Minutes of the Financial Stability Oversight Council

December 19, 2018

PRESENT:

Steven T. Mnuchin, Secretary of the Treasury and Chairperson of the Financial Stability Oversight Council (Council)
Jerome H. Powell, Chairman, Board of Governors of the Federal Reserve System (Federal Reserve)
Jelena McWilliams, Chairman, Federal Deposit Insurance Corporation (FDIC)
Jay Clayton, Chairman, Securities and Exchange Commission (SEC)
J. Christopher Giancarlo, Chairman, Commodity Futures Trading Commission (CFTC)
Kathleen Kraninger, Director, Consumer Financial Protection Bureau (CFPB)
Melvin Watt, Director, Federal Housing Finance Agency (FHFA)
Joseph Otting, Comptroller of the Currency, Office of the Comptroller of the Currency (OCC) (by telephone)
J. Mark McWatters, Chairman, National Credit Union Administration (NCUA)
Thomas E. Workman, Independent Member with Insurance Expertise
Ken Phelan, Acting Director, Office of Financial Research (OFR), Department of the Treasury (non-voting member)
Charles G. Cooper, Commissioner, Texas Department of Banking (non-voting member)
Eric Cioppa, Superintendent, Maine Bureau of Insurance (non-voting member)
Melanie Lubin, Securities Commissioner, Maryland Office of the Attorney General, Securities Division (non-voting member)

GUESTS:

Department of the Treasury (Treasury)
Justin Muzinich, Deputy Secretary
Brent McIntosh, General Counsel
Brian Callanan, Deputy General Counsel
Bimal Patel, Deputy Assistant Secretary for the Council
Eric Froman, Principal Deputy Assistant General Counsel (Banking and Finance) and Executive Director of the Council
Stephen Ledbetter, Director of Policy, Office of the Financial Stability Oversight Council

Board of Governors of the Federal Reserve System
Randal Quarles, Vice Chairman for Supervision
Andreas Lehnert, Director, Division of Financial Stability

Federal Deposit Insurance Corporation
Travis Hill, Senior Advisor to the Chairman

Securities and Exchange Commission
Jaime Klima, Chief Counsel

Commodity Futures Trading Commission
Maggie Sklar, Senior Counsel to the Chairman

Consumer Financial Protection Bureau
Brian Johnson, Acting Deputy Director

Federal Housing Finance Agency
Sandra Thompson, Deputy Director, Division of Housing Mission and Goals

Comptroller of the Currency
Grace Dailey, Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner

National Credit Union Administration
Ralph Monaco, Chief Economist

Office of the Independent Member with Insurance Expertise
Charles Klingman, Senior Policy Advisor

Federal Reserve Bank of New York
John Williams, President and Chief Executive Officer
Sandra Lee, Vice President

Office of Financial Research
Stacey Schreft, Deputy Director for Research and Analysis

Federal Insurance Office
Steven Seitz, Deputy Director

Texas Department of Banking
James Cooper, Senior Vice President for Policy, Conference of State Bank Supervisors

Maine Bureau of Insurance
Mark Sagat, Assistant Director, Financial Policy and Legislation, National Association of Insurance Commissioners

Maryland Office of the Attorney General, Securities Division
Christopher Staley, Counsel, North American Securities Administrators Association

PRESENTERS:

Nonbank Financial Company Designations Guidance
- *Bimal Patel, Deputy Assistant Secretary for the Council, Treasury*
- *Eric Froman, Principal Deputy Assistant General Counsel (Banking and Finance) and Executive Director of the Council, Treasury (available for questions)*

Digital Assets and Distributed Ledger Technology

- *Bimal Patel, Deputy Assistant Secretary for the Council, Treasury*
- *Sigal Mandelker, Under Secretary for Terrorism and Financial Intelligence (available for questions)*

2018 Annual Report

- *Bimal Patel, Deputy Assistant Secretary for the Council, Treasury*
- *Stephen Ledbetter, Director of Policy, Office of the Financial Stability Oversight Council, Treasury*

Executive Session

The Chairperson called the executive session of the meeting of the Council to order at approximately 4:01 P.M.

The Chairperson began by welcoming Kathleen Kraninger, Director of the Consumer Financial Protection Bureau, to her first Council meeting. He also thanked Melvin Watt, Director of the Federal Housing Finance Agency, for his nearly five years of service on the Council and at the FHFA. He then outlined the meeting agenda, which had previously been distributed to the members together with other materials. The agenda for the executive session of the meeting included (1) potential changes to the Council's interpretive guidance on nonbank financial company designations, (2) an update on the Council's digital assets and distributed ledger technology working group, and (3) the current expected credit losses accounting methodology.

1. Other Business

The Chairperson first asked Christopher Giancarlo, Chairman of the CFTC, for an update regarding the end of the membership of the United Kingdom (U.K.) in the European Union (Brexit). Chairman Giancarlo stated that the European Union had announced that it would adopt a one-year equivalence decision regarding central counterparties based in the U.K. He stated that the European Securities and Markets Authority was also working to limit the risk of disruptions related to U.K. central counterparties. He said that as a result, derivatives central counterparties based in the U.K. would not be forced to offboard firms from the remaining European Union member states.

2. Interpretive Guidance on Nonbank Financial Company Designations

The Chairperson then introduced the first agenda item, potential changes to the Council's interpretive guidance on nonbank financial company designations under section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Chairperson introduced Bimal Patel, Deputy Assistant Secretary for the Council at Treasury, and Eric Froman, Principal Deputy Assistant General Counsel (Banking and Finance) and Executive Director of the Council at Treasury.

Mr. Patel provided an update regarding staff efforts to develop potential amendments to the

Council's interpretive guidance on nonbank financial company designations. He described staff's discussions regarding amended interpretive guidance, including the adoption of an activities-based approach to identifying and addressing potential risks to U.S. financial stability. He noted that a report issued by the Secretary of the Treasury on November 17, 2017, regarding the Council's processes for designating nonbank financial companies and financial market utilities had recommended that the Council adopt an activities-based approach in order to promote a level playing field and competitive equality among market participants, and to address risks that arise across markets. Mr. Patel described a potential process the Council could adopt for an activities-based approach. He also explained potential changes to the Council's process for considering nonbank financial companies for designation.

Council members then asked questions and had a discussion regarding the activities-based approach and potential changes to the Council's procedures related to nonbank financial company designations. In particular, Council members discussed the efficacy, scope, and flexibility of the activities-based approach. Council members also discussed the factors that the Council should take into account in its analyses under the activities-based approach.

3. Digital Assets and Distributed Ledger Technology Working Group

The Chairperson then introduced the next agenda item, an update about the Council's digital assets and distributed ledger technology working group. The Chairperson turned to Bimal Patel, Deputy Assistant Secretary for the Council at Treasury.

Mr. Patel provided an update regarding the working group's efforts and the staff-level engagement that had occurred. He explained that the working group had focused both on sharing information among regulators and on assessing potential risks and regulatory authorities related to digital assets. He described some of the working group's efforts, including related to digital asset market developments, potential risks related to illicit finance, and cybersecurity and operational risks. He then described potential next steps for the working group.

Members of the Council then had a discussion, including regarding the cross-regulatory nature of this issue, recent market developments, and financial institutions' exposures to digital assets.

4. Current Expected Credit Losses

The Chairperson then introduced the next agenda item, a discussion on the current expected credit losses accounting methodology. He turned to Joseph Otting, Comptroller of the Currency, for a presentation.

Comptroller Otting noted that the current accounting standard, known as the "incurred-loss" standard, requires firms to recognize credit losses only when those losses are probable. He noted that during the financial crisis, this standard resulted in loan loss allowances that some commentaters criticized as "too little, too late." He also noted that the incurred-loss standard could be procyclical. He then described the process of the Financial Accounting Standards Board (FASB) to develop a new standard, the current expected credit loss (CECL) standard. He described the extensive work undertaken by the FASB, including publicly issuing proposals in

2010, 2011, and 2013, prior to the adoption of CECL in 2016. He stated that the adoption of CECL would require firms to recognize credit losses earlier than under the incurred-loss standard. He then described the phased-in process for firms to adopt CECL. He stated that the new standard is effective in 2020 for SEC registrants, in 2021 for public companies that do not file with the SEC, and in 2022 for all others (including many community banks). He stated that the OCC believes CECL is an improvement over the incurred-loss accounting model. He noted interest in this issue, including stakeholder requests for a delay in implementation of CECL and a hearing on CECL by the House Financial Services Committee. He stated that market participants had raised concerns regarding CECL's procyclicality and effects on loan terms and structures. Comptroller Otting stated that the federal banking agencies were adopting a rulemaking that provides a three-year transition period to phase-in CECL's day-one effect on a banking organization's regulatory capital ratios.

Members of the Council then had a discussion, including regarding statements from members of Congress about CECL, an upcoming FASB public roundtable discussion to gather additional views on CECL, and the FASB's independence. Members also discussed the federal banking agencies' efforts to adopt a three-year regulatory capital phase-in of CECL, and the Federal Reserve's intention to adopt a two-year delay for the incorporation of CECL for stress-testing purposes. In addition, members discussed whether CECL could be procyclical, could lead to double-counting of credit losses, and reflects how firms conduct their businesses.

The Chairperson adjourned the executive session of the meeting at approximately 5:03 P.M.

Public Session

The Chairperson called the open session of the meeting of the Council to order at approximately 5:10 P.M.

1. 2018 Annual Report

The Chairperson began the open session by discussing the Council's 2018 annual report. The Chairperson noted that the Council's annual report is the product of extensive analysis and collaboration across all of the Council's member agencies. He stated that the report explains the Council's views of potential risks across the financial system for Congress and the public, and that it includes recommendations for specific actions to mitigate those risks, where necessary. The Chairperson stated that the report highlights recent accomplishments and also areas where further work is needed.

The Chairperson thanked the members of the Council and their staffs for their work in preparing this year's report.

The Chairperson then introduced Bimal Patel, Deputy Assistant Secretary for the Council at Treasury, and Stephen Ledbetter, Director of Policy in the Office of the Financial Stability Oversight Council at Treasury, to provide an overview of the report's findings and recommendations.

Mr. Patel began by thanking the staff from around the Council member agencies for their efforts in developing the Council's annual report. Mr. Patel noted that the Council is required by statute to report annually to the Congress on activities of the Council; significant financial market and regulatory developments; and potential emerging threats to U.S. financial stability. He noted that the statute also requires the annual report to include Council recommendations to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; to promote market discipline; and to maintain investor confidence. He stated that the report is a collaborative document that reflects the collective judgment of the Council.

Mr. Patel stated that the report notes the strong economic growth of the last two years, while emphasizing the importance of remaining vigilant regarding potential emerging threats to financial stability. The report states that overall risks to U.S. financial stability remain moderate, though they have evolved in the previous year. He noted that the report also states that financial stability risks outside the U.S. appear to have increased; most notably, the potential for a disorderly Brexit in March 2019 could have serious implications for some global financial markets and firms.

Mr. Patel stated that the report describes actions by financial regulatory agencies since the Council's last annual report, including steps designed to make financial services regulations more efficient and effective. These include proposed changes to modify requirements under the Volcker Rule, the Federal Reserve's tailoring of enhanced prudential standards for bank holding companies, and agency-proposed rules to create a more efficient regulatory framework for exchange-traded funds.

Mr. Patel noted that the report recommends that Council member agencies continue to address regulatory overlap and duplication, modernize outdated regulations, and, where authority exists, tailor regulations based on the size and complexity of financial institutions. He stated that the Economic Growth, Regulatory Relief, and Consumer Protection Act, signed into law in May 2018, should provide more tools for Council member agencies to achieve these objectives.

Mr. Patel stated that the report also notes the Council's continued focus on promoting market discipline to reduce the risk of future financial crises. He stated that the Council will work with regulators to analyze ways to promote market discipline and reduce any lingering perceptions that some institutions are too big to fail. He noted that this year's report emphasizes 11 key areas of potential risk.

Mr. Patel stated that the first theme emphasized in the report is cybersecurity. The report notes that, as the financial system increases its reliance on information technology, the risk increases that a cybersecurity event in the industry will have severe negative consequences. He stated that the report describes the channels through which a cybersecurity event could threaten the stability of the broader financial system. The report recommends that member agencies ensure a robust and consistent standard of cybersecurity monitoring and examinations of financial markets, institutions, and infrastructures. He noted that, at the same time, the unique and complex threats posed by cyber risks require the public and private sectors to cooperate to identify, understand, and protect against these risks. The report encourages the use and development of these partnerships, including efforts to increase harmonization of cybersecurity examinations across regulatory authorities.

Mr. Patel stated that the second theme in the report is central counterparties, or CCPs. The report states that, due to the critical role CCPs play in financial markets, effective regulation and risk management of CCPs is essential to financial stability. The report notes that CCPs have taken steps aimed at improving risk management practices and providing greater transparency, consistent with the requirements adopted by their regulators. He stated that the report recommends that member agencies continue to evaluate whether existing rules and standards for CCPs and their clearing members are sufficiently robust to mitigate potential threats to financial stability and that supervisory agencies continue to conduct evaluations of the performance of CCPs under stress scenarios. He stated that the report also recommends that agencies continue to monitor and assess interconnections among CCPs, their clearing members, and other financial institutions; assess appropriate quantitative data and disclosure standards; and promote further recovery planning and development of resolution plans for systemically important CCPs.

Mr. Patel stated that the third theme in the report relates to reference rates. With respect to reference rates, the report notes that reliance on LIBOR remains high, and the weaknesses of that benchmark may undermine market integrity and financial stability. He stated that the report commends the significant progress of the Alternative Reference Rates Committee (or ARRC) during the last year to establish the Secured Overnight Funding Rate (SOFR) as a viable alternative to LIBOR. He noted that more work is needed to complete the transition away from LIBOR. He stated that the report thus encourages market participants to consider potential uses of SOFR in new transactions, and that where participants choose to continue to reference LIBOR, the report encourages them to make the LIBOR-linked contracts more robust. The report recommends that member agencies work with market participants to identify and mitigate risks from potential dislocations during the transition process.

Mr. Patel stated that the fourth theme in the report relates to capital, liquidity, and resolution. The report describes the improved resiliency of many financial institutions in the years since the financial crisis, particularly through strengthened capital positions and improvements in their ability to respond to draws on liquidity. He stated that the report recommends that agencies continue to ensure that the largest financial institutions have sufficient capital and liquidity to reduce their vulnerability to economic and financial shocks. It also recommends that regulators monitor and assess the impact of rules on financial institutions and markets, including on market liquidity and incentives to centrally clear derivatives.

Mr. Patel stated that the fifth theme in the report is risks related to short-term wholesale funding markets. The report cites the progress made in recent years to reduce risks in these markets, particularly the reduction of counterparty risk exposures in repo markets and the 2016 reforms of money market mutual funds. He stated that given the continued importance of these markets in the U.S. financial system, the report recommends continued monitoring by relevant regulators. He noted that the report recommends an assessment of the increased concentration risk in the tri-party repo market; greater understanding of the repo market, which should be aided by a new proposed OFR data collection on centrally cleared repo; continued monitoring of the 2016 reforms of money market mutual funds; and assessment of the potential risks posed by other types of cash management vehicles.

Mr. Patel stated that the sixth theme in the report is financial innovation. He stated that the report discusses potential implications of financial innovation for financial stability. He noted that the report highlights that new financial products and practices can offer substantial benefits, but they may also create new risks and vulnerabilities. He stated that the report discusses technology-enabled financial products such as digital assets, and notes the ongoing work of the Council's digital asset and distributed ledger technology working group. He stated that the report recommends that financial regulators monitor and analyze the effects of new financial products and services on consumers, regulated entities, and financial markets, and evaluate their potential effects on financial stability.

Mr. Patel stated that the seventh theme in the report is data quality, collection, and sharing. With respect to data quality, collection, and sharing, he stated that the report notes the important steps taken to address data gaps exposed by the financial crisis. He noted that the report also discusses the continued reliance by market participants on data that are not aligned to standard definitions and that inhibit data sharing. He noted that the report makes a number of recommendations that regulators and market participants further improve the coverage, quality, and accessibility of financial data, including through use of the Legal Entity Identifier in regulatory reporting and other agency data collections, where appropriate.

Mr. Patel stated that the eighth theme in the report is vulnerabilities associated with the long credit expansion in the United States. He stated that the report discusses a number of metrics that indicate that nonfinancial corporate debt and leverage are elevated. The report also discusses indications that valuations may be elevated in key U.S. financial markets, including equities, corporate debt, and some commercial and residential real estate. He stated that the report notes that these elevated leverage and asset valuations can make downturns in these markets more severe. The report also notes that strong interest coverage and liquidity positions have allowed businesses to service their debt with low delinquency rates, but these factors may not prevent increased defaults if business earnings were affected by a recession or other financial shock. He noted that the report points out that any potential impact on financial stability would depend on the extent and severity of defaults, whether there are spillovers to other markets, and the ability of investors and intermediaries to manage the fallout. He stated that the report recommends that agencies continue to monitor levels of nonfinancial business leverage, trends in asset valuations, and potential implications for the entities they regulate in order to assess and reinforce their ability to manage severe, simultaneous losses in those markets. Finally, he noted that the report states that assuring that relevant investors and intermediaries can manage such losses, rather than amplify or transmit them, will reduce the risk to financial stability such a scenario could pose.

Mr. Patel stated that the ninth theme in the report is housing finance reform. He stated that the report notes that Fannie Mae and Freddie Mac are now in their eleventh year of conservatorship, and that the report reaffirms the need for housing finance reform to create a more durable and vibrant housing finance system that enhances financial stability.

Mr. Patel stated that the tenth theme in the report is changes in financial market structure, such as increased use of automated trading systems, the higher speed of transaction quoting and execution, increased diversity of liquidity providers, and the expansion in trading venues. He noted that the report explains that such changes and complexities may create unanticipated risks that can interrupt normal financial market functioning or, in a severe case, amplify threats to financial stability. He stated that the report recommends that market participants and regulators continue to evaluate changes that may have adverse effects, assess the factors that could cause stress to propagate across markets, and consider potential ways to mitigate those risks.

Mr. Patel stated that the eleventh theme in the report relates to asset management products and activities. With respect to asset management, he stated that the report reaffirms the Council's focus on ensuring adequate information to evaluate risks in the asset management industry. He stated that the report notes rules issued or amended by the SEC to promote liquidity risk management and enhanced data reporting by registered investment companies. He noted that the report recommends that the SEC evaluate the extent to which those rules address potential risks in the asset management industry. Regarding private funds, he stated that the report recommends that relevant regulators review their data collections and assess whether they are sufficient for the Council to monitor whether and how private funds may pose risks to financial stability.

Following Mr. Patel's remarks, the Chairperson presented to the Council the following resolution approving the annual report:

WHEREAS, the Financial Stability Oversight Council (the "Council") under section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA") is required to annually report to and testify before Congress on (1) the activities of the Council; (2) significant financial market and regulatory developments, including insurance and accounting regulations and standards, along with an assessment of those developments on the stability of the financial system; (3) potential emerging threats to the financial stability of the United States; (4) all determinations made under section 113 or title VIII of the DFA, and the basis for such determinations; (5) all recommendations made under section 119 of the DFA and the result of such recommendations; and (6) recommendations (a) to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; (b) to promote market discipline; and (c) to maintain investor confidence; and

WHEREAS, the staffs of the Council members and their agencies prepared the attached 2018 annual report of the Council (the "2018 Annual Report") pursuant to section 112 of the DFA, and members of the Council have reviewed and commented on the attached report.

NOW, THEREFORE, BE IT RESOLVED, that the Council hereby approves the 2018 Annual Report and authorizes the Chairperson, or his designee, to take such action as they may deem necessary or appropriate to transmit the 2018 Annual Report to Congress and to release it to the public; and

BE IT FURTHER RESOLVED, that the Council hereby delegates authority to the Chairperson, or his designee, to make technical, nonsubstantive, or conforming changes to the text of the 2018 Annual Report and to take such other actions as they may deem necessary or appropriate to prepare the report for transmittal to Congress and release to the public.

The Chairperson asked for a motion to approve the resolution, which was made and seconded. The Council approved the resolution by unanimous vote.

2. Resolution Approving the Minutes of the Meeting Held on October 16, 2018

BE IT RESOLVED, by the Financial Stability Oversight Council (the "Council"), that the minutes attached hereto of the meeting held on October 16, 2018 of the Council are hereby approved.

The Chairperson asked for a motion to approve the resolution, which was made and seconded. The Council approved the resolution by unanimous vote.

The Chairperson adjourned the meeting at approximately 5:27 P.M.