

MEMO# 31585

January 29, 2019

FSOC 2018 Annual Report to Congress - Recommendations of Interest to the Regulated Fund Industry

[31585]

January 29, 2019 TO: ICI Members
Investment Company Directors

ICI Global Members SUBJECTS: Money Market Funds

Systemic Risk RE: FSOC 2018 Annual Report to Congress - Recommendations of Interest to the Regulated Fund Industry

Late last month, the US Financial Stability Oversight Council (FSOC) issued its 2018 annual report to Congress.[\[1\]](#) As required by Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the FSOC report addresses significant financial market and regulatory developments, provides an assessment of those developments on the stability of the financial system, and identifies potential emerging threats to US financial stability. Section 112 further requires the report to make recommendations to enhance the integrity, efficiency, competitiveness, and stability of US financial markets, to promote market discipline, and to maintain investor confidence. This memorandum briefly describes the contents of the FSOC report and highlights the recommendations that may be of particular interest to members.[\[2\]](#)

Content of the FSOC Report

In structure and in content, the FSOC report is very similar to those issued in 2016 (the last year of the Obama Administration) and 2017 (the first year of the Trump Administration). The executive summary notes that “[o]verall, risks to US financial stability remain moderate, though they have evolved since the last annual report.” This evolution is reflected in the report’s recommendations, which address largely the same issue areas as the 2016 and 2017 reports but with differences in emphasis. For example, the Council’s recommendation regarding asset management products and activities (summarized in the next section of this memorandum) is less detailed and less prominent than in those earlier reports.

Following discussion of FSOC’s recommendations, the report provides an update on financial developments, including with respect to: US Treasuries, sovereign debt markets, corporate credit, household credit, real estate markets, foreign exchange, equities, commodities, wholesale funding markets, derivatives markets, bank holding companies and

depository institutions, nonbank financial companies, investment funds, and new financial products and services. It next reviews regulatory developments and FSOC activity since the 2017 annual report. In a final section entitled Potential Emerging Threats and Vulnerabilities, the report discusses six areas: cybersecurity, ongoing structural vulnerabilities,^[3] managing vulnerabilities amid prolonged credit expansion, changes in financial market structure, asset management products and activities, and global economic and financial developments (including risks associated with Brexit).

Recommendations of Particular Interest to Members

- **Asset Management Products and Activities.** The report states that “[e]nsuring that adequate information is available to evaluate risks in the asset management industry remains a Council focus.” It calls on the SEC to monitor implementation of its rules on liquidity risk management and data reporting and to evaluate the extent to which those rules address potential risks in the asset management industry. The report further recommends that relevant agencies continue to review their data collections and assess whether they are sufficient to allow the Council to monitor whether and how private funds may pose risks to financial stability.
- **Wholesale Funding Markets.** The report notes that progress has been made in reducing counterparty risk in the repo markets but recommends that relevant authorities continue to monitor these markets for any signs of changes in liquidity conditions and any attendant impact on financial stability. With respect to money market funds, the report calls on the SEC to continue to monitor the impact of its October 2016 reforms, in light of the approximately \$1 trillion shift from prime money market funds to government money market funds since the adoption of the reforms. With respect to other types of cash management vehicles, the report recommends that regulators consider whether regulatory gaps exist for such vehicles and evaluate the extent to which additional data would be helpful in monitoring and addressing such gaps.
- **Managing Vulnerabilities amid Prolonged Credit Expansion.** The report notes that nonfinancial corporate debt and leverage have reached elevated levels according to certain metrics, and that there is some indication of elevated valuations in key US financial markets, including equities, real estate and corporate debt. It recommends that agencies monitor these trends and “potential implications for the entities they regulate in order to assess and reinforce their ability to manage severe, simultaneous losses in those markets.” The report then observes that “[a]ssuring that the relevant investors and intermediaries can manage such losses, rather than amplify or transmit them, will reduce the threat to financial stability posed by such a scenario.”
- **Data Quality, Collection, and Sharing.** The report generally recommends that regulators and market participants continue to work together to improve the scope, quality, and accessibility of financial data, as well as data sharing between relevant agencies. It notes that broader adoption of the legal entity identifier (LEI) by financial market participants continues to be a Council priority and recommends that, where appropriate, member agencies move to adopt the use of the LEI in regulatory reporting and other data collections.
- **Regulatory Efficiency and Effectiveness.** The report notes that while the regulatory environment has contributed to improvements in financial stability and the

resiliency of financial institutions since the financial crisis, new regulations also have raised concerns about increased compliance costs and regulatory burdens, especially for smaller institutions. The Council recommends that federal and state regulators continue to work together to evaluate regulatory overlap and duplication, modernize outdated regulations and, where authority exists, tailor regulations based on the size and complexity of financial institutions.

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endnotes

[1] Financial Stability Oversight Council, 2018 Annual Report, *available at* <https://home.treasury.gov/system/files/261/FSOC2018AnnualReport.pdf>.

[2] In addition to the recommendations summarized below, the report makes recommendations in the following areas: cybersecurity; capital, liquidity and resolution; central counterparties; reforms related to reference rates; housing finance reform; managing vulnerabilities amid prolonged credit expansion; changes in financial market structure; and financial innovation.

[3] The report briefly discusses six structural vulnerabilities that were identified in previous FSOC reports: large, complex, interconnected financial institutions; central counterparties; short-term wholesale funding; reliance on reference rates; data gaps and challenges to data quality, collection, and sharing; and financial innovation.