Minutes of the Financial Stability Oversight Council

November 4, 2022

PRESENT:

Janet L. Yellen, Secretary of the Treasury and Chairperson of the Financial Stability Oversight Council (Council)
Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System (Federal Reserve)
Martin Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation (FDIC)
Gary Gensler, Chair, Securities and Exchange Commission (SEC)
David Gillers, Chief of Staff, Commodity Futures Trading Commission (CFTC) (acting pursuant to delegated authority)
Rohit Chopra, Director, Consumer Financial Protection Bureau (CFPB)
Naa Awaa Tagoe, Deputy Director, Division of Housing Mission and Goals, Federal Housing Finance Agency (FHFA) (acting pursuant to delegated authority)
Michael J. Hsu, Acting Comptroller of the Currency, Office of the Comptroller of the Currency (OCC)
Todd M. Harper, Chairman, National Credit Union Administration (NCUA)
Thomas E. Workman, Independent Member with Insurance Expertise
Steven Seitz, Director, Federal Insurance Office (FIO), Department of the Treasury (non-voting member)
Charles G. Cooper, Commissioner, Texas Department of Banking (non-voting member)
Elizabeth K. Dwyer, Superintendent of Financial Services, Rhode Island Department of Business Regulation (non-voting member)
Melanie Lubin, Securities Commissioner, Maryland Office of the Attorney General, Securities Division (non-voting member)

GUESTS:

Department of the Treasury (Treasury)
Nellie Liang, Under Secretary for Domestic Finance
Sandra Lee, Deputy Assistant Secretary for the Council
Laurie Schaffer, Principal Deputy General Counsel
Eric Froman, Assistant General Counsel (Banking and Finance)
Sean Hoskins, Director of Policy, Office of the Financial Stability Oversight Council

Board of Governors of the Federal Reserve System
Michael Barr, Vice Chair for Supervision
Andreas Lehnert, Director, Division of Financial Stability

Federal Deposit Insurance Corporation
James McGraw, Senior Deputy Director, Division of Complex Institution Supervision and Resolution

Securities and Exchange Commission
Amanda Fischer, Senior Counselor

Commodity Futures Trading Commission
Rahul Varma, Associate Director, Division of Market Oversight

Consumer Financial Protection Bureau
Gregg Gelzinis, Advisor to the Director

Comptroller of the Currency
Jay Gallagher, Senior Deputy Comptroller for Supervision Risk and Analysis

National Credit Union Administration
Andy Leventis, Chief Economist

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

Federal Reserve Bank of New York
Richard Crump, Financial Research Advisor, Capital Markets Function

Office of Financial Research (OFR)
James Martin, Deputy Director, Operations
Sriram Rajan, Associate Director, Research and Analysis Center

Federal Insurance Office
Philip Goodman, Senior Insurance Regulatory Policy Analyst

Texas Department of Banking
Karen Lawson, Executive Vice President for Policy and Supervision, Conference of State Bank Supervisors

Rhode Island Department of Business Regulation
Ethan Sonnichsen, Managing Director, National Association of Insurance Commissioners (NAIC)

Maryland Office of the Attorney General, Securities Division
Vincente Martinez, General Counsel, North American Securities Administrators Association

PRESENTERS:

Market Developments and Financial System Vulnerabilities

- *Julie Remache, Head of Market and Portfolio Analytics, Markets Group, Federal Reserve Bank of New York*
- *Rebecca McCaughrin, Director, Cross-Market Monitoring and Analysis, Markets Group, Federal Reserve Bank of New York (available for questions)*

2022 Annual Report Update

- *Jeff Gerlach, Vice President, Quantitative Supervision and Research Unit, Federal Reserve Bank of Richmond*
- *Alexandra Somers, Senior Policy Advisor, Office of the Financial Stability Oversight Council, Treasury (available for questions)*
- *Nicholas Steele, Deputy Director, Office of Debt Management, Treasury (available for questions)*

Hedge Fund Working Group Update

- *Ron Alquist, Senior Policy Advisor, Office of the Financial Stability Oversight Council, Treasury*
- *Danny Barth, Senior Economist, Division of Financial Stability, Federal Reserve (available for questions)*
- *Ted Berg, Senior Financial Analyst, OFR (available for questions)*
- *Andrew McKenna, Assistant Vice President, Federal Reserve Bank of New York (available for questions)*
- *Adam Minson, Lead, Financial Sector Risk, Federal Reserve Bank of New York (available for questions)*
- *Phillip Monin, Economist, Division of Monetary Affairs, Federal Reserve (available for questions)*
- *Alexandra Somers, Senior Policy Advisor, Office of the Financial Stability Oversight Council, Treasury (available for questions)*

Climate-related Financial Risk in the Insurance Sector

- *Elizabeth K. Dwyer, Superintendent of Financial Services, Rhode Island Department of Business Regulation*
- *Steven Seitz, Director, FIO*
- *Elizabeth Brown, Senior Insurance Regulatory Policy Analyst, FIO (available for questions)*
- *Silabhadra Mohanty, Senior Insurance Regulatory Policy Analyst, FIO (available for questions)*
- *Ethan Sonnichsen, Managing Director, NAIC (available for questions)*

Executive Session

The Chairperson called the executive session of the meeting of the Council to order at approximately 10:00 A.M. The Council convened by videoconference. The Chairperson outlined the meeting agenda, which had previously been distributed to the members together with other materials. The agenda for the executive session included (1) a presentation on recent market developments and financial system vulnerabilities, (2) an update on the Council's 2022 annual report, (3) an update on the work of the Council's Hedge Fund Working Group, (4) a presentation on climate-related financial risk in the insurance sector, and (5) a vote on the minutes of the Council's meeting on October 3, 2022.

1. Market Developments and Financial System Vulnerabilities

The Chairperson introduced the first agenda item, a presentation on market developments and financial system vulnerabilities. She introduced Julie Remache, Head of Market and Portfolio Analytics in the Markets Group at the Federal Reserve Bank of New York.

Ms. Remache discussed market developments since the previous Council meeting on October 3. She noted that Treasury yields and the S&P 500 had risen, high-yield credit spreads had decreased, and the dollar had appreciated. She said that financial conditions had tightened in 2022 by the greatest amount since the financial crisis, in light of the increases in policy rates by the Federal Reserve. She noted that implied volatility in assets remained very high. She noted that other central banks had tightened in response to inflationary pressures, but some had begun to moderate their rate of tightening or had begun to signal an intent to do so.

Ms. Remache noted that presenters at the October 3 Council meeting had discussed the market effects of the September 2022 announcement of the United Kingdom (U.K.) budget proposal. She said that, following the retraction of those proposals, market strains had eased and that purchases to support market function by the Bank of England were modest in size. She also discussed some differences between U.K. and U.S. pensions, including a relatively smaller ownership share by the pension system of government securities in the United States compared to the U.K. She noted that implied volatility in the U.S. Treasury market had risen, while liquidity in the Treasury and mortgage-backed securities markets had deteriorated. She said that the cost of credit had recently risen in the corporate, consumer, and real estate markets, issuance activity had slowed, and the extension of corporate debt maturity schedules had reduced the need to issue new debt. She stated that analysts were not expecting significant amounts of downgrades or defaults. She also discussed the substantial growth of private credit markets over the preceding decade. Finally, she said that the nominal trade-weighted dollar had appreciated in 2022, representing a vulnerability for borrowers reliant on dollar-denominated financing.

Following the presentation, the Chairperson stated that continued global energy supply shocks, elevated inflation around the world, and uncertainty about the effects of higher interest rates had led to financial market volatility and rising liquidity and credit concerns. She said that the financial system had been resilient, but that it was important that member agencies continue to monitor potential vulnerabilities and act to address them. She stated that she was particularly focused on potential vulnerabilities arising in two areas.

The Chairperson stated that the first area related to the Treasury market, which she noted is at the core of the financial system. She stated that this market had been functioning smoothly, and that the recent deterioration in liquidity was broadly commensurate with the increase in uncertainty. She said that a resilient Treasury market is essential to financial stability, and stated that member agencies should continue their efforts to enhance Treasury market resilience over the longer-term. She said that the agencies in the Inter-Agency Working Group on Treasury Market Surveillance (IAWG) were making significant progress in addressing the vulnerabilities in this market.

The Chairperson stated that the second area related to vulnerabilities in money market funds, open-end funds, and hedge funds, which she noted continue to pose risks to financial stability. She said that these funds can amplify shocks, transmitting stress to important counterparties and markets. She stated that member agencies should act to address these concerns. She noted the importance of the SEC's recently proposed rule on open-end funds, while noting that there are also other risks that member agencies should monitor.

Council members then had a discussion about the vulnerabilities identified by the Chairperson and other potential risks.

2. Update on 2022 Annual Report

The Chairperson then turned to the second agenda item, an update on the Council's 2022 annual report. She introduced Jeff Gerlach, Vice President of Quantitative Supervision and Research at the Federal Reserve Bank of Richmond.

Mr. Gerlach provided an update on the development of the annual report and discussed potential recommendations and other topics that the report may address. He also provided an update regarding the proposed timing for completion of the report.

Council members then asked questions and had a discussion about potential topics that the report may address.

3. Hedge Fund Working Group Update

The Chairperson then introduced the next agenda item, an update on the progress of the Council's staff-level Hedge Fund Working Group in developing a risk-monitoring framework. She noted that the working group's efforts are an important part of advancing the Council's understanding of the risks associated with nonbank financial intermediation, which she noted is a Council priority. She then introduced Ron Alquist, Senior Policy Advisor in the Office of the Financial Stability Oversight Council at Treasury.

Mr. Alquist stated that he would present the first Hedge Fund Working Group risk assessment based on the risk-monitoring framework developed to identify current and emerging threats to financial stability related to hedge fund activities. He noted that data used by the working group was subject to statutory confidentiality protections. Mr. Alquist noted that in a February 2022 meeting of the Council, the working group had presented conclusions from two case studies: the March 2020 dislocations in U.S. Treasury markets and the failure of the family office Archegos Capital Management. He said that in July 2022, the working group presented to the Council a pilot version of its risk assessment based on the risk-monitoring framework being developed. He said staff on the working group would now provide their first assessment highlighting how the most prominent financial stability vulnerabilities had evolved in 2022 and some potential short-term risk scenarios.

Mr. Alquist stated that the risk-monitoring framework consisted of two components, one quantitative and the other qualitative. He said that the quantitative component, produced by the

OFR, incorporated a number of sources that track trends in the hedge fund industry, including data reported on the SEC's Form PF, which provides information on leverage, exposures, borrowing, derivatives use, and other data, along with the Federal Reserve's Senior Credit Officer Opinion Survey, the CFTC's Commitments of Traders report, and other market data. He said that in the future, the working group intended to leverage the non-centrally cleared bilateral repurchase agreement (repo) data collection being developed by the OFR. He stated that the qualitative component of the risk-monitoring framework incorporated input from Council member agencies and market participants.

Mr. Alquist then explained three channels through which hedge funds can create systemic risks: by causing or contributing to market disruptions through large asset liquidations; by transmitting risks to counterparties that are large, highly interconnected financial institutions; or by reducing financial intermediation, which could, under certain conditions, potentially impair market functioning. He said that the working group used these channels to guide its analysis of potential risks and vulnerabilities.

Mr. Alquist stated that the two most significant hedge fund-related risks were the risk of disruptive liquidations by hedge funds in important markets, and material deficiencies identified by supervisors in counterparty credit risk management practices. He then discussed the working group's analysis of leverage rates, asset exposures, and funding risks among hedge funds. He described hedge fund borrowing, noting that hedge funds borrow extensively from global systemically important banks and are highly interconnected with them. Turning to counterparty risks, he addressed the degree of concentration in connection with the extension of bank credit and derivatives exposures in the hedge fund industry. He then described banks' counterparty credit risk management practices, noting the importance of these practices in managing the risks of the interconnections between hedge funds and the broader financial system. He also discussed near-term risk scenarios that the working group was considering, based on potential volatility in relevant markets.

Mr. Alquist stated that there are significant risks of disruptive hedge fund liquidations in some important markets, such as rates, foreign exchange, U.S. Treasury, and bilateral repo markets. He noted that supervisory work had identified deficient counterparty credit risk management practices that fail to mitigate the risk of stress transmission to banks or other counterparties. He said that supervisors were continuing their work to remediate the deficiencies. He stated that despite recent volatility in commodity markets, fund exposures in that asset class did not currently represent a material financial stability risk to the United States. He concluded by discussing ongoing regulatory efforts, noting that, in addition to supervisory efforts to remediate deficient counterparty credit risk management practices, ongoing work by several agencies would mitigate some of the vulnerabilities identified by the working group.

Council members then had a discussion about the working group's risk-monitoring framework and related topics, including the evolution of risks related to hedge funds over the preceding two decades, risks identified by the Hedge Fund Working Group, how the OFR's non-centrally cleared bilateral repo data collection may inform the working group's efforts, and other agency authorities to address risks related to hedge funds.

4. Climate-related Financial Risk in the Insurance Sector

The Chairperson then turned to the next agenda item, a presentation on climate-related financial risk in the insurance sector, including an update on Hurricane Ian and its effect on local communities and the Florida insurance market. She noted that Hurricane Ian is another reminder of the increasing severity and frequency of climate-related disasters and the importance of the Council's efforts to address resulting financial risks. She then turned to Elizabeth K. Dwyer, Superintendent of Financial Services for the Rhode Island Department of Business Regulation, and Steven Seitz, Director of FIO, for the presentation.

Superintendent Dwyer discussed the impact of Hurricane Ian on Florida, noting that this was the first major hurricane to make landfall in Florida since 2018. She said that the initial insured loss estimates of Hurricane Ian varied, but were in the range of $35 to $55 billion including losses sustained by the government-sponsored National Flood Insurance Program (NFIP), or roughly $7.7 billion excluding NFIP. She noted that nearly 600,000 insurance claims had been filed. She then discussed the financial condition of the insurance industry and the impact of Hurricane Ian. She stated that for the majority of impacted insurers and reinsurers, Hurricane Ian may be an earnings event rather than a solvency event, while noting that some smaller and regional carriers in Florida were facing challenges. She noted that Florida has the highest property-insurance rates in the country, which are likely to further rise.

Superintendent Dwyer stated that Hurricane Ian illustrated the importance of wide-ranging solutions to close the insurance protection gap for policyholders (the difference between the amount of insurance that is economically beneficial and the amount of insurance actually purchased). She noted that according to some estimates, $1 invested in mitigation can result in as much as $13 in savings. She also stressed the importance of building codes and enforcement in mitigating extreme weather events. She said that Florida's building code updates adopted after Hurricane Andrew in 1992 had reduced windstorm damage by 73 percent compared to prior codes. She stated that insurance take-up in Florida is driven by mortgage requirements rather than the degree of risk, and noted that only 13 percent of Florida residents have flood insurance. She said that Florida's market relies on global reinsurance and government insurers and reinsurers of last resort.

Superintendent Dwyer said that state insurance regulators were working through the NAIC to expand coverage and factor in climate risk. She said that insurance regulators had updated climate-related disclosures, which were applicable to 80 percent of the insurance market, based on disclosures developed by the Task Force on Climate-related Financial Disclosures, created by the Financial Stability Board. She said that insurance regulators were also developing climate risk assessment examination guidance, reviewing policies designed to cover "named storm" deductibles, developing models of climate scenario analysis for the insurance sector, and working to expand private flood insurance as an alternative to the NFIP.

Superintendent Dwyer then addressed the broader economic impact of Hurricane Ian and climate-related financial risk. She said that uninsured economic losses resulting from Hurricane Ian may represent more than double the insured losses, a cost that is borne by consumers, taxpayers, and other parts of the financial sector. She stated that, in a growing number of markets in the country, rising home values may become untethered to risk and insurance availability and adequacy. She noted that inflation, labor supply, construction costs, and supply chains all impact the resolution of claims and uninsured economic losses. She stated that a slow recovery and uninsured losses may impact consumer and commercial loans or related securities and the broader economic recovery in the region. She said that the tensions of insurance availability and affordability are experienced most by those consumers least able to bear these burdens.

Director Seitz stated that in October 2022, FIO had issued a request for public comment on a proposed collection of nationwide data from certain property and casualty insurers regarding current and historical underwriting data on homeowners' insurance. He said the data would assist FIO in understanding how climate-related financial risks impact families and individuals across the United States, and how these effects could impact the broader financial system. He stated that the collection of such data was an important step in obtaining consistent, granular, and comparable insurance metrics that would help assess the availability of insurance for Americans. After discussing the data that FIO proposed to collect, Director Seitz noted that FIO had tried to balance the need for granular information with the burden on insurers to compile such information. He said that FIO therefore sought to restrict the scope of its proposed data collection to a limited set of underwriting data primarily from large writers of homeowners' multi-peril insurance.

Addressing other areas of FIO's engagement on climate-related financial risk, Director Seitz stated that FIO had been assisting the Council's Climate-related Financial Risk Committee (CFRC) in its efforts to help member agencies leverage the data and analytical capabilities of the OFR Data and Analytics Hub. Director Seitz also highlighted FIO's international engagement, noting that FIO joined the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) in 2022. He said that FIO was one of the only insurance authorities that is a member of the NGFS, and was working to incorporate insurance-sector perspectives into the work of the NGFS. He noted the need for increased engagement with the insurance sector in international efforts on climate-related financial risk, given the role that insurance plays with regard to financial stability, and said this would be a priority area for FIO.

Council members then asked questions and had a discussion about the insurance protection gap, building codes requirements, and FIO's proposed data collection. Following the discussion, the Chairperson noted that the climate report issued by the Council in 2021 encouraged Council members to identify and address climate-related data gaps.

5. Resolution Approving the Minutes of the Meeting Held on October 3, 2022

BE IT RESOLVED, by the Financial Stability Oversight Council (Council), that the minutes attached hereto of the meeting held on October 3, 2022 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 11:32 A.M.