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Hearing Summary *February 6, 2024*

HFSC Convenes Hearing to Examine the Annual Report of the Financial Stability Oversight Council

Executive Summary

On February 6, the House Financial Services Committee held a hearing to examine the Financial Stability Oversight Council's (FSOC) 2023 annual report, featuring testimony from FSOC Chair and Treasury Secretary Janet Yellen. The hearing centered around discussion of the 2023 bank failures, the Basel III Endgame capital requirements proposal, other proposed banking regulations, and FSOC's nonbank systemically important financial institution (SIFI) designation guidance.

Republicans were generally critical of FSOC for failing to identify emerging instability from interest rate risk prior to the 2023 bank failures, and most GOP lawmakers expressed opposition to the Basel proposal. Moreover, many Republicans — led by Chair Patrick McHenry (R-NC) — raised concerns about the nonbank SIFI designation guidance, in response to which Secretary Yellen emphasized that SIFI designation is not necessarily the preferred tool of the Council. Democrats, on the other hand, praised the regulatory actions being taken by financial and prudential regulators, with many expressing support for the Basel proposal. Democrats also endorsed FSOC's focus on addressing risks posed by digital assets, climate change, and cybersecurity.

Notably, when pressed by GOP lawmakers, Secretary Yellen expressed support for legislative actions that would address regulatory gaps in the digital asset spot market and the stablecoin industry, though she did not offer support for a specific bill. There was also discussion of the insurance industry, particularly as it relates to the Federal Insurance Office's (FIO) climate-related risk data collection initiative. Additionally, Republicans and Democrats expressed concerns about the potential risks posed by artificial intelligence (AI) to financial stability and consumers. Other issues that were discussed to a lesser extend include payments, cloud computing, tax policy, the Securities and Exchange Commission's (SEC) climate disclosures proposal, and sanctions.

Opening Statements

Chair Patrick McHenry (R-NC) criticized FSOC for failing to identify emerging instability from interest rate risk that resulted in the 2023 bank failures. Chair McHenry pushed back against President Biden's assertions that the reforms enacted in the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) contributed to the bank failures. Additionally, Chair McHenry raised concerns about the nonbank SIFI designation guidance, arguing that it does not address the root cause of the bank failures and is not aligned with statutory intent.

Ranking Member Maxine Waters (D-CA) applauded the efforts of financial and prudential regulators under the Biden administration, crediting them with growth in the U.S. economy. Ranking Member Waters pushed for finalization of the Basel proposal, reasoning that the capital requirements would protect consumers. The Ranking Member also expressed support for FSOC's nonbank SIFI guidance and the Council's work to protect against risks posed by AI, digital assets, and climate change.

Financial Institutions and Monetary Policy Subcommittee Chair Andy Barr (R-KY) echoed Chair McHenry's criticisms of FSOC in failing to identify interest rate risk prior to the 2023 bank failures. Chair Barr raised concerns about the nonbank SIFI guidance and labeled FSOC as a "rogue regulator."

Financial Institutions and Monetary Policy Subcommittee Ranking Member Bill Foster (D-IL) noted that the 2023 annual report is the first to mention AI risk, and he supported financial regulators' steps to address risk — especially deepfakes — from the emerging technology.

WITNESS TESTIMONY

Treasury Secretary Janet Yellen (testimony), Chair of FSOC, discussed actions taken by regulators to prevent contagion following regional bank failures last year. Secretary Yellen touted FSOC's publication of its analytic framework to increase transparency into how the regulator examines potential risks. She described the FSOC's focus on various risks, including those from the banking sector, nonbank financial institutions, climate change, cybersecurity, AI, and digital assets. Secretary Yellen indicated that FSOC is also focused on enhanced assessments, coordination, and regulation among its member regulators, especially concerning climate-related financial risks and the regulation of stablecoins and digital assets.

DISCUSSION AND QUESTIONS

Basel & Banking Regulations

- Ranking Member Waters applauded regulators' actions in response to the 2023 bank failures, and she reiterated her criticisms of the 2018 banking reforms as reducing requirements for large regional lenders. She asked the Treasury Secretary to speak to the importance of the Basel proposal. Secretary Yellen asserted that strong capital requirements are important to the safety and stability of the financial system.
- Ranking Member Waters cited research claiming that well-capitalized banks typically lend more during both times of economic stability and stress, and she asked Secretary Yellen to address concerns about the Basel proposal's potential impact on lending. The Secretary pointed to the Dodd-Frank reforms and the impact of the COVID-19 pandemic as demonstrating that implementing strong liquidity and capital rules resulted in a stronger banking system overall.
- When Ranking Member Waters argued that more capital would have prevented the 2023 bank failures, Secretary Yellen emphasized that Silicon Valley Bank's (SVB) management of interest rate risk and overreliance on uninsured deposits contributed to its failure.

- **Reps. Frank Lucas (R-OK), David Scott (D-GA)**, **Bill Huizenga (R-MI), Ann Wagner (R-MO)**, Barr, **Roger Williams (R-TX)**, **William Timmons (R-SC), and Dan Meuser (R-PA)** raised concerns about the Basel proposal, specifically arguing that it would decrease lending to consumers and businesses. Rep. Lucas asked whether the Treasury Department has offered feedback on the proposal. Secretary Yellen was unsure whether Treasury has offered formal feedback. She refrained from offering specific thoughts on the Basel proposal throughout the entirety of the hearing, instead noting that prudential regulators have received public comments voicing concerns about the proposal.
- **Rep. French Hill (R-AR)** observed that the Federal Reserve and Office of the Comptroller of the Currency (OCC) do not support the SEC's proposed rule for registered investment advisors that would alter custody requirements. Secretary Yellen remarked that FSOC has discussed its concerns with SEC Chair Gary Gensler regarding the proposal's potential impact on banks.
- **Rep. Brad Sherman (D-CA)** stressed the importance of striking a balance on capital requirements for banks, reasoning that regulators must ensure that banks continue to lend to businesses and consumers.
- Rep. Timmons asked whether FSOC has reviewed other proposals from prudential regulators, such as the rulemaking on long-term debt. Secretary Yellen maintained that banking regulations are under the authority of banking regulators and that FSOC is not involved in the proposals.
- Rep. Lucas raised concerns about the combined impact of the Basel proposal and the SEC's recently finalized central clearing rule for U.S. Treasuries. Secretary Yellen indicated that FSOC member regulators are actively coordinating on the stability of the Treasuries market.
- **Rep. Nydia Velázquez (D-NY)** expressed support for the Basel proposal.
- **Rep. Blaine Luetkemeyer (R-MO)** asked how FSOC has addressed banks that are particularly vulnerable to interest rate risk. Secretary Yellen responded that prudential regulators engage in bank supervision and that FSOC is not responsible for managing interest rate risk.
- Rep. Wagner asked whether Treasury and prudential regulators have instructed financial institutions to search legal transactions to "surveil" their purchases. Secretary Yellen responded that Treasury intends to investigate this matter further and respond.
- Rep. Barr argued that the OCC's proposed rulemaking on bank mergers would effectively ban mergers for nationally chartered banks.
- **Rep. Ritchie Torres (D-NY)** was concerned about signs of volatility at New York Community Bank. Secretary Yellen refrained from commenting on the situation but indicated that FSOC is in touch with supervisors on the situation and that the Council is aware of the risks that commercial real estate vulnerabilities pose to the banking system.
- Rep. Torres asked whether the "intensive" regulation of banking led to the emergence of the largely deregulated "shadow banking" system. Secretary Yellen agreed that there are often attempts to move outside of a regulatory perimeter and that private credit might be an example of that. Rep. Torres asked whether the Basel proposal would accelerate this trend, in response to which Secretary Yellen emphasized the importance of capital requirements.

- **Rep. Ayanna Pressley (D-MA)** observed investments from large banks in addressing racial wealth gaps, but she argued that banks have failed to make internal policy changes to this end, such as by eliminating overdraft fees, expanding language access, and increasing the diversity of firm leadership.
- **Rep. Steven Horsford (D-NV)** stressed the importance of businesses incorporating diversity, equity, and inclusion (DEI) practices.
- **Rep. Scott Fitzgerald (R-WI)** raised concerns about the "slow pace" of federal approval of bank mergers, arguing this generates uncertainty and a "chilling effect." Secretary Yellen responded that there are typically several issues that must be investigated, which takes time.

Nonbank SIFI Designation Guidance

- Chair McHenry asked whether there are firms currently being analyzed under FSOC's revised nonbank SIFI designation guidance. Secretary Yellen could not answer directly, though she stated that the Council has not yet taken any action or received recommendations with respect to designation. In response, Chair McHenry panned the nonbank SIFI designation process as "opaque" and, therefore, risking greater financial instability.
- Rep. Hill asked whether the Fed has sufficient expertise to oversee different industries, including payments and cloud computing, if such firms were designated as systemically important. Secretary Yellen stressed that nonbank SIFI designation is not the preferred approach of FSOC and is just "one potential tool."
- Rep. Sherman asked why FSOC is focusing on nonbank SIFI designations for firms without significant liabilities, such as mutual funds and money managers. Secretary Yellen did not answer the question directly, instead stating that FSOC is focused on all systemically important risks to the financial system.
- **Rep. Joyce Beatty (D-OH)** applauded the nonbank SIFI guidance, though she noted concerns about due process protections in the designation process. Secretary Yellen explained that nonbanks being considered for SIFI designation would receive information from FSOC and would have opportunity to provide additional information.
- Rep. Wagner cited a 2019 letter and 2021 testimony from Secretary Yellen where she argued that activities-based regulation is the appropriate approach to asset management, and Rep. Wagner contended that this statement is inconsistent with the nonbank SIFI designation guidance. Secretary Yellen stressed repeatedly that SIFI designation is not the preferred approach of FSOC and member regulators, and that activities-based regulation is sometimes the appropriate approach.
- Rep. Meuser did not support FSOC's nonbank SIFI designation guidance, and he asked why the Council has decided not to include economic cost-benefit analyses in the designation process. Secretary Yellen responded that FSOC chose not to include cost-benefit analyses because the benefit of SIFI designation is a "reduced chance" of a financial crisis, which is difficult to quantify.
- **Rep. Rashida Tlaib (D-MI)** prompted Secretary Yellen to discuss the "shadow" banking sector and its connections with the traditional banking sector. Secretary Yellen commented that the shadow banking sector is large and that the Council is examining it for potential risks.

- Rep. Tlaib applauded FSOC's nonbank SIFI designation guidance, but asked why the Council has yet to designate a nonbank firm as systemically important. Secretary Yellen explained that financial risks often stem from market practices rather than a few select firms, once again emphasizing that SIFI designation is not always the best tool.

Digital Assets & Stablecoins

- Chair McHenry touted the Clarity for Payment Stablecoins Act (H.R.4766) and the Financial Innovation and Technology for the 21st Century Act (FIT21) (H.R.4763), and he asked Secretary Yellen to elaborate on FSOC's view that legislative changes are needed to regulate the digital asset spot market. Secretary Yellen responded that FSOC has identified gaps in regulatory authority and consumer protection — such as the Commodity Futures Trading Commission (CFTC) lacking supervisory and regulatory authority regarding spot market digital asset commodities, such as Bitcoin — and she urged Congress to take action to fill those gaps. Additionally, she argued that stablecoins present some risks to the financial system that could become "significant" over time and requires a federal floor for all states' stablecoin regulations. The Treasury Secretary added that a federal regulator should have the authority to bar an entity from issuing stablecoins.
- Rep. Hill stressed FSOC's recommendation for legislative action to address regulatory gaps in the digital asset spot market and stablecoins. He asked Secretary Yellen to describe FSOC's actions to encourage coordination between the SEC and Consumer Financial Protection Bureau (CFPB) on the digital assets and stablecoins legislative frameworks. In response, Secretary Yellen indicated that she has not met with the SEC and CFPB to specifically discuss FIT21 and the Clarity for Payment Stablecoins Act.
- **Rep. Warren Davidson (R-OH)** questioned whether FSOC should be noting digital assets and stablecoins in its annual report given the relatively small size of the sector. While Secretary Yellen agreed that the sector is small and has limited connections to the broader financial system, she noted that digital assets played a role in the 2023 failures of Signature and Silvergate banks. Additionally, Secretary Yellen pushed for a regulatory framework for stablecoins, especially one that would require issuers to hold quality and liquid reserves.
- Rep. Torres asked whether stablecoin issuers should be regulated similar to banks, as called for in the President's Working Group on Financial Markets (PWG) stablecoin report. Secretary Yellen conceded that issuers should be regulated differently, perhaps in a manner similar to narrow banks, which have been proposed banks that are restricted to holding liquid and safe government bonds as opposed to other equities, such as loans.
- Secretary Yellen answered in the affirmative when Rep. Timmons asked whether regulatory gaps in digital asset markets pose threats to consumers.

Insurance & Commercial Real Estate

- Rep. Velázquez noted that the Council's annual report identifies property insurance — which she characterized as becoming "prohibitively" expensive for homeowners — as an increasing risk to financial stability. Rep. Velázquez also raised concerns about the impact of rising property insurance costs on affordable housing. She asked how the FIO is working with the National Association of Insurance Commissioners (NAIC), insurance carriers, and state regulators to analyze this issue. Secretary Yellen remarked that FSOC is very focused on rising insurance costs and the risks to homeowners, banks, and the financial system. She added that FIO is working to improve its understanding of the impacts of climate change on insurance costs and availability, and she pointed to FIO's data collection initiative on climate risks, which is being done in collaboration with NAIC.

- When Rep. Velázquez asked how FIO is working to ensure that its efforts are not duplicative with those of NAIC or state regulators, Secretary Yellen stated that the need for data is slightly different between FIO and NAIC, though they are coordinating to prevent duplication.
- Rep. Velázquez asked whether FIO has had conversations with the Department of Housing and Urban Development (HUD) on how insurance premiums are impacting the operation of affordable housing programs. Secretary Yellen was unable to offer specifics, but she believed that FIO and HUD have had these conversations.
- Secretary Yellen agreed with **Rep. Juan Vargas (D-CA)** when he stressed his concerns regarding climate-related financial risks. In particular, Secretary Yellen was worried about insurance and reinsurance companies leaving certain regions due to heightened climate risk.
- **Rep. Barry Loudermilk (R-GA)** advocated for a voting seat on FSOC representing state insurance regulators. Secretary Yellen did not have a position on this matter.
- Rep. Loudermilk noted that FIO stated that the climate-related risk data it requested could not be obtained from state insurance regulators in a "timely manner," and he asked for additional details on how FIO reached this assessment. In response, Secretary Yellen stated that NAIC is initiating its own efforts to collect more granular climate-related data and that opportunities for collaboration between FIO and NAIC exist.
- **Rep. John Rose (R-TN)** blamed the withdrawal of insurance and reinsurance companies in certain regions on "a terrible state-based regulatory environment," which he argued has challenged the financial viability of these companies. In particular, likely speaking in reference to California's Proposition 103, Rep. Rose argued that insurers being forced to issue policies at certain rates has challenged their solvency.
- Rep. Scott observed that FSOC's annual report has identified commercial real estate lending vulnerabilities as risks to the financial system, and he was worried about the importance of commercial lending to community banks. **Rep. Emanuel Cleaver (R-MO)** echoed Rep. Scott's concerns regarding commercial real estate weakness. Secretary Yellen explained that office spaces in some cities are of "special concern" due to increases in vacancy rates and declines in property values.

AI, Payments, and Cloud Computing

- Rep. Luetkemeyer agreed with FSOC's assessment regarding the financial stability risks of AI.
- **Rep. Stephen Lynch (D-MA)** was worried about the explainability of algorithms being used by financial institutions, especially as many small firms are acquiring algorithms that they may not fully understand. Secretary Yellen stated that FSOC is still working to understand the risks and vulnerabilities of AI, acknowledging that the explainability of algorithms — especially ones making credit actions — is an area of concern.
- Rep. Lynch asked whether third-party providers of AI technology to financial services firms fall under financial regulatory oversight. Secretary Yellen was unsure, but she noted that

third-party providers of other technologies and services to banks typically fall under prudential regulatory oversight.

- Rep. Foster was concerned about scams enhanced by AI tools, particularly deepfakes. He mused that digital IDs would be the most effective solution to deepfakes. Secretary Yellen characterized digital ID proposals as "valuable," and she indicated that FSOC and Treasury staff are planning on issuing a report on AI-specific cybersecurity and fraud risks, which will include follow-up work with the financial sector.
- When Rep. Hill asked for the Treasury Secretary's view on the CFPB's proposed rule to define larger participants for the payments market, she responded that the Council has not taken a position on the proposal. Rep. Hill pressed Secretary Yellen on whether she agrees with the CFPB's assessment that peer-to-peer (P2P) payments apps — such as Zelle or Venmo — present financial instability risks. Secretary Yellen stated that FSOC has not highlighted this matter in its annual report.
- Rep. Foster promoted his Strengthening Cybersecurity for the Financial Sector Act (H.R.7036) to give the National Credit Union Administration (NCUA) and the Federal Housing Finance Agency (FHFA) the authority to oversee pertinent third-party vendors.
- Rep. Velázquez asked how the Cloud Executive Steering Group (CESG) has engaged with cloud service providers to address risks to financial stability. Secretary Yellen stated that CESG is still working to examine gaps and identify regulatory authorities to address these issues.

Taxes

- In a dialogue with Secretary Yellen, Rep. Sherman urged the Internal Revenue Service (IRS) to finalize its rules regarding digital asset transaction taxation, as was mandated by the Bipartisan Infrastructure Law (BIL).
- Rep. Sherman commended the IRS' Direct File pilot program and he urged the Treasury Department to consider sending a pre-populated form to taxpayers, similar to other countries.
- Rep. Sherman criticized the capital gains allowance for investments in the stocks of China-based companies, contending that there is no national security benefit to investing in the Chinese economy. Secretary Yellen countered that inbound and outbound investment have been beneficial for the U.S. economy.
- **Rep. Josh Gottheimer (D-NJ)** asked about the Treasury Secretary's view on the SALT Marriage Penalty Elimination Act (H.R.339), which would double the state and local tax (SALT) deduction for married couples. Secretary Yellen did not offer her views on the bill.

Debt, Climate Change, & Sanctions

- When questioned by **Rep. Pete Sessions (R-TX)** on the national debt, Secretary Yellen and pointed to the Biden administration's budget proposals as promoting fiscal sustainability.
- When Rep. Huizenga asked about FSOC's view of the SEC's climate disclosures proposal, Secretary Yellen expressed support for additional climate-related disclosures.
- Rep. Beatty asked Secretary Yellen to describe the risks of climate change to low-income communities. Secretary Yellen cited research demonstrating that low-income communities are less able to afford protections, such as insurance.

- Rep. Williams criticized the inclusion of climate-related financial risk in the FSOC annual report, arguing that it could lead to the “politicization” of the banking system.
- Rep. Timmons stressed his concerns about the financial stability risks posed by the Chinese government, which he viewed as actively working to undermine the U.S. economy.
- **Reps. Bryan Steil (R-WI)** and Gottheimer asked whether Treasury plans to levy sanctions against Chinese entities purchasing Iranian oil products. Secretary Yellen was unaware whether Treasury has sanctioned these companies, though she stated that the Department has been working to address the sale of sanctioned Iranian oil.