboration, and transparency throughout our Office, and establish a rewarding sense of fulfillment that comes from good work done well.

Financial Stability and Economic Opportunity

When it comes to economic opportunity, the United States stands as the world's leader. A resilient financial sector is vital to maintaining that lead, and increasing the welfare of every American. The remarkable frequency of banking crises during the last three decades,[1] however, remind us that we can do better.

The Great Financial crisis is sometimes characterized as a perfect storm,[2] but it did not have to happen. Credible warnings were plentiful, but a lack of transparency and accountability[3] saw too many people dancing until the music abruptly stopped.[4]

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[1] Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises & Scarce Credit*, Princeton University Press, 2014, p. ix.
[2] International Monetary Fund, "The Perfect Storm," *Finance and Development*, June 2009, 46(2), https://www.imf.org/external/pubs/ft/fandd/2009/06/blanchard.htm; Anthony H. Catanach, Jr. and Julie Anne Ragatz, "2008 Financial Crisis: Black Swan, Perfect Storm or Tipping Point? (Buzzwords make it possible to deflect responsibility for financial cataclysm)," *Bank Accounting and Finance*, April-May 2010.
[3] Dodd-Frank's preamble calls for greater transparency and accountability.
[4] As Citigroup's CEO prior to the crisis, Charles Prince is quoted to have said that, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance."

In early 2006, the President released his Economic Report. One of the chapters focused on why financial services are vital for upward mobility in households and businesses alike. It also called on regulators "to mitigate the likelihood of systemic events."[5]

Despite their accessibility and timeliness, none of these warnings could mitigate, let alone stop, the crisis that was to come.

Reflecting on this history, a prominent economist and former central banker eschewed calls for increased regulation of an already heavily regulated sector. Instead, he focused on opportunities for data analysis and monitors to increase transparency for inter-institution exposures and concentrations of risk in the financial system.[6,7] Our Office was established to deliver on exactly those types of data and research services, so that regulators and the public can better gauge potential risks to financial stability.

OFR: A Simple but Consequential Mission

OFR was established to, in considerable part, increase the likelihood that future warnings will be more credible when grounded on economic fundamentals and informed by high-quality data and careful research.[8] OFR supports the FSOC and its member agencies with data and research services that work toward that important end.[9]

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https://www.fnlondon.com/articles/chuck-princes-dancing-quote-what-we-have-learned-10-years-on-20170714

[5] *Economic Report of the President*, Transmitted to the Congress February 2006, Together with the Annual Report of the Council of Economic Advisers, pp. 208-210.

[6] Justin Lahart, "Mr. Rajan Was Unpopular (But Prescient) at Greenspan Party," Wall Street Journal, January 2, 2009. https://www.wsj.com/articles/SB123086154114948151

[7] Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, 2010, Princeton University Press, page 173.

[8] As one post-crisis author puts it, "increasing financial complexity with decreasing data quality is a toxic mix." William A. Barnett, *Getting it Wrong: How Faulty Monetary Statistics Undermine the Fed, Financial System, and the Economy*, MIT press, 2012, p. xxxi.

[9] "The purpose of the Office is to support the Council in fulfilling the purposes and duties of the Council and to support member agencies." DFA Sec. 153. Purpose and Duties of the Office.

Americans have long enjoyed the greatest of economic opportunities. Even more are available through robust growth. Tailoring research and data services to Council and member needs can provide important support.

Reporting on Financial Stability

Dodd-Frank clearly defines our Office's purpose and duties as:[10]

- Collecting data for the Council,
- Standardizing data formats,
- Developing applied and long-term research, and
- Measuring and monitoring risks.

Complementing our Office's support of the Council and member agencies, our Office submits an Annual Report to Congress assessing the state of the U.S. Financial System. The Report analyzes threats to financial stability, shares key findings from our research and analysis, and reviews progress in fulfilling our mission.[11]

The OFR's stability assessment starts with a consideration of risks in seven different categories. Macroeconomic, market, and credit risks arise from the interplay between the financial sector and the rest of the economy.

Solvency and leverage, funding and liquidity, and contagion risks arise from connections between financial sector firms.

And a seventh category of risks covers those that do not fit squarely (e.g., cybersecurity) into other categories. Vulnerabilities in any of these areas can originate, amplify, or transmit shocks and stress.

One of the many tools that informs the OFR's risk assessment is our Financial System Vulnerabilities Monitor - a quarterly heat map of indicators that is shared publicly online. Changes in these monitors can signal vulnerabilities that may benefit from deeper investigation.

Our Office also draws on a broader range of data and monitoring tools, qualitative information, and deeper analysis to build on our heat map and

[10] Dodd-Frank, Sec.
[11] Dodd-Frank Sec. 154 (d) Reporting Responsibilities.

further refine our risk assessments. Finally, risks can evolve with changes in the financial system, and the OFR monitors those risks as well. Our Office's final assessment regarding any type of risk can thus be higher or lower than our heat map or any one monitoring tool indicates.

OFR Collaborations

Complementing our Office's efforts in research, analysis, and data products, the OFR regularly solicits stakeholder feedback, which importantly includes that from FSOC and its member agencies.

Another complement to OFR's important mission comes from our Office's Financial Research Advisory Committee. Established in 2012, this committee provides academic and industry expertise to advance the OFR's important mission.

Our Office also cosponsors two financial stability conferences. The OFR and University of Michigan's Center on Finance, Law, and Policy held their fourth annual conference in November 2018. That conference considered how activity and entity-based regulation might increase financial resiliency without creating an undue regulatory burden.

The OFR also co-sponsors an annual conference with the Federal Reserve Bank of Cleveland. The most recent Cleveland conference considered financial stability concerns and management more broadly.

2018 Annual Report to Congress: Financial Stability Assessment and Key Findings

Our Office's latest Annual Report to Congress was published on November 15, 2018. That Report finds that risks to financial stability remained in the medium range, reflecting a mix of high moderate, and low risks across different dimensions of our financial system.

The OFR continued to see relatively high market and cybersecurity risks. Market risk had been elevated for a few years. Stock market valuations, the U.S. Treasury term premium (a measure of compensation to long-term

investors for taking the risk of rising interest rates), and bond duration (price sensitivity to interest rate changes) signaled the most risk.

Our Office assessed credit risk as moderate overall, with increased risk from leveraged lending tempered somewhat by lower risk from consumer credit. The OFR assessed risk from solvency and leverage as remaining low, though some large banks, insurers, and hedge funds could be vulnerable to severe stress.

Similarly, funding and liquidity risk was low overall, thanks to favorable borrowing conditions and high liquidity buffers for most banks. However, these risks can change quickly.

Cybersecurity risk continued to warrant attention. Our Office first discussed risks from cybersecurity in the inaugural 2012 Annual Report, and has reported on them every year since. Our 2018 Annual Report also reported on how network analysis could provide a clearer view of risks from cybersecurity.

Our Office has continued its monitoring and risk evaluations since, and expects publication of the OFR's 2019 Annual Report later this year. Because that Report remains a work-in-progress today, I cannot speak to its details. Based on currently available data, however, our overall risk assessment will likely remain in the medium range, with trends identified in the 2018 report continuing.

Looking Ahead

Personnel Priorities

Since publishing our 2018 Annual Report, the OFR has continued its diligent monitoring and evaluation of risks to our financial system. We expect to publish OFR's 2019 Annual Report later this year.

Throughout, our Office will pursue priorities that continually strengthen the OFR's mission-focused capabilities. Our top priority in this important regard is making sure that current staff members have what they need to thrive. Conversations during our bi-weekly staff lunches are informing that effort, and we will continually solicit and act on that feedback as we move forward.

A second important goal is building a culture of accountability for all members of our staff, so that performance is driven by effectiveness and professionalism in contribution to mission. We are already taking concrete steps to realize this goal, and look forward to the empowering workplace environment and organizational efficiencies that it can bring.

Finally, our Office is recruiting, hiring, and retaining the most talented and motivated people to further OFR's incredibly important mission. This effort will allow current staff members to focus on the highest-value contributions associated with their roles, and strengthen our organizational abilities to best serve the Council and its member agencies with the data and research services they need to effectively evaluate and address risks in their regulatory domains.

Data Initiatives

Quality data are essential to conduct a robust review and analysis of systemic threats to the U.S. markets. As data quality improves, OFR, FSOC, and its member agencies can increasingly engage in more robust financial stability analysis.

Our Office ensures that our FSOC and its members have access to the most complete, relevant, and reliable information available. Documenting important work to this end, the OFR's 2018 Report also reviews the Office's work to fulfill data-related mandates through an array of initiatives, including the issuance of a rule to collect data on centrally cleared repurchase agreements, or repo, transactions.[12] This data collection will start next month, and bring greater transparency to a short-term funding market.

In addition, for several years, the Council has called for better insight and transparency into markets for securities financing transactions. These wholesale funding markets are critical to the functioning of our financial

[12] The OFR adopted a rule in February 2019 to establish a data collection covering centrally cleared funding transactions in the U.S. repurchase agreement (repo) market. The data collection is expected to begin in October 2019. https://www.financialresearch.gov/from-the-management-team/2017/11/22/ofr-update-on-bilateral-repo-collection/

system. The interest rate data on cleared repo transactions will inform the Federal Reserve's production of the Secured Overnight Financing Rate (the SOFR). SOFR was selected to be an alternative to the London Interbank Offered Rate, or LIBOR. LIBOR has been a widely used interest rate benchmark in global financial markets and the economy, but attempted manipulation of LIBOR during the financial crisis and ongoing doubts about LIBOR's reliability, led to efforts to develop an alternative.

The data collection also will shed light more broadly on the specifics of repo funding. By doing so, the collection will help the Council and its members better understand and monitor stress in asset and funding markets.

Closing

American economic opportunity is the envy of the world. And the OFR's statutory charge plays an important role in fortifying financial stability for the world's greatest economy. I am honored to lead our Office, and very proud of the good people on our team who wake up every day to advance our incredibly important mission. Thank you again for your invitation to testify, and I look forward to addressing your questions.

Congress of the United States

Washington, D.C. 20515

July 31, 2019

The Honorable Jerome Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Jelena McWilliams
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

The Honorable Joseph Otting
Comptroller
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, DC 20219

Dear Chairman Powell, Chairman McWilliams, and Comptroller Otting:

We write to express our strong opposition to any weakening of the initial margin requirements for swaps transactions between insured depository institutions (IDIs) and their affiliates because it would harm financial stability and U.S. taxpayers.

As you know, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act in the wake of the 2008 financial crisis to ensure that banks would no longer be able to gamble on risky derivatives, like swaps, and expect to get bailed out by the government when they lost those bets. In order to reduce risk, increase transparency and promote market integrity, Title VII of Dodd-Frank established a new regulatory framework for the previously opaque over-the-counter (OTC) derivatives market. Under the law, swaps transactions generally require collateral in the form of margin and capital to ensure that counterparties can honor their commitments. Such collateral protects taxpayer-insured banks from gambling by their affiliates operating in the capital markets, as well as by their foreign affiliates that can avoid U.S. regulation.

Initial margin for swaps between taxpayer-backed banks and their affiliates is not just collateral that the banks would otherwise be able to use. Instead, margin requirements are the primary means of addressing risks from affiliates that may be transferred back to the banks. For that reason, the Federal Reserve Board (Fed), Office of the Comptroller of Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Farm Credit Administration, and Federal Housing Finance Agency explicitly required banks to collect margin when transacting with their affiliates, which may be located overseas.[1]

According to former FDIC Vice Chairman Thomas Hoenig, "[i]nter-affiliate margin ensures there is sufficient capital and liquidity to the financial firm and the market, should any unit of a consolidated

[1] Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (Nov. 30, 2015), https://www.govinfo.gov/content/pkg/FR-2015-11-30/pdf/2015-28671.pdf

banking company find itself in a position where it cannot serve end-users, or where its failure becomes a threat to the broader economy and the taxpayer."[2] Vice Chairman Hoenig pointed out that affiliates are incentivized to transfer their risk though uncleared swaps to U.S. banks who have valuable subsidies, including the implicit presumption that they will be bailed out. If the banks do not collect margin from their affiliates on these trades, the banks effectively take on their affiliates' risks, which then become subsidized by the taxpayer. Vice Chairman Hoenig also noted that, "requiring JP Morgan's affiliate operating in London to post margin to JP Morgan's US Bank, would have helped keep the [$2 billion] London Whale trading losses outside of the federally-insured bank."

Moreover, regulators explicitly rejected any argument that transactions among banking affiliates should be exempted from inter-affiliate margin because it is unnecessary and may discourage effective risk-management. As Daniel Tarullo, a former governor at the Fed, noted in 2015, requiring initial margin for these transactions "will protect the safety and soundness" of the banks and "will make the resulting risks transparent to both parties and will incentivize strong risk management."[3] The final margin rule passed by prudential regulators stated that it was necessary to maintain initial margin postings for transactions with prudentially regulated affiliates because otherwise such transactions could "pose a risk to systemic stability."[4]

Developments abroad also caution against any further weakening of inter-affiliate margin requirements. We are particularly concerned about offshore risks affecting U.S. affiliates in light of the U.K.'s decision to leave the European Union, known as Brexit, which is set to take place later this year. This action could not only lead to market instability, but also a race-to-the-bottom approach to financial regulation generally between the U.K. and E.U. Indeed, the head of the Financial Conduct Authority in the U.K. has already stated that he would favor a "lower burden" approach to financial regulation.[5]

Troublingly, U.S. regulators have also sought to lower regulatory safeguards, including capital requirements for the largest Wall Street banks. In particular, the Fed and OCC last year proposed to "tailor" the enhanced supplementary leverage ratio for globally systemically important holding companies, which, by their own analysis, would reduce the amount of capital held by taxpayer-backed insured depository institutions by approximately $121 billion.[6]

These actions, here and abroad, will result in a reduced amount of funds held by U.S. banks and their foreign affiliates to safeguard taxpayers from another financial crisis where they, not the banks, will be left to foot the bill. Expanding the inter-affiliate swap exemption to all transactions would drain even more resources from insured depository institutions and increase the risk of a future taxpayer bailout still further.

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[2] Letter from FDIC Vice Chairman Hoenig to Chairman Rodger and Ranking Member Lowey of the House Committee on Appropriations (July 16, 2015), *available at* https://www.fdic.gov/about/learn/board/hoenig/hoenigletter6-16-15.pdf.

[3] Letter from Daniel Tarullo to the Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/aboutthefed/boardmeetings/swap-margin-board-memo-20151030.pdf.

[4] 80 Fed. Reg. 74,889.

[5] Cat Rutter Pooley, *FCA Chief Eyes "Lower Burden" Regulation After Brexit*, Financial Times (Apr. 23, 2019), *available at* https://www.ft.com/content/62097db4-65c1-11e9-9adc-98bf1d35a056.

[6] Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. 76 (Apr. 19, 2018).

Finally, banks have seen record profits and do not appear to be economically constrained by current margin requirements. There are eight U.S. banks that have been designated as global systemically important banks (G-SIBs) that hold a combined $11.1 trillion in assets, comprising roughly 50 percent of domestic banking assets.[7] In 2018 alone, the six largest U.S. banks made more than $111 billion in profits.[8] Over the last 10 years, U.S. G-SIBs made $780 billion in profits.

For all of these reasons, we urge you to maintain the current requirements to post initial margin for any swaps transaction with a prudentially regulated affiliate of a U.S. banking entity. Any decision to reduce such requirements is a deliberate decision for less stability in the financial system.

Sincerely,

The Honorable Maxine Waters
Chairwoman
House Committee on Financial Services

The Honorable Sherrod Brown
Ranking Member
Senate Banking Committee

[7] For a list of the largest bank holding companies, *see* https://www.ffiec.gov/nicpubweb/nicweb/hcsgreaterthan10b.aspx.; *see also* U.S. Department of The Treasury, "A Financial System That Creates Economic Opportunities- Banks and Credit Unions" (Jun. 2017), https://www.treasury.gov/press-center/press-releases/documents/a%20financial%20system.pdf.

[8] L.A. Times, *The nation's largest banks enjoyed $111 billion in record profits last year- with more to come* (Jan. 16, 2019), https://www.latimes.com/business/la-fi-bank-record-profits-20190116-story.html. The industry as a whole made a record $236.7 billion in profits in 2018, which is an increase of 44 percent from 2017. *See* Federal Deposit Insurance Corporation, *FDIC Quarterly Banking Profile* (Feb. 21, 2019), https://www.fdic.gov/bank/analytical/qbp/2018dec/https://www.fdic.gov/bank/analytical/qbp/2018dec/.

40 billion giveaway

Waters Statement on FDIC Proposal to Eliminate Inter-Affiliate Swaps Initial Margin

Washington, DC, September 17, 2019
Tags: *Dodd–Frank Wall Street Reform and Consumer Protection Act*, *OCC*, *FDIC*

Today, following the release of a Federal Deposit Insurance Corporation (FDIC) proposal to eliminate the requirement that banks collect initial margin when transacting with their affiliates, **Congresswoman Maxine Waters (D-CA)**, Chairwoman of the House Financial Services Committee, issued the following statement:

> "The rollback of this important safeguard has been on Wall Street's wishlist since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which Democrats put in place to a prevent another devastating financial crisis. Now, the megabanks have found a friendly audience among Trump-appointed regulators, and unfortunately, some Members who were not in Congress during the crisis have endorsed this rollback. The fact of the matter is that the FDIC's proposal would ultimately be a $40 billion giveaway to Wall Street megabanks at the expense of our economic stability and U.S. taxpayers. The FDIC should not adopt this proposal, and I will continue to work to prevent its implementation."

In August, Chairwoman Waters and Senator Sherrod Brown (D-OH), Ranking Member of the Senate Committee on Banking, Housing and Urban Affairs, sent a **letter** to Jerome Powell, Chairman of the Board of Governors of the Federal Reserve System; Jelena McWilliams, Chairman of the Federal Deposit Insurance Corporation (FDIC); and Joseph Otting, Comptroller of the Office of the Comptroller of the Currency (OCC), urging them to maintain the current requirements to post initial margin for any swaps transaction between insured depository institutions (IDIs) and their affiliates.

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Chairwoman @RepMaxineWaters' Statement on House Consideration of the #SAFEBankingAct and the Need For Comprehensive Cannabis Reforms

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