# 2 Executive Summary

In the nearly five years since the initial strains of the subprime crisis emerged, the U.S. financial system has traveled from the brink of collapse in late 2008 and early 2009 to a more resilient system with stronger capital, more liquidity, improved funding, and important progress on reform. Even with that progress, however, the Financial Stability Oversight Council (Council) believes that the financial system in the United States and globally still faces significant challenges. Investor confidence has not been restored to pre-crisis levels. The crisis in the euro area and general weakness in global economic growth present identifiable threats to financial stability. There is still work to be done to address structural vulnerabilities within the financial system itself.

A key feature of the current environment is the stress in the euro area, which has disrupted sovereign debt markets and put considerable pressure on euro area banks. European leaders recognize the need to address near-term strains and are continuing to elaborate a path toward greater fiscal and financial union that would garner both political and market support. Because the combined economies of the euro area constitute the second largest economy in the world and are home to many of the world's largest and most interconnected financial institutions, problems in Europe could have very real consequences for financial stability in the United States.

The potential threats from the crisis in Europe and continued economic weakness in the United States and globally underscore the need for regulators to continue strengthening the financial system and addressing structural vulnerabilities. Such reforms are essential to ensure that financial markets continue to serve the real economy even during periods of stress. Reducing amplification mechanisms and strengthening shock-absorbing capacity make the financial system more resilient, whether shocks originate from inside or outside the system. This increased resilience in turn can reduce, though not eliminate, the impact these shocks deliver to economic activity and employment. More broadly, a sound financial system is a necessary foundation for sustained growth.

Both our financial health and our reform efforts are inextricably linked to the rest of the world. The very complexity of the global financial system makes designing and implementing effective reforms an inherently challenging process that at times moves more slowly than would be the case if we acted alone. International coordination is necessary, however, as there are key areas where the effectiveness of the U.S. reforms will depend on a level playing field with strong and consistent regulatory regimes internationally.

## Macroeconomic Environment

Three years after the end of the deepest and longest recession since the Great Depression, the U.S. economy is expanding at a moderate pace, but growth has not accelerated to the rate required to make rapid progress replacing lost jobs

and meeting the employment needs of a growing workforce. Consequently, while unemployment has trended down, it remains at unacceptably high levels.

Investment spending in the first half of 2012 appears to be growing at a restrained pace, likely reflecting continued subdued confidence and elevated uncertainty. Corporate balance sheets are generally strong, and large businesses have access to ample financing in the capital markets. Smaller businesses, in contrast, continue to face a more challenging operating environment that has constrained their recovery.

Consumption continues to expand, but U.S. households still see only modest growth in income. Housing remains a drag on household balance sheets and weighs on broader economic activity, as housing wealth has declined by 50 percent or $6.8 trillion from its peak in 2006:Q1 to 2012:Q1. Aggregate household debt is declining gradually, but remains well above historical levels as a percentage of GDP. Access to mortgage credit is still constrained for many households, limiting the extent to which they can benefit from low interest rates. Overall, the mortgage market remains dependent on the Federal Housing Administration and the government-sponsored enterprises (GSEs). Housing activity remains weak, but there are some positive signs emerging in recent data.

Fiscal policy is no longer providing support to growth as it did in 2009-2010, and the federal deficit is declining as a share of GDP. In addition, states and localities are a drag on demand and employment as they struggle to repair their finances. However, the U.S. government has benefited from very low interest costs, a factor that will reverse over time as monetary policy normalizes.

In the long run, U.S. budgetary trends are unsustainable and must be addressed in a manner that is consistent with supporting the ongoing recovery. The aging of the population and the rising costs for health care will add to long-term deficits. States and localities remain challenged by unfunded pension obligations.

Abroad, growth in Europe has slowed sharply as GDP has declined in a number of nations. Growth in most emerging market economies (EMEs) remains high relative to the industrialized world, but has been slower of late, with more variation in performance. EMEs, particularly China, have taken an increasingly important role in the global economy. However, dependence on export and investment-led growth leaves many of these economies exposed to weaker prospects in the developed world. Weak global growth limits the self-healing capacity of financial institutions and can put stress on parts of the financial system.

### Financial Developments

Market volatility increased sharply in the summer and fall of 2011 around the U.S. debt ceiling debate, and intensified at the end of 2011 and in the spring and early summer of 2012 amid concern over Europe. The debt limit debate and questions about the political will to resolve U.S. fiscal challenges led Standard and Poor's to downgrade the long-term sovereign credit rating of the United States from AAA to AA+ in August 2011. However, demand for U.S. sovereign debt remains strong. As sovereign bond yields in the euro area periphery

increased, sovereign yields in the United States, Japan, the United Kingdom and Germany declined further and are now at historically low levels. These low yields reflect both safe-haven inflows as well as expectations that global economic weakness may warrant prolonged monetary policy accommodation. Extraordinarily low interest rates provide essential support to growth and jobs, but this low-growth, low-rate environment represents a challenge for life insurers, pension funds, money market funds (MMFs), and some banks and credit unions, which invest the savings of many Americans.

Financial stress in Europe and consequent spillovers to the United States has been mitigated to some degree by the aggressive provision of liquidity within the euro area. In the initial stages of the crisis, the European Central Bank (ECB) purchased peripheral sovereign debt directly. U.S. dollar swap lines were extended and their fees reduced, and the ECB conducted two large longer-term refinancing operations and authorized further financing under the Emergency Liquidity Assistance process for banks in the hardest-hit countries.

U.S. financial institutions have strengthened their balance sheets by augmenting their capital levels and by accumulating more liquid assets. They also have more stable funding profiles than in recent years, with greater use of deposits and less reliance on short-term wholesale funding. The number of bank failures has been decreasing since 2010, and the FDIC's list of problem banks is shrinking.

Within the euro area, a number of banking systems remain under stress. Recently, the Spanish government announced plans to strengthen its bank recapitalization fund with EU support. In late June 2012, euro area heads of government proposed to allow the European Stability Mechanism (ESM) to recapitalize banks directly, rather than through national governments, and to establish a single European banking supervisor. At a subsequent meeting on July 9, euro area finance ministers welcomed the European Commission's intention to present proposals in early September for a single supervisory mechanism involving the ECB, with the European Council expected to consider these proposals by the end of 2012.

Meanwhile, European financial institutions are reducing their share of lending activity—including sovereign debt purchases—in other euro area states. Cross-border financing of current account deficits by private sector financial institutions in core Europe has declined. Official sector funding, notably in the form of ECB loans to banks in peripheral Europe, is making up for this decline.

Periods of risk aversion in short-term funding markets, particularly in the fall of 2011, have only reinforced the need to promptly address sources of vulnerability in these markets, such as weaknesses in the tri-party repo infrastructure and among money market funds. Over the past year, the U.S. tri-party repo market continued to shift away from non-traditional, riskier collateral towards Treasury and agency obligations. However, limited progress has been made in substantially reducing the reliance of this market on intraday credit or improving risk-management and collateral practices to avoid fire sales in the event of a large dealer default. Money market funds continue to maintain short weighted average

maturities and have shifted their portfolio composition more toward government debt and repurchase agreements, although they retain some exposure to riskier assets. As highlighted last year, money market funds remain susceptible to destabilizing runs because the commitment to a stable net asset value, without the requisite buffers to absorb losses, gives investors, particularly institutional investors, an incentive to be the first movers in redeeming shares.

Meanwhile, advances in technology continue to transform the business of trading, providing financial markets with enhanced speed and efficiency while potentially enabling increased transparency. The market infrastructure has generally functioned well over the past year. Still, the trend towards high-speed algorithmic trading, and the resulting increases in market complexity, may create vulnerabilities like those witnessed in the "flash crash" of 2010.

### Dodd-Frank Implementation and Activities of the Financial Stability Oversight Council

Over the past year, financial regulators have focused on strengthening the financial system against potential threats and eliminating incentives to take excessive risk. These efforts are most notable in steps to implement the Dodd-Frank Act. The financial reforms in the Dodd-Frank Act are designed to create a more resilient financial system that is better able to absorb a wide range of shocks, whether they originate within the financial system (as with the subprime crisis of 2007), outside it (for instance in the event of an oil price shock), or a combination of the two (as is the case with the problems in the euro area). Regulators are making progress in implementing the Dodd-Frank Act in a consistent and coordinated manner. The reform effort has proceeded along four broad dimensions: strengthening the safety and soundness of core financial institutions; making financial markets more resilient and transparent; implementing new authorities to resolve large, complex financial institutions; and enhancing investor and consumer protections.

As a result of this effort, federal banking regulators have imposed tougher standards on the largest, most complex financial institutions. The Federal Reserve has proposed enhanced prudential standards for large bank holding companies—standards that will also apply to nonbank financial companies designated by the Council for Federal Reserve supervision. Through the Comprehensive Capital Analysis and Review (CCAR) process, it evaluated bank holding companies' capital planning processes to ensure that they would remain well capitalized in a stressed economic scenario. In addition, the Federal Reserve, FDIC, OCC, SEC, and CFTC proposed substantively identical proposals to implement the Volcker Rule, which prohibits banks from engaging in proprietary trading, and (subject to certain exemptions) from owning, sponsoring, or having certain relationships with, a hedge fund or private equity fund. In June 2012, federal banking regulators finalized changes to the market risk capital rule to better reflect the risks faced by an institution and to help ensure the adequacy of capital related to an institution's trading positions. Concurrently, they invited comment on three joint proposed rules to implement Basel III and the Dodd-Frank Act that will increase the amount of high-quality capital banks are required to hold relative to their risk exposures.

Regulators led by the FDIC have also taken important steps to build a framework under the "orderly liquidation authority" (OLA) that could be used to resolve a large failing financial company in cases where normal bankruptcy would have serious adverse effects on financial stability in the United States. The purpose of OLA is to ensure that in the event of a big financial company's failure the cost is borne by its shareholders and creditors and not the U.S. taxpayer. Establishing the framework under OLA and progressively working through the many practical issues required to implement this authority is essential to end the perception that some financial companies are "too big to fail" and to address other moral hazard problems. The Dodd-Frank Act also requires the largest bank holding companies to produce resolution plans or "living wills" to explain how they could be resolved in an orderly manner if they failed. In July 2012 the first such plans were submitted to the Federal Reserve and the FDIC.

A stable financial system also requires resilient and transparent markets. To this end, the CFTC and SEC have proposed and begun to finalize rules that will provide, for the first time, a comprehensive regulatory framework for the over-the-counter derivatives market. The CFTC and SEC have adopted final rules that provide precise definitions of the instruments and entities to be covered. The CFTC has adopted rules that increase market transparency for both the public and regulators; provide for centralized reporting of trades; require swap dealers to establish risk-management policies; and require swap dealers to interact fairly with customers in their sales practices. In addition, the CFTC has completed rules related to designated contract markets, which will be able to list and trade swaps, and position reporting rules for physical commodity swaps. Regulators are also working together to strengthen financial market utilities (FMUs)—the infrastructures that transfer, clear, and settle financial trades—to enhance their ability to withstand the failure of participating firms. To this end, the Federal Reserve and the SEC have proposed, and the CFTC has finalized, rules for FMUs, including rules establishing risk-management requirements for these entities. In addition, the Council has made its initial designations of systemically important FMUs. The Office of Financial Research (OFR) is making substantial progress to improve the quality and availability of financial market data.

Regulators continue to bring greater transparency to the financial markets. The SEC has implemented the Dodd-Frank Act's requirement that advisers to most hedge funds and certain other private funds register with the SEC. As of March 31, 2012, public reporting of the identities of these advisers is required, as well as information about the private funds' size and key service providers. In addition, in October 2011 the SEC and CFTC adopted a joint rule that requires non-public reporting by certain advisers to hedge funds and other private funds to facilitate the assessment of systemic risk. This non-public reporting includes information about the operations and risk profiles of these private funds, which will enable regulators to review risk trends over time.

Regulators are working to strengthen protections for consumers and investors. Notably, the CFPB has adopted and proposed a variety of rules required under the Dodd-Frank Act, including the adoption of new rules to provide protections to consumers who make remittance transfers and the proposal of

rules to consolidate mortgage loan disclosure forms to make loan information more useful to consumers and to reduce burdens on lenders. In addition, the CFPB launched its supervision program for very large depository institutions (in coordination with prudential regulators) and for certain nonbanks. It has established its consumer response function, and assumed rulemaking responsibility for federal consumer financial laws.

Because financial markets are global, U.S. authorities are closely engaged in international regulatory negotiations as they continue to implement the Dodd-Frank Act. The effectiveness of reform at home could be undermined if risk is able to migrate to jurisdictions with weaker standards. Therefore, it is essential to have internationally consistent regulations on capital and liquidity, resolution regimes, derivatives markets and regulation of large, complex financial institutions, while acknowledging that individual countries may require different approaches based on structural differences in their financial systems. The task of achieving strong and consistent global standards is essential because the ultimate outcomes of U.S. and international reform efforts are intimately connected.

While much progress has been made, U.S. regulators are operating with limited resources to implement reforms that apply to very complex markets and institutions and are essential for the national economic interest. Ultimately, for these reforms to be successful, regulators must have the necessary resources to undertake their policymaking, supervisory and enforcement responsibilities.

The Council—which brings together our many different regulatory agencies—has convened 12 times since last year's report to share information on key financial developments, coordinate on regulatory implementation, and monitor progress on recommendations from the first annual report. The Council finalized a rule outlining the process it will use for determining which nonbank financial companies will be supervised by the Federal Reserve and subject to enhanced prudential standards, including resolution planning requirements. As previously discussed, the Council has also designated an initial set of systemically important financial market utilities that will be subject to enhanced risk-management standards. It remains focused on both identifying near-term threats and addressing structural vulnerabilities in the financial system.

### Potential Emerging Threats to U.S. Financial Stability

Threats to financial stability, like threats to national security, are always present, even if they are not always easy to discern in advance. The euro area poses an obvious risk to U.S. financial stability. To date, euro area authorities have been able to prevent a major dislocation by providing large quantities of liquidity to their banking systems, and by providing official sector funding on a case-by-case basis, conditional on fiscal and structural reforms, for nations that have lost market access. The nations under stress have taken painful steps to reduce structural fiscal deficits, and have undertaken some economic liberalization in an effort to boost growth and competitiveness. Euro area leaders have also taken actions towards recapitalizing troubled banks. However, the uncertainty surrounding euro area developments remains high.

Many argue that the euro area needs a more system-wide solution that deepens financial and fiscal integration and completes economic and monetary union. Such a solution might include a roadmap to strengthen the institutional foundations of the euro, with appropriate governance and incentives, as well as a credible crisis-fighting bridge to that future set of arrangements.

Moreover, the challenges surrounding Greece have focused market attention on the sustainability of countries' euro membership and the costs of a potential euro breakup. The establishment of the single currency was a remarkable step towards greater European unity, and dissolution of the euro would come at great cost. Specifically, market participants highlight credit risk, legal risk, and redenomination risk—the risk that obligations due in euros will be repaid in an alternative, less valuable, currency.

The direct net exposures of large U.S. banks to the most stressed euro area sovereigns are very small relative to capital. However, a systemic crisis in Europe, in which contagion and spillover effects spread widely among euro area countries and markets, represents a significant risk for U.S. institutions. In addition, asset price declines due to shocks originating in the euro area would likely have an adverse impact on the balance sheets of U.S. institutions, as would a generalized deterioration in market sentiment due to increased European volatility.

While Europe is the principal financial stability risk facing the U.S. financial system today, it is not the only source of potential threat. The U.S. recovery has not yet transitioned from moderate to self-sustainable growth. The "fiscal cliff" around year end—including expiration of the tax cuts originally enacted in 2001 and 2003, the expiration of payroll tax cuts and extended unemployment benefits, and the Budget Control Act-mandated sequester—represents a threat to the recovery and financial stability if not addressed.

Structural and cyclical weaknesses persist in the housing sector, including the large number of households with low or negative equity in their homes. As a result, the housing market could face increased pressures should there be a slowdown in economic growth. Meanwhile, cybersecurity remains a constant area of concern and potential vulnerability.

Risks could also arise from uncertainty about the vigor of global growth outside Europe, including in the emerging markets. Authorities in China and a number of other EMEs face the challenge of supporting demand and employment at a time of weakness in the industrialized world while attempting to avoid fuelling domestic real estate bubbles. China's substantial contribution to global growth and its purchases of advanced economy debt mean that a hard landing there would have important implications for the U.S. economy.

It is essential to enhance the resilience of the financial system against both the threats that we can identify today and ones we cannot. Vulnerabilities in the financial system can be grouped into three broad classes or types: inherent vulnerabilities (features of our financial system that will always make financial markets and institutions fragile), potential control weaknesses (failures in

operations, risk management, and governance), and behavioral vulnerabilities (incentives to take too much risk).

One area that merits ongoing scrutiny is the potential interaction between reliance on short-term wholesale funding (an inherent vulnerability) and incentives to "reach for yield" (a behavioral vulnerability) in a low interest rate environment, for instance, by taking on excessive duration or credit risk or by shortening the tenor of funding. Some nonbank financial companies already rely heavily on short-term market financing, which could represent a source of instability if borrowers were to have difficulty rolling over liabilities in a time of stress. For example, while short-term funding markets were not disrupted by the recent downgrades of internationally active financial institutions, these events are causing market participants to reevaluate both concentration and duration of exposures in these markets. While the use of short-term liabilities to fund long-term assets is central to financial intermediation, the risks associated with this practice must be carefully managed and subjected to appropriate oversight. Events over the past year have also highlighted the importance of potential control weaknesses particularly for concentrated exposures or complex trading strategies.

While member agencies of the Council are engaged in implementing the Dodd-Frank Act, much of the Council's attention has also been on vulnerabilities that require additional focus beyond Dodd-Frank rulemaking. As emphasized in last year's report, the instability of short-term wholesale funding markets is exacerbated by ongoing structural vulnerabilities in the tri-party repo market and in the money market fund industry. These vulnerabilities cannot be adequately addressed only at the firm level and must be tackled at the system level.

Consistent with the recommendation of the Council last year, the Federal Reserve has now taken a more direct supervisory approach to pursuing the necessary changes to the tri-party repo market. Similarly, the SEC continues to work through policy options for much needed reform of money market funds. Section 3 of this report sets out the Council's 2012 recommendations in these and other areas.

The Council remains vigilant against potential shocks and vulnerabilities in financial markets. Regulators cannot eliminate risk nor provide guarantees that in the event of a major disruption in the euro area or elsewhere, there would be no impact on U.S. financial stability. However, thanks in part to progress on financial reform, the U.S. financial system is stronger and better able to absorb shocks than was the case even a year ago. Moreover, the member agencies of the Council have important tools to combat contagion and mitigate its effects on our national economy, and will not hesitate to use these tools should the national interest require them.