June 27, 2023

Financial Stability Oversight Council  
Attn: Eric Froman, Assistant General Counsel for Banking and Finance  
1500 Pennsylvania Avenue NW  
Room 2308  
Washington, DC 20220  

Re: Analytic Framework for Financial Stability Risk Identification, Assessment, and Response, RIN 4030–[XXXX]

Dear Mr. Froman:

Introduction

The Center for American Progress ("CAP") welcomes the opportunity to submit comments to the Financial Stability Oversight Council’s ("FSOC" or “the Council”) notice and request for comment titled, Analytic Framework for Financial Stability Risk Identification, Assessment, and Response ("the proposal" or “proposed analytic framework”).¹ CAP is an independent, nonpartisan policy institute dedicated to improving the lives of all Americans, through bold, progressive ideas, strong leadership, and concerted action.

The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") marked a turning point for financial regulation, as the events of the 2007-2008 financial crisis illuminated the shocking inadequacies of the financial regulatory framework as it existed prior to the crisis. When crafting the new reforms, Congress acknowledged the importance of creating a body charged with overseeing the financial system as a whole by establishing the Financial Stability Oversight Council. And lawmakers granted the FSOC broad authority to monitor, assess, and address risks to financial stability.

The proposed analytic framework provides important transparency into how the FSOC plans to achieve its statutory purpose. Acknowledging the FSOC’s expansive mandate, the proposal details the range of asset classes, institutions, and activities it monitors for potential risks to financial stability. The framework also discusses the series of vulnerabilities and transmission channels that can exacerbate risk and the tools the Council possesses to mitigate risks. CAP commends the FSOC for proposing this new framework and offers some considerations on how it can be applied to pressing issues concerning financial stability.

Addressing climate-related risks to financial stability

The U.S. financial system is already facing the well-documented reality of climate-related financial risks as more frequent and destructive billion-dollar extreme weather disasters fueled by climate change are sustained year over year.\(^2\) Moreover, the Intergovernmental Panel on Climate Change warns, “Climate change impacts and risks are becoming increasingly complex and more difficult to manage. Multiple climate hazards will occur simultaneously, and multiple climatic and non-climatic risks will interact, resulting in compounding overall risk and risks cascading across sectors and regions.”\(^3\)

These risks are so substantial that the Financial Stability Oversight Council released a report in 2021 finding that climate risk is an “emerging threat to financial stability.”\(^4\) We commend the FSOC for its efforts thus far to understand these risks. Additionally, we are encouraged by the FSOC releasing this proposal to clarify its approach to risk monitoring, as well as another proposal to remove the dangerous barriers to its designation process for nonbank financial companies.\(^5\) These steps take important action in allowing the FSOC to employ its full set of tools to address risks to the U.S. financial system, including climate risk.

The proposed analytic framework importantly calls out that the FSOC will monitor for “developments affecting the resiliency of the financial system, such as cybersecurity and climate-related financial risks”\(^6\) in identifying risk. Climate-related risks have implications for all institutions, and we are increasingly concerned with its impact on the insurance market.\(^7\)

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In 2022 alone, insurers incurred nearly $100 billion in insured losses. Companies are exiting risky markets as seen in the recent reports of State Farm General Insurance Company and Allstate Corporation ending new contracts in California. In describing its recent decision to halt new policies in Florida, Farmers Insurance Group stated, “With catastrophe costs at historically high levels and reconstruction costs continuing to climb, we implemented a pause on writing new homeowners policies to more effectively manage our risk exposure.” Where insurers choose to stay, they are sharply increasing premiums, forcing some consumers to drop coverage altogether. These decisions can have grave implications for U.S. households, businesses, and other financial companies who rely upon insurers’ risk-bearing and loss-absorbing role, especially as climate-induced disasters become more destructive.

A recent report by Federal Reserve Board senior economist Benjamin Dennis describes this flow of risk, using the example of Miami residential real estate damage caused by hurricanes: “In the event of a hurricane in Miami, insurance companies take the first loss ... When insurance coverage does not exist or is insufficient, losses spillover to homeowners. If homeowners default for whatever reason, losses accrue to mortgage originators or purchasers depending on their exposure.” As insurance becomes increasingly unaffordable and unavailable, risk flows from insurance companies to consumers, and pools at the feet of lenders and other financial intermediaries. Following destabilizing weather events, governments must often step in to help communities rebuild.

Insurance is disparately regulated at the state-level, which presents limitations when addressing an issue as pervasive as climate change, as effects are not confined to state borders. We believe that the proposed analytic framework is well-designed to address these risks, and we strongly urge the FSOC to investigate how climate-driven decisions to withdraw coverage or increase premiums can have reverberating effects across the financial system. Additionally, in evaluating risks, the FSOC should consider how climate-related financial risk can exacerbate vulnerabilities stemming from a firm’s interconnectedness with other entities in the financial system. While the Federal Insurance

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Office, an FSOC member agency, has taken steps to understand climate-related financial risks in proposing a data call for such information, it will require the whole of the FSOC’s expertise to analyze the implications of the data for financial stability concerns, given insurers’ role as highly interconnected financial players. FSOC can use its authority to conduct further research, make policy recommendations for addressing such risks for state regulators, and, where appropriate, designate certain firms as systemically important and subject to enhanced oversight by the Federal Reserve.

Addressing the role of nonbank financial companies and dealers in the March 2020 Treasury market volatility

The March 2020 volatility of the Treasury market demonstrates how a confluence of risk drivers can send stress throughout the financial system. When financial market participants reacted to the coronavirus pandemic, there were very large sales of U.S. Treasuries. Many of these sales were made by U.S. bond funds and hedge funds. In a matter of days, the 10-year yield shot up by 64 basis-points rather than falling as is typically expected during periods of stress, while the stock market continued to decline. These actions prompted the Federal Reserve to step in to purchase more than $1 trillion in treasury securities. The unprecedented level of activity also demonstrated the limitations of the dealers that facilitate these transactions.

The FSOC, supported by its proposed analytic framework, may consider several actions to help prevent another event like the March 2020 Treasury market turmoil. For instance, it may wish to consider whether large, interconnected nonbank financial companies like the bond funds should be considered for systemic risk designation. If designated, an institution would be subject to more robust supervisory and regulatory standards, including heightened liquidity requirements.

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Conclusion

We commend the FSOC for undertaking this proposal, which provides important transparency into how the Council approaches the identification, assessment, and addressing of risk within the financial system. If you have questions related to the considerations outlined above, please contact Lilith Fellowes-Granda, Senior Policy Analyst for Financial Regulation and Corporate Governance, at lfellowesgranda@americanprogress.org.

Sincerely,
Center for American Progress