# Letter from the Chair

The institutions, markets, and infrastructure that make up the U.S. financial system provide essential services to the U.S. and global economies—helping to allocate funds from savers to borrowers, allowing households and businesses to plan for the future and manage their risks over time, and facilitating the enormous volume of financial transactions necessary to support real economic activity and employment on a daily basis.

Three years after the worst financial crisis in generations, our financial system is now on more solid ground, less prone to excessive leverage and risk-taking, more transparent to investors, creditors, and regulators, and more resilient to unexpected adverse events. Financial institutions hold substantially more capital relative to risk than they did before the crisis and fund themselves more conservatively. We have withdrawn most of the emergency actions we took to resolve the crisis and recovered most of the investments we made to stabilize the financial system.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) made important and fundamental changes to the structure of the U.S. financial system to strengthen safeguards for consumers and investors and to provide better tools for limiting risk in the major financial institutions and the financial markets. The core elements of the law were designed to build a stronger, more resilient financial system—less vulnerable to crisis, more efficient in allocating financial resources, and less vulnerable to fraud and abuse.

- **Tougher constraints on excessive risk taking and leverage across the financial system.** To lower the risk of failure of large financial institutions and reduce the damage to the broader economy of such failures, the Dodd-Frank Act provided authority for regulators to impose more conservative limits on risk that could threaten the stability of the financial system.
- **Stronger consumer protection.** The Dodd-Frank Act created the Bureau of Consumer Financial Protection to concentrate authority and accountability for consumer protection in a single federal agency, with the ability to enforce protections on banks as well as other types of firms involved in the business of consumer finance.
- **Comprehensive oversight of derivatives.** The Dodd-Frank Act created a new regulatory framework for the over-the-counter derivatives market to increase oversight, transparency, and stability in this previously unregulated area.
- **Transparency and market integrity.** The Dodd-Frank Act included a number of measures that increase disclosure and transparency of financial markets, including new reporting rules for hedge funds, trade repositories to collect information on derivatives markets, and improved disclosures on asset-backed securities.
- **Orderly liquidation authority.** The Dodd-Frank Act created a new orderly liquidation authority to break up and wind down a failing financial firm in a manner that protects taxpayers and the economy.

- **Accountability for stability and oversight across the financial system.** The Dodd-Frank Act established the Financial Stability Oversight Council (Council) to coordinate across agencies in monitoring risks and emerging threats to U.S. financial stability, and the Office of Financial Research to improve data quality and facilitate access to and analysis of data for the Council and its member agencies.

The Council will play an important role in implementing and overseeing these reforms and mitigating current and potential future threats to financial stability.

In our regulatory framework, a significant number of independent agencies are responsible for specific aspects of the challenge of promoting financial stability, including overseeing the safety and soundness of banking organizations, safeguarding the stability of financial infrastructure, promoting disclosure and market integrity, and protecting investors and consumers against abuse. Each of these individual responsibilities is critical to a stable and well-functioning financial system, but as the crisis demonstrated, threats to financial stability are often manifested across a range of markets and institutions and may not always be effectively mitigated by any one agency alone.

The Dodd-Frank Act established the Council to create joint accountability for identifying and mitigating potential threats to the stability of the financial system. By creating the Council, Congress recognized that financial stability will require the collective engagement of the entire financial regulatory community.

This is an inherently difficult exercise. No financial crisis emerges in exactly the same way as its predecessors, and the most significant future threats will often be the ones that are hardest to diagnose and preempt. Aspects of the financial system that appear to make markets more liquid and financial institutions more prosperous in normal times may be the same ones that make the world more dangerous in crisis. Actions taken to preemptively mitigate threats may appear at the time to be more dangerous than the problems they are designed to address.

We cannot predict the precise threats that may face the financial system. The best way to prepare for this uncertainty is to continue to build the shock absorbers and safeguards that improve the resilience of the financial system. We need to recognize that policy and regulation will often be behind the curve of innovation, and we must meet assumptions of ongoing stability with a heavy dose of skepticism. Our best plan is to plan for constant change and the potential for instability, and to recognize that the threats will constantly be changing in ways we cannot predict or fully understand.

Reducing threats to financial stability will require persistence, creativity, and a willingness to adapt more quickly to changes in markets. We must work to ensure that the regulatory framework keeps pace with the evolving global financial system. We cannot wait until we have passed the point of no return to strengthen safeguards against the type of race to the bottom in credit terms or underwriting standards that often characterizes periods of financial expansion. We need to be willing to act prudently and preemptively in the face of emerging vulnerabilities or imbalances.

This task will be made easier if we are able to better marshal the power of market discipline. Financial market participants and investors should no longer operate with the expectation that government assistance will be available to save the stakeholders in financial institutions from the consequences of their own mistakes. And the regulatory community needs to continue to work hard to improve the information available to investors and the public about the nature and magnitude of the risks individual institutions are taking.

The challenge of maintaining a stable financial system is exacerbated by the difficulty of balancing the benefits of regulation against the costs of excessively restraining prudent risk-taking behavior. If we were to set the overall combination of margin, liquidity, and capital requirements too high, we could handicap the ability of the financial system to support economic growth. Further, financial activity would inevitably move more quickly to firms, markets, and countries where the intensity of regulation is weaker. So we need to continue to strive for a careful balance between the imperatives of creating a more stable system and promoting a level of innovation and dynamism.

Measures of risk in the financial system before the crisis provided little warning of the force of the storm to come. Many of the standard observable measures of risk were very low; indeed the real warning sign was that neither credit ratings nor the pricing of a range of financial products showed any expectation of the fragility of the global financial system to a fall in U.S. house prices.

This should make us all humble about our ability to make judgments about the future, even as we strive to acquire better data and quantitative metrics. Nonetheless, there is a strong case for improving the quality of information available to the public, supervisors, and regulators about risks in financial institutions and markets. With our new authorities, we are working to build a broader set of quantitative metrics to assess not just what is happening in individual institutions and markets, but throughout the whole system.

The information we collect and the analysis we undertake will allow us to measure more accurately the nature of risk in individual firms and across the system, but it must be complemented with a forward-looking perspective that analyzes evolving market practices and activities and tests the resilience of the financial system to a wide set of future events. This perspective requires careful assessments of the relative likelihood of a range of potential outcomes, including assessing the potential impact on the functioning of the financial system and understanding where reforms to markets, firms, and infrastructure may mitigate threats. And it requires an ongoing focus on incentives within the financial system that might create or exacerbate vulnerabilities.

Working through the Council, we will focus our efforts in four distinct areas:

- **The ongoing interaction between the financial system and the economy.** We need to continue to strengthen our analysis of the interactions between the financial system and the economy, including the impact that financial sector decisions have on the economy. We also need to better assess how potential external shocks could be amplified by structural weaknesses and imbalances in the financial system. Stress testing is an important tool in making such assessments. It is also important to develop techniques that give us the ability to analyze the destabilizing second-round effects of shocks across financial institutions and markets. While it is impossible for stress tests to capture all potential threats, the discipline of repeatedly stressing institutions and networks against low-likelihood adverse scenarios will help temper overly optimistic assumptions that might otherwise lead to harmful behaviors and outcomes.
- **The buildup of systemwide leverage and funding mismatches.** It is crucial to complement the evaluation of the safety and soundness of individual institutions with an assessment of leverage in the financial system and imbalances between funding and assets across the financial industry. It is hard to detect vulnerabilities that can build in the interconnections between firms and markets. Thus, we need to work to ensure that the capital buffers and liquidity safeguards available to the system are sufficient.

- **The ongoing evolution of financial market activity and practices.** We will need to be attentive to the implications of very rapid growth in types of financial activity and new products. This is true in consumer product innovation, but also in the institutional markets where large institutions and firms interact. Innovation is an essential element of a healthy system, but rapid growth in products and activities untested by time and adversity necessarily entails challenges and requires more care and attention.
- **The potential opportunities for regulatory arbitrage.** Where the opportunity and incentive exist to avoid regulation and supervision, financial activity will migrate to areas of the system where there are gaps in authority or inconsistencies in regulatory standards. A substantial buildup in risk and leverage outside the regulated core of the financial system can increase threats to the system as a whole. We must also work to eliminate meaningful opportunities for arbitrage between countries, particularly in the key areas of capital and liquidity, derivatives, and resolution authority.

A stable financial system cannot be maintained by regulation and oversight alone. Those in positions of leadership in the financial sector will need to establish and maintain much higher standards for integrity and a more sophisticated understanding of the risk inherent in the business of finance than prevailed before and during this crisis.

This will require continued improvements in management structure and corporate governance practices. Compensation must be structured to create better incentives for robust risk management. Risk management officers in financial firms need to have a strong voice in decision making. Boards of directors need to actively engage with management and represent stakeholder interests by ensuring an appropriately long horizon and a broad perspective in making strategic choices. With improved disclosure and transparency, firms that take this long-term perspective should prosper in the long run, while those that do not will face higher funding costs and less indulgent investors.

In this first annual report, we describe the current state of the U.S. financial system and some of the major forces that will shape its development going forward. The Council and its members will continue to implement the Dodd-Frank Act on a coordinated basis to enhance the integrity, efficiency, transparency, competitiveness, and stability of U.S. financial markets. The report also includes recommendations for additional steps that should be taken to complement these efforts and further strengthen the financial system.

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