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# THE ANNUAL REPORT AND OVERSIGHT OF THE OFFICE OF FINANCIAL RESEARCH

## HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC POLICY

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

REVIEWING THE OFFICE OF FINANCIAL RESEARCH'S ANNUAL REPORT, DISCUSSING OFR'S EFFORTS, ACTIVITIES, OBJECTIVES, AND PLANS, AND CONTINUING ITS OVERSIGHT OF THE IMPLEMENTATION OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

JANUARY 29, 2014

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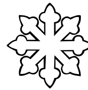

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# THE ANNUAL REPORT AND OVERSIGHT OF THE OFFICE OF FINANCIAL RESEARCH

**WEDNESDAY, JANUARY 29, 2014**

U.S. SENATE,
SUBCOMMITTEE ON ECONOMIC POLICY,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Subcommittee met at 3:30 p.m., in room 538, Dirksen Senate Office Building, Hon. Jeff Merkley, Chairman of the Subcommittee, presiding.

**OPENING STATEMENT OF CHAIRMAN JEFF MERKLEY**

Chairman MERKLEY. Good afternoon. I call this hearing to order of the Economic Policy Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs.

I have a short opening statement. I believe that Senator Heller may be joining us in a moment. He may have a short statement, as well. And then we will turn directly to Dr. Berner's testimony. We are so pleased to have you with us today.

Mr. BERNER. Happy to be here.

Chairman MERKLEY. A healthy, safe financial system is vital to a robust economy that works for middle-class America. From deposits to small business loans, retirement advice to loan insurance, to a home mortgage, to an auto loan for working families and the Main Street economy rely every day on the financial system to help them build a healthy financial foundation. This system is critical to a growing economy, as it also helps channel capital to new opportunities.

But as we all remember from Jimmy Stewart and "It's a Wonderful Life", and more recently from our own experience in 2008, the financial system can also be quite fragile. When firms have too little capital, too little oversight, or weak interconnections and volatile markets, in other words, when systemic risks go unaddressed, the result is often a banking crisis that can culminate in a great recession or a great depression. Ordinary families lose jobs, homes, savings, and businesses as lender and investor confidence dries up. There is no accident. It takes much longer to return to full employment after a financial crisis than after a simple recession.

In the years since the 2008 crash, we have put in place a series of important reforms. We established a dedicated Consumer Protection Agency. We mandated clearing and transparent trading of derivatives. We separated hedge fund-like betting from the loan-making banking system. We required higher capital in our banks. And we created the ability to wind down a failed financial company.

Dodd-Frank has sought to restore protections and oversight to make our system work better for the middle class and to prevent future crises.

Have we done enough? There is undoubtedly more to do and we should not stop grappling with that question.

One clear lesson from the 2008 financial crisis was that neither the private sector nor the public regulatory agencies could adequately identify the risks they faced. In the future, we must do a much better job of identifying and addressing the systemic risks before it is too late.

That is why Dodd-Frank created the Office of Financial Research. As its Congressional authors envisioned it, OFR is supposed to be a kind of National Institute of Finance, to cure gaps in data and analysis, to engage in and support cutting-edge research, and to look through the complexity of our financial system and provide Congress and the public with independent and transparent assessment of what risks we face and what can be done about it.

The mission set out for OFR is no small task, and it is important that OFR and others get it right, from understanding asset managers to monitoring repo and more. The Annual Report that we will hear about today is only the beginning of OFR's efforts to live up to that mission.

This is the first appearance of Dr. Berner, or any OFR Director, before the Senate Banking Committee. I thank Dr. Berner for being here today and to further discuss OFR's work over the last year and the contents of its Second Annual Report. It is tremendous to have you, and we will now turn to Senator Heller, if you have an opening statement.

## STATEMENT OF SENATOR DEAN HELLER

Senator HELLER. I do. Thank you, Mr. Chairman, and thanks for holding this hearing today, and thank you, also, to Dr. Berner for being here and giving our Subcommittee an overview.

Created by Dodd-Frank, the OFR serves the Financial Stability Oversight Council with the stated goals of improving the quality, transparency, and accessibility of financial data and information. I think it is worth reminding everyone that this Government organization does not receive Congressional appropriations and lacks standard accountability to Members of Congress, and most importantly, to the American public. Much like the Consumer Financial Protection Bureau, the OFR has the authority to collect unprecedented amounts of data from businesses.

While there are many concerns about this organization, I will focus most of my attention today on OFR's September report on asset management and financial stability. In this report, the OFR alleges that asset managers could pose risks to the broader financial system. Since the report was released, there have been serious allegations that OFR's conclusions were unsupported by inadequate data, used one-size-fits-all modeling, and neglected to consider current regulatory frameworks.

While there are certainly individuals who would like to argue whether one company or another should be labeled as systemically important, I think everyone should agree that those decisions

should be made after evidence-based facts have been found through comprehensive evaluations.

After a few years, both Republicans and Democrats have expressed concerns with OFR's actions, and even the Government Accountability Office has questioned OFR's standards. It is my hope today that Dr. Berner will provide some clarity and transparency about OFR's recent work and decisions.

So, again, Mr. Chairman, thank you and I look forward to hearing Dr. Berner's testimony.

Chairman MERKLEY. Thank you very much for your opening statement. The record will remain open for 7 days for additional statements or for questions for the record.

Would the Senator from Massachusetts like to make an opening statement?

Senator WARREN. No, Mr. Chairman. I am ready to get right to the testimony and the questions. Thank you.

Chairman MERKLEY. Thank you.

I would now like to introduce Dr. Richard Berner, our witness. Dr. Berner has served as the first Director of the Office of Financial Research since January of 2013. Prior to his confirmation as Director, he served as counselor to the Secretary of the Treasury with responsibility for standing up the OFR.

Before joining the Treasury in April 2011, he was cohead of Global Economics at Morgan Stanley. Dr. Berner previously served as Chief Economist at Mellon Bank, and before that, he worked as a Senior Economist at Morgan Stanley, Salomon Brothers, Morgan Guaranteed Trust Company. For 7 years, he worked on the research staff of the Federal Reserve Board in Washington. He has also been an Adjunct Professor of Economics at Carnegie Mellon University and George Washington University.

More follows. Dr. Berner has been a member of the Economic Advisory Panel of the Federal Reserve Bank of New York, the Panel of Economic Advisors of the Congressional Budget Office, the Executive Committee and the Board of Directors of the National Bureau of Economic Research, and Advisory Committee of the Bureau of Economic Analysis.

Dr. Berner has won forecasting awards from Blue Chip Economic Indicators, the *Wall Street Journal,* Market News, and the National Association for Business Economics. He received his Bachelor's degree from Harvard College and his Ph.D. from the University of Pennsylvania.

Dr. Berner, welcome, and please begin.

**STATEMENT OF RICHARD BERNER, DIRECTOR, OFFICE OF FINANCIAL RESEARCH, DEPARTMENT OF THE TREASURY**

Mr. BERNER. Chairman Merkley, Ranking Member Heller, and Members of the Subcommittee, thank you very much for your kind introduction and the opportunity to testify today about our 2013 Annual Report and oversight of the Office.

Chairman Merkley, as you noted, this is my first Senate hearing as OFR Director, so let me take this opportunity to state my commitment to make the OFR a valued resource for the Congress, the Financial Stability Oversight Council, and the American people. This report and my testimony are two of many ways that we can

inform the Congress and other stakeholders about our work. We are committed to being transparent and accountable, so I look forward to further opportunities to discuss with you our efforts to help promote financial stability.

My written testimony covers in detail the topics in your invitation letter, so I just want to highlight a few of those topics now.

First, our report documents how we are doing our job. We focus on potential threats to financial stability and the tools and data we are developing to assess and monitor them. In the report, we unveil a new tool, our Financial Stability Monitor, to identify and monitor such threats. By tracking five areas of risk and spotting vulnerabilities across the financial system, we aim to pinpoint causes of instability rather than just symptoms. The monitor is a prototype. We are already working to improve it. For example, we plan to develop more forward-looking indicators to help us see not only where we are, but also where we are going.

In the report, we identify eight potential threats to financial stability. One of those threats, instability in emerging markets, has affected U.S. financial markets in the last 2 weeks. Recent sharp declines in some emerging markets, economies, currency and asset markets, spilled over quickly into U.S. markets for risky assets, such as stocks. In coordination with Council member agencies, we are monitoring these developments carefully.

We are mandated to fill key gaps in financial data and to implement data standards. The report outlines several OFR projects to improve the scope and quality of financial data. For example, we are working with the Federal Reserve Bank of New York to improve and expand data to measure activity in short-term funding markets. Data standards are critical to improve financial data quality, and we devote a whole chapter in the report to them.

One key example is the Legal Identity Identifier. LEIs are like bar codes for uniquely identifying entities involved in financial transactions. They benefit industry by helping to lower reporting costs. They benefit regulators with better data for policy decisions. And they benefit researchers with consistent data for analysis. The Office has provided global leadership for the LEI system. We lead the U.S. regulatory delegation, and our Chief Counsel serves as Chair of the LEI's Regulatory Oversight Committee. To be truly useful, the LEI and other data standards must be universally adopted, so I have called on regulators in the U.S. and globally to require use of the LEI through regulatory rulemaking.

Another data standard that is important to establish is a single cradle to grave standard for mortgage data called the Universal Mortgage Identifier. Our Annual Report and our latest working paper describe this proposal in detail. This standardization effort is a good example of how we coordinate with other agencies. In addition, publishing the proposal in our working paper series and our Annual Report illustrates two of the several ways we make our analysis and studies available to the public.

The work I have just described is a fraction of what we have done and we plan to tackle much more in 2014. We no longer talk about standing up the OFR as an institution. The OFR is not only standing on its own, but is making important contributions to help promote U.S. financial stability. Hearings like this one are vital fo-

rums for you and the American people to receive timely and accurate information about our work and our plans. I look forward to further engagement.

Thank you again for the opportunity to appear today. I would be happy to respond to your questions.

Chairman MERKLEY. Thank you very much, Doctor, and I think we will have 5 minutes on the clock for each Senator and I will begin the questioning with this observation.

If this was 2007, we might be expecting you to put up a chart showing the dramatic replacement of prime mortgages with subprimes. You might be talking to us about collateralized debt obligations and CDO-squared. You might be commenting on the risks imposed by credit default swaps that posed as—apparently created an insurance—attempted to create an insurance for mortgage securities, and whether or not those were actually backed up in the form that an insurance product needed to be backed up. You might have identified, also, the challenge with the rating of credit securities or mortgage securities and the model in which folks essentially find out what their rating is before they choose who will do the rating. You might have mentioned a whole bunch of things that were central to the meltdown that occurred in 2008.

As you sit here today, if you were kind of recreating in this moment the key factors that we should consider to prevent a meltdown in 2016, 2 years from now, what would be the top three factors you would identify?

Mr. BERNER. Well, Senator, that is a great question, not an easy one to answer. Let me state first that when we think about the financial system, it is very hard to predict financial crises. In fact, I am not sure that we really can predict crises. We can identify, however, vulnerabilities, and it is those key vulnerabilities that we look to to see where the weak points are in the financial system that might be exposed by shocks to the system.

So, as I think about the top three vulnerabilities that are out there right now, we have identified some of them in our annual report. One relates to the potential for the markets to be exposed to an abrupt and sharp rise in interest rates or in volatility. That is because while interest rates have risen somewhat, portfolios are still oriented toward the notion that interest rates would stay quite low, so a rise in rates could be disruptive. A rise in volatility in financial markets, likewise, could be disruptive, because that would change asset prices and have a profound impact on markets. So, those two related factors would be the first vulnerability that I would look to.

The second vulnerability that I think has been mentioned many times before by others are the continuing issues surrounding short-term wholesale funding and securities financing transactions. Those are markets that are extremely important for the functioning of our financial system. They are markets that do not have the advantage that bank deposits have. They do not have a backstop from the lender of last resort. Deposit insurance does not cover them. And there are lots of proposals out there to make those markets stronger and more stable, although we have not yet implemented them and there is still risk in those markets and in related transactions.

Chairman MERKLEY. You are referring to the repo markets?

Mr. BERNER. I am referring to repo markets, yes.

Chairman MERKLEY. Repo, yes.

Mr. BERNER. Repo, among others, and related activities such as what is called the reinvestment of cash collateral in securities lending transactions. So those are all—that is a group of problems that we might focus on.

The last of the top three might be the one I referred to before, and that is we live in a global, interconnected world. Markets are global. Institutions are global. Shocks that emanate from abroad, vulnerabilities that exist abroad, can spill over back to our markets and our economy. I think we need to be aware of those. I think the emerging market situation today, while it does not seem to be, at the moment, one that could spill over in the ways that it perhaps has in the past, it is something that we need to monitor pretty carefully, and it is that monitoring and assessment of where the potential risks might lie that really animates our work.

Chairman MERKLEY. In the 40 seconds I have left, I was surprised to see that you had the spillovers from emerging markets, but not spillovers from the European markets. Any quick insight on that?

Mr. BERNER. I do. That is still an issue. The European economy is still troubled by slow or no growth. Their banking system still has many problems that are widely known. So, you cannot rule out that there would be problems that emanate from that source, as well.

Chairman MERKLEY. Thank you.

Senator Heller.

Senator HELLER. Thank you.

Doctor, thanks again for being here. Your asset management report states that it was conducted to better inform FSOC as to whether or how to consider asset management firms, their designation as SIFI institutions, systemically important financial institutions. Do you believe that the OFR study should be solely relied on as FSOCs move forward with considering asset managers as systemically important?

Mr. BERNER. Senator, the report was put out to inform the consideration of the Council and it is only one ingredient in the Council's deliberations. I obviously cannot speak for the Council. I am a member of the Council, but a nonvoting member, so I cannot speak for the Council or its other members. But I want to draw a sharp distinction between the work that we do in support of the Council and the Council itself. The Council will decide on what to do with assessing truly whether there are threats in the activities of asset managers and what, if any, remedies ought to be taken in response to those threats. And our report was designed to inform the Council and to provide them with information. The work of the Council is ongoing and we continue to support the Council with data and analysis in that regard.

Senator HELLER. Also, your asset management report, you mentioned that OFR was looking for activities rather than particular firms. Some argue that the size of the asset manager alone would not or should not indicate whether it was a source of greater risk. Would it then be appropriate that the SEC should be looking into

whether certain activities deserve tighter oversight rather than simply selecting larger asset managers and putting them under heightened supervision through SIFI designation?

Mr. BERNER. Well, Senator, I definitely agree with the notion that the analytical focus that should be used in looking at asset management activities is the activity. That captures where the activity is being undertaken, whether it is in an asset manager or its counterparties, its clients, and its intermediaries. And so I think that is a better way to look at the potential problems. I cannot prescribe what other regulators should do, but I think that is the way to look at it.

Senator HELLER. Has there been a designation of a SIFI, any SIFI designations up to this point?

Mr. BERNER. Senator, there have been designations of a captive finance company and two insurance companies——

Senator HELLER. OK.

Mr. BERNER. ——and the process continues.

Senator HELLER. In that report, it also stated that significant data gaps impeded effective macroprudential analysis and oversight of asset management firms and activities. The question is, is it responsible as a researcher to publish any conclusions in a report without complete and appropriate data to back those conclusions?

Mr. BERNER. Well, Senator, I think it is responsible to put the information out there. We clearly indicated that our estimates of a variety of metrics relating to the asset management industry were just that, estimates. Because there are data gaps, we would like very much to focus on some of the areas for which we do not have adequate data and to fill those gaps so that we can do more work on looking at the industry. Those include separately managed accounts for which we have only scarce data, as well as more detailed data on securities lending transactions, which, as I mentioned earlier, could be the source of a potential problem.

Senator HELLER. Did you ever ask asset managers directly to provide data of their asset management report?

Mr. BERNER. We have not directly asked asset managers to provide any data. We did, however, engage with—vigorously with ten asset managers and the industry and trade groups continually to discuss their business model, their business mix, how they manage their risk, other factors relating to the very detailed nature of their business. So, we have had a lot of discussions with the industry itself.

Senator HELLER. Did OFR ever work with the SEC on this report before issuing a final product?

Mr. BERNER. Yes, we did. We engaged with the SEC almost from the start, because they are the primary regulator for most of these companies and they have the expertise, long acquired, to look at these companies. So, we wanted to make sure that we were on the same page, both with respect to the existing regulation, the nature of the businesses, and where the problems might arose. And so on all three accounts, we did engage aggressively for more than a year with the SEC and had, I cannot tell you how many phone calls, et cetera, meetings with them, to talk about this report.

Senator HELLER. Doctor, thank you. Mr. Chairman.

Chairman MERKLEY. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, Ranking Member, for holding this hearing. Thank you for being here, Dr. Berner.

So, the OFR obviously plays a very important part in our regulatory system. In essence, your job is to look at the data and the gaps in the data and identify possible sources of risk in the financial system—no politics, just an independent analysis of what is going on. I think it is a really important role.

And that is exactly what OFR did in its recent report on asset managers. You reviewed the available data, you identified serious gaps in the data, and you raised some issues that prompted a robust and healthy debate about the role that asset managers play in the financial system. So, I want to say, thank you, Dr. Berner, for the work you and your staff put into that report. I think that is very important.

Mr. BERNER. Thank you.

Senator WARREN. So, what I want to focus on, though, is the importance of collecting the necessary data, because you identify data gaps in this report. So, I imagine that the agencies that oversee the financial system, the SEC, the OCC, the Fed, the FDIC, have all sorts of data that the OFR would find helpful in its research, and yet as I read Dodd-Frank, those agencies are not required to share the data with OFR. So, what I want to ask about is whether OFR has been able to obtain all of the data it needs from these agencies.

Mr. BERNER. Thanks for your question. The answer to your question is, so far, yes, but I want to emphasize the fact that the engagement with our colleagues elsewhere on the Council is one that requires some thought and some care, and that is because many of the data sets that we look at that they collect are nonpublic data and they have confidential information in them.

Senator WARREN. I understand.

Mr. BERNER. As a consequence, they want to be assured that the data that they share with us are kept as secure as they would keep them, and so we have worked out a process to exactly do that, a variety of processes to make sure there is an agreement, a memorandum of understanding between us for each characteristic of each particular data set, and sometimes that takes time to work out. The more specific we can be in our request, the more finely we can tailor those agreements to reflect the nature of the data.

We are working hard on data sharing, which is something that we think is necessary for the Council, not just for us, to do its job. We have made several proposals on how to make that easier. The Council of Inspectors General for Financial Oversight has made several proposals on that and we are working hard in the context of the Council to make sure that the Council embraces and adopts those proposals so that we can better share data, on one hand, while keeping them confidential on another.

But, we have obtained data in several different areas and we are using those very detailed nonpublic data to analyze interconnectedness and risks and the transmission of risks across the financial system.

Senator WARREN. Well, good, because I think it is very important that all of the agencies be sharing data with you. I am glad you are working on the MOUs to make that possible. And I hope there are no difficulties in data sharing as we go forward, because with-

out good data, you cannot give good independent advice. So, let us know if there are problems there.

But, I want to ask you one other data question in this, and that is about your ability to obtain data from financial companies. I know that you have subpoena power to require companies to produce data under certain limited circumstances, but from what I understand, you have never used that power, is that right?

Mr. BERNER. That is true, and we actually have never asked a financial company in the United States to turn over data to us because there are many data that are available already, as you indicated, that are collected by other agencies, that are publicly available or available in some other form. And so our philosophy for filling data gaps has three steps. First is to prioritize and identify the questions we want to answer. Second, to take stock of the data we have, and we just published a very recent data inventory on our Web site to do exactly that. And then matching those two things enables us to sort of look to where the gaps in data are and to prioritize them.

Now, there are still lots of gaps in data, as you and I agree, and what we need to do is to work very carefully to think about asking the companies for exactly what we need, to make sure, just as we do with other regulators, that those data would be kept secure if they are nonpublic data, and confidential, to assure the companies that their data will not be in jeopardy, their data will not be compromised, and that is particularly important in today's environment, where we are all concerned and trying to take steps to assure that threats, cybersecurity threats, do not destabilize our financial system.

Senator WARREN. Well, I very much appreciate that you are cautious in your data requests, both from other agencies and from financial institutions, but at the same time, I hope you are vigorously pursuing everything that you need and that you have all of the tools you need to get those data, because without good data, you will not be able to make good recommendations. I know you know that and I just want to offer my support for your ability to get the information that you need to help advise us all about the risks we face in the financial system. Thank you.

Mr. BERNER. Thank you, Senator. If I need any help, I will be sure to let you know.

Senator WARREN. Good.

Chairman MERKLEY. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman, and thank you, Dr. Berner, for your work and for being here.

Like several others, I have a concern about the possible push to designate several asset manager firms as systemically important, and I apologize if you all have discussed this before I came. And it is interesting, in this specific issue, in this case, you have some very divergent people and views in terms of financial services, like Barney Frank and Peter Wallison both agreeing that they do not think this should be considered. Barney Frank, in particular said, quote, "it just seemed to me a listing of possible horror stories with no indications that there was any significant likelihood of any of it happening. Systemic risks occur not only when people lose money, but when the people who lose money cannot back up their

losses and you get this cascading effect. That would make everyone in America a systemic risk. I was really disappointed in that one," close quote, talking about, I think, part of your study. Can you react to that in general and the Peter Wallison and Barney Frank critique of this possible movement in this direction?

Mr. BERNER. Senator, if I could, I would like to separate the identification of possible risks and asset management activities from any remedies that might be taken in response to those risks. Part of our job is to identify the risks and where they might lie and to provide the framework of analysis and the data, as we were just discussing, to identify those risks. The Council's job is to also work on identifying those risks, but also to propose and potentially implement any remedies. So, I am not in the business of proposing remedies. I am in the business of trying to identify where the risks might lie and——

Senator VITTER. Well, first of all, I understand that, but obviously, the study is a prelude to that decision, so they are closely related. And, second, it seems to me this critique is about characterizing the nature of the risk.

Mr. BERNER. Well, the study focused on activities, not on firms, and the study, therefore, analytically could not be used as the sole basis for any designation process.

Senator VITTER. Yes. I did not say it would be the sole basis.

Mr. BERNER. And, frankly, it could not be really used as the basis, because to designate a firm, you need to do the analysis that relates to that firm. We wanted to look at activities because we fully recognize that asset managers are basically in the business, and in the agency business, they manage assets on behalf of their clients, not on behalf of themselves. It is, as you indicated earlier, it is money that they—where the client may lose money, but the asset manager itself may not be threatened by a simple change in market value.

Those are not the risks that we are concerned about. We are concerned about other risks that we talk about in the report in some of the activities in asset managers, where there is opacity, for example, in separately managed accounts, which we think are roughly 40 percent of assets under management by U.S. firms on a global basis. We need to shine a spotlight in those areas and find out more about what is going on in those accounts.

Second, we pointed out that when asset managers lend out their securities in a securities lending transaction, they get in receipt for the lending of those securities, they get cash back that they can then reinvest. If there is an abrupt change in market prices, that investment of the cash collateral, as it is called, that comes back, could unwind quickly and could have destabilizing impacts on markets. So, asset managers are affected by market developments, and if they are sharp changes in market prices, or a sharp change in perceptions, then their activities could give rise to potential threats to financial stability, and we think those are some of the vulnerabilities that we need to take a closer look at.

We have not arrived at any conclusions, as I said, about remedies. We are simply looking at potential threats.

Senator VITTER. Related to this, let me also ask you about process. A lot of the firms involved and others, including members,

have been frustrated and concerned about what they consider sort of a black box process and very little ability for folks in the business who know the details of their business to see elements of an ongoing study and react to it or critique it in a constructive way at all. I know there is not any legal requirement for you to have some sort of comment period, but what is the purpose of not being more interactive than you are in doing studies with the goal of getting the study right and understanding as good as possible what the true facts are and situations are in the real world?

Mr. BERNER. Senator, as I indicated earlier, we engaged with ten large asset managers in considering our study. We sent teams of experts to visit with those asset managers. I personally went to visit with five or six of them, or were on the phone with some of the others. I spent 30 years in the business, so I have a lot of contacts in the asset management industry with whom I consulted and we all consulted in putting the report together.

I think that it is important to recognize that we have a transparent, open door policy. There is not a single asset manager, not a single trade group, representatives of asset managers, who asked to have a meeting with us that we have turned down. We repeatedly——

Senator VITTER. I do not want to interrupt, but I think if you talk to them and ask them, they will say, yes, we had a meeting and we got no reaction from anyone about what the thinking was or where this might be headed and no real ability to react to that. And so that is what they thought was completely lacking.

Mr. BERNER. Senator, all I can say is that I found those meetings very constructive. There was a vigorous give and take at those meetings about—and a lot of questions about the things that we might be concerned about, some of which I mentioned earlier. So, I cannot speak for them. All I can do is say that those discussions were vigorous. We continue to welcome engagement with the industry. We continue to welcome opportunities to talk to the industry. And we continue to welcome the opportunity to do more work in this area.

Senator VITTER. Well, I would just ask you to think about that process——

Mr. BERNER. OK.

Senator VITTER. ——because there is real frustration about that process from their point of view, about hearing where might be headed or what your sort of draft thoughts are and having an opportunity to react to that rather than just be able to make a presentation to sort of a stone-faced representative, and I think that is an accurate description of most of their reaction. It took the SEC, for instance, to put the study out to comment in any way, so that certainly was not formally done by you all. But thank you.

Chairman MERKLEY. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and I appreciate your indulgence in allowing me to attend, since I am not on the Subcommittee, but I am on the full Committee, and I appreciate your having this hearing.

Dr. Berner, thank you very much for being here. I kind of want to go down a similar road that Senator Vitter went down, and I share his concern that I think you could argue that the September

report in some ways may overstate the risks and in some ways minimizes the very extensive regulation that is already in place on asset managers. And our concern—some of us are concerned that if that is the impression that the report creates, it might increase the chances of a SIFI designation, which I think would be a big mistake, and I understand that is not your call, and I am not suggesting that that was your intent, but it could be the consequence.

And so one of the things that strikes me is that the report does not spend much emphasis on the very extensive regulation that is already in place, has been in place on asset managers for a very long time. As you know, they are regulated by the SEC, the CFTC, the DOL, the Treasury Department, as well as international regulators. Senator Vitter pointed out quite rightly that even Congressman Barney Frank suggested that Dodd-Frank was never intended to result in asset managers being designated as SIFIs.

And so in light of the extensive, and, I would argue, very effective regulation that this industry has been subject to for a very long time and continues to be subject to, I guess, could you reflect on how additional either prudential regulation or a SIFI designation, how would that diminish systemic risk throughout the system?

Mr. BERNER. Senator, as I mentioned earlier and as you indicated, the actual remedies for any threats to financial stability are not in my bailiwick. But, I think the basic—I would like to make a couple of points.

One is that when we engaged with the SEC, one of the reasons that we engage so extensively and over a long period of time with the SEC was to make sure that we got the description as well as the effect on the industry of the regulations that exist. And there are, as you well know, two basic parts to the industry. The '40 Act funds that are regulated extensively and comprehensively by the SEC are not our primary concern, although there are some issues potentially that might exist in the activities of asset managers that relate to those funds.

It is in other areas and other activities that we see potential problems and potential vulnerabilities. And so that is why I keep emphasizing the basic fact that it is those activities that I think are important to focus on. It is those activities where we have to do more work, more analysis. It is those activities where—for which we lack adequate data right now to do the analysis and for which we intend to collect on an appropriate basis and in an appropriate way additional data so that we can do the work on those activities.

Senator TOOMEY. So, systemic risk by its very nature is a risk that is transmittable throughout the system, throughout institutions. Otherwise, it is not systemic, right. Could you just give us some thoughts about what are the transmission mechanisms you are concerned about with respect to asset managers.

Mr. BERNER. Well, again, focusing on asset management activities, one of the things that concerns us is that if an asset manager is hit by an external shock, even if it is not the source of that shock, it could transmit or amplify to the rest of the financial system through its activities that shock.

Senator TOOMEY. How would it transmit them?

Mr. BERNER. It would transmit them through potentially what are called fire sale, if the asset manager in question—a fire sale is a sale of assets at prices well below their indicative value——

Senator TOOMEY. Right, but just to explore that a little bit, right——

Mr. BERNER. Mm-hmm.

Senator TOOMEY. If there were a specific problem with a specific manager that caused the investors to decide they wanted to withdraw their money, is it not quite likely they would just put their money with a different manager, because they want to be invested in the markets under this scenario. They have just got a concern with this particular manager.

Mr. BERNER. Right. And that is why, Senator, I am talking about activities. So, if a lot of asset managers are doing similar things, and these problems affect more than one asset manager, they affect the activities of a particular asset manager rather than a specific firm, that is the circumstance where we think there might be potential threats. So, it is not about the firms as we characterize it and as we do our analysis. It is about the activities in which those firms engage, and those are the things that we need to keep in mind.

Senator TOOMEY. And those activities are regulated now by the SEC and other—principally, but other regulators, as well, right?

Mr. BERNER. Well, the regulation of—they are all regulated, for example, by the Department of Labor, by ERISA, as Senator Merkley and Senator Heller indicated, but the regulation of, for example, activities in separately managed accounts is quite different from the regulation that oversees so-called '40 Act accounts.

So, let me give you an example. In '40 Act accounts, there is a restriction on the extent to which you can lend out for securities lending purposes the portfolio that you are managing. It is limited to roughly a third. In separately managed accounts, however, there is no such limitation. You can lend out the entire portfolio.

So, a firm that engages in securities lending activity may choose to lend out the entire portfolio from its separately managed accounts, but that is something that we are not quite sure of, where there is a lot of opacity around, and if you are lending out the whole portfolio and the circumstances arise that would create the unwind that I was talking about, then that is something that we should know more about. It is something that we should try to monitor and to try to assess where the risks are.

Senator TOOMEY. Thanks very much. Thank you, Mr. Chairman.

Chairman MERKLEY. Thank you very much, and I think folks are interested in another round of questions.

I wanted to start with the two issues that you identified as number one and number two, a potential sharp rise in interest rates and then the repo markets and the potential contagion effect that can occur between firms. In regard to a potential sharp rise in interest rates, of course, up here on Capitol Hill, we hear the words "sharp rise in interest rates" and we are thinking in the context of U.S. Treasury bonds and what that means to our budget. But that may not be exactly what you are concerned about here, so paint out a couple scenarios that lead to the sharp rise in interest rates and where those interest rate rises occur, and then how those

reverberate through the economy in ways we should be concerned about.

Mr. BERNER. Well, Senator, it is a good question. The rise in rates that could be destabilizing, it is hard to calibrate exactly what we mean by sharp, or hard to characterize what we mean by abrupt. But right now, the fact is that we live in a relatively moderate growth, low inflation environment and investors have embraced that and they positioned their portfolios to take account of that.

So, portfolios are skewed toward fixed-income securities and they are skewed toward the longer end of the yield curve, longer-term securities, and we have seen a rise in interest rates there. The rise that occurred last, I think, last spring and summer is a possible foretaste of what could happen if rates were to rise more sharply.

One of the things that is very difficult to do is to predict when the rise might occur, how sharp it would be, and exactly what its sources might be. Our job is to try to identify what the impact of such a rise in rates might be. We can conduct, or construct scenarios that might entail such a rise in rates. Ten-year Treasuries, for example, are around two-and-three-quarters percent. Other rates are aligned with them. If they were to rise sharply, by 100 basis points or more, that is in the ballpark of what we are talking about for a sharp rise in rates.

That would create a shift in portfolio allocations. It would create a shift in market expectations. It would spill over into other parts of the financial markets as we saw last summer.

Chairman MERKLEY. So, I think many folks might consider the current low rates to be the anomaly and that a higher rate might be more expected over time. But, my question, what is the source of that higher rate? For example, if this is a change in monetary policy that drives this, that is one factor. If it is a loss of confidence in the ability of the U.S. Government to pay its debts, that is entirely something different. Can you spin out a couple scenarios that you have particular concern about?

Mr. BERNER. The Fed has been very careful about the way it is conducting its monetary policy, and we have seen that the Fed, even today, announced another adjustment in its monetary policy, and the way they are doing that has not had a big impact on interest rates. But, if circumstances change, then the Fed may have to change, as well, and predicting when circumstances might change is difficult. If we, ironically, if we have faster growth, then rates could rise significantly. The faster growth would be a great thing, more jobs, more growth, more housing, more consumer spending.

If, on the other hand, rates rose because investors were concerned about our creditworthiness, as you point out, that's a different source. That would not be productive. And, in fact, one of the risks we identify in our report is the lingering uncertainty over our—the progress we are making or not on dealing with our long-term fiscal problems. So, those are factors that we consider in thinking about what the source of an interest rate rise might be.

Chairman MERKLEY. Well, thank you.

Senator Heller.

Senator HELLER. Thanks again, Mr. Chairman.

Doctor, I want to go back to what Senator Toomey was talking a little bit about. You have done a good job, in my opinion, to identify some of the concerns, repos, derivatives, other exchange-traded funds that you look at in your concern for certain activities. I guess my question, and going back to what Pat said, was that you are an asset manager and, basically, you have an agreement, an investment agreement, with your client. What keeps that client from going from one asset manager to another if they are recorded or designated a SIFI, or perhaps even participating in this activity on their own?

Mr. BERNER. Senator, nothing—it is true that if you do not like the business you are conducting with one firm, you can move your investments to another firm. But that is not really what we are talking about. What we are talking about is activities that are widespread across the asset management industry that are engaged in by a number of firms, identified a couple. If those activities were not very important and not widespread, then, obviously, they would not be that important for assessing risk to the entire financial system. But, because they are widespread and because they are important and because they do contain the potential for risk when stress arises in the financial system, that is why I think we want to focus on them in thinking about where the vulnerabilities to our system might lie.

Senator HELLER. OK. While you were working on your report, was it your intent to make it public or a private report?

Mr. BERNER. While we were working on the report, we thought hard about the fact that we are committed to being transparent and open and want to engage with the public and want to engage to get comments on our work, and we certainly had no shortage of those. We are always committed to making our work available and public in many ways and many forms, and we want to be as transparent as possible, so—and that is true when we engage in meetings with asset managers in other firms. It is true when we engage with the public in general. We want to make sure that we are as open and disclosing as possible.

Senator HELLER. So, if I understand correctly, are you willing to commit that any future OFR research on this topic will be made public, and also any future agency meetings, you will disclose?

Mr. BERNER. Well, Senator, if the Council asks us to do work and it is work that we do on behalf of the Council, then, you know—and it is the Council's property, then the Council would have to make some of those decisions. We exist to serve the needs of the Financial Stability Oversight Council, and if that work is, in their judgment, something that is a draft or predecisional or in other ways not appropriate because it might contain confidential data, for example, for public distribution, then the Council would have the final say. However, I just want to make sure that you understand that if it is appropriate to release information, if it is appropriate to release our analysis, if it is appropriate to release data that we have collected that bear on questions of financial stability, then we are going to find a way to do that.

Senator HELLER. Thank you.

Chairman MERKLEY. Thank you very much. I invite you to conclude just by giving us some of your thoughts on the challenging

and complex issues related to financial stability and the repo market.

Mr. BERNER. OK. Thanks, Senator. The U.S. repo markets are really, are very important for the functioning of our financial system. They enable broker-dealers, investors, others, to finance themselves in the public market on attractive terms. They are used to finance securities transactions, as part of that nomenclature indicates, and so they facilitate financial transactions. They facilitate the ability of financial intermediaries to engage in their basic risk taking, risk pricing, risk management businesses. Unfortunately, as I indicated earlier, those markets, as we learned in the crisis, are subject to either runs or fire sales or both when they come under stress, and those markets have many investors and many borrowers. And so we need to look at all the investors, all the borrowers, and thinking about where the stress points might lie. In one of the three parts of the U.S. repo market, the so-called tri-party market, there have already been put in place by the Federal Reserve System several reforms that are making that market stronger, the reduction of the intraday credit exposure for the institutions involved in that market, the so-called clearing banks. But, that market is still subject to vulnerabilities under stress and those have been discussed pretty well in a variety of places, both by us and the Fed. There are two other parts to the market where we have—one of them, at least, we have very little data. That is the so-called over-the-counter or bilateral part of the repo market, which is used not to transact in the way the tri-party market works, through an intermediary, but directly between the borrower and the lender. That is an area where we have very little clarity and transparency about the transactions that are occurred on a comprehensive, systemwide basis. It is an area where we are working, as I indicated, with the New York Fed to collect more data. But it is an area where we see, potentially, as we saw in the crisis, even more dramatic adjustments to not just the willingness to provide financing, but also in the terms and conditions on which that financing is applied. Each of those areas is one in which we want to investigate as we look at these markets and try to figure out ways to make them more stable.

Chairman MERKLEY. It sounds like we can anticipate that your next Annual Report will continue to explore these issues on the repo markets. I do want to thank you for your first appearance before the Senate Banking Committee and for the contribution that your research is making to the deliberations of the FSOC and wish you well in your quest to help fill in some of the data gaps and data analysis that can help us understand better the vulnerabilities in our system. And with that, I am going to adjourn the Subcommittee meeting, unless my Ranking Member has anything else he would like to add.

Senator HELLER. No, thank you.

Chairman MERKLEY. Meeting adjourned.

Mr. BERNER. Thank you.

[Whereupon, at 4:26 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

## PREPARED STATEMENT OF RICHARD BERNER

DIRECTOR, OFFICE OF FINANCIAL RESEARCH, DEPARTMENT OF THE TREASURY

JANUARY 29, 2014

### Introduction

Chairman Merkley, Ranking Member Heller, and Members of the Subcommittee, thank you for the opportunity to testify today on behalf of the Office of Financial Research about our 2013 Annual Report. [1] This is our second report to Congress, fulfilling an annual requirement to assess the state of the United States financial system and analyze threats to U.S. financial stability.

This is my first Senate hearing as OFR Director. Let me take this opportunity to state my commitment to make the OFR a valued resource for the Congress, the Financial Stability Oversight Council, and the American people. Our annual report and my testimony are just two ways we make our work known to our stakeholders. We are fully committed to being transparent and accountable, and I look forward to future opportunities to appear before you.

My testimony today will cover the four topics cited in your invitation letter:

1. Our efforts to monitor financial stability and assess potential threats to it;
2. The status of OFR data collection and analysis, and related data security measures in place and under development;
3. Studies conducted and facilitated by the OFR; and
4. Coordination with relevant agencies.

Before I begin that discussion, I would like to step back and review the core mission of the Office and the status of our efforts to meet it.

### OFR Mission and Status

The financial crisis revealed serious deficiencies in financial data and in our understanding of vulnerabilities in the financial system. A core part of the OFR's mission is to fill those critical gaps in data and analysis for the benefit of the Financial Stability Oversight Council (FSOC or Council) and, ultimately, the public. Our mandate is not to duplicate work done at other Council member agencies, but to complement their work—to provide the connective tissue that will help us look across the financial system.

To assure transparency and accountability, we regularly engage with our stakeholders in several ways. Our staff regularly briefs members of Congress and their staffs. We also publish our studies through the 12 papers in our Working Paper Series and our two annual reports, and make them available on our Web site. We have also developed our Web site to be user-friendly and a growing source of content. We routinely make public presentations to industry, academia, government, and public interest groups in order to share our research insights and receive feedback from the broader community. We invite outside experts to seminars to share and debate their findings and sponsor conferences to engage with the public. In the past year, we jointly sponsored three such meetings with the Council and the federal reserve banks of Cleveland and New York.

The structure of the Office assures a balance between this transparency and accountability on one hand, and autonomy on the other. The OFR is an office within the Treasury Department. However, it is unique among Treasury offices. The integrity and independence of the Office's work is protected by statute. The Office serves the Council but is separate from it. In particular, the OFR does not make policy, the Council does. That puts us in an objective position to analyze threats to financial stability and to evaluate policies to mitigate them.

To ensure objectivity, our Congressional testimony and, by extension, our research, must be independent. Under the statute, no officer or agency of the United States can require the OFR Director to submit Congressional testimony for approval, comment, or review prior to delivery to Congress.

In creating the OFR, the Dodd-Frank Act prescribed other key differences from the Treasury. The OFR is funded by assessments on certain financial companies. The OFR's pay and employee benefits are comparable to those of other federal financial regulators. At the same time, the law requires the Director to consult on the OFR budget, hiring, employee compensation, and other matters with the Council Chair, who is the Secretary of the Treasury.

[1] The views expressed in this testimony are those of Richard Berner, Director of the Office of Financial Research, and do not necessarily represent the views of the President.

The Office has developed rapidly during the 18 months since we released our first annual report. In addition to our headquarters here in Washington, DC, we have a satellite office in New York City to engage closely with market participants. Our workforce now stands at more than 190 employees, up from only 30 in fiscal 2011. By fiscal 2015, we plan to reach a full staff of about 280.

As we have grown, we have refined our management structure and our policies and procedures to help us carry out our mission. For example, we established an office of External Affairs, led by a member of our senior management team, to coordinate engagement with external stakeholders and partners in Government. Building on the strategic framework that we released in March 2012 to cover FY2012–14, we are working on a new, 5-year strategic plan to take effect in FY2015. The strategic goals in both plans are tied to objectives, outcomes, and performance measures that will focus our work and keep us accountable to ourselves and the public.

We no longer talk about standing up the OFR. Today, the OFR is not only standing on its own, but is making important contributions to promote the stability of the U.S. financial system.

**OFR Annual Report**

The OFR and the Council produce annual reports at 6-month intervals. The two reports cover similar ground but take different approaches. The Council report takes a comprehensive view of vulnerabilities and recommends ways to strengthen the financial system. It is a consensus report, signed by all Council members. In contrast, our report dives more deeply into data and research issues related to those vulnerabilities. We provide an independent assessment of the state of the U.S. financial system, although we solicit and incorporate feedback from Council member agencies and other subject matter experts.

The OFR's 2013 Annual Report contains analyses that focus on analyzing threats to financial stability, evaluating macroprudential policy, presenting findings of OFR research on financial stability (specifically, financial contagion, market liquidity, and interconnections among financial institutions and markets), addressing data gaps and OFR's efforts to fill them, and promoting data standards, such as the Legal Entity Identifier. The report also discusses the status of the Office in achieving its mission, and concludes with our future research and data plans.

*Monitoring Financial Stability and Potential Threats*

Thanks to an array of policy measures and industry actions, the U.S. financial system has grown stronger and more stable since we issued our inaugural annual report in July 2012. However, the financial crisis taught us never to be complacent about a potential buildup of risks that can damage the financial system and the economy. Threats to U.S. financial stability persist and we must remain vigilant.

Today's environment of persistently low interest rates and low volatility might seem benign, but this environment can breed complacency. It can encourage market participants to take more risks and employ more leverage to achieve desired returns. Those, in turn, increase potential vulnerabilities to shocks, such as sharp increases in interest rates and jumps in volatility.

The weaknesses in the financial system are often hidden—becoming obvious only when shocks expose them. Our job at the OFR is to try to identify and assess the vulnerabilities before shocks hit.

We are developing a new tool—our prototype Financial Stability Monitor—to identify and monitor these threats and to assess the interplay among them. This new monitor, a heat map, tracks five functional areas of risk: macroeconomic, market, credit, funding and liquidity, and contagion. We consider this breakdown best for looking at risks across the financial system and identifying causes rather than just symptoms. We quantify risks through a mix of economic indicators, market indexes, and measurements that we calculate.

This monitor is the first version of a tool that we will refine and improve over time. One limitation of Version 1.0 is that our current set of metrics largely tells us where we are, not where we are going. To address that, we are working to incorporate new, forward-looking indicators into our framework.

Informed by this monitor, we have identified a range of potential threats to financial stability. The first four are closely related and often occur together.

1. Disruptions in wholesale funding markets, such as repurchase agreements, or repo.
2. Exposure to a sudden, unanticipated rise in interest rates.
3. Exposure to shocks from greater risk-taking in a low-volatility environment.
4. Exposure to a sudden shock to market liquidity.

5. Excessive credit risk-taking and lax underwriting standards.
6. Operational risk from automated trading systems, such as high-frequency trading.

One additional risk is worth discussing in light of the events of the past week. Recently, emerging-market currency and asset markets have come under significant pressure, and such stress has spilled over quickly into global markets for risky assets, such as equities. In our 2013 Annual Report, we highlighted emerging-market vulnerabilities, including those that have played out in financial markets in the last 2 weeks. We are monitoring these developments carefully.

In Chapter 4 of our annual report, we summarize OFR research projects on new tools for measuring and monitoring market liquidity (examining the measurement of liquidity shocks across asset classes) and network analysis to improve our understanding of contagion among financial firms exposed to each other.

Macroprudential policies are those aimed at reducing contagion and other vulnerabilities that span the entire financial system. They address threats that cut across financial institutions and markets, and are designed to reduce the likelihood and severity of financial crises.

The Dodd-Frank Act requires us to evaluate macroprudential policies. In Chapter 3 of the report, we outline a framework for evaluating such policies. Since the financial crisis, U.S. regulators have expanded the macroprudential toolkit, for example, through supervisory stress tests. Further improvement to stress tests would incorporate funding risks, potential spillovers, and feedback effects to increase value for financial stability assessments.

*Data Collection, Standards, Analysis, and Security*

*Filling data gaps.* A key mandate for the OFR is to improve the scope and quality of financial data. To better measure financial activity and thus better understand how the financial system works—its interconnections, its vulnerabilities, and its risks—we are engaged in several projects to fill data gaps.

A critical step in filling data gaps involves taking stock of existing data. To that end, we have produced and recently published the public portion of an Interagency Data Inventory on the OFR Web site. The OFR produced the inventory in collaboration with the FSOC Data Committee.

The inventory is a catalog of the data that FSOC-member agencies collect from industry that we will update regularly. It contains a listing of datasets, or "metadata," not the data themselves. The public portion posted on our Web site excludes information about nonpublic data, including those derived from other data.

The inventory is essential for identifying gaps in data, avoiding duplication in future requests for data from industry, and improving research and analysis to understand threats and vulnerabilities in the financial system. It is thus a key building block in the OFR data analysis and reporting architecture.

Chapter 5 of our annual report discusses data gaps in detail. It assesses gaps related to short-term funding markets and related financial activities, explains why filling gaps in data related to these markets is a top priority, and describes ways we will fill them. In 2014, we are working with the Federal Reserve Bank of New York to improve and expand data that measure activity in such markets, like repo and securities-lending activities.

*Data standards.* High-quality data are critical for good decision making. Data standards are essential to assure data quality, and thus for comparing, aggregating, linking, and analyzing data. Their adoption will improve data quality and reduce collection costs and duplication.

What are data standards? They are rules that help precisely identify parties to financial transactions, precisely define financial instruments and how they relate to one another, and precisely specify how data should be collected. Standards for collection specify the data fields for collected data and the formats in which they are collected. In the same way that templates are used to collect address information with separate fields for street, city, state, and zip code, the use of standards improves data management and the quality of analysis.

We are making needed investments in the development and implementation of data standards. Chapter 6 of our annual report describes the framework we have developed for creating and promoting data standards. Not surprisingly, a key conclusion is that to be effective, standards should be adopted universally. We all need to use the same standards, or alternatively to be able to translate one set of standards smoothly into another. More work is needed, and I ask for your support to promote their use.

The report also describes progress on implementing the Legal Entity Identifier (LEI), a global standard like a bar code for uniquely identifying parties to financial

transactions. OFR leadership in the initiative to establish and promote the use of the LEI includes serving as Chair of the LEI's Regulatory Oversight Committee.

The LEI's benefits are huge. Precise identification of counterparties would give firms a clearer picture of their exposures in the marketplace. Estimates from financial industry sources suggest that use of the LEI will save billions of dollars that the industry now spends on cleaning and aggregating disparate data and on reporting data to regulators.

For financial regulators, the LEI would assist in data aggregation and comparisons, thus help in identifying vulnerabilities in the financial system and providing insight into ways shocks can spread across financial markets.

Given those benefits, the case for universal adoption of the LEI system is strong. We are collaborating with primary regulators to achieve broader implementation of the LEI in U.S. financial reporting, to sync with efforts abroad. I call on regulators in the U.S. and around the world to require use of the LEI through regulatory rulemaking.

The need for data standards also extends to financial products. For example, a universal mortgage identifier (UMI) is clearly needed. Mortgage debt represents 70 percent of U.S. household liabilities. The mortgage finance system is complex and the data produced by this system are fragmented. A single UMI would bring coherence to these data and would significantly benefit households, industry, regulators, and researchers.

We call for the establishment of a single, cradle-to-grave, universal mortgage identifier that protects the privacy of the borrowers. With substantial input from industry and several agencies, we have just published an OFR working paper that discusses the characteristics that a UMI should have and criteria for implementation.

Industry participants strongly favor the LEI and the UMI to help make their internal data and their reporting activities coherent and efficient.

In another initiative, we are engaging with the Commodity Futures Trading Commission (CFTC) to design and use standards to improve the quality of data collected from trade and swap data repositories.

*Data analysis.* Our annual report contains preliminary results of OFR research using newly available, highly granular data. For example, our analysis of money market fund investments enables us to assess the factors triggering the large decline in U.S. money fund holdings of European bank liabilities during the European sovereign debt crisis. An analysis of the sovereign credit default swap market enables us to identify the sellers, market makers, and buyers of credit protection, and thus to locate sources of risk. We also analyzed hedge fund leverage using aggregated data from Form PF. These aggregated data suggest that hedge fund use of leverage is inversely related to the liquidity of, and the risks in, assets in the funds' portfolios.

*Data security.* No OFR goal is more important than safely and securely collecting data and safeguarding the data we hold.

OFR information security standards are governed by those of the Treasury, and our Chief Information Security Officer works closely with his Treasury counterpart to assure that our policies and procedures meet or exceed the standards of the Treasury Department, as well as the standards of Council member organizations.

To support OFR staff research and to clean, manage, and store large-scale datasets, we have made substantial progress in building our technological infrastructure and the analytical environment that will house our data and give our researchers the advanced tools they need to conduct innovative research.

Our information security standards are fundamental to this new technology infrastructure, verifying access permissions at the most granular level. Technology is necessary but insufficient alone to assure security, so the systems we are building for data acquisition, management, and dissemination are accompanied by strict and clear rules for data security and data sharing.

As required by the Federal Information Security Management Act, the Office has established an information security program policy and data handling procedures for proper safekeeping of information at the highest level of the Federal Information Processing Standards. Our program also includes postemployment restrictions for employees who handle sensitive information.

In addition, we are expanding security controls for sharing information among Council member agencies, collaborating to forge bilateral data-sharing agreements to assure all participants that shared data will be protected, secured, and treated consistently. The agreements are consistent with the analysis of Council data sharing by the Council of Inspectors General for Financial Oversight.

For data-sharing agreements to work, agencies must agree on information security classifications and how to apply them. For example, different agencies may have had different policies for handling data defined as "restricted" or "high security."

The Office led an initiative by the Council Data Committee to “crosswalk” security classification categories. An interagency working group established a common framework for information security practices, processes, and compliance requirements.

The National Institute of Standards and Technology assisted the working group in aligning the framework with the Federal Information Security Management Act of 2002 and the Federal Information Protection Standards. These federal standards represent the common base to which all federal agency classifications are mapped.

*OFR Studies Conducted and Facilitated*

The OFR has conducted and facilitated a wide range of studies in support of its mission. For example, our Working Paper Series is designed to inform the process of assessing, measuring, monitoring, and mitigating threats to financial stability. In addition to the paper about the Universal Mortgage Identifier, discussed above, we have released a paper assessing contagion in financial networks and several papers on the theory and practice of stress testing.

The OFR has also conducted analysis for the last two FSOC annual reports. We have also facilitated analysis for the Council, such as evaluating the risks of money market funds and data related to the process of designating nonbanks for supervision by the Federal Reserve.

In the international arena, the OFR contributes to work streams of the Financial Stability Board on ways to improve data quality in swap data repositories and data gaps in shadow banking.

In September 2013, we released Asset Management and Financial Stability, a report on asset management summarizing the results of a study requested by the Council. We designed the report to inform the Council’s consideration of what threats in asset management activities exist and what remedies, if any, might be appropriate to mitigate any such threats.

The report had three key findings:

- Asset management activities and firms differ from banking activities and banks. To quote the first page of the report, asset management activities “differ in important ways from commercial banking and insurance activities. Asset managers act primarily as agents: managing assets on behalf of clients as opposed to investing on the managers’ behalf. Losses are borne by—and gains accrue to—clients rather than asset management firms. In contrast, commercial banks and insurance companies typically act as principals: accepting deposits with a liability of redemption at par and on demand, or assuming specified liabilities with respect to policy holders.”
- Vulnerabilities in some activities could give rise to threats to financial stability, in particular, risk-taking in separately managed accounts and the reinvestment of cash collateral in securities lending transactions.
- Significant data gaps hamper analysis. Filling them would be essential to verifying our findings.

It is also important to note what the report did not do:

- It did not evaluate individual firms. Any designation process by the FSOC would involve evaluation of individual firms. The OFR report did not focus on individual firms, but instead on asset management activities. As a result, the OFR report alone could not be used as the basis for designating any particular firm.
- It did not substitute for the Council’s work. The goal of the report was to provide information. The Dodd-Frank Act established the OFR as a research and data organization with the mandate to support the Council and its member agencies in their efforts to identify and mitigate threats to financial stability. Responding to the Council’s request for this analysis is part of fulfilling that mandate. However, the OFR’s responsibilities do not extend to deciding on policy actions. The OFR Director is a nonvoting member of the Council and only the voting members of the Council decide on the specific threats posed by any activity and whether any remedies are necessary to mitigate such threats.

Finally, it is important to note that the OFR followed an open and transparent process in gathering information for the report:

- The OFR research team met with representatives from the asset management industry on numerous occasions. Not only did we grant every request from the industry to meet, but we actively sought meetings with industry representatives to learn as much as possible about industry business models and practices.

- The OFR research team engaged with experts from FSOC member agencies throughout the entire course of the process, including extensive interaction with experts from the Securities and Exchange Commission (SEC). Many important contributions from those experts appear verbatim in the report.

*Sponsoring research.* We do not conduct our research and analysis in a vacuum. On the contrary, we seek to create a virtual research community to promote and sponsor world-class research by exchanging and testing ideas. The conferences, workshops, seminars, and public appearances that I mentioned earlier serve as incubators for generating new ideas about promoting financial stability and making our financial system safer.

Another such incubator is our Financial Research Advisory Committee, 30 distinguished professionals in economics, data management, risk management, information technology, and other fields who provide expert advice to the OFR and bring diverse perspectives to help the OFR fulfill its mission. In August 2013, the committee submitted its first set of recommendations to the OFR; these recommendations and the proceedings of the Committee are posted on our Web site.

We have also established a program for sponsoring research through grants. In May 2013, we announced our partnership with the National Science Foundation to sponsor novel research related to financial stability. The first grant was awarded in September 2013 for a project to examine the impact of high-speed trading on the financial system. This research promises to yield additional insights into working with extremely large financial datasets in a supercomputing environment. Researchers at the University of Illinois at Urbana-Champaign and the San Diego Supercomputing Center are conducting the research.

*Coordination With Relevant Agencies*

Interagency coordination is part of the OFR's every day routine in engaging with FSOC member agencies and others. Examples include our extensive coordination with relevant agencies on our asset management report, on data sharing, in seeking input from agencies on other research-related publications, and in providing subject-matter expertise to them.

The OFR leads the FSOC's Data Committee, which handles issues related to data collection, gaps, and standards. We are also supplying data and analysis to the FSOC Systemic Risk Committee and the Nonbank Designation Committee.

Before publishing a research working paper or annual report, we solicit feedback from subject matter experts in academia and at FSOC member agencies and other financial regulators, such as the Federal Reserve Bank of New York.

We are also collaborating with the SEC on cleaning and analyzing data from Form PF, which is submitted by hedge funds and other private funds and, as I mentioned, we are engaging with the CFTC to improve the quality of data reported to swaps data repositories.

As I already mentioned, we are also collaborating with Council member agencies through the Council's Data Committee to promote data sharing, consistent with the strictest security measures.

**Conclusion**

As the financial system changes, evolves, and innovates, new threats and vulnerabilities continuously emerge. At the OFR, we face the challenge every day of filling gaps in data, and conducting and sponsoring essential research that will help us not only understand the financial system of today, but also identify the vulnerabilities that could ensnare our financial system and economy tomorrow.

It is critical for Congress and the American people to receive timely and accurate information about our essential work. That is what makes venues such as this hearing so important.

Thank you again for the opportunity to appear today. I would be happy to respond to your questions.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM RICHARD BERNER**

**Q.1.** What additional disclosures, reporting, limits, or other actions could mitigate concerns about asset manager exposures in the derivatives market?

**A.1.** As we noted in our Asset Management Report and our recent Annual Report, the OFR is working with the SEC and other members of the Council to analyze the Commission's Form PF in an effort to understand and address remaining data gaps and improve disclosures in asset management activities. In addition, the OFR is working with the CFTC to identify ways to improve the quality of the data describing derivatives transactions and exposures that are being collected by swaps data repositories, and is also engaged on the international level to better align swaps data collections to provide a more precise and coherent global view of these markets.

Higher-quality data are needed to improve the understanding of exposures in both derivatives markets and in the securities lending and repo activities described in the response to the next question. The OFR believes that implementation of a common data template would help improve data quality; it should meet the following requirements:

- The data template should be based on a clear dictionary of data definitions to ensure effective and consistent data aggregation across multiple types of market participants;
- reporting periods should be consistent across all firms where feasible;
- reporting frequency and timeliness should ensure that potential market dislocations are captured;
- data elements should provide the common minimum set of standards for U.S. regulatory agencies.

Any such data initiatives should also be designed with consideration of market structure and scale, and should build upon existing data collection processes and market infrastructures. For example, collecting transactions-level data for exchange-traded derivatives may be best accomplished through financial market utilities, including swap data repositories.

The OFR has not conducted analysis of potential mitigating actions that regulators could take in this area.

**Q.2.** What elements should be included in any reporting requirements pursuant to Section 984 to fully inform regulators of the risks involved in securities lending activities? Would a rule under Section 984 require disclosure on all types of securities lending and all relevant parties, or could holes remain?

**A.2.** The OFR is seeking to close the data gaps related to both securities lending and repo activities; they have many features in common. Steps in that project include ongoing analysis of the short-term funding markets, input from the largest and most interconnected market players, and, involvement in other efforts to learn more about the securities lending activities managed by the largest custodian banks.

Additional disclosure requirements could be helpful. These could include information on the type of securities lent, the amount of

cash collateral held related to securities lending and how it is managed, rebates paid to securities borrowers, the percentage of securities for which the firm provides an indemnity in the event a borrower is unable to return the security, securities borrowed, and counterparties the asset manager works with for securities lending transactions.

**Q.3.** Have prudential regulators expressed concerns about the types and concentration of reinvestment of cash collateral undertaken by securities lenders? If yes, does OFR plan to work with these regulators to address concerns about reinvestment of cash collateral? If not, do regulators feel that cash collateral reinvestment practices are sufficiently sound to protect both fund assets and securities borrowers, and does OFR agree with this assessment?

**A.3.** Since the financial crisis, the scope of securities lending activities has decreased substantially. Many lenders who sustained losses have exited their securities lending programs. Collateral reinvestment practices have been reviewed to ensure better risk management. Nevertheless, U.S. regulators continue to express concern about cash collateral reinvestment activities undertaken by securities lenders—see for instance the FSOC 2013 Annual Report (pages 68 and 144) and contributions to reports from the Financial Stability Board. The concern stems from two sources: First, that under stress, such reinvestment transactions might be unwound quickly, resulting in fire-sale conditions; and second, that regulatory agencies lack reliable, detailed data on reinvestment activities and specific investment practices. The OFR's analysis of market sources indicates that reinvestment practices vary widely. We will continue to investigate and monitor these issues and we will work with regulators to address their concerns.