MEMO# 28126

May 15, 2014

FSOC Issues 2014 Annual Report to Congress

[28126]

May 15, 2014

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 21-14
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 36-14
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 10-14
ETF ADVISORY COMMITTEE No. 9-14
EQUITY MARKETS ADVISORY COMMITTEE No. 8-14
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 10-14
MONEY MARKET WORKING GROUP
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 8-14
RISK ADVISORY COMMITTEE No. 3-14
SEC RULES COMMITTEE No. 21-14
UNIT INVESTMENT TRUST COMMITTEE No. 1-14 RE: FSOC ISSUES 2014 ANNUAL REPORT TO CONGRESS

The Financial Stability Oversight Council (FSOC) recently issued its 2014 annual report to Congress. [*] 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 U.S. financial stability. Section 112 further requires the report to make recommendations to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets, to promote market discipline, and to maintain investor confidence. This memorandum briefly describes the contents of the FSOC report and the recommendations that may be of particular interest to ICI members.

Content of the FSOC Report

The FSOC report begins with an executive summary and discussion of the FSOC's recommendations. It then reviews recent macroeconomic developments and provides an update of financial developments. Areas addressed include asset valuations, wholesale funding, bank holding companies and deposit institutions, nonbank financial companies, investment funds (such as money market funds, other mutual funds, and exchange-traded products), and derivatives infrastructures. The report next reviews regulatory developments and FSOC activity since the 2013 annual report. Finally, it discusses potential emerging threats, including (i) risk of reliance upon short-term wholesale funding, (ii) developments in financial products, services, and business practices, (iii) risk-taking incentives of large, complex, interconnected financial institutions, (iv) reliance upon reference rates as a vulnerability, (v) financial system vulnerability to interest rate volatility, (vi) operational risks, (vii) foreign economic and financial developments, and (viii) data gaps and data quality.

Recommendations of Interest to ICI Members

- Money market funds. The report notes that in 2012 the FSOC issued a proposed recommendation that the SEC implement structural reforms "to mitigate the vulnerability of [money market funds] to runs." The report also notes that in 2013 the SEC proposed rules to reform the structure of money market funds "to make them less susceptible to runs." The report then expresses the FSOC's view that "the SEC, by virtue of its institutional expertise and statutory authority, is best positioned to implement reform to address the risk that [money market funds] present to the economy." The report indicates that the FSOC does not expect to issue a final Section 120 recommendation to the SEC "if the SEC moves forward with meaningful structural reforms of [money market funds.]" The report recommends that its member agencies examine the "nature and impact" of any structural reform of money market funds that the SEC implements to determine whether the same or similar reforms are appropriate for other cash-management vehicles. It points out that such an examination "would provide for consistency of regulation while also decreasing the possibility of the movement of assets to vehicles that are susceptible to large-scale runs or otherwise pose a threat to financial stability."
- Tri-party repo market. The report notes progress in addressing the vulnerabilities in the tri-party repo market that were highlighted in the FSOC's 2013 report. Specifically, it states that significant progress has been made in reducing market participants' reliance on intraday credit from clearing banks and that market participants now face "stronger incentives to manage risks prudently." The report indicates, however, that the general collateral finance (GCF) repo activity, which settles on the tri-party repo platform, is still relatively reliant on clearing bank intraday credit to facilitate settlement and that "[i]mproving the resiliency of GCF repo settlement is a key focus of industry reform for 2014." To that end, the FSOC "urges that market participants work to extend improvements in the tri-party repo settlement process to GCF repo settlement as soon as possible." The report also finds that the "risk of fire sales of collateral by creditors of a defaulted broker-dealer, many of whom may themselves be vulnerable to runs in a stress event, remains an important financial stability concern." Although the FSOC recognizes that regulatory reforms implemented since the crisis may help to mitigate the risk of default, it advises all U.S. regulators of firms that rely on this market for funding to assess whether "additional steps may need to be taken to further increase tri-party repo borrowers' protection against funding runs in the broader context of liquidity regulation." The FSOC also "urges coordination between market participants and financial regulators to address the risk of post-default fire sales of assets by tri-party repo investors."
- Transparency of the wholesale funding markets. While acknowledging that some areas of the wholesale funding markets, such as GCF repo and tri-party repo, have become more transparent, the report finds that improvements are necessary in other segments, notably bilateral repo and securities lending. The report recommends that

all FSOC member agencies continue to collaborate with the Office of Financial Research (OFR) to improve transparency in this area of the financial system.

- Reforms relating to reference rates. In the 2013 report, the FSOC recommended international cooperation to develop “high-level principles” for governance, controls, data sufficiency, and oversight of financial benchmarks. It further recommended taking steps to promote an orderly transition to alternative benchmarks. The 2014 report notes that some progress has been made, but that more work is needed to achieve the 2013 recommendations. In the 2014 report, the FSOC recommends that U.S. regulators continue to cooperate with foreign regulators and official sector bodies in their assessment of market practices and benchmarks in the FX markets. The FSOC further recommends U.S. agencies consider applying the IOSCO principles of governance, quality, and accountability for all financial benchmarks to their ongoing assessment of financial benchmarks in the United States. Finally, the FSOC recommends development of a plan to implement a “smooth and orderly transition to any new benchmarks.”

- Cybersecurity. The FSOC report highlights cybersecurity as an area of operational risk deserving close attention. The FSOC recommends that regulators continue to develop the ability to leverage insights to inform oversight of the financial sector and to assist institutions, market utilities, and service providers that may be targeted by cyber incidents. The FSOC further recommends that financial regulators continue their efforts to assess cyber-related vulnerabilities facing their regulated entities and identify gaps in oversight that need to be addressed. The FSOC also recognizes the importance of “removing legal barriers” to information sharing between public and private sector partners “to enhance overall awareness of cyber threats, vulnerabilities, and attacks, including through Congress’ passage of comprehensive cybersecurity legislation.”

- Market infrastructure and market continuity. The report also identifies the risk of malfunctions in the technology of automated markets as an operational risk that “can potentially erode market confidence and affect the strength and resilience of the financial system.” It specifically raises concerns about alternative trading venues and methods that “may present operational and other risks by magnifying system-wide complexity.” The report further finds that these “vulnerabilities may be heightened, particularly in fragmented markets, by high frequency or low latency automated trading activities.” As such, FSOC recommends that regulators should focus not only on centrally-traded products, but also on a broader set of financial products and trading methods that trade off exchanges.

- Data resources and analytics. The FSOC recommends that regulators and market participants continue to work together to improve the quality and comprehensiveness of financial data in the United States as well as globally. Specifically, the FSOC recommends that FSOC members and member agencies promote and establish, where appropriate, the use of legal entity identifiers. The FSOC also recommends that members and member agencies work with international regulators to promote “high standards in derivatives data reporting” and resolve the challenges faced by U.S. authorities in accessing data stored at repositories. The FSOC further recommends that regulators broaden the scope of data with respect to the repo and securities lending markets. Finally, following on the OFR’s study on Asset Management and Financial Stability, the FSOC recommends that member agencies and the OFR discuss additional sources of data for that industry, particularly with respect to the management of separate accounts.

Jane G. Heinrichs
Senior Associate Counsel

endnotes

[*] Financial Stability Oversight Council, 2014 Annual Report, available at http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf.