



THE TREASURY DEPARTMENT



5 Priorities for the Financial Stability Oversight Council

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Introduction and summary

The Financial Stability Oversight Council (FSOC) was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to identify and mitigate threats to the stability of the financial system, particularly those that develop outside the traditional banking sector.¹ Although the United States is notable for having many financial regulatory agencies, before the 2008 financial crisis, no one regulator or regulatory body was responsible for looking out across the financial system and addressing systemic risks. Financial regulators focused on their respective jurisdictions, while significant risks built up across jurisdictions and outside of any one regulator's purview. Risky financial activities and products sprouted in the cracks of the financial regulatory infrastructure as regulatory arbitrage, intentionally exploiting its fragmentation. The FSOC was structured to mitigate some of these regulatory design flaws. It is chaired by the secretary of the U.S. Department of the Treasury and brings together the heads of all eight federal financial regulators², and a voting member with insurance expertise, around one table.³ The FSOC's goal is to improve coordination across agencies and tackle emerging financial sector risks and vulnerabilities before they trigger or amplify another financial crisis.

The Obama administration built up the FSOC and worked to execute its vital mission. Former Treasury Secretaries Timothy Geithner and Jack Lew staffed up the council from scratch, convened regulators to address financial sector turmoil, subjected certain nonbank financial companies to stricter regulation and oversight, and identified risky activities in parts of the financial system that warranted further attention.⁴ Unfortunately, the Trump administration took every opportunity to tear down this work. Former Treasury Secretary Steven Mnuchin eroded the FSOC's institutional capabilities, conducted fewer and shorter meetings, and used the council to undermine financial stability and deregulate financial institutions.⁵ It is critical that the Biden administration revitalize the FSOC and aggressively tackle the many important challenges ahead. From emerging issues such as climate change and financial technology to preexisting issues like leveraged hedge funds and short-term funding markets, the FSOC has its work cut out.

A safer and more stable financial system would deliver more robust, equitable, and sustainable growth over the long term for workers and communities across the country. These efforts are particularly important for the economic well-being of communities of color, which are disproportionately harmed by financial crises and have been historically abused by the financial sector. The FSOC must center issues of economic justice and racial equity in its core work. Doing so is not just good policy; it is the law. Dodd-Frank explicitly directed the FSOC, for example, to consider the impact that a nonbank financial company's failure could have on communities of color as well as the potential for risky financial activities to impair the availability of financial services for these communities.⁶

Too many individuals and households were still economically and psychologically scarred from the 2008 financial crisis when the coronavirus pandemic began battering the economy last year. Many of the same fragilities that helped fuel the 2008 financial crisis manifested themselves in financial dislocations in March 2020, prompting the Federal Reserve to intervene in markets in massive ways once again. This recurring pattern highlights the need for a proactive FSOC. It is as important as ever to promote a resilient financial system as the economy starts to recover from the most recent catastrophic shock. While there are many problems that the FSOC will need to address over the next several years, this report outlines five issues that should be top priorities:

1. Restoring budget and staffing at the FSOC and the Office of Financial Research (OFR)
2. Repealing the 2019 systemically important financial institution (SIFI) designation guidance
3. Coordinating efforts to mitigate climate-related financial risks
4. Addressing the long-standing shadow banking fragilities that were resurfaced by the COVID-19 shock
5. Developing and implementing a comprehensive financial data strategy

Restore budget and staffing levels at the FSOC and the OFR

Over his term as treasury secretary, Mnuchin worked with Trump-appointed voting members of the FSOC to erode its institutional capacity. Compared with the budget and staffing levels at the end of the Obama administration, the Trump administration almost immediately slashed the FSOC's budget by more than 25 percent and reduced staffing by almost 60 percent.⁷ The same is true for the OFR, the FSOC's data-driven research arm. The Trump administration cut the office's budget by more than 25 percent and severely reduced staffing.⁸ At the end of 2016, the OFR had 214 employees and plans to expand staff levels to 255.⁹ At the end of September 2020, the OFR had only 107 staffers.¹⁰

When pressed on these staffing and budget cuts before Congress, Secretary Mnuchin said, "Again, we are just trying to save taxpayer dollars."¹¹ This justification was downright misleading and factually incorrect. The budget and staffing cuts did not save the public any money, as both the FSOC and the OFR are funded through fees levied on systemically important financial institutions and not through the congressional appropriations process. Effectively, the Trump administration hollowed out systemic-risk oversight to provide tens of millions of dollars to Wall Street. Weakening the oversight and regulation of the financial system in order to cut a check to large financial firms is a recipe for disaster. Restoring FSOC and OFR budget and staffing levels is essential. As outlined in this report, the agencies have a lot of work to do to promote a more stable financial system. The FSOC and OFR cannot meet these challenges without first rebuilding their institutional capacities.

As quickly as possible, current Treasury Secretary Janet Yellen should work with the voting members of the FSOC and the OFR director to raise the budget and staffing levels to those in place at the end of the Obama administration. The FSOC's fiscal year 2021 budget was approved on September 25, 2020.¹² Ideally, the FSOC would not wait to increase its budget and staffing levels until the FY 2022 budget is set forth in September 2021. The FSOC's priorities are pressing, and its current resources are insufficient. There are certain procedural hurdles, though, that may prevent the FSOC

from moving in a timely manner on this priority.¹³ The FSOC should at least use its full budget allocated for FY 2021 to increase staffing to the greatest extent possible. During Secretary Mnuchin's tenure, the FSOC budget annually called for a slight increase in staff. Those increases never occurred. In FYs 2018, 2019, and 2020, the budget called for the 14-person staff (formerly 36 under the Obama administration) to increase to 18.¹⁴ Each year, however, it remained at 14—with the exception of 2020, when it jumped to 15. The FY 2021 budget would allow for an increase to 21 staff, which would be a start toward rebuilding the office. In addition, the council could lean on detailees from member agencies to plug any gaps in advance of the next budget cycle.

In advance of the FY 2022 budget proposal, Secretary Yellen should conduct a thorough review of the FSOC's internal capacity and consider additional budget and staffing increases over and above the levels that were in place at the end of the Obama administration. The director of the OFR, in consultation with Secretary Yellen, should also increase the OFR's budget and staffing levels as soon as practicable, given the process hurdles mentioned above. Similar to the FSOC's staffing situation under the Trump administration, the OFR's staffing count repeatedly fell significantly below the already-reduced amount set in the annual budgets. Short of restoring the budget to Obama-era levels prior to FY 2022, the director should at least increase staffing from the current 107 to the 145 under the FY 2021 budget.¹⁵ To fulfill these goals, current OFR Director Dino Falaschetti should be replaced with an appointee committed to rebuilding the institution. A Trump appointee, Falaschetti oversaw the erosion and muzzling of the OFR. The fact that his tenure saw the OFR's public research grind to a halt, and the agency's institutional capacity crumble, was not a surprise. In his previous role as chief economist of the U.S. House Committee on Financial Services under Chairman Jeb Hensarling (R-TX), he fought to repeal the OFR.¹⁶

Repeal the 2019 SIFI designation guidance

One of the FSOC's most powerful statutory tools is its authority to designate nonbank financial companies as systemically important financial institutions (SIFI).¹⁷ Once designated as a SIFI, a company is subjected to enhanced prudential regulation and supervision by the Federal Reserve Board. The 2007-2008 financial crisis showed that financial companies outside the regulated banking sector, such as insurance companies and investment banks, could pose systemic risks to the financial system and imperil the broader economy. The Fed's ability to apply heightened safeguards to these designated shadow banks—that would otherwise avoid such oversight—limits the chance that they will fail and improves the resilience of the financial system. Although the FSOC has other key tools and can play an important coordinating role, the authority to expand the prudential regulatory perimeter to large, complex, and interconnected shadow banks is arguably the most important tool in its arsenal. The Trump administration cast this authority aside and sought to restrict future administrations' ability to use it appropriately. The Biden administration should swiftly repeal the hurdles the Trump administration put in place, and the FSOC should once again use this tool to promote a more stable financial system.

During the Obama administration, the FSOC used this authority to designate four nonbank financial firms as systemically important: American International Group Inc. (AIG), Prudential, MetLife, and GE Capital.¹⁸ When President Trump took office, AIG and Prudential were still designated, while MetLife was in the process of contesting its designation in court.¹⁹ The Obama administration de-designated GE Capital after it effectively broke itself up and fundamentally altered its business model.²⁰ The Trump FSOC de-designated the two remaining insurers and dropped the appeal in the MetLife case, reducing the number of designated firms to zero, despite significant evidence that these and other firms posed systemic risk.²¹

The Trump FSOC also sought to tie the hands of future administrations looking to use this important authority. In December 2019, the FSOC finalized changes to its designation guidance that placed significant procedural hurdles on the designation process.²²

First, the guidance required the FSOC to evaluate the likelihood that a financial institution would experience material financial distress before designating the firm as a SIFI. Restricting designations to firms that have a high likelihood of experiencing material distress is operationally and substantively flawed, would exacerbate risks, and runs counter to the statutory requirements laid out in Dodd-Frank for the FSOC. There is no metric or methodology that reliably predicts material financial distress years in advance, which is when enhanced safeguards would need to be implemented to prevent the impact and likelihood of that stress.²³ Moreover, if a designation signaled publicly that stress at a firm was likely, it could spark a run at the firm and do more harm than good.²⁴ In addition, this change was a direct violation of the statutory requirements under Dodd-Frank. The FSOC is required to assume a firm is experiencing material financial distress and evaluate whether such distress could disrupt financial stability.²⁵ If distress at a firm could inflict serious damage on the financial system, the firm should face heightened financial stability safeguards—regardless of the likelihood of that distress.²⁶ Even a Trump-appointed regulator acknowledged that this change to the guidance likely violated the statute before ultimately deciding to vote for it.²⁷

Second, the updated guidance put in place a rigid cost-benefit requirement. That type of requirement was intentionally left out of the designation process in Dodd-Frank.²⁸ As members of Congress who drafted and passed Dodd-Frank noted, “Requiring FSOC to factor into its analysis the possible costs of the regulation on the entity itself would hamstring FSOC’s ability to ensure that there could be adequate Fed regulation of the very systemically important nonbank entities whose insufficient regulation led to the Great Recession.”²⁹ Cost-benefit analyses have historically been wielded by conservative regulators, courts, and industry against prudent regulation. It is easy to quantify the private near-term industry costs of regulation and much more difficult to precisely quantify the social benefits of financial regulation—for example, the economic benefits of averting or limiting the chances of a financial crisis—even though the magnitude of the benefits are often substantial. This dynamic tends to skew traditional cost-benefit calculations against regulations that would impose near-term costs on financial institutions but provide significant long-term benefits to the broader economy.³⁰ It is therefore reasonable to have presumptive standards toward prudent safeguards instead of rigid requirements that force quantification of low-probability and high-cost events.³¹ These additional cost-benefit requirements also needlessly increase the vulnerability of designations to legal challenges.³²

Third, the Trump administration updated the guidance to prioritize activities-based reviews before designations could be initiated. However, the FSOC currently has no authority to directly regulate activities across the financial system, such as the operation

of the multitrillion-dollar repo market. It only has the power, through Section 120 of the Dodd-Frank Act, to make recommendations to a primary regulator, assuming that there is a regulator with authority over the activity in question. Moreover, under the final guidance, it could take more than six years for the council to take the steps outlined in the activities-based approach before proceeding to and finalizing a designation.³³ The effect is to delay the use of existing FSOC authority under the pretext of focusing on problems over which the FSOC has virtually no authority.³⁴

Identifying systemically risky activities is an important function, but it is not a substitute for designations and should not always take precedence over designations. Focusing solely on activities does not fully capture the risks posed by an entity's size, funding profile, interconnections, complexity, and mix of activities.³⁵ Under the updated guidance, not a single company has even been considered under stage one or stage two review of the designation process.³⁶

It is important for the FSOC to undo this harmful guidance and once again pursue designations where appropriate. While the designation authority is not the best solution to every financial stability problem facing the FSOC, the council would be unable to fulfill its critical mission without using it. Given the lessons learned through the 2007-2008 financial crisis—and the bailouts, regulatory forbearance, and other extraordinary government interventions required to keep the shadow banking sector on life support just last March—it strains credulity that there is not a single nonbank financial company that warrants heightened oversight. Industry opposition to designations is fierce, as financial firms do not want to internalize the costs that their systemic footprint places on the financial system and the rest of the economy. The incoming FSOC must fight through the industry backlash in pursuit of its statutory mandate: to mitigate risks to financial stability. Workers, communities, and the economy will be better off for it.

Coordinate efforts to mitigate climate-related risks to the financial system

The FSOC has a central role to play in evaluating, monitoring, and mitigating climate-related risks to the financial system. Climate change is an existential threat to the planet and has implications for almost every sector of the economy, including the financial system. The physical effects of climate change, including extreme weather events and long-term environmental shifts, could significantly impair the value of an array of real and financial assets.³⁷ The increase in frequency and severity of wildfires, floods, hurricanes, droughts, and other weather events will decrease the value of physical property, disrupt supply chains, compress corporate profits, drive up insurance claims and reduce the availability of insurance, and generally limit the ability of affected borrowers to repay debt.³⁸ Climate-driven environmental shifts, such as rising sea-levels, will compound these impacts.³⁹ Ultimately, these economic consequences could trigger losses for financial institutions and investors exposed to related equity, debt, derivative, real estate, and commodity assets as physical shocks materialize or as investor sentiment anticipates such shocks and assets reprice accordingly.⁴⁰

In addition, the financial system is exposed to risks associated with the inevitable transition to a low-carbon economy—a transition that is, in many ways, already underway. If policymakers take legal and regulatory actions to stabilize global temperatures, the value of hydrocarbon reserves will be severely diminished.⁴¹ The value of these assets would be stranded and written down on the balance sheets of fossil fuel companies. These write-downs could materially erode the companies' financial condition and increase the credit and market risk of their financial obligations. If ailing fossil fuel companies are unable to meet their financial obligations, there would be a negative repricing of debt, equity, and derivatives instruments tied to the sector. As a result, banks, insurance companies, and other investors exposed to these assets could face significant losses.⁴² It is important to note that there is some transition risk variance within the fossil fuel sector itself. For example, thermal coal companies face more immediate and acute transition-related risks relative to other energy companies that derive revenues from different fossil fuels, and exposures tied to an expansion of fossil fuel activities face more transition risk than exposures tied to existing fossil fuel reserves and infrastructure.⁴³ Overall, however, financial instruments tied to this sector face the most severe transition-related risks across the economy, given that fossil fuels are the ultimate source of the bulk of greenhouse gas emissions.

Financial instruments tied to other carbon-intensive sectors could face losses as well—including transportation, agriculture, and chemical and industrial material production—although those effects are more nuanced and more difficult to model. The financial system’s failure to adapt to and mitigate these transition risks could lead to what former Bank of England Governor Mark Carney has referred to as a “climate ‘Minsky moment.’”⁴⁴ The bursting of the carbon bubble could send shockwaves throughout the financial system as financial firms abruptly price in transition effects and sell off carbon-intensive assets in fire sales. Technological advancements and market sentiment could also spur these effects in advance of any policy action. The most extreme negative financial sector outcomes would occur under a delayed, then rapid and disorderly transition. The longer policymakers wait to decarbonize the economy, the more likely this type of disorderly transition becomes.

As Federal Reserve Board Governor Lael Brainard has noted, “Climate change could pose important risks to financial stability. That is true for both physical and transition risks.”⁴⁵ Climate change is a systemic threat due to the potential magnitude of the physical and transition-related risks it poses, as well as the wide array of financial institutions and markets exposed to these risks and the speed with which these possibly correlated risks could materialize.⁴⁶ Climate-related shocks could impair the normal functioning of the financial system and inflict damage on the broader economy. A physical or transition shock could cause severe losses at a SIFI or correlated losses across a string of financial institutions, leading to fire sales of impaired assets, creditor runs from distressed institutions, and second-order counterparty losses and contagion at institutions that may not have been directly exposed to the initial shock.⁴⁷ These first- and second-order effects could create vicious feedback loops, undermine confidence in the financial system, and ultimately trigger a credit contraction and a broad increase in the cost of financial intermediation. Commissioner of the U.S. Securities and Exchange Commission (SEC) Allison Herren Lee has cautioned that climate-driven financial stability disruptions “can also spread in ways that are less predictable because climate risk is unique in terms of its scope, breadth, and complexity.”⁴⁸ In a particularly troubling financial stability scenario, a physical shock could trigger a near-simultaneous transition shock. After delaying robust and orderly decarbonization, a brutal string of natural disasters could spur policymakers to take aggressive and disorderly steps to stabilize global temperatures. In short, climate-related shocks could be immediately amplified by and transmitted throughout the financial system, disrupting the normal functioning of the system and leading to spillover effects on the real economy.⁴⁹

Climate-related risks have implications for every part of the financial system and, in turn, every financial regulator. As Federal Deposit Insurance Corporation (FDIC) Board Member Martin Gruenberg, a former voting member of the FSOC, recently argued:

Going forward, all of the federal financial regulatory agencies—the banking agencies and the market regulators—will have to engage proactively with the financial risks of climate change. We must act individually, collaboratively—including with our state counterparts, and on a government-wide basis through the FSOC.⁵⁰

This is the type of cross-cutting risk that the FSOC was designed to address. The FSOC can use its research and coordinating functions to drive better climate-related risk analysis, monitoring tools, and risk-mitigating policies at primary regulators. When necessary, it can also use its powerful statutory tools to directly address certain climate-related risks and push primary regulators to act.

As a start, the FSOC should embed a focus on climate change and climate-related capabilities into its operating structure. Chartering a Climate Risk Committee to handle the portfolio of ongoing climate-related work would be a good initial step toward this end. Relatedly, the FSOC should work with the director of the OFR to establish a Division of Climate Risk Analysis. The OFR should spearhead the FSOC’s data collection, analysis, and research priorities on climate-related financial risks, working with member agencies on their needs. Secretary Yellen has already committed to establishing a climate hub in the Treasury Department that would be led by a senior department official.⁵¹ These recommendations would complement that important commitment.

FSOC member agencies should then make it an early priority to coordinate on the development of agency-specific commitments to integrate climate-related risks into their respective core functions. These clear and actionable goals could be developed after consultation with the public through an agency request for information and announced in advance of the U.N. Climate Change Conference (COP26) in November 2021, which features a robust private finance agenda.⁵²

Over the long term, the FSOC should use its statutory authorities to address any identified gaps with respect to climate-related financial risks. The FSOC’s Section 120 authority to issue nonbinding recommendations to primary regulators could help pressure regulators to act where they have the existing authority to do so. Primary regulators have substantial authority to use disclosure requirements, stress testing, capital frameworks,

supervision, fiduciary obligations, and more to mitigate climate-related risks and align the financial system with the low-carbon transition. These tools have the power to improve the resilience of the financial system to climate-related shocks and to facilitate the decarbonization of the economy. The FSOC should stand ready to push unwilling regulators to act, or go further, when necessary.

Furthermore, the FSOC should integrate climate-related risk as a factor into its designation guidance.⁵³ There are currently two statutory standards under which a nonbank financial company can be designated as systemically important. If a firm's material financial distress could destabilize the financial system, it can be designated under the first standard. That standard is agnostic to the cause of the material distress, so there is not an obvious climate-related intersection. Under the second standard, designation can occur if "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of the nonbank financial company could threaten financial stability.⁵⁴ Under this standard, therefore, the FSOC could evaluate a firm's contribution to climate-related financial risks through its carbon-financing activities. Financing high-emission activities intensifies climate change and increases physical and transition risk-related losses for financial institutions and the economy in the future, exacerbating systemic risk. It is unlikely that the FSOC would designate any firm solely based on climate-related risk considerations, but the council could reasonably add these considerations to the calculus under the second standard.

Separately, the Federal Reserve should apply robust climate-related prudential regulation to nonbank financial companies that are designated as systemically important under either standard, regardless of whether climate considerations are factored into the decision to designate them. Depending on the former primary regulator of the designated company, it may or may not have faced climate-related financial regulation previously. As the new primary prudential regulator, the Fed is responsible for bolstering the resilience of designated nonbank financial companies, and it is important that these systemic firms can weather climate-related shocks, among other risks.

It is also critical that the FSOC approach this issue through an equity lens. The mitigation of climate risks is an important economic and environmental justice issue. Communities of color have been disproportionately harmed by both the climate crisis and financial crises. Agricultural communities have been and are likely to be severely affected as well, and many of them are also communities of color that have suffered repeated injustices.⁵⁵ A climate-driven financial crisis would be catastrophic for many of these communities. As previously mentioned, Dodd-Frank specifically charges the FSOC with evaluating the potential risks that systemic entities and activities pose to the provision of financial services in these communities.

Climate-related financial risks could destabilize the financial system, unless financial regulators across the board act to mitigate these risks. The FSOC is well positioned to lead and coordinate this effort, and it should be a key priority. As Sheila Bair, former chair of the FDIC and a former FSOC voting member, recently stated:

It is naive to think that somehow the financial system will remain immune to the inevitable economic losses that will ensue if there are no forceful efforts to identify and prevent them. With climate change, the worst is yet to come. The time to act is now.⁵⁶

Address the long-standing shadow banking fragilities resurfaced by COVID-19

Major segments of the nonbank financial system were destabilized in March 2020, as the economic implications of the COVID-19 pandemic reverberated throughout financial markets worldwide. The significant stress in this part of the financial system required extraordinary levels of liquidity support from the Federal Reserve and forbearance from financial regulators to avoid a financial crisis. Many of the intermediaries and markets that required a public rescue had long-standing fragilities that were well known to policymakers. They include shadow banking participants such as money market mutual funds (MMMFs), mortgage real estate investment trusts, hedge funds, and other actors that rely on short-term funds to finance longer-term assets without the prudential regulation that such operations merit.

In some cases, these same fragilities helped fuel the 2008 financial crisis following the subprime mortgage market shock. Both 2008 and March 2020 saw elements of a run on shadow banks. The FSOC should play a leading role in designing and implementing policies that would improve the resilience of the shadow banking sector. If this fragility is left unaddressed, policymakers will again be forced to bail out the shadow banking system in the face of a devastating financial crisis. Shadow banks and their investors will continue to benefit from higher returns in positive economic times, while the public foots the bill in times of stress. Even the Fed’s Vice Chair for Supervision Randal Quarles—a Trump appointee who has advanced a robust deregulatory agenda over the past several years—stated a few months after the Fed’s pandemic-related interventions that “[w]hile extraordinary central bank interventions calmed capital markets ... such measures should not be required.”⁵⁷

As the severity of the pandemic and its potential impact on the global economy became clear in late February and early March, financial markets started to price in this reality. At first, equity prices declined sharply, and corporate credit spreads for higher-yield bonds started to tick up.⁵⁸ Yields on safe assets such as Treasuries and certain highly rated corporate debt declined as investors de-risked.⁵⁹ In mid-March, however, this typical de-risking turned into what the Financial Stability Board (FSB) has dubbed a “dash for cash.”⁶⁰

Investors began to broadly sell off financial instruments, including safe assets, to increase their cash holdings. This de-risking and dash for cash placed severe strains on portions of the nonbank financial system, which in turn amplified this stress and necessitated government assistance to prevent a severe financial crisis.⁶¹

MMMFs played a key role in transmitting stress throughout the shadow banking system during this period. These open-end funds engage in maturity and liquidity transformation by offering immediate redemptions to investors while investing in less liquid assets such as reverse repurchase agreements and commercial paper, which are forms of secured and unsecured lending for businesses and financial companies. In March 2020, investors redeemed shares in MMMFs invested in commercial paper, reverse repo, and municipal debt because they wanted cash or exposure to less-risky government MMMFs.⁶² The run on these MMMFs required the funds to start selling off illiquid assets at fire-sale prices to meet the redemptions. These outflows created feedback loops as others pulled funds when MMMF asset values continued to decline and for fear of the imposition of redemption gates and fees.⁶³ In turn, there was a substantially reduced supply of liquidity to repo and commercial paper markets as MMMFs pulled out—exacerbating stress in those short-term funding markets.⁶⁴

Investors in open-end taxable bond funds similarly increased redemptions, causing funds to sell off assets to meet redemptions.⁶⁵ These fund outflows likely contributed to stress in both the Treasury market—the first assets sold to raise cash to meet redemptions—and corporate debt markets. Fixed-income exchange-traded fund (ETF) share prices, which are actively traded on exchanges, also deteriorated significantly.⁶⁶ The sell-off in shares did lead to selling in the underlying bonds even though the sellers of ETF shares were not directly redeeming shares with the fund (as is the case for open-end funds).⁶⁷ In fact, fixed-income ETF outflows were “similar or larger during the stress” compared with open-end funds relative to assets under management, according to the FSB’s holistic review.⁶⁸

As mentioned above, the Treasury market—the most liquid and reliable market in the world—suffered bouts of instability during this stress. Part of the broad selling pressure in Treasury securities came from highly leveraged hedge funds.⁶⁹ In recent years, relative value arbitrage funds have commonly engaged in a trading strategy known as a basis trade, taking advantage of a historical difference in pricing between Treasuries and Treasury futures. A typical transaction consists of hedge funds selling Treasury futures (taking a short position), while purchasing Treasuries in the cash market. The cash Treasuries are financed using a significant level of borrowed funds in the repo market to turn razor-thin trading margins into sizable profits.

As of February 2020, hedge funds' gross notional exposure to Treasuries was \$2.3 trillion—a \$1 trillion increase from two years prior.⁷⁰ The cash Treasuries holdings were funded by \$1.5 trillion in repo borrowing.⁷¹ The dash for cash in early March 2020 disrupted the historical relationship between Treasuries and Treasury futures that hedge funds were seeking to arbitrage.⁷² As their trades went south, hedge funds faced increased repo haircuts (demands for more collateral), difficulty rolling over repos, and margin calls.⁷³ These funding difficulties caused them to unwind their trades in a disorderly fashion, decreasing their Treasury exposures by \$400 billion during March.⁷⁴ Financial intermediaries and end investors could not absorb the broad selling pressures from hedge funds, foreign holders of Treasuries, and other asset managers in an orderly fashion, driving major volatility.⁷⁵

Nonbank mortgage companies also experienced severe distress due to the COVID-19 shock.⁷⁶ Mortgage forbearance programs allowed households to halt monthly mortgage payments.⁷⁷ Yet nonbank mortgage companies, which constitute a significant portion of the mortgage servicing market, were still contractually required to make several months of payments to investors in certain mortgage-backed securities that held these mortgages.⁷⁸ Nonbank mortgage servicers have limited liquidity resources and are not prudentially regulated at the federal level. The need to continue to make payments to mortgage-backed securities (MBS) investors while payments were not being collected from homeowners put a severe strain on these companies.⁷⁹ Moreover, the value of their mortgage servicing rights was at risk and threatened their limited capital resources.⁸⁰ Mortgage real estate investment trusts (mREITs) also contributed to stress in the MBS market. These firms employ significant leverage and rely heavily on short-term funding, particularly repo markets. In February and early March of last year, they faced margin calls and funding pressures, leading to forced deleveraging. As the FSOC's 2020 annual report noted, "The substantial forced selling and rapid deleveraging intensified stresses in the agency RMBS market and contributed to a further widening of spreads, creating a feedback loop between spread widening and forced deleveraging of mREITs' portfolios."⁸¹

In late March, the shadow banking sector was teetering. Runs, fire sales, and failures in the nonbank financial sector would have led to severe contraction in credit and financial intermediation for businesses and households. The crisis would have eventually spread to banks and insurance companies, which are significantly intertwined with the shadow banking system, causing a full-blown financial crisis. To prevent the looming economic damage, the Federal Reserve stepped in to prop up the shadow banking sector and corporate debt markets more broadly. The Fed effectively backed the repo market by offering \$1.5 trillion in repo funding capacity in March and announcing that it stood ready

to support the market as needed.⁸² The Fed also significantly increased its purchases of Treasuries and agency MBS to stabilize the market and relieve the dislocations sparked by the broad selling pressures.⁸³ In addition, the Fed used its authority under Section 13(3) of the Federal Reserve Act, in coordination with the Treasury Department, to establish a range of emergency lending facilities for financial and nonfinancial actors, including facilities for the commercial paper market, MMMFs, and corporate credit markets.⁸⁴ Moreover, regulators issued a series of interim final rules to provide regulatory forbearance to financial institutions during the stress in the financial system.⁸⁵ Notably, the Federal Housing Finance Agency placed a four-month cap on payments that nonbank mortgage servicers must advance to MBS holders for loans in forbearance—loans on which payments are not currently being made.⁸⁶ The shadow banking system, along with banks and insurance companies, also indirectly benefited significantly from Congress' large-scale fiscal support, and the finances of nonbank mortgage companies were aided by an unprecedented increase in refinancing activity.

The need to effectively backstop and bail out large segments of the financial system every 12 years is not tenable. In positive economic times, shadow banks and their investors pocket the higher profits that flow from a reliance on cheaper—and highly fragile—short-term funding. During periods of stress, the public picks up the tab. The current system fuels moral hazard, causes inflated asset prices and a misallocation of capital, and amplifies shocks that threaten the broader financial system and real economy. Policymakers should not continue to subsidize these vulnerable structures; instead, they should require these entities to internalize the systemic costs they are placing on the financial system.

Most of these issues stem from the fundamental vulnerabilities created by liquidity transformation and leverage outside the regulated banking sector. These shadow banking institutions and markets do not have explicit access to standing Fed liquidity support or deposit insurance and do not face prudential safeguards. Many of these vulnerabilities played out during the 2008 financial crisis or had been identified in the years since: MMMFs, repo, and commercial paper markets, for example, were core vulnerabilities that exacerbated the 2008 financial crisis.⁸⁷ Policymakers and academics have warned about capital and liquidity issues at nonbank mortgage companies for years.⁸⁸ The FSOC's 2014–2016 asset management inquiry warned about liquidity transformation at open-end mutual funds, particularly fixed-income (bond) funds.⁸⁹ The FSOC's 2016 hedge fund working group—later disbanded by the Trump administration—presciently warned about increasing leverage among large macro and relative-value hedge funds.⁹⁰ The fragilities exposed by the COVID-19 shock should not come as a surprise.

Efforts to improve the resilience of this portion of the financial system, including the SEC's 2014 MMMF reforms and regulators' narrow repo market reforms, have clearly fallen short and warrant the FSOC's careful attention going forward.

The FSOC should conduct a thorough review of the COVID-19-related turmoil and issue recommendations to improve the resiliency of the shadow banking sector, including recommendations for primary regulators and Congress, as well as council-specific action.

Policies that should be considered in the FSOC review include structural reforms for MMMFs⁹¹; redemption delays for illiquid open-end mutual funds and tools to reduce first-mover advantage⁹²; central clearing and minimum haircut requirements for wholesale funding markets⁹³; central clearing and all-to-all trading in Treasury markets⁹⁴; SIFI designations to expand the prudential regulatory perimeter for certain large and complex shadow banks; expanded regulatory authority over systemically risky activities⁹⁵; and statutory changes that directly target liquidity transformation outside the banking system.⁹⁶

Moreover, the FSOC should continue to monitor events in the nonbank financial system and expand this review as appropriate. For example, the recent volatility among certain stocks raises questions about the resiliency of broker-dealers, the gamification of retail trading, and the role of social media during periods of volatility, as well as hedge fund-related trading activities, the current T+2 settlement cycle, and more.⁹⁷ As some of these questions may have implications for financial stability, the FSOC should evaluate them accordingly.

Develop and execute a comprehensive financial data strategy with the OFR

Regulators need access to granular data on financial institutions' balance sheets, financial contracts, service providers, and counterparties in order to appropriately identify, evaluate, and mitigate threats to financial stability. One of the many financial stability-related issues highlighted by the 2008 financial crisis was the opacity and lack of regulatory understanding regarding certain financial products, activities, and interconnections in some corners of the financial system. For example, regulators did not have data on the market for over-the-counter derivatives, which allowed significant levels of leverage and interconnectedness to build up outside of regulators' view.⁹⁸ The OFR was created in the wake of the crisis as the FSOC's data-driven research arm to improve regulators'—and the public's—understanding of financial sector risks. It was designed as an early warning system for future financial shocks and vulnerabilities. Sen. Jack Reed (D-RI), the sponsor of the Dodd-Frank provision that established the OFR, emphasized the role of the agency in his floor speech introducing the bill: “[A]ny new regulatory structure will be ineffective unless we also equip it with a strong, independent, and well-funded data, research, and analytic capacity to fulfill its mission.”⁹⁹ Regulators could not be expected to successfully improve the resiliency of the financial system, or improve market discipline, without the data and transparency necessary to spot risks and design policy interventions. Accordingly, the OFR has a mandate to collect and standardize financial data, facilitate data-sharing across agencies, perform research, develop risk measuring and monitoring tools, and support the overall financial stability mission of the FSOC.¹⁰⁰

Dodd-Frank gave the OFR the authority to collect and standardize financial data as appropriate in order to execute its mission.¹⁰¹ Importantly, the agency has the authority to issue subpoenas to financial institutions to compel the production of data if the institution does not voluntarily provide it and if its primary regulator does not already collect the data. These tools are powerful and provide the OFR all the firepower it needs to close any and all financial regulatory data gaps. Yet while the agency has made some progress over its first 10 years, it has a long way to go to fulfill the vision laid out during the drafting of Dodd-Frank.

The FSOC, in coordination with member agencies, should work with the OFR director to develop a comprehensive financial data strategy.¹⁰² This strategy should identify clear data gaps and outline an actionable plan to close such gaps in a timely manner. There are several areas where regulators, including the OFR, have identified data gaps, but they have so far failed to address them sufficiently. Three areas that should be at the top of the list include:

1. **Repurchase agreements and securities lending:** Short-term wholesale funding markets played a significant role in the 2008 crisis. Banks and nonbank financial companies alike relied heavily on the repo market for funding, leaving them vulnerable to runs and damaging fire sales when creditors pulled those short-term loans. Similarly, securities lending caused fire sales and severe losses at firms, including at AIG.¹⁰³ Borrowers questioning the viability of lenders returned securities and demanded their cash collateral, which had often been reinvested in speculative securities. Regulators had very little data on these markets in the run-up to the 2008 crisis. As discussed earlier, repo markets again displayed fragility in March 2020.

The OFR identified these markets as clear data gaps that should be addressed in 2012.¹⁰⁴ After two pilot programs, an FSOC annual report recommendation to collect this data, and an official data collection rule-making, regulators are still in the dark with respect to a significant segment of the repo market and the securities lending market.¹⁰⁵

2. **Structured financial products:** The most complex segments of the financial system tend to be the opaquest and where risk is likely to build up in the shadows. The OFR should carefully analyze the available data on derivatives, securitized products, and other complex financial instruments to identify and rectify any gaps. The focus on leveraged lending and collateralized loan obligations over the past several years provides a useful example. The increase in the size of this market in the late 2010s raised significant questions regarding regulatory data on the structure, terms, and ultimate bearers of the risk of these products.¹⁰⁶ The OFR should also examine whether the data already collected on derivatives markets, including through swap data repositories, are sufficient in scope, granularity, and standardization.

3. **Private funds:** After several years of growing leverage concentrated at the largest hedge funds, the FSOC Hedge Fund Working Group made five data-related recommendations in 2016 that would help policymakers better evaluate the financial stability risks posed by highly leveraged funds.¹⁰⁷ The recommendations included improved swap data standardization, more granular data on hedge fund

exposures, more information on hedge funds' funding risks, closing the previously mentioned uncleared bilateral repo data gap, and more data on hedge fund margin and unencumbered cash available to meet potential margin calls.¹⁰⁸ In addition, the OFR should evaluate data collected on private equity fund activities. Private equity firms tend to use minimal leverage and derivatives at the fund level and do not typically rely on unstable sources of funding. But their activities create significant leverage for the financial and nonfinancial firms they control and build credit risk throughout the financial system.¹⁰⁹ The potential risks created by these activities are worthy of closer examination.

In addition to these preexisting areas of concern, the financial data strategy should be forward-looking and identify emerging data gaps such as:

- **Climate risk:** Climate change poses serious risks to the stability of the financial system. While data and research have improved on climate-related financial risks, more needs to be done to map the financial system's exposure to various physical and transition-related risks. It is clear that regulators will need much better data on climate-related risks for institutions and markets under their jurisdiction. The OFR can help coordinate these efforts across regulators and address any financial stability-related gaps as appropriate. Moreover, the OFR could facilitate financial regulators' access to government datasets and analysis at other nonfinancial agencies such as the Environmental Protection Agency and the National Oceanic and Atmospheric Administration.
- **Fintech:** The emergence of new technologies in the financial system and the development of novel financial products, processes, and entities create both opportunities and risks. The OFR should examine whether regulators need more granular data on a range of fintech-related issues, including cloud service provider interconnections, correlated exposures created by common algorithms utilized or offered by fintech companies, vulnerabilities in digital asset markets (such as Bitcoin and stable coins), and more.¹¹⁰ In addition to collecting data, the OFR must increase its own capabilities to understand, evaluate, and react to these technological developments.¹¹¹

The financial data strategy should be reviewed regularly by the OFR director, FSOC chair, and member agencies to ensure that it is being executed in a timely manner and is responsive to the changing needs of financial regulators. It is important to note that the OFR director must be willing to use the agency's subpoena authority to execute the financial data strategy when necessary. Noncooperation from financial institutions

is not an acceptable excuse for leaving regulators in the dark about the information necessary to effectively promote the stability of the financial system. Developing and executing a comprehensive financial data strategy is a necessary, but insufficient, step for the OFR to take in order to live up to its statutory mission. The agency must couple data collection, standardization, and sharing across regulators with robust and intentional research. The OFR must work with the FSOC and member agencies to analyze financial data and perform research with an eye toward developing and refining risk monitoring tools, as well as directly informing the design of policies to reduce identified vulnerabilities.

Conclusion

The creation of the Financial Stability Oversight Council was one of the most important elements of the U.S. response to the 2008 financial crisis. Before the crisis, no regulator was responsible for looking at risks as they built up across the financial system. Risks that emerged in the cracks of the financial regulatory architecture amplified the crisis and inflicted severe harm on businesses and households throughout the economy. The Obama administration stood up the FSOC and began its important work to mitigate the chances and severity of another financial crisis. The administration understood that vigilance was key and that a lack of sufficient systemic risk oversight could be extremely costly. The Trump administration, however, worked tirelessly to undo this vital progress. The FSOC's and OFR's budgets and staffing were slashed; large and complex non-bank financial companies were deregulated; the OFR was muzzled; and the council's critical tools were shelved. This backsliding left the economy overly exposed to old and new financial sector risks alike. Beginning in March 2020, the COVID-19 shock again demonstrated core vulnerabilities in the shadow banking sector and reemphasized the FSOC's important role in ensuring that the U.S. financial system is resilient to shocks.

A properly functioning FSOC and OFR are more important now than ever. Secretary Yellen and President Biden's financial regulatory appointees have a tall task ahead of them. The council must address both preexisting financial stability risks and new emerging threats. From short-term funding markets and nonbank mortgage companies to climate change and hedge funds, the challenges are wide-ranging. But it is critical for the FSOC and OFR to meet the moment. This report covers only five such priorities, while indirectly mentioning several others such as potential risks posed by private equity and fintech. There are undoubtedly many other important issues for the FSOC to address, including cybersecurity, the resiliency of central counterparties, the transition away from the London Inter-Bank Offered Rate¹¹², the impact of low-interest rates on financial sector risk-taking¹¹³, and more.

The financial system and broader economy have been battered twice in the past 12 years, and small businesses, workers, and communities—especially communities of color—have suffered the consequences. In order to build an equitable and sustainable economy, the financial system must be resilient and positioned to support long-term growth. A vigorous FSOC that aggressively seeks to achieve its statutory mission can go a long way toward creating such a financial system.

About the author

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Before joining American Progress in 2016, Gelzinis completed a graduate school fellowship at the U.S. Department of the Treasury in the Office of Financial Institutions. During his undergraduate career, he held internships at Swiss Re, the Federal Home Loan Bank of Atlanta, and in the office of Sen. Jack Reed (D-RI). Gelzinis graduated summa cum laude from Georgetown University, where he received a bachelor's degree in government and a master's degree in American government, and was elected to the Phi Beta Kappa Society. He is a Massachusetts native and a die-hard Boston sports fan.

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And we believe an effective government can earn the trust of the American people, champion the common good over narrow self-interest, and harness the strength of our diversity.

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