FedFin Client Report

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FSOC Tells Public Why It Worries, Not What It Will Do – If Anything

Client Report: **FSOC16**

Executive Summary

In this report, we provide our in-depth analysis of FSOC's annual systemic-risk report, focusing on changes since the 2014 report (see Client Report **SYSTEMIC71**), and on specific recommendations that could lead to policy-maker action. As always, FSOC sets a measured tone to avoid alarming the markets—it again says that systemic risk is "moderate" even as its in-depth analysis shows several very alarming spikes in possible risk drivers. Some of these—e.g., geopolitical risk—are well outside both FSOC's control and the specific ambit of regulatory action. Others—e.g., yield-chasing, HFT, CCPs—are very much on regulators' radar, and could thus be subject to still more substantive financial and monetary-policy intervention given that FSOC's public report is only a mild version of closed-door discussions. The nation's biggest banks were found to be safer, with FRB Chair Yellen emphasizing this in her remarks at Tuesday's FSOC meeting. Still, we do not anticipate any pull-back in FRB standards, with Ms. Yellen's comments also signaling continuation of its newly-toughened stand on the large-bank resolution plans due on July 1.

Analysis

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

- Cybersecurity: FSOC reiterates concerns loudly voiced in prior reports and by U.S. policy-makers, recommending actions long endorsed by them (e.g., legislation to enhance collaboration and information-sharing). FSOC also pushes for accelerated action on best practices and updated regulatory guidance mapped to NIST standards. More work to supervise third-party vendors is also recommended, with Congress urged to grant this power to the NCUA and FHFA. Response-and-recovery resilience also needs work, FSOC says.

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- Low-Yield Environment: Yield-chasing is cited here, as are efforts by banks, credit unions, and broker-dealers to boost earnings by holding longer-duration assets, easing credit standards, and taking other risks. Pension funds and insurance companies are also taking more risks than FSOC thinks is good for them, although it believes recent banking-agency action on leveraged loans (see FSM Report **LENDING5**) has curtailed some problems in this sector. However, after laying out these concerns and noting how all of them could lead to market illiquidity and collateral fire sales, FSOC suggests no specific actions.
- Market Structure: As noted, FSOC fears that high-frequency and similar trading poses significant market risk, risks accelerated by otherwise-unrelated broker-dealer actions (e.g., reduced holdings of high-quality assets). New trading venues also trouble FSOC, but it does not go beyond the operational-risk worries described recently by global bank supervisors (see Client Report **HFT2**) to recommend any specifics, although the report does note that some intermediaries have operate outside regulatory boundaries and suggests that regulators consider legislation to recommend to Congress that would eliminate this opportunity.
- CCPs: FSOC applauds unspecified regulatory and policy actions recognizing CCP risk. It does, though, urge that current standards for margining, stress-tests, disclosures, and cybersecurity be assessed to ensure they protect market resilience. CCP risks related to credit, liquidity, and default, bank/CCP interaction risk management, recovery and resolution planning require particular attention.
- Geopolitical Risks: These are catalogued (e.g., Greece, China, Ukraine).
- Financial-Activity Migration: Regulators are urged to monitor new products to ensure they do not pose new risks, and to assess non-banks that take on increasingly bank-like activities. Non-bank mortgage servicers are cited here, with recent FHFA action noted but calls made for greater state regulation.
- Short-Term Wholesale Funding: Worries about banks in this arena are lower, as are FSOC's now with respect to tri-party repos. General-collateral financed repos remain a systemic risk.
- SIFI Incentives to Take Risks: FSOC reiterates its strong support for the Dodd-Frank resolution framework.
- Reference-Rate Reform: These are detailed and supported, with progress since 2014 described.
- Housing-Finance Reform: FSOC still wants this. However, now it also wants additional liberalization of representation-and-warrantee requirements, calling on FHFA, HUD, and Treasury to work with the industry to make them still more standardized and, thus, predictable.

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- Data Quality, Collection and Sharing: FSOC also still likes the LEI and pushes for adoption of it as well as action on data-aggregation and similar issues under active consideration by U.S. and global regulators.

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