KPMG

Regulatory Alert

Financial Services Regulatory Insight Center

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FSOC Annual Report

Key points

— The FSOC's Annual Report highlights areas of emerging risk and vulnerability that encompass information security, alternative reference rates, central counterparties, nonfinancial business leverage, and automated trading systems.

— The emerging risks and related recommendations are consistent with reports released by the FSOC's member agencies, including the Federal Reserve's recent Financial Stability Report and the Treasury's reports on the U.S. financial regulatory system.

— In most cases, the FSOC recommends coordination among the regulators and further monitoring.

The Financial Stability Oversight Council (FSOC) published its 2018 Annual Report highlighting developments in the financial markets and regulation, emerging threats, and recommendations to promote U.S. financial stability.

The emerging threats and related recommendations include:

Cybersecurity: Continued investment in and greater reliance on information technology across a broad array of interconnected platforms is increasing the risk of a cybersecurity event. The FSOC recommends regulatory agencies ensure a robust and consistent standard of cybersecurity monitoring and examinations, and harmonize cybersecurity supervision and regulation.

Market factors: The FSOC suggests that the following issues could pose potential threats to U.S. financial stability: the concentrations of activities and exposures in central counterparties (CCPs); reliability and sustainability of LIBOR; risk-taking in large, complex, interconnected financial institutions; reliance on short-term wholesale funding markets; financial innovation; and data quality, collection, and sharing. In response, the FSOC recommends:

— The CFTC, Federal Reserve, and SEC coordinate on supervision of all systemically important CCPs, evaluate the robustness of existing rules and standards including stress testing, and promote further recovery and resolution planning.

— The Alternative Reference Rates Committee (ARRC) complete its work to achieve a smooth transition away from LIBOR and market participants consider potential uses of the Secured Overnight Financing Rate (SOFR) in new transactions.

— Large, interconnected institutions maintain sufficient capital and liquidity to reduce their vulnerability to economic and financial shocks.

— Regulators continue to monitor the liquidity of repurchase agreement markets as well as assess potential financial stability risks from other types of cash management vehicles.

— New approaches to reduce regulatory fragmentation with regard to financial innovation.

— Regulators and market participants collaborate to improve the coverage, quality, and accessibility of financial data and data sharing, including nonbank mortgage and derivatives data.

Prolonged credit expansion: The FSOC notes that nonfinancial business leverage is at the upper end of historical ranges. It recommends the regulatory agencies monitor levels of nonfinancial business leverage, trends in asset valuations, and the ability of regulated entities to manage severe, simultaneous losses.

Changes in market structure: The FSOC suggests that the use of automated trading systems, increased speed of executed transactions, and wide variety of trading venues and liquidity providers have increased the potential for liquidity mismatches and the need for real-time liquidity monitoring. It recommends the regulatory agencies:

— Assess complex linkages among markets, factors that could cause "flash events," and potential ways to mitigate risks.

— Identify areas in which improved data-gathering might fill in gaps in understanding of the market structure.

— Evaluate the use of coordinated tools, particularly in response to market stress or incidents that threaten financial stability.

Asset management: The U.S. asset management industry is of growing importance to the financial system and economy. In response, the SEC has begun to assess potential threats and vulnerabilities related to liquidity and redemption risk and the use of leverage. The FSOC recommends the SEC monitor the implementation of rules for registered investment companies that promote improved liquidity risk management and data reporting and evaluate their effectiveness. In addition, the FSOC recommends the regulators review their data collections for private funds and assess whether the data is sufficient to allow the FSOC to monitor risks to financial stability from these entities.

Global economic and financial developments: Economic and financial risks in foreign jurisdictions, such as risks from a "no-deal UK exit from the EU," the European sovereign debt markets, trade tensions with China, and emerging markets issues, may impact U.S. financial stability through direct financial exposures or spillover effects on economic and financial confidence. The FSOC highlights these risks but does not detail specific recommendations

The emerging threats highlighted in the FSOC's Annual Report are consistent with recent reports by the Federal Reserve (Financial Stability Report and Supervision and Regulation Report – see KPMG related Regulatory Alerts here and here), the OCC (Semi-Annual Risk Perspective, Fall 2018), and the Treasury.

KPMG's Ten Key Regulatory Challenges of 2019 similarly highlights regulatory challenges that overlap with the FSOC emerging risks, and identifies key actions firms can take in response to heightened regulatory focus.

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