Testimony of Amias Gerety
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A note on conflicts: The views expressed today are my own, not those of my firm or my partners. However, it is worth noting that as a Partner at QED Investors, I have economic interests in a wide variety of startup financial services firms globally, including some that operate in the crypto and blockchain space.

Mr. Chairman, Ranking Member Lynch, thank you for the opportunity to testify today and to support this committee's important work. As a Treasury official from 2009 to 2017, I have many fond memories of working with this committee on the legislative process to design and create the Financial Stability Oversight Council, and I had the honor of being the first ever staffer for the Council and the first Deputy Assistant Secretary for the Financial Stability Oversight Council. I was integrally involved with the Council during my time at Treasury and have been an engaged observer and supporter from the outside since my departure from government service 7 years ago this month. While my focus today will be on the Council and its role, it is worth noting that my day job as a venture capital investor focused on financial services gives me a front row seat on financial innovation, and so I will be glad to engage with the committee on that topic as well.

My aim in this testimony will be to cover three broad topics: First, to offer some historical perspective on the creation of the Council and the centrality of its mission for the U.S. economy in the long term. Second, to talk specifically about the Council's authority to require large, complex nonbank financial companies to be subject to enhanced prudential standards, and the recently revised guidance regarding how the Council will exercise that authority. In particular, I will explain how the designation authority is an essential complement to the Council's general authority relating to monitoring and addressing risks associated with market practices. Finally, I will end by discussing the Council's role in monitoring the financial system for emerging risks and why, as we round 15 years from the height of the financial crisis, its focus on the future of the financial system is even more critical than it was at its founding.

The title of this hearing connects the mission of the Financial Stability Oversight Council to the potential innovation in our financial system and economy. I believe that everyone on this Committee would agree that we want innovation that enables broader access to financial services and more stability. But we can't have an innovative financial system if risks can build up without oversight and regulators are unable to coordinate across markets.

Most innovations are designed to provide broad-based benefits rather than benefiting a single company, and these innovations are primarily the purview of the Council's member agencies as primary financial regulators. But in the lead up to the financial crisis, too many innovations were designed to make risk more opaque and convoluted, to increase leverage and to create a game that

benefited individual risk takers instead of the economy as a whole. As I will discuss in more detail below, the existence of the Council and its designation authority is actually a critical component of an innovative and stable financial system.

I. Mission and History of the Council

The Council was created in 2010 based on a key and obvious learning from the financial crisis. While risk had been building in every part of the system there was neither a mechanism nor accountability for our regulatory leaders to understand how that risk could impact our financial system and economy as whole.

In the years leading up to the Global Financial Crisis, risk was building in loosely or unregulated markets designed to sit right at the edge of existing regulatory oversight. For example, AIG, an insurance company, built an offshore hedge fund that exploited the huge balance sheet and stability of their life insurance business to take risky bets on a subprime mortgages through derivative instruments which were exempted from securities, futures and insurance oversight. Non-bank investment 'banks' did versions of the same, many of them borrowing short-term in deposit-like instruments that were not subject to bank oversight, all of them subject to broker-dealer regulatory regimes that were not designed to view companies from the perspective of holistic capital and risk. Banks and bank regulators were not immune from criticism. As banks participated alongside nonbanks and the originate to distribute model of high-risk mortgages put families into crippling debt.

Dodd-Frank created the Council as part of a variety of reforms to address the manifest weaknesses in our regulatory architecture after the Global Financial Crisis. Dodd-Frank regulated derivatives markets, created new tools for regulators to handle the failure of the largest and most complex nonbank financial companies, completely overhauled capital requirements for the financial industry and created a dedicated watchdog for consumer financial protection.

By and large, the Council does not have the most powerful statutory authorities created by Dodd-Frank. In fact, the Council's primary authorities are quite limited in scope. The Council has the authority to make recommendations to Congress and to its members. The Council has the authority to designate nonbank financial companies for heightened supervision by the Federal Reserve, and the Council has authority to designate Systemically Important Financial Market Utilities also for heightened supervision. Finally, the Council has the authority to require submission of reports from financial companies to help it pursue its duties.

In the early days of the Council, memories of the crisis motivated everyone and we had much work to do to create an infrastructure for the Council to fulfill its mandate. There was a long list of statutory requirements to work through and we also need to find ways to bring together Council members not just to address crises, but to look forward for potential risks.

For example, in July of 2011, the Council published its first ever report to Congress on the stability of the U.S. financial system. It was a mammoth undertaking, that we had completed with incredible collaboration from economists and analysts across the member agencies. I was, and remain, proud of that work; the first ever financial stability report from the U.S. government. But I remember clearly a blog post that articulated how easy it was to be jaded about our mission. The blog post now seems to be lost in the bowels of the internet, but it made fun of the Council for putting so much effort into its report. The author pointed out that 2011 was when the Council's job should have been easiest. After all, financial crises rarely happen one after the other, and so rather than putting so much effort into monitoring, the Council should have taken a breather and relaxed – confident that the probability of another crisis happening on their watch was close to zero.

The Council's job is to try to analyze low probability, high impact events and their duty is to try to prevent those events. To do so, they must anticipate risks to financial stability that have not yet materialized. This is not an easy task and there is inevitable paradox that the Council will never be credited with preventing financial crises that never happened.

This paradox however does not mean that the role of a financial stability council is hopeless. Rather it demonstrates that the importance of vigilant monitoring and analysis of financial stability only gets more important as memories of the last financial crisis fade. With each passing year, fewer and fewer market participants have direct knowledge of the searing risk management lessons that we all got in that time. Periods of stability inexorably increase risk tolerance, gradually sowing the seeds of the next crisis.

Most importantly, the blog post and this jaded perspective missed one of the most important elements of the requirement to write a financial stability report. In the later stages of the drafting of Dodd-Frank, Congress required an attestation from each member of the Council, stating that the report had made a complete accounting of the risks to financial stability and the recommendations that they thought necessary to address those risks. My experience that it was this attestation requirement, even more than the analysis that the staff had done, which served as a marker for the Council members and reinforced the need for each Council member to deeply engage with every element of the report.

The strength of the Council is not its few targeted authorities but rather its unique purview on the financial system. The Council is designed to require interagency cooperation and to avoid the tendency of siloed regulatory agencies to focus only on the areas of the financial system that they oversee. Moreover, it's one of the few places where regulators have the ability to consider and address risks that fall outside of traditional regulatory boundaries and the individual mandates of each member agency. It is precisely this lack of accountability and the rigidity of the pre-crisis regulatory perimeter that facilitated regulatory arbitrage and the build-up of catastrophic risks in the shadows of regulatory oversight.

II. Designation Authority and Activities-Based Policy

The Council's designation authority is narrow relative to the collective authority of its member agencies. But this authority is a critical complement to any activities-based policy. The FSOC's activities-based approach is an effective mechanism for identifying regulatory gaps where products or activities might threaten financial stability, and for which an existing authority by a primary regulator can provide an effective, broad-based response. In particular, the Council has publicly stated that it expects "to continue addressing most risks through its collaboration with primary financial regulators."

Designation authority, on the other hand, is designed to address risks that arrive directly because of the risk associated with individual nonbank institutions. This authority gives us an opportunity to make sure that "any financial firm whose material distress or failure could result in a significant threat to financial stability should be subject to enhanced prudential supervision."[1]

These two authorities complement each other. Just as importantly, the ability to target enhanced prudential standards at particularly large, complex financial companies actually is a support to innovation in our economy. As two former FSOC and Federal Reserve Chairs wrote in 2019, "a fundamental feature of a market oriented, innovative financial system is that – over time – risk will migrate around the prudential constraints that apply to banks, shrinking the effective scope of those defenses, and leaving the overall financial system more fragile. This is what happened in the decade leading up to the crisis, and the failure of prudential regulation to prevent this is a critical reason why the crisis was so severe and challenging to manage."[2]

In other words, it is inevitable that a dynamic financial system will naturally build up risk around the constraints that are imposed in well-supervised institutions and markets. This dynamism can be scary, but it is also a feature of our vibrant economy. Some financial innovations really do make the world a better place, while others are purely creatures of regulatory arbitrage. With a functioning designation authority, our system can allow these innovations to grow and even to support the creation of very large, complex nonbank financial companies – but only if we are committed to the principle that if their size and complexity can pose a risk to financial stability they will be subject to oversight.

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[1] Ben Bernanke, Timothy Geithner, Jacob Lew, and Janet Yellen, "Comment letter from two former FSOC Chairs and two former Federal Reserve Chairs," May 13, 2019, pgs. 1-2, https://www.regulations.gov/comment/FSOC-2019-0001-0010

[2] Bernanke et al., pg. 7.

The 2023 Guidance removes pre-requisites that made the designation authority unworkable.

The Council recently finalized revised guidance concerning the nonbank designation authority as well as publishing an analytical framework providing the public with additional transparency into how the Council will view threats to financial stability and how the Council may seek to address those threats through activities-based approaches or with entity-based designations.

Over the past 14 years, the Council has made a continuous effort to engage with industry and other stakeholders to gather feedback on the designation authority and to provide transparency on how it intends to do that work. In the early years, the Council went through a notice and comment process to establish guidance that provided transparency into the types of companies that would be likely considered by the Council as well as the analytical framework and the formal process that the Council would follow in its consideration. In 2015, the Council published additional informal guidance providing additional clarity about certain analytical and procedural questions.

In 2019, the Council formally incorporated many of the clarifications from the 2015 notice and simplified the process from three steps to two, removing a set of public quantitative thresholds that had been established in the early days of the Council. Unfortunately, the 2019 guidance also incorporated a series of unworkable analytical requirements for itself. Taken together, these made the designation authority impossible to use, and frustrated the very purpose of the Council. In fact, the first statutory purpose is to "to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace."[3]

The most recent guidance restores the balance of the Council's authority, removing these three unworkable impositions while simultaneously reaffirming their commitment that most risks will be addressed using an activities-based approach.

There are three material changes being made between the 2019 and 2023 guidance, in each case to remove a "prerequisite" to the exercise of the designation authority: First, the Council has restored a balanced approach to activities-based and entity-based action, rather than promising to consider designation only after an activities-based approach had been exhausted. Second, the Council has removed a self-imposed requirement to conduct a cost-benefit analysis of its determination. Third, the Council has removed a self-imposed requirement to analyze the probability of a company's material financial distress. Taken together these three pre-requisites would have made the designation authority unworkable, leaving a key protection created by Dodd-Frank on the sidelines.

[3] 12 U.S. Code § 5322(a)(1).

Designation Authority Must Operate Independently of Activities-Based Approaches

Most importantly, the requirement to conduct and evaluate activities-based approaches prior to considering designation would likely have made the designation process take six or more years to complete.[4] To put that in perspective, six years prior to the failure of Lehman Brothers, its total assets were only $202B.[5] Six years later, in an analysis of its own balance sheet in the spring of 2008, Lehman said that its "gross balance sheet is regularly over $1 trillion."[6]

More recently, consider the case of FTX, which was founded in 2019 and failed barely three years later in 2022. FTX's implosion due to fraud and a rapid shift in crypto markets was luckily not a threat to U.S. financial stability, but it does not take too much imagination to think of an alternate history where FTX grew to be 10 or 20X bigger or had become intertwined with the traditional global financial system before it failed.

Even if you take timing considerations out of the question, it is simply not true that activities-based approaches – which set rules for a particular market activity and apply to all firms who engage in that activity, can substitute for oversight and supervision of entities who are defined by their size, complexity and interconnectedness in the financial system.

Again, the case of Lehman Brothers is instructive. Its failure stemmed from balance sheet losses across a wide range of activities, whether over the counter derivatives trades (subsequently regulated by Dodd-Frank), so-called Repo 105 transactions (subsequently reformed by changes to accounting rules), asset-backed securities on its balance sheet (subsequently reformed in Dodd-Frank), or simply bad bets on commercial real estate. But even if all of the post-crisis activities-based reforms had been in place, none of them would have prevented Lehman Brothers' management from running a 31x leverage ratio, or ignoring prudent standards on liquidity management. Those types of prudential standards simply must be imposed at the level of a corporate entity – taking into account the wide basket of risks, and hopefully combined with quality oversight and supervision.

As Geithner, Lew, Bernanke, and Yellen point out, the absence of oversight *increases* the economic cost and distortions from a too big to fail market perception. When a firm reaches a certain size and complexity, a too big to fail perception will lower that firms funding costs, it's high degree of risk perversely allowing it to compete even more effectively against smaller, less complex firms.[7] Addressing too big to fail in Dodd-Frank requires more than just designation authority, but to the

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[4] Bernanke et al, pg. 7.

[5] Lehman Brothers, Report 10-Q, Consolidated Statement of Financial Condition as of August 31, 2002, pg. 6. https://www.sec.gov/Archives/edgar/data/728586/000091205702038678/a2091327z10-q.htm

[6] Erin Callan, "Lehman Brothers – Leverage Analysis," Lehman Brothers, April 7, 2008. LBEX-DOCID 1401225

[7] Bernanke et al, pg. 6. "If a nonbank from a weakly regulated corner of the financial system becomes large and deeply interconnected with the rest of the financial system, and investors perceive that its failure would cause considerable harm to the American economy, they will inevitably place some odds on the firm being bailed out. This lowers the firm's funding cost, giving it an advantage over competitors, and allowing it to grow further. Designation can stop this kind of self-fulfilling prophecy."

extent that prudential standards such as capital and liquidity requirements increase a firm's funding cost – that increase moves the market more towards equilibrium.

Compare that impact to the counterfactual of using an activities-based approach to try to affect the risk caused by a small number of very large, complex firms. The new activities-based standards would increase costs for all participants and end users in a market, while the competitive and funding advantage created by the size, complexity and risk of a few firms would be completely unaffected. The Council's considerations are not predominantly concerned with financial services innovation, but it is worth noting that the existence of the designation authority enables a more pro-innovation stance than would be possible with only activities-based approaches.

For example, imagine a new financial services activity that has an uncertain risk profile. The market participants in this activity include a large number of small players with a variety of strategies who mostly don't have access to debt capital markets (and so are unlevered) and one large nonbank financial services company whose exposures to this activity have grown to $1 trillion on a balance sheet that is levered 25 to 1.

What is the appropriate response to this risk? For sure, the Council should consider activities-based recommendations – perhaps one of its members has authority to address the risk within existing statutory authority, perhaps recommendations to Congress to pass new laws are appropriate. But in the same breath, it is an unacceptable risk for the financial system to have such a large, levered and unsupervised financial services company operating without monitoring or prudential standards. In a framework where many advocate for a patient approach to innovation, activities-based regulation sufficiently strong to address the risk of one giant market participant would likely impose an inappropriate burden on smaller participants in this innovative market.

Put simply, both approaches will be appropriate in different circumstances and the primary regulators working together through the Council must have the freedom and the accountability to make those judgments.

Cost-Benefit Analysis is Not in The Statute and Assumes False Precision About a Dynamic System

The costs of the Global Financial Crisis have been measured as much as a full-year of U.S. GDP.[8] As my colleagues and I wrote in our comment letter to the Council, "the costs of a financial crisis in lost savings and foregone U.S. economic output will always outweigh the cost of regulatory oversight on a single institution."[9] In addition, there is no legislative history or statutory text to suggest a requirement for cost-benefit analysis. Some commenters suggest that cost-benefit analysis

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[8] Josh Bivens, "Why is recovery taking so long—and who's to blame?," Economic Policy Institute, August 11, 2016 https://www.epi.org/publication/why-is-recovery-taking-so-long-and-who-is-to-blame/ estimates the cumulative output gap in the economy at 133% of GDP.

[9] Gerety et al, pg. 5.

is implied by the statutory language that allows the Council to consider "any other risk-related factors that the Council deems appropriate." But this language is clearly *permissive* and cannot be read to require anything of the Council.

Any attempt to include cost-benefit analysis in the Council's designation analysis also falters on substantive grounds for three reasons.

First, the costs of supervision may offset inappropriate market distortions. The industrial logic of very large, complex financial institutions is that they are able to use larger scale and cross-subsidies from higher risk activities to compete with smaller entities in more commoditized markets. This is to some extent unavoidable, but it becomes perverted as we realize that in the cyclical nature of financial markets, these cross-subsidies from higher risk activities will become even more pronounced in good times. By the time cycles change and downside risks become evident, the exposure of the market to irresponsible companies can weaken a much wider swathe of companies.[10] Moreover, these two dynamics exist even without accounting for the market perception of too big to fail discussed above.

Second, cost-benefit analysis does not account for regulatory or management decisions in response to designation. For example, both AIG and GE engaged in significant business and risk restructuring before and after Council designation. AIG engaged in a multi-year process to simplify its business, lower its risk profile, and sell off multiple business units. By the time of the Council's rescission, AIG was a completely different company than it had been in the crisis or even than it had been at the time of designation.[11] The Council cannot know what choices management may make over time. Given the timing dynamics of making a designation decision and implementing appropriate standards, neither can it rely on plans or representations of management. Doing so would imply that Council would become a party to a company's strategy and long-term planning, which is not an authority the Council has or should have.

The Council can play a more active role in the design and implementation of the prudential standards that would apply to a designated entity, but the expectation and statutory direction to the Council and the Federal Reserve is for those standards to be tailored to the risks that the company presents. It would be inappropriate for the Federal Reserve to impose duplicative or bank-like standards on activities that don't mirror bank activities. For example, the Federal Reserve Board engaged in an extensive process to understand and tailor potential regulations of designated insurance companies in deep consultation with insurance regulators both in the U.S. and abroad. The goal of any regulation is to minimize deadweight loss, narrowly tailoring requirements to

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[10] For any who doubt whether these dynamics can infect all types of financial firms, recall that the CEO of Citigroup, Chuck Prince, predicted trouble in the summer of 2007, but argued that the firm was powerless to change its behavior before the market dynamics changed. "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing," quoted in "Citigroup chief stays bullish on buy-outs," Michiyo Nakamoto and David Wighton, Financial Times, July 9, 2007.

[11] Financial Stability Oversight Council, "Notice and Explanation of the Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding American International Group, Inc. (AIG)," September 29, 2017.

precisely offset negative externalities and control risks. While we know that this theoretical goal is not achievable or measurable, the Council cannot know in advance exactly how close to achieving this goal the Federal Reserve will come in creating enhanced prudential standards. The contest between assumptions regarding theoretical future actions would be the inevitable result of an attempt to supplant the Council's judgment with an artificially precise cost-benefit analysis.

Third, the nature of preventive action and risk mitigation means that the supervisory program and enhanced prudential standards would remain in place for as long as a designated nonbank financial company could pose a threat to financial stability. But even in a financial crisis, there will be many banks and nonbank financial companies who may not play a critical role in the risks that materialize. These projections forward in time and the inevitable uncertainty about not just when a financial crisis will occur but the path that it will take means that any attempt to designate "only if the expected benefits to financial stability from the determination justify the expected costs that the determination would impose"[12] is a futile exercise in false precision. The only result from such an analysis is to undermine the central importance of the Council's judgment in favor of arguments about algebra, discount rates, and whether financial crises should be expected to occur every 10, 20, 50 or 100 years.

Waiting for the Probability of Distress to be High is Self-defeating and Potentially Self-fulfilling

The Council's decision to remove the consideration of a nonbank financial company's probability of experiencing material financial distress shows a prudent commitment to the Council's statutory mission to "prevent or mitigate risks to the financial stability…from… large interconnected financial institutions."[13]

The logic of the Council's designation authority is that the Council must act before the Federal Reserve can begin supervising a designated entity. The Federal Reserve also has an obligation to "establish and refine" the prudential standards that apply to any designated entity. Because these designations and prudential standards are intended to prevent and mitigate any potential threats to financial stability, it necessarily follows that they must be in place far before any material financial distress were to appear.

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[12] Financial Stability Oversight Council, "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies," Federal Register, Vol. 84, No. 49, March 13, 2019, pg. 9029.

[13] 12 U.S. Code § 5325 (a)(1). This text comes from a description of the purpose of the Council's recommendations to the Federal Reserve for enhanced prudential standards. The emphasis on prevention clearly demonstrates that designation must occur sufficiently before any potential risk that the prudential standards could be effective. "In order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions, the Council may make recommendations to the Board of Governors concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to nonbank financial companies." Moreover, these recommendations are intended to apply to both large, interconnected bank holding companies as well as designated nonbanks.

As discussed above, even under the original 2012 guidance, the Council's designation process took 1.5-2 years for each designated entity and the development of a full set of tailored prudential standards were proposed by the Board more than 2 years after that. While I personally believe that the development of such standards should have been developed more expediently, it is undeniable that the preventative benefit of a designation process would take multiple years to be effective in the normal course. At the same time, we know that the largest, most complex financial institutions can grow quite quickly and the inherent nature of financial crises is that risks can change quickly and failure can come on suddenly.

Just this year, we saw how quickly a run on Silicon Valley Bank could develop and require extraordinary government action to quell contagion to the rest of the banking system. As the former FSOC and Fed Chairs emphasized in their letter in 2019:

> *The overwhelming lesson of our experience in the financial crisis is that uncertainty pervades all decision making, especially when financial risks are developing in real time. Even in the months leading up to the crisis, it was not clear which financial firms were most at risk of failing nor was it clear how the risks from the failure of those firms would impact other financial institutions, financial markets, or the economy as a whole.*[14]

This uncertainty associated with potential financial distress and the clear statutory exhortations to use careful and deliberate processes for both designations and for applying prudential standards, mean that an attempt to delay a designation decision until probability of financial distress was evident would be self-defeating.[15] History shows that failures typically follow errors in judgment, business strategy, risk management or outright fraud. By definition, these errors and their impact on the firm will not be obvious *ex ante* and will be potentially impossible to spot without the benefit of enhanced supervision.

While the case of FTX is overdetermined, it illustrates how different the application of rules and supervision can be. FTX was engaged in a massive financial fraud, which means that they were willing to produce false reports and to appear to comply with the limited financial rules that they were subject to. But we know that this fraud crumbled almost immediately as competent financial professionals were able to look for underlying documentation and processes, something only supervision can achieve.

Moreover, designation is not supposed to act as an early warning sign of a company's financial weakness or potential distress. Most of the largest, most complex financial institutions – whether banks or nonbanks – have been in existence for many decades, and yet we also know that financial

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[14] Bernanke et al., pg. 2.

[15] For example, the 2019 Guidance suggests using market-based measures such as credit default swap pricing or accounting-based measures like capital adequacy, or combinations of the two. These indicators are not nearly forward-looking enough for the Council to act. For example, CDS spreads on the six largest U.S. banks reached the same level in the summer of 2008 as they had been at the end of 2007. FSOC Annual Report, 2011, Chart 5.1.16, pg. 53.

confidence can be fickle, especially in periods of market disruption. If the Council's action, based on a thorough review of nonpublic information, were seen as a prediction of a nonbank company's failure, it could easily precipitate the very risk the Council has a mandate to prevent.

The 2019 guidance's self-imposed requirement to consider the likelihood of distress was not only self-defeating, but even more dangerously could have been self-fulfilling if it had ever been used.

The FSOC's Revised Guidance Stabilizes a Bi-partisan Consensus on Procedural Protections

From the perspective of procedural fairness, the Council's designation authority is narrow and strictly controlled by an extensive list of required statutory considerations and voting thresholds set by Congress. While the financial services industry continues to voice concerns, the most recent guidance does not make material changes to the step-by-step procedures outlined in the 2019 guidance, which themselves incorporated revised guidance created in 2015.

In particular, the Council has always stated that it expects to follow engage with a company's primary financial regulator (if applicable), base it's determination on a data-driven analysis that is tailored to the particular business model, risks, and potential mitigants to those risks, and to offer the company itself multiple opportunities to engage with both staff and members of the Council, including direct notice that the Company is being considered, as well as an opportunity for a hearing in front of the Council itself after a proposed determination.

The latest guidance follows the 2019 guidance in its simplification of the process from three stages to two, and in its removal of the simple quantitative thresholds that the Council had established to identify an initial set of companies for analysis in the immediate aftermath of the crisis. It also maintains the engagement of the Council early in the process, notifying a company and explaining that the Council itself will vote on whether to advance a company to the second stage of the analytical process.

Finally, the ultimate test of whether the Council is conducting a rigorous and even-handed process is measured in the results. Many commentators who have expressed concern about designation authority have called for an "off-ramp" but the pattern shows clearly that both during the Obama Administration and during the Trump Administration, companies that had previously been designated were able to be reconsidered by the Council and the heightened supervision was removed. Without commenting on the potential for disagreements about those judgments, the question is asked and answered: an off-ramp exists and it works.

III. The Current and Future Risks to the Financial System

While the designation authority is a critical tool for the government to have to prevent and mitigate potential threats to financial stability, it is also designed for narrow purposes. Only four nonbank financial companies have ever been designated by the Council and currently none are designated.

The primary activity of the Council is taken up by two of its duties: first, its duty to "monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States;" and second, its duty to "provide a forum for discussion and analysis of emerging market developments and financial regulatory issues."[16]

I know that many on this Committee may have concerns about the topics that the Council has taken up. Some may think that the Council is too concerned about climate change or too focused on crypto, or perhaps some think that the Council should be spending even more time on private credit or generative artificial intelligence, or some other topic.

My hope, as I close this testimony, is to encourage precisely that sort of dialogue with members of the Council but also to give you frameworks that may help you understand how the Council does conduct this work. The financial system is always generating new and interesting ideas. I know based on my experience that the members and staff who support the Council are always looking to learn – sometimes from the perspective of understanding how innovation can support our economy and sometimes from the perspective of understanding an emerging risk. In finance, we know that risk and opportunity are always paired.

As this Committee does its work, I would encourage you to look closely at the statutory language that guides the Council's work, rather than simply discussing the common language that is used to describe the role of the Council. In particular, I want to articulate a significant difference between the Council's duty to "identify potential threats to financial stability" and the common language that describes the Council as focused on "systemic risk."

My sense is that the phrase 'systemic risk' calls to mind risks that are already large, and likely marbled throughout the financial system. The phrase evokes the way that subprime mortgages and their risks infected nearly every part of the financial system prior to the financial crisis – they had imperiled consumers, and the housing sector of course, but they had been packaged in mortgage-backed securities and found their ways onto the balance sheets of hedge funds, banks, life insurance companies. They were bundled into the commercial paper markets that also served as the lifeblood of short-term liquidity management for large corporations. Their risk came to dominate capital markets as well, as large broker dealers built huge businesses on derivatives markets that were themselves infected by bets on those same asset-backed securities. It's natural, given this history, to

[16] These two duties are only two of the fourteen duties of the Council, 12 U.S. Code § 5322 (a)(2)(c) and (m).

think that the Council's job is to focus on systemic risks -- risks that seem to be "everything, everywhere, all at once."

But the statutory language of the Dodd-Frank Act embedded a different type of insight and wisdom. When Congress created the Council they realized that the Council could not achieve its mission if it waited for risks to metastasize in this way. Instead, the language of the Council's statutory guidance focus on "potential", "emerging" threats. This may seem subtle, but it is a simple and important difference.

Imagine a skyscraper. A systemic risk for that building would occur if the builders had misunderstood the proper way to mix concrete – systemically every floor would then be infected with this improper recipe. But a threat to the stability of the building could be something much narrower. If just one corner of the foundation were sitting on top of limestone sinkhole the whole building (though properly built) would be unstable. Going one step further, imagine that the sinkhole doesn't exist yet, but that there has been a shift in underground water patterns that have the capacity to dissolve the rock. This is an emerging threat to the building's stability.

There is an old adage that policy always fights the last war. In the immediate aftermath of the Global Financial Crisis, there were a wave of new efforts to analyze financial stability. The IMF, the European Central Bank, and the Bank of England all issued new reports and, in many cases, created new bodies to address financial stability. Characteristically, these financial stability reports focused primarily on issues that had been present in the crisis – capital levels, imbalances in financial markets, sovereign debt markets in Europe.[17] None of these reports mentioned cybersecurity at all.

The Financial Stability Oversight Council was the first major financial stability body globally to highlight cybersecurity as a major potential threat to financial stability. Yet now, cybersecurity is routinely highlighted as one of the most important threats to financial stability. Indeed, table top exercises in collaboration with regulators, law enforcement and industry routinely highlight the perils to our financial system from state and non-state exercises who might try to harm our economy with cyberattacks.[18] It would be difficult for any actor to launch a cyberattack on the entirety of the U.S. financial sector at once, but since the financial system is interconnected to itself a successful attack on even a narrow portion of our system could have unpredictable and potentially catastrophic impacts. This is why the Council's mandate to examine potential emerging threats to financial stability is so critical.

This framework for potential emerging threats is key to understanding the Council's choices and its allocation of time. When I served at the Treasury, I often started my conversations with financial

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[17] See for example, Bank of England, "Financial Stability Report," Issue No. 30, December 2011; European Central Bank, "Financial Stability Review," June 2011. Neither of these reports mentions cybersecurity at all.

[18] See for example the Hamilton Series, coordinated by the Treasury Department along the FS-ISAC, an industry group that acts of the financial services coordinating council to help protect U.S. critical infrastructure. https://www.fsisac.com/hubfs/Resources/FS-ISAC_ExercisesOverview.pdf

services executives by referencing Dorothy in the Wizard of Oz. Financial crises are often defined by the risks that people don't expect. Like Dorothy, the Council Members and its member agencies are usually focused on the obvious "lions and tigers and bears, oh my!" but for staff dedicated explicitly to the Council's mission, I always asked "what is the risk that you're worried about and nobody else is? What's going to come up from behind and bite us in the butt?"

To take three hot button examples from the current moment, I would argue that the financial stability risks in the near term from climate, crypto and AI are all limited. But it's undeniable that climate change is changing the financial risk of commercial and residential real estate across the country and the world. It's undeniable that crypto enthusiasts believe that they are in the process of reinventing the financial system. Finally, I defy anyone to spend time playing around with generative AI models and not wonder at the ways that they may alter the scale and speed of potential scams and frauds, including ones that might actually strike at the heart of our largest institutions.

The Council is an organic collection of our nation's financial regulatory bodies. It is powerful largely because its member agencies have been vested by Congress with authority to oversee the disparate parts of our financial system. The Council succeeds when it brings together those disparate authorities and perspective seeking to understand the organic growth and change in risk and innovation in our financial system.

It is precisely the wisdom of the statutory mandate to be forward looking, focused on risk, and worried about low probability, high severity events that gives us some hope that the Council may make financial crises less common and less severe.

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