

CIGFO's Corrective Action Verification on the Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities

Report to the Financial Stability Oversight
Council and the Congress

PREPARED BY
THE COUNCIL OF INSPECTORS GENERAL
ON FINANCIAL OVERSIGHT



MAY 2017
CIGFO-2017-002

Table of Contents

Transmittal Letter	1
Executive Summary	3
CIGFO Working Group Audit	4
Background	4
Corrective Actions Taken by FSOC	5
Conclusion	8
Appendices	
Appendix I: Objective, Scope, and Methodology	9
Appendix II: Prior CIGFO Audit Reports	10
Appendix III: FSOC Response	11
Appendix IV: CIGFO Working Group	12

Abbreviations and Acronyms

CIGFO	Council of Inspectors General on Financial Oversight
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
FMU	Financial market utility
FMU Committee	Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee
FSOC or Council	Financial Stability Oversight Council
PCS	Payment, clearing, and settlement
SEC	Securities and Exchange Commission
Treasury	Department of the Treasury



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 26, 2017

The Honorable Steven T. Mnuchin
Chair, Financial Stability Oversight Council
Washington, D.C. 20220

Dear Mr. Chairman:

I am pleased to present you with the Council of Inspectors General on Financial Oversight (CIGFO) report titled, *CIGFO's Corrective Action Verification on the Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*.

One of the statutory duties of the Financial Stability Oversight Council (FSOC) is to identify systemically important financial market utilities (FMUs) and payment, clearing, and settlement activities. Accordingly, CIGFO convened a Working Group to determine whether FSOC had taken actions responsive to recommendations made in CIGFO's July 2013 report titled Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities.

In this resulting audit report, we concluded that FSOC has taken corrective actions responsive to each of the five recommendations made by CIGFO in the July 2013 report titled Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities. We are not making any recommendations to FSOC as a result of this audit.

I would like to take this opportunity to thank the FSOC members for their support, especially those Treasury officials who assisted with this effort.

CIGFO looks forward to working with you on this and other issues. In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, CIGFO is also providing this report to Congress.

Sincerely,

/s/

Eric M. Thorson
Chair
Council of Inspectors General on Financial Oversight

THIS PAGE IS INTENTIONALLY LEFT BLANK.

Executive Summary

Why and How We Conducted this Audit

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created a comprehensive regulatory and resolution framework designed to reduce the likelihood, and severe economic consequences, of financial instability. The Dodd-Frank Act established the Financial Stability Oversight Council (FSOC or Council) and charged it with: identifying risks to the nation's financial stability, promoting market discipline, and responding to emerging threats to the stability of the nation's financial system. Among other things, Title I of the Dodd-Frank Act requires FSOC to report to Congress annually about: (1) its activities; (2) significant financial market and regulatory developments; (3) potential emerging threats to the financial stability of the U.S.; and (4) recommendations to: (I) enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; (II) promote market discipline; and (III) maintain investor confidence.

The Dodd-Frank Act also created a Council of Inspectors General on Financial Oversight (CIGFO), whose members include the Inspectors General with oversight authority for the majority of FSOC's member agencies. The Dodd-Frank Act authorizes CIGFO to convene a Working Group of its members to evaluate the effectiveness and internal operations of FSOC. In May 2016, CIGFO convened a Working Group to determine whether FSOC has taken corrective actions responsive to the recommendations in CIGFO's July 2013 report titled *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*¹.

To accomplish CIGFO's objective, the Working Group interviewed FSOC Secretariat officials from the Department of the Treasury (Treasury) to develop a better understanding of FSOC's efforts to address the recommendations included in the July 2013 CIGFO report. In addition, the Working Group obtained and reviewed relevant documentation from the FSOC Secretariat and publicly available sources. The Working Group conducted fieldwork from July 2016 through September 2016 in accordance with generally accepted government auditing standards. On March 23, 2017, the Working Group briefed FSOC representatives on the overall results of the audit. Appendix I provides additional details about the objective, scope, and methodology of this audit.

What We Learned

FSOC has taken corrective actions responsive to each of the five recommendations made by CIGFO in the July 2013 report titled *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*.

FSOC Response

In a written response, FSOC thanked the working group for the opportunity to review and comment on the report. FSOC noted that CIGFO made no recommendations to FSOC as a result of the working group's review.

1 CIGFO, *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*, July 2013, [https://www.treasury.gov/about/organizational-structure/ig/OIG Sorter/CIGFO_AUDIT_71713.pdf](https://www.treasury.gov/about/organizational-structure/ig/OIG%20Sorter/CIGFO_AUDIT_71713.pdf).

CIGFO Working Group Audit

This report presents the results of the CIGFO Working Group's corrective action verification audit on the July 2013 report titled *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*. CIGFO is issuing this report to FSOC and Congress as part of its responsibility to oversee FSOC under the Dodd-Frank Act. See Appendix II for a listing of previous CIGFO reports.

BACKGROUND

The Dodd-Frank Act established FSOC to create joint accountability for identifying and mitigating potential threats to the stability of the nation's financial system. By creating FSOC, Congress recognized that protecting financial stability would require the collective engagement of the entire financial regulatory community. As shown in Figure 1,² the Council consists of 10 voting members and 5 non-voting members and brings together the expertise of federal financial regulators, state regulators, an insurance expert appointed by the President by and with the advice and consent of the Senate, and others. The voting members of FSOC provide a federal financial regulatory perspective as well as an independent insurance expert's view. The non-voting members offer different insights as state-level representatives from bank, securities, and insurance regulators or as the directors of offices within Treasury — the Office of Financial Research and the Federal Insurance Office.

Within Treasury, a dedicated policy office, led by a Deputy Assistant Secretary, functions as the FSOC Secretariat and assists in coordinating the work of the Council among its members and member agencies.

Figure 1: FSOC Council Membership	
Federal and Independent Members	State Members
<ul style="list-style-type: none"> • Secretary of the Treasury, Chairperson (v) • Chairman of the Board of Governors of the Federal Reserve System (v) • Comptroller of the Currency (v) • Director of the Consumer Financial Protection Bureau (v) • Chairman of the Securities and Exchange Commission (v) • Chairperson of the Federal Deposit Insurance Corporation (v) • Chairperson of the Commodity Futures Trading Commission (v) • Director of the Federal Housing Finance Agency (v) • Chairman of the National Credit Union Administration Board (v) • Director of the Office of Financial Research • Director of the Federal Insurance Office • Independent member with insurance expertise (v) <p>(v) Indicates Voting Member</p>	<ul style="list-style-type: none"> • State Insurance Commissioner • State Banking Supervisor • State Securities Commissioners

² 12 U.S.C. § 5321(b).

The statutory purposes of FSOC are to:

- identify risks to the financial stability of the U.S. that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace
- promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and
- respond to emerging threats to the stability of the U.S. financial system.³

In February 2013, CIGFO convened a Working Group to examine the rules, procedures, and practices established by FSOC to designate financial market utilities (FMUs) as systemically important and therefore be subject to the requirements of Title VIII of the Dodd-Frank Act. In its July 2013 report, CIGFO made five recommendations to FSOC relevant to designations of FMUs and payment, clearing, and settlement (PCS) activities.

CORRECTIVE ACTIONS TAKEN BY FSOC

Recommendation 1

CIGFO recommended that FSOC establish a formal structure for the Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee (FMU Committee)⁴, including designating a chairperson and keeping a record of committee meetings to document, among other things, its deliberations and key recommendations.

In its June 2013 written response to the recommendation, FSOC stated that it is focused on continuously improving governance over its activities. FSOC also indicated that Council staff had already begun examining ways to further enhance the governance of the Council's staff committees, and this recommendation would be included as part of that review. The Working Group commented that FSOC's commitment to include this recommendation in its review of its staff committees was responsive to CIGFO's recommendation.

The Working Group determined that on May 19, 2015, the Council adopted formal charters for all of its committees, including the FMU Committee. The FMU Committee charter outlines its purpose, duties, committee oversight, committee authorities, composition, administrative duties, meetings, committee action, working groups and analytical teams, and confidentiality. With regard to the designation of a chairperson, an FSOC Secretariat representative stated that the Council determined that it would be more appropriate for the FSOC Secretariat to assume the administrative functions that are typically assigned to a chairperson. Some of the reasons given for this were to avoid issues related to staff turnover and differences in records management among the member agencies. The FMU Committee charter states that the FSOC Secretariat will perform the administrative functions to facilitate the operations and work of the FMU Committee, and that such functions may include among others, calling meetings of the FMU Committee, preparing meeting

³ 12 U.S.C. § 5322(a)(1).

⁴ The purpose of the FMU Committee is to support FSOC in fulfilling the Council's responsibilities relating to FMUs and PCS activities under the Dodd-Frank Act.

agendas, developing work plans, distributing materials, producing analysis, coordinating the production of FMU Committee work products, maintaining distribution lists for purposes of communications to participants on the FMU Committee, and retaining custody of all records of the FMU Committee. Although formal meeting minutes of FMU Committee meetings are not recorded, an FSOC Secretariat representative stated that FSOC maintains records of key recommendations made by the FMU Committee and stores any documents sent to committee members on a SharePoint site which also contains all other Council records. The Working Group obtained and reviewed relevant documentation, including FMU Committee meeting invitations and agendas.

Recommendation 2

CIGFO recommended that FSOC determine a course of action with regard to foreign-based FMUs consistent with its authorities, as foreign-based FMUs may be systemically important to the stability of the U.S. financial system.

In its June 2013 written response to the recommendation, FSOC stated that the FMU Committee is expected to continue its discussions on this matter at its upcoming meetings and would communicate any developments to the Deputies Committee⁵ and the Council as appropriate. The Working Group commented that FSOC's commitment to continue its discussions was responsive to CIGFO's recommendation.

The Working Group was told by an FSOC Secretariat representative that the FMU Committee formed a group in the third quarter of 2013 to consider the range of issues associated with the potential designation of foreign-based FMUs. The group discussed its analysis with the FMU Committee and the Deputies Committee in 2014. Our review of the documented presentation to the Deputies Committee shows the group's analysis considered the regulatory landscape for significant foreign-based FMUs with potential U.S. connections, existing avenues for U.S. authorities to exercise oversight, legal considerations, and the potential policy implications of designation. Based on the group's analysis, the consensus of the Deputies Committee members in May 2014 was to not take any further action at that time with respect to the potential designation of foreign-based FMUs. Subsequently, an FSOC Secretariat representative informed the CIGFO Working Group that the Council, through its staff committees, will continue to monitor any potential risks associated with FMUs, including foreign-based FMUs as appropriate, as part of its regular, ongoing efforts to identify risks to U.S. financial stability. This representative also communicated that individual Council members may present matters associated with foreign-based FMUs for consideration, or the Council may direct further work to be done, at its discretion.

Recommendation 3

CIGFO recommended that FSOC continue deliberations on the process and rules regarding possible future designation of PCS activities conducted by financial institutions as systemically important.

In its June 2013 written response to the recommendation, FSOC stated that the FMU Committee is expected to continue its discussions on this matter at its upcoming meetings and would communicate any developments to the Deputies Committee and the Council as appropriate. FSOC indicated that proposals for the designation of PCS activities would be considered in the ordinary course of the FMU Committee's

⁵ The Deputies Committee's duties include coordinating and overseeing the work of the committees of the Council, coordinating the Council's agenda, and assisting the Council in fulfilling its duties.

work. Specific procedures and rules for the future designation of PCS activities were not being considered by the FMU Committee at that time, although such procedures and rules may be developed in the future as a result of FMU Committee discussions or as directed by the Council. The Working Group commented that FSOC's commitment to continue its discussions with respect to PCS activities was responsive to CIGFO's recommendation.

An FSOC Secretariat representative stated that this topic is always on the radar of the FMU Committee, and that there is a process in place for FSOC members to bring an issue to the forefront with the other members. The FSOC Secretariat representative stated that an example of this was when the Securities and Exchange Commission (SEC) presented a trade matching service for consideration during the April 2015 FMU Committee meeting. The Working Group confirmed that the agenda for the quarterly FMU Committee meeting held on April 3, 2015 included the SEC's presentation of the PCS activity and a discussion of PCS activities.

Recommendation 4

CIGFO recommended that FSOC define the nature, frequency, and communication of updates on designated FMUs from the FMU regulators.

In its June 2013 written response to the recommendation, FSOC stated that the FMU Committee would be asked to continue the work it has begun in this area by proposing specific procedures to address this matter. The Working Group commented that FSOC's planned action was responsive to CIGFO's recommendation.

An FSOC Secretariat representative stated that although the final rule on ***FSOC's Authority to Designate Financial Market Utilities as Systemically Important***⁶ states that the FMU Committee will review designated FMUs on a periodic basis, FSOC has always reviewed designated FMUs annually. We reviewed FSOC's internal written procedures used to guide these reviews. Those procedures state that the supervisory agencies provide submissions of quantitative supervisory data annually, which is generally year-end data from the previous year. FSOC staff subsequently formats those submissions to achieve consistency and compiles them into a presentation. The written procedures also state that the supervisory agencies and FSOC staff review the quantitative factors that served as the basis for the designations, and this information is presented to the FMU Committee during the third quarter of each year. During the third quarter FMU Committee meeting, agencies walk through material quantitative changes and also provide qualitative updates if there are notable changes in businesses and strategies. An FSOC Secretariat representative confirmed that this is generally the process and timing that FSOC has followed since the initial designations were made in 2012, although the review has in some cases concluded in the fourth quarter rather than the third quarter of the year.

Recommendation 5

CIGFO recommended that FSOC establish a timeline for periodic reviews of non-designated FMUs that may be systemically important.

In its June 2013 written response to the recommendation, FSOC stated that the FMU Committee will be asked to continue the work it has begun in this area by proposing specific procedures to address this matter. The Working Group commented that FSOC's planned action was responsive to CIGFO's recommendation.

6 76 Fed. Reg. 44,763

FSOC's internal written procedures also state that the FMU Committee will review non-designated FMUs annually for potential future designation, if the supervisory or other agencies believe they could be considered systemically important. An FSOC Secretariat representative stated that non-designated FMUs are reviewed during the third or fourth quarter of each year as part of the same process as reviewing the designated FMUs.

Conclusion

The CIGFO Working Group determined that FSOC has taken corrective actions consistent with the intent of each of the five recommendations made in the July 2013 report titled ***Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities***.

FSOC Response

In a written response, FSOC thanked the working group for the opportunity to review and comment on the report. FSOC noted that CIGFO made no recommendations to FSOC as a result of the working group's review.

Appendix I: Objective, Scope, and Methodology

Objective

The audit objective was to determine whether the Financial Stability Oversight Council (FSOC) has taken corrective actions responsive to the Council of Inspectors General on Financial Oversight's (CIGFO) recommendations made in its July 2013 report titled *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*.

Scope and methodology

The scope of this audit included the actions FSOC has taken to respond to CIGFO's recommendations regarding the designation of financial market utilities (FMU) from July 2013 to September 2016.

To accomplish our objective, we:

- reviewed the CIGFO recommendations made in the July 2013 report titled *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*;
- queried the Department of the Treasury's Joint Audit Management Enterprise System to review the status of the recommendations;
- interviewed FSOC Secretariat officials and obtained documentation to support their responses, including FMU Committee meeting invitations and agendas, internal FMU designation and review process guidance, summary reports reflecting FMU Committee activities, documentation showing communication among the FMU Committee members and between the FMU Committee and the Deputies Committee; and
- reviewed publicly available information regarding FSOC's designation activities.

We performed fieldwork from July 2016 through September 2016. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Prior CIGFO Audit Reports

The Council of Inspectors General on Financial Oversight (CIGFO) has issued the following prior audit reports:

- Audit of the Financial Stability Oversight Council's Controls over Non-public Information, June 2012
- Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities, July 2013
- Audit of the Financial Stability Oversight Council's Compliance with Its Transparency Policy, July 2014
- Audit of the Financial Stability Oversight Council's Monitoring of Interest Rate Risk to the Financial System, July 2015
- Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline, February 2017

Appendix III: FSOC Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

April 26, 2017

The Honorable Eric M. Thorson
Chair, Council of Inspectors General
on Financial Oversight (CIGFO)
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Response to Draft Audit Report: CIGFO's Corrective Action Verification on the Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities

Dear Mr. Chairman:

Thank you for the opportunity to review and respond to your draft audit report, CIGFO's Corrective Action Verification on the Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities (the Draft Report). The Financial Stability Oversight Council (Council) appreciates the CIGFO working group's review of the Council's efforts to address the recommendations included in the July 2013 CIGFO report on the Council's designation of financial market utilities. This letter responds on behalf of Secretary Mnuchin, as Chairperson of the Council, to the Draft Report.

As the Draft Report notes, in its 2013 report CIGFO made five recommendations to the Council relevant to designations of financial market utilities and payment, clearing, and settlement activities. The Draft Report notes that the Council has taken corrective actions responsive to all five of the 2013 recommendations. CIGFO made no recommendations as a result of the working group's review.

Thank you again for the opportunity to review and comment on the Draft Report. We value CIGFO's input and look forward to working with you in the future.

Sincerely,

/s/

Eric Froman
Principal Deputy Assistant General Counsel
(Banking and Finance) and Executive Director of
the Council

Appendix IV: CIGFO Working Group

Department of the Treasury Office of Inspector General, Lead Agency		
Eric M. Thorson, Inspector General, Department of the Treasury, and CIGFO Chair		
Deborah Harker	Lisa Carter	Jeffrey Dye
Clyburn Perry	Eduardo Coney	Susan Marshall
Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau Office of Inspector General		
Mark Bialek, Inspector General, Board of Governors of the Federal Reserve System and Consumer Financial Protection Bureau		
Laura Shakarji	Jennifer Ksanznak	
Securities and Exchange Commission Office of Inspector General		
Carl Hoecker, Inspector General, Securities and Exchange Commission		
Rebecca Sharek	Colin Heffernan	Elizabeth Palmer Gontarek
Francis Encomienda		

