

2 Executive Summary

The efficient provision of financial services is critical to the nation's economic growth and prosperity. A stable financial system can continue to provide financial services while absorbing a range of shocks. A stable financial system should not be the source of, nor amplify the impact of, shocks.


The Financial Stability Oversight Council is charged with identifying risks to the financial stability of the United States, promoting market discipline, and responding to emerging threats. Council members have many tools at their disposal to accomplish these goals, owing to their involvement in supervision and regulation, consumer and investor protection, and market and infrastructure oversight.

Macroeconomic Environment

The U.S. economy continues to heal from the 2007–09 recession (the longest since the Great Depression). Consumer spending and business investment have increased, but housing markets remain depressed and the unemployment rate is elevated. The global economy is also recovering, albeit at varying rates across advanced and emerging economies.

The financial crisis produced great upheaval in the U.S. financial sector, but the impact on the economy was even more devastating. At the height of the crisis, credit conditions tightened for households and businesses, as well as for financial firms of all sizes, reflecting severe disruptions to a range of financial markets that proved far more damaging than the disruptions from the initial credit losses themselves.

Credit conditions have improved significantly from the depths of the crisis. Recently, credit flows have shown signs of recovery, with large corporate borrowers facing favorable financing conditions and households experiencing an increase in credit. Corporate balance sheets deteriorated significantly during the crisis, primarily as a result of falling asset values, but they have recovered since mid-2009 as cash flows and profits have increased. Corporate bond markets have also recovered for both investment-grade and non investment-grade issuers. The outlook is more challenging for small businesses, which tend to borrow against real estate assets. They report weak demand for their products and services, as well as borrowing constraints, although the number of small businesses reporting difficulties obtaining credit has declined since the crisis.



Nonmortgage lending to consumers has grown recently after declining for several years. Household balance sheets are recovering, partly because of the rebound in stock prices, but they remain challenged by the weak labor market, slow income growth, and declines in real estate values. As a result of the fall in home values, a significant number of homeowners now have low or negative equity in their properties, and record numbers of homes have entered the foreclosure process. However, low interest rates have helped mitigate some of the costs of mortgage debt and, in the aggregate, households' ability to meet debt payments has improved since 2007.

Government budgets, both federal and nonfederal, have been strained by the cyclical response of revenues and expenditures to a weak economy as well as the fiscal actions taken to ease the recession and aid the recovery. The federal government deficit grew from 1.2 percent of GDP in 2007 to 8.9 percent in 2010, and net publicly held federal debt outstanding rose from \$5 trillion to \$9 trillion. This public borrowing largely replaced private borrowing in the credit markets, and global financial markets readily accommodated the increase in federal debt. Even after economic conditions return to normal, the federal government faces a long-run imbalance between revenues and expenditures. This need for long-run fiscal sustainability has been a focus of recent attention from credit rating agencies. Achieving long-run sustainability of the national budget is crucial to maintaining global market confidence in U.S. Treasury securities and the financial stability of the United States.

State and local government revenues were severely affected by the economic downturn. While state finances started to improve in the second half of 2010, several quarters into the economic recovery, local governments remain challenged. The municipal debt market exhibited evidence of considerable stress last year.

Sovereign and banking sector strains are evident among a number of advanced economies. Three countries in the European Monetary Union have required financial assistance as markets have priced elevated sovereign credit risk into their debt. The relatively new phenomenon of differentiated compensation for sovereign credit risk in advanced countries has added to volatility in global markets. It has also exposed tensions within the European Monetary Union and limitations in the pre-crisis set of tools available to European policymakers to respond to economic and financial stress.

In contrast, most emerging economies have recovered relatively quickly from the crisis, partly because of their lack of financial imbalances before the financial crisis. However, emerging economies face challenges from robust capital inflows and the potential for overheating. Recent instability in North Africa and the Middle East and the natural disaster in Japan have added to uncertainty in the international environment.

Financial Developments


At the peak of the financial crisis, the U.S. government introduced unprecedented support for financial markets, injecting hundreds of billions of dollars of capital and liquidity into the financial sector. As market confidence has returned, private funding has gradually replaced those support programs: many financial institutions have returned the government's capital; the Federal Reserve is no longer offering extraordinary liquidity support to financial markets; and the FDIC guarantees for bank senior debt will expire in 2012.

Funding has not returned to the private securitized mortgage market, which financed a significant portion of household borrowing in the first decade of the 2000s. In the past, the government's role encouraged housing purchases and real estate investment over other sectors and ultimately left taxpayers responsible for much of the risk incurred by a poorly supervised housing market. This led to the two large government-sponsored enterprises, Fannie Mae and Freddie Mac, being placed into federal conservatorship. These entities and the Federal Housing Administration now dominate mortgage lending, guaranteeing or insuring over 90 percent of mortgage loan originations. This is not a viable long-term solution, but, given the current fragility of the real estate market, the transition back to more private involvement will require time and care.

Profitability has returned in the banking sector and for many other financial institutions. Investors purchased large amounts of new equity in the largest bank holding companies in 2009 and 2010, partly responding to the results of the 2009 supervisory-run stress test. U.S. banking institutions now have substantially stronger capital and liquidity buffers than before the crisis. However, smaller banks, particularly those with large commercial real estate exposures, have not recovered as quickly as larger banks and have continued to fail at elevated rates. At the same time, in taking prudent measures to conserve their capital and liquidity, many banks have been slow to expand their direct lending activity since the financial crisis.

Assets have grown at insured depository institutions relative to other financial institutions since the crisis, following a long period in which financial activities moved from banks to markets. In particular, money market fund assets declined as investors transferred significant funds into insured bank deposits during the crisis. At the same time, the crisis reinforced the trend toward concentration and globalization in the banking industry, and foreign banking organizations have expanded their activities in the United States in recent years.

The financial system is less leveraged than it was before the crisis. Four of the five largest independent investment banks, all highly leveraged institutions, were acquired by or converted their charters to become bank holding companies in 2008, and the fifth failed. The specialty finance sector, which also relied heavily on market financing, is now



smaller and more stable. Several of the largest companies in the specialty finance sector also became bank holding companies during the crisis to expand their funding options. These and other companies have reduced their leverage significantly below the levels before the crisis.

Short-term wholesale funding markets provide liquidity for financial institutions to support their activities, but the financial crisis showed that these markets can be fragile and subject to runs by risk-averse investors. In response to unprecedented strains in these markets, the Federal Reserve, the FDIC, and the Treasury took extraordinary steps to support market functioning. The crisis also revealed, in particular after the freezing of Lehman Brothers' prime brokerage assets in London, that differences in international bankruptcy regimes can accelerate runs on short-term wholesale funding markets. Activity in several of these markets remains significantly below pre-crisis levels, as investors and supervisors have a new sensitivity to potential liquidity risks and other risks.

The credit risk transfer markets that contributed to the financial crisis—specifically, those for credit default swaps and collateralized debt obligations—are now significantly smaller, partly owing to new regulatory and accounting rules. Derivatives markets generally will be subject to greater supervisory oversight under the Dodd-Frank Act.

Supervisors and market participants are more aware of the potential for extreme market fluctuations in the future and the need to maintain a stronger set of shock absorbers in individual institutions and in markets to absorb the impact of such events. These issues are particularly relevant when market participants are highly leveraged or when derivatives or other complex instruments are involved.

In general, the pricing of risk in important markets appears to be in line with historical averages. For example, the price-to-earnings ratios for corporate equities are well within historical ranges, and the credit risk premium on high-yield corporate debt is in the lower part of its long-run historical range. Prices for commodities and agricultural land have risen strongly but do not appear to be associated with high debt levels.

Compensation practices that incited financial institution employees to take excessive risks are widely acknowledged to have been a contributing factor in the financial crisis. Under pressure from regulators and investors, financial institutions are reforming their compensation practices to better align the interests of managers, traders, and other employees with the long-term health of the firm, although more needs to be done.

Following the rebound in equity markets, aggregate assets in mutual funds and hedge funds have recovered to pre-crisis levels. Assets in defined contribution plans have also recovered, although many

pension plans for state and local government employees appear to face funding shortfalls over the long run. Investors have increasingly turned to exchange traded funds, which offer low fees and intraday liquidity.

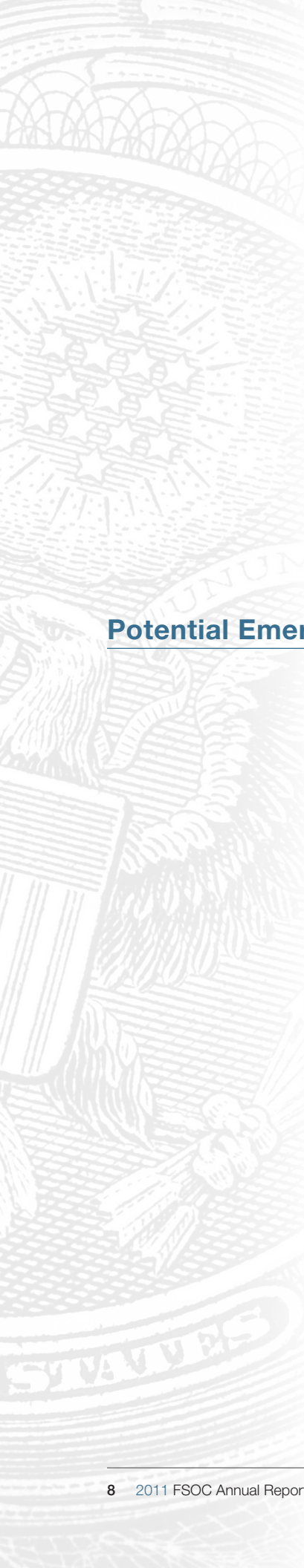
Regulatory reforms and advances in technology have altered the landscape for financial infrastructure, providing financial markets with advances in efficiency and transparency. While this infrastructure and the markets that it supports have generally performed their primary functions in an orderly fashion during and since the crisis, there were exceptions. One was the so-called flash crash of May 2010, when equities and equity futures markets plunged more than 5 percent and then rebounded in a matter of minutes. This incident illustrates some of the risks associated with increasingly complex and connected financial markets interacting with ever-faster automated trading systems. Poor functioning in mortgage servicing and the tri-party repo market were also identified during the crisis, and regulators are taking steps to address them.

Progress of Regulatory Reform

In the period after the financial crisis, the legal, regulatory, and accounting framework of our financial system has changed significantly. The Dodd-Frank Act, which created the Council, closed gaps in the financial regulatory framework and strengthened supervisory, risk management, and disclosure standards in important ways. The new Basel III international standards for banks, negotiated with major input from U.S. regulators, will require banks globally to hold more capital, particularly when they take market risk, and will subject banks to a liquidity standard for the first time, and new accounting rules will serve to limit financial institutions' off-balance-sheet activities.

For the first time, information on trading in swaps will be available through trade repositories. In addition, standardized derivatives will have to be traded on regulated trading platforms and centrally cleared, improving price transparency and reducing counterparty credit risk for market participants. Once regulators complete the implementation of the Dodd-Frank Act, the mix of complex structured credit products, derivatives, and short-term wholesale funding that helped produce the financial crisis is unlikely to reappear in its previous form.

U.S. regulators continue to work out the details of several important initiatives, including those mandated by the Dodd-Frank Act and those agreed to with their international counterparts. For example, the Council has defined the characteristics under which it will designate systemically important financial market utilities for enhanced supervision. The Council is also in the process of defining the characteristics under which it will designate nonbank financial institutions for Federal Reserve supervision, and the Federal Reserve, in consultation with other Council member agencies, is establishing tougher supervisory guidelines for large financial institutions. Regulators are also developing new reporting and disclosure requirements for designated nonbank financial companies.



The Dodd-Frank Act also established a new framework for resolving large complex financial institutions, limiting the expectation that the government will bail out such institutions in a crisis. As part of the enhanced supervisory standards, designated nonbank companies and large bank holding companies will be required to maintain detailed resolution plans. Until the Dodd-Frank Act is fully implemented, the public will not receive the full set of protections provided by the improved regulatory system. In addition, to maximize all the benefits of the new regulatory framework, it is imperative that relevant regulatory agencies be funded at levels consistent with their expanded missions.

Regulators are also working with their international counterparts to promote consistency in global regulatory reform, particularly with regard to implementing the new Basel III capital and liquidity standards; strengthening the supervision of, designing capital surcharges for, and developing a framework for the resolution of large, globally active financial institutions; promoting harmonization for the oversight of derivatives markets; and regulating global financial infrastructures.

Potential Emerging Threats to U.S. Financial Stability

Assessing future threats to financial stability will require attention to the broad forces driving the evolution of the financial system, which determine the profit opportunities available to market participants and financial institutions along with the risks they take. In addition to these long-run challenges to maintaining financial stability, a number of possible shocks and vulnerabilities could produce more immediate threats to U.S. financial stability.

Globalization and technological innovation are among the most important forces that could affect future financial stability. While the rise of international banking and the important role of foreign banks in U.S. financial markets allow risks to be transferred more broadly across the global economy, they also increase the links across economies and add to the complexity of the financial system. Global interconnectedness is heightened by the role of the U.S. dollar as the international reserve currency and the funding needs of large foreign firms that hold U.S. dollar-denominated assets.

Financial product innovation and growth is crucial to support a vibrant economy, but at times it can result in dramatic changes in business models and can introduce increased complexity, thereby altering the evolution of linkages among firms. Three such products examined in the report are exchange traded funds, structured notes, and collateralized commercial paper. While the level of activity in these products in the United States is not high enough to represent a threat, the level of activity abroad and the links to derivatives have led regulators in other countries to focus special attention on them.

The functioning of the U.S. financial system has proven resilient to the impact of a number of recent shocks, such as the natural disaster in Japan and the fluctuating concerns over European sovereign debt.

Further, increases in trading volumes and enhanced market liquidity have been fostered, in part, by the increasing use of electronic trading. This liquidity can evaporate in stressed environments, as the flash crash demonstrated. New technology has helped strengthen the resilience of payment systems, data repositories, and other financial infrastructure. This has given firms the tools to handle increasingly intricate transactions, including transactions in short-term wholesale funding markets that can provide hundreds of billions of dollars overnight to cover daily funding needs. Operational risk events, along with recent high-profile cyberattacks, are important reminders that both regulators and firms need to continuously upgrade the resilience of their electronic systems and networks.

There is significant market uncertainty in Europe, notably associated with the sovereign credit risk of Greece, Ireland, and Portugal. U.S. financial institutions have very limited net direct exposure to these three countries. They have larger exposure and important ties to major financial institutions elsewhere in Europe that in turn have large exposures to Greece, Ireland, and Portugal.

Some major European banks obtain substantial short-term wholesale U.S. dollar funding from U.S. money market funds. Further, money market funds remain an important supplier of cash to the tri-party repo market. Structural vulnerabilities in money market funds and tri-party repo amplified a number of shocks in the financial crisis. Reforms undertaken since the crisis have improved resilience, and money market funds report de minimis exposure to Greece, Ireland, and Portugal; however, amplification of a shock through these channels is still possible.

The impact on the U.S. financial system of events in Europe depends on how the peripheral European sovereign debt crisis evolves and on the resilience of U.S. financial institutions and markets. If the crisis, now affecting Greece, Ireland, and Portugal, were to intensify significantly or spread more broadly across the euro area, then the impact on the U.S. financial system would be greater. Supervisors have for some time been working with U.S. financial institutions to improve their ability to withstand a variety of possible financial contagion stress scenarios emanating from Europe. The Council and its member agencies will continue to carefully monitor the potential risks that could emerge from the peripheral European sovereign debt crisis.

Real estate-related exposures remain a significant risk for many U.S. financial institutions. However, the improvement in capital across the financial system provides an important buffer against further declines in real estate prices and larger losses; this makes it less likely that U.S. financial institutions will have to reduce assets or reduce growth in lending in response to a more prolonged period of weakness in the housing market or in the U.S. economy more generally. On the other hand, the transition path back to a greater role for private capital in the housing finance system remains uncertain.



The weakness of the current recovery has delayed monetary policy normalization and exacerbated the unsustainable fiscal trajectory in the United States. Despite the sustained low interest rate environment, there is limited evidence of major U.S. market participants “reaching for yield.” One possible exception has been in some of the activity in the markets for non investment-grade bonds and loans.

Both monetary policy normalization and fiscal consolidation will have important consequences for the business models of many financial firms that are currently funding large holdings of government securities and reserves at the Federal Reserve with low-cost deposits. Uncertainty over the pace of monetary policy normalization and fiscal consolidation has the potential to generate shocks; however, with appropriate planning and risk diversification, the financial market impact of such shocks should be absorbed without affecting the functions of the system.

The capital and liquidity of the largest U.S. financial institutions have improved substantially. However, many large U.S. financial institutions currently receive the highest credit rating for short-term funding partly because of a presumption of possible government support in stressed conditions. Further, the Federal Reserve, in its Comprehensive Capital Analysis and Review, found a number of weaknesses in the capital planning processes at many large banking institutions. These factors highlight some of the challenges still ahead in building a stronger financial system.

The recent financial crisis provides a stark illustration of how quickly confidence can erode and financial contagion can spread, as well as how challenging and expensive it is to repair the damage. This lesson is important to bear in mind in the current debate over the increase in the federal government’s debt limit. It is vital to the stability of the U.S. financial system and the global financial system for the debt limit to be raised in a timely manner to avoid creating any risk of default on U.S. obligations.