

MEMO# 34154

May 23, 2022

Highlights from Treasury Secretary Janet Yellen's Testimony on the FSOC Annual Report

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TO: ICI Members

ESG Advisory Group SUBJECTS: ESG

Financial Stability

Money Market Funds RE: Highlights from Treasury Secretary Janet Yellen's Testimony on the FSOC Annual Report

Recently, Treasury Secretary Janet Yellen testified about the Financial Stability Oversight Council (FSOC) 2021 Annual Report before the Senate Banking, Housing, and Urban Affairs Committee (on May 10) and the House Financial Services Committee (on May 12).^[1] Secretary Yellen's written statements^[2] and oral testimony to the two Committees addressed several issues relevant to ICI members,^[3] including non-bank financial intermediaries (NBFI), climate change, stablecoin and digital assets, and Treasury market functioning. Her remarks on these topics are briefly summarized below.

NBFI and Systemically Important Financial Institution (SIFI) Designations

Secretary Yellen's written statements addressed "vulnerabilities in the nonbank financial sector, which were highlighted by the turmoil in financial markets in March 2020." The statements focused on NBFI vulnerabilities stemming from "liquidity mismatch and use of leverage," concluding that these "stresses can be transmitted and amplified to the broader financial system." Secretary Yellen noted that FSOC has taken steps such as re-establishing its Hedge Fund Working Group and supporting the SEC's efforts in proposing reforms for money market funds and considering potential reforms for open-end funds.

During the Senate hearing, Senator Elizabeth Warren (D-MA) asked about the 2019 letter that Yellen co-authored with former policymakers (Federal Reserve Board Chair Ben Bernanke and Treasury Secretaries Timothy Geithner and Jacob Lew), which expressed concerns about the then-proposed FSOC guidance on an activities-based approach to SIFI designations. Secretary Yellen testified that she still agreed with the arguments contained in that letter.^[4]

In response to a question about whether she would reverse FSOC's 2019 guidance prioritizing an activities-based approach to addressing potential financial stability risks from NBFI, Secretary Yellen stated "[w]e're looking at this very carefully and examining what our options are." Secretary Yellen went on to say that

"designation is not the only tool that was given to FSOC to address financial stability risks in the non-bank, financial sector. Activity-based regulations are also relevant. And so, there are two kinds of tools...I would give you money market funds as an example. There is a practice that occurs throughout the financial sector, many firms are involved in it. The risk comes from the activities or structures that many firms have that risk. In situations of that sort of an activity-based approach may be relevant."

Secretary Yellen reiterated FSOC's focus on NBFI, including money market funds and open-end funds.

Climate Change

Secretary Yellen's written statements highlighted FSOC's work "to ensure that financial institutions better understand their climate-related financial risks." She emphasized FSOC's October 2021 Report on Climate-Related Financial Risk,[\[5\]](#) which recommended that regulators build their capacity and expand their efforts to address climate-related risks, improve the availability of data, enhance and standardize disclosures, and assess and mitigate risks to financial stability. She also highlighted FSOC's staff-level Climate-related Financial Risk Committee, which is composed of FSOC members, and Climate-related Financial Risk Advisory Committee, which gathers information and analysis from external stakeholders.

In response to a question from Senator Pat Toomey (R-PA), Secretary Yellen stated that "climate change is an existential threat to—to our globe and to our future...Financial institutions themselves have voluntarily decided that they need to align their portfolios with a framework of net zero by 2050, and that's really in the absence of any requirement that they do so. I do believe that transition risks are very real."

Secretary Yellen also supported the SEC's climate change disclosure proposal,[\[6\]](#) noting in response to a question from Senator Tina Smith (D-MN): "huge investor community asset managers want to be able to understand the risks that they're undertaking when they invest in firms, and without this kind of disclosure of climate related risks[, w]e're not providing the investor community, the information they know [sic] to allocate capital properly." Secretary Yellen also noted that other countries are requiring similar disclosures.

During the House committee hearing, Secretary Yellen similarly noted that potential financial institution climate change disclosure "will allow [a financial institution's] supervisors to form a clearer view of the risks that these institutions are taking and then ensure that they're managing them properly, and it will help the institutions themselves better appreciate the risks that they're undertaking." She also supported climate change scenario analysis for banks.

During the House committee hearing, Representative Andy Barr (R-KY) remarked that "many ESG-related ETFs and investments trade at elevated price to earnings ratios and multiples because investment returns are sacrificed for non-pecuniary factors." He asked whether Secretary Yellen as "evaluating that risk to the financial system." Secretary Yellen responded that "we do look at asset valuations and recognize that significant shifts in them can be a risk to financial stability."

Stablecoin and Digital Assets

Secretary Yellen's written statements stated that "digital assets may pose risks to the financial system, and increased and coordinated regulatory attention is necessary." She referenced the March 2022 Presidential Executive Order recommending a comprehensive approach to digital asset policy and FSOC upcoming draft report discussing financial stability risks and regulatory gaps. She stated her eagerness "to ensure that payment stablecoins and their arrangements are subject to a federal prudential framework on a consistent and comprehensive basis."

Secretary Yellen reiterated the need for "a comprehensive and consistent regulatory approach for stablecoin" in her oral testimony. In response to a question from Senator Toomey, she noted that stablecoin is a "rapidly growing product." Responding to a question from Senator Catherine Cortez Mastro (D-NV), Secretary Yellen noted that there are risks associated with the increased concentration of stablecoins that are issued by firms that already have substantial market power. She believed that stablecoins also had "run risks, which could threaten financial stability risks associated with the payment system and its integrity." In response to a question from Representative Tom Emmer (R-MN), Yellen said it "bears examination" whether digital asset and stablecoin activities should be designated as systemic risks.

Regarding the regulatory approach to stablecoin, Secretary Yellen believed there are significant differences between stablecoin and banking, although she agreed in response to a question from Representative Brad Sherman (D-CA) that the insured depository framework for banks reduced run risk in that industry. However, in response to a question from Representative Ritchie Torres (D-NY), she agreed that "a slightly different [regulatory] model should apply in regulating [stablecoin]."

Treasury Market Functioning

In her written statements, Secretary Yellen noted FSOC's work to support the resilience of the Treasury market and coordination with the Interagency Working Group on Treasury Market Surveillance. She stated that "[p]otential steps to be taken include improving data quality and availability, evaluating expanded central clearing, and enhancing trading venue transparency and oversight." She cited recent SEC proposals on alternative trading systems and the definition of a government securities dealer and the Office of Financial Research's work "to fill identified data gaps for uncleared bilateral repurchase agreements through a pilot data collection, which should improve visibility into a major source of financing for non-bank financial institutions in Treasury markets."

During the House committee hearing, Representative French Hill (R-AR) asked Secretary Yellen whether the current \$1.9 trillion "reverse repurchase agreement balance is a challenge to financial stability as we go through a tightening phase at the Federal Reserve." Secretary Yellen responded that FSOC is "concerned about the functioning of the Treasury market" and is coordinating with the Interagency Working Group to consider reforms to ensure this market "has the liquidity that it needs."

endnotes

[1] The Senate Banking, Housing, and Urban Affairs Committee's hearing page is available at <https://www.banking.senate.gov/hearings/05/03/2022/the-financial-stability-oversight-council-annual-report-to-congress>. The House Financial Services Committee's hearing page is available at <https://financialservices.house.gov/events/eventsingle.aspx?EventID=409377>. The 2021 FSOC Annual Report is available at <https://home.treasury.gov/system/files/261/FSOC2021AnnualReport.pdf> and ICI's memorandum summarizing the report is available at <https://www.ici.org/memo33970>.

[2] Secretary Yellen's written statement to the House committee is available at: <https://financialservices.house.gov/uploadedfiles/hhrg-117-ba00-wstate-yellenj-20220512.pdf>. Her written statement to the Senate Banking Committee written statement is available at: <https://www.banking.senate.gov/imo/media/doc/Yellen%20Testimony%205-10-22.pdf>.

[3] In addition to the below topics, Yellen's testimony also included discussion of inflation, the ongoing coronavirus pandemic, cybersecurity risks, and the Russian invasion of Ukraine.

[4] The letter is available at <https://int.nyt.com/data/documenthelper/887-bernanke-geithner-lew-yellen-letter/a22621b202dfcb0fe06e/optimized/full.pdf>. The letter stated in relevant part "But activity-based approaches cannot address risks that are tied to the funding, leverage, and combination of activities within a corporation."

[5] The FSOC Report on Climate-Related Financial Risk is available at <https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf>. ICI's memorandum summarizing the report is available at <https://www.ici.org/memo33872>.

[6] See ICI Memorandum No. 34086 summarizing the SEC's proposal, available at <https://www.ici.org/memo34086>.