FedFin Client Report

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Fintech, Hedge Funds Move Up Front On FSOC Worry List

Client Report: **FSOC21**

Executive Summary

In this report, we provide our in-depth analysis of the FSOC's annual systemic-risk report, focusing on areas it finds are of continued and increasing risk as well as on FSOC's action recommendations. Fintech is now highlighted as an emerging risk, with FSOC warning that distributed ledger technology (DLT) poses uncertainty due to limited market participant experience and possible technological failures, as was recently demonstrated by Bitcoin trade confirmation delays and trade failures. FSOC is also worried by the cross-jurisdictional nature of DLT and similar fintech innovations. Hedge funds – long an FSOC fear – have also gained new prominence in this annual report, with the Council releasing a methodology on fund risk that may prove preliminary to firm designation should legal uncertainty abate in FSOC's favor. Unsurprisingly, the annual report reiterates the importance of designation, committing the Council – at least under President Obama – to a hard fight to overturn the MetLife decision (see Client Report **SIFI19**). As in its prior reports, FSOC argues that vulnerabilities remain moderate despite several worrying concerns regarding slowing global growth, supply gluts in commodities markets, and shifts in exchange rate and global monetary policies, which all lead to significant price swings for a large swath of financial assets. Accommodative monetary policy is also found to contribute to increased yield-chasing. However, the report does note that resolvability of these large and complex institutions has improved significantly in recent years. CCPs are credited in the report for increasing market resilience, but FSOC now cites resulting increased interconnectedness as a risk needing further study.

Analysis

The top risks identified by FSOC and its recommended actions are:

- Cybersecurity: FSOC reiterates that cyber threats continue to be a pressing concern. While noting that the financial services sector has made significant investment in cybersecurity over the past several years, including through the

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

development of system-wide plans for responding to major incidents and expanded of information sharing, FSOC recommends continued work between government agencies and the private sector to enhance information sharing, baseline protections, and response and recovery planning. FSOC also says that NIST standards are not designed to be regulatory ones and recommends that financial regulators establish a common risk-based approach to assessing cybersecurity. FSOC also warns of the cyber threats posed by third-party service providers and continues to support efforts to synchronize their supervision across financial regulators.

- Asset Management: FSOC reiterates many of the concerns that led to its request for comment on this sector (see FSM Report **SYSTEMIC75** and reflected in yesterday's FSB consultation). It now also raises concerns regarding the leverage in the hedge-fund industry; the Council has created an interagency working group that will assess hedge-fund systemic risk.
- SIFIs: Risks to large, inter-connected financial institutions drawing FSOC attention are a low and relatively flat yield curve, rising credit risk in some market segments, litigation expenses, and other factors putting pressure on BHC equity valuations and profitability. The report recommends that regulators continue to ensure financial institutions maintain capital and liquidity to reduce systemic risk by finalizing the TLAC for GSIBs and large FBOs with U.S. operations (see FSM Report **TLAC3**).
- CCPs: FSOC concedes that the risk-mitigation and financial-stability functions provided by CCPs are only achievable if CCPs are highly resilient. Noting that regulators have made significant progress in promoting robust risk management and greater transparency, the report recommends that the FRB, CFTC, and SEC continue to coordinate FMU supervision and evaluate the effectiveness of existing rules to reduce financial stability threats, in part by working with international standard setting bodies. This will be particularly important as additional derivatives-clearing requirements are implemented in other jurisdictions. The report also calls on the agencies to finalize outstanding rules regarding CCP risk management standards. Regulators are also encouraged to work collaboratively to develop resolution plans for systemically important CCPs.
- Short-Term Wholesale Funding: Worries about banks in this arena continue to decrease, as do those with respect to tri-party repos. FSOC notes that additional work is needed to bring the settlement of general collateral finance repo transactions in line with post-crisis reforms. Data gaps are also cited as an issue warranting regulatory attention, as are market responses to the new SEC MMF rules (see Client Report **MMF13**).
- Reliance on Reference Rates: FSOC praises the post-crisis reforms but warns that the decrease in volume of unsecured wholesale lending makes it difficult to

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E-mail: info@fedfin.com www.fedfin.com

root LIBOR submissions in a significant number of observable transactions. FSOC thus cautions, as FRB Gov. Powell did on Tuesday, that the increased reliance of LIBOR on the judgement of submitting banks poses risk in that it may not be possible to publish the benchmark on an ongoing basis if transaction volume declines. Regulators and market participants are encouraged to pursue efforts to develop alternative rates.

- Data Quality, Collection, and Sharing: While noting the progress that has been made to fill data gaps, FSOC argues that much work remains with regards to securing the data FSOC sees as necessary to comprehensively monitor and understand developments across financial markets. Each agency's data, information, and analysis are focused primarily on the entity types and market segments for which it has regulatory purview and says it is imperative that the agencies expand the scope of their data operations as financial transactions increasingly cross regulatory jurisdictions.
- Housing-Finance Reform: The report again laments the lack of housing finance reform legislation, saying it is needed to create a more sustainable financial system. FSOC warns that federal and state regulators are approaching the limits of their ability to enact reforms that foster a vibrant, resilient housing finance system.
- Market Structure: FSOC praises the increased access to markets prompted by the growth of proprietary trading firms and other market participants relying on automated trading systems but cautions that the shift in market structure may introduce vulnerabilities such as operational risk and destabilizing price-feedback dynamics. The report recommends increased coordination among regulators to address these risks, particularly in circumstances where economically similar products are traded in different markets and are regulated by different agencies.
- Financial-Activity Migration: Regulators are also urged vigilantly to monitor new products, particularly in the fintech arena, to ensure they do not pose new risks, and the Council recommends that consumer-protection policies should be reviewed on an ongoing basis to assess the appropriate treatment of new products.

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