

Minutes of the Financial Stability Oversight Council

July 16, 2021

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)
Jelena McWilliams, Chairman, Federal Deposit Insurance Corporation (FDIC)
Gary Gensler, Chair, Securities and Exchange Commission (SEC)
Rostin Behnam, Acting Chairman, Commodity Futures Trading Commission (CFTC)
David Uejio, Acting Director, Consumer Financial Protection Bureau (CFPB)
Sandra L. Thompson, Acting Director, Federal Housing Finance Agency (FHFA)
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)
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
Eric Froman, Assistant General Counsel (Banking and Finance)
Stephen Ledbetter, Director of Policy, Office of the Financial Stability Oversight Council, and Executive Director of the 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, Deputy to the Chairman for Policy

Securities and Exchange Commission

Amanda Fischer, Senior Counselor

Commodity Futures Trading Commission

David Gillers, Chief of Staff

Consumer Financial Protection Bureau

Abhishek Agarwal, Senior Advisor, Division of Supervision, Enforcement and Fair Lending

Federal Housing Finance Agency

Naa Awaa Tagoe, Acting Deputy Director, Division of Housing Mission and Goals

Comptroller of the Currency

Jonathan Fink, Assistant Chief Counsel

National Credit Union Administration

Andrew Leventis, 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

Richard Crump, Vice President, Capital Markets Function

Office of Financial Research

Sriram Rajan, Associate Director

Federal Insurance Office

Philip Goodman, Senior Insurance Regulatory Policy Analyst

Texas Department of Banking

Michael Townsley, Policy Counsel, Conference of State Bank Supervisors

Maine Bureau of Insurance

Mark Sagat, Assistant Director, Financial Policy and Legislation, National Association of Insurance Commissioners (NAIC)

Maryland Office of the Attorney General, Securities Division

Vincent Martinez, General Counsel, North American Securities Administrators Association

PRESENTERS:

Federal Reserve Stress Tests

- *Randal Quarles, Vice Chairman for Supervision, Federal Reserve*
- *Lisa Ryu, Senior Associate Director, Division of Supervision and Regulation, Federal Reserve*

Housing Markets and Recent Trends

- *Will Doerner, Supervisory Economist, Division of Research and Statistics, FHFA*

Climate Report Update

- *Stephen Ledbetter, Director of Policy, Office of the Financial Stability Oversight Council, and Executive Director of the Council, Treasury*
- *Eric Juzenas, Counselor to the Under Secretary for Domestic Finance, Treasury*

Executive Session

The Chairperson called the executive session of the meeting of the Council to order at approximately 10:03 A.M. The Council convened by videoconference. The Chairperson began by welcoming Sandra Thompson, FHFA Acting Director, as a member of the Council. The Chairperson then outlined the meeting agenda, which had previously been distributed to the members together with other materials. The agenda for the executive session included (1) the Federal Reserve's stress tests, (2) housing markets, (3) the Council's report under the Executive Order on Climate-Related Financial Risk, and (4) a vote on the minutes of the Council's meeting on June 11, 2021.

1. Federal Reserve Stress Tests

The Chairperson turned to the first agenda item, the Federal Reserve's stress tests. She noted the importance of the stress tests and stated that the benefits of a better-capitalized banking system and improvements to firms' risk management were evident during the COVID-19 crisis in 2020. She then turned to Randal Quarles, Vice Chairman for Supervision at the Federal Reserve, and Lisa Ryu, Senior Associate Director of the Division of Supervision and Regulation at the Federal Reserve.

Mr. Quarles began by summarizing how the stress testing framework had evolved since the beginning of 2020 and what had been learned about that framework during the COVID-19 event. He noted that the Federal Reserve had put in place a new stress testing approach in March 2020. Under the new approach, the stress capital buffer uses stress test results to set the risk-based capital requirements for large banks; as a bank's capital declines into the stress capital buffer, it automatically subjects the banks to increased capital requirements. He stated that the stress capital buffer framework establishes bank-specific requirements based on losses shown for that bank in the stress test. He noted that those requirements are in addition to the capital surcharge for global systemically important banks. He stated that soon after the release of the stress capital buffer rule in 2020, the COVID-19 event severely disrupted the U.S. economy. He stated that the Federal Reserve adapted the stress test to conduct sensitivity analyses during the initial period of uncertainty under three different hypothetical scenarios. He noted that the Federal Reserve suspended certain capital distributions by large banks. He then explained that in the fall of 2020, the Federal Reserve had run two new stress test scenarios, which showed firms maintaining strong capital levels under both scenarios. He stated that in March 2021, the Federal Reserve announced that if a bank stayed above its capital requirements in the stress test results to be announced in June 2021, limitations on the bank's capital distributions would be eliminated. He noted that all of the banks had passed that test, and stated that the results indicated that the banking system would have remained strong even without the fiscal assistance provided to the economy. He noted that the temporary limitations on capital distributions had ended, but that the firms were subject to the stress capital buffer, which he stated was in some ways more restrictive

than the limitation on capital distributions imposed in 2020. He concluded by stating that the seven stress tests conducted over the past year provided confidence in the stress capital buffer framework.

Ms. Ryu then described the quantitative results of the 2021 Dodd-Frank Act stress test (DFAST). She noted that DFAST assesses the capital adequacy of the largest U.S. banks by determining the decline in common equity tier 1 capital ratios that would occur under a “severely adverse” scenario. She noted that the aggregate capital decline under the 2021 stress test was in line with the results from the previous couple years. She noted that no firm breached its post-stress minimum capital ratios, so as of July 1, 2021, no firm was subject to the capital distribution limitation that the Federal Reserve had introduced in June 2020. She then described the scenario the Federal Reserve used for the stress test. She noted that one difference compared to the six prior stress tests was that the test used only a single scenario. With respect to the assumptions under the scenario, she explained that the unemployment rate started at a higher level than the assumptions in the 2020 DFAST, then declined more, while interest rates started at lower levels and remained lower and flatter than in the 2020 stress test.

Ms. Ryu stated that the aggregate loan losses under the stress tests had returned to levels seen in other recent stress tests. She described projected loan losses compared to loan loss reserves and the total impact the projected losses would have on the firms’ net income. She also described projected loan losses on consumer loans compared to business loans, noting that projected consumer loan losses were down while business loan losses were higher than in the 2019 and 2020 stress tests. She stated that the primary driver of projected business loan losses was commercial real estate loans, and she stated that the Federal Reserve was closely monitoring this sector. She noted that hotel vacancy rates had reached an historical peak in 2020. She also noted that projected net revenue continued its decline from recent years, driven by compression in net interest margin due to low interest rates and firms shifting to lower-yielding assets such as Treasury securities and agency securities. She concluded by noting that higher projected trading revenue had offset the contribution of lower net interest income for certain firms.

Members of the Council then asked questions and had a discussion, including regarding banks’ exposures to commercial real estate and the importance of risk management.

2. Housing Markets and Recent Trends

The Chairperson then introduced the next agenda item, a presentation on housing markets and recent trends. She stated that while the factors contributing to the recent surge in house prices may be different than those preceding the financial crisis, the housing market had been the center of financial market stress in past crises and that it was important for the Council to continue to monitor this area. She also noted that Treasury was focused on housing issues, including ways to expand fair and equitable access to homeownership and affordable rental opportunities. She then turned to Will Doerner, Supervisory Economist in the Division of Research and Statistics at the FHFA.

Mr. Doerner began by stating that his presentation would describe housing market trends and issues FHFA was monitoring with respect to residential real estate markets. First, he highlighted

rapid house price gains. He stated that first-quarter 2021 real house prices had risen over 15 percent above the long-run trend, with excess gains of over 1 percent in every month since June 2020. He then compared house price gains in each state and described areas with the strongest gains. He noted that the data did not reflect an exodus from big cities. He also described the distribution of annual house price changes for metropolitan statistical areas compared to the financial crisis, explaining that the entire distribution of house prices had shifted up during the pandemic. He stated that the positive gains were not new, and that almost all metropolitan statistical areas had had eight years of consistently positive returns.

He then described house prices compared to housing starts over the last 50 years, and noted that approximately 10 years ago, starts had begun lagging. He stated that real estate markets had frozen in April 2020, but that total home sales recently passed the historical average, though not rising to the levels seen prior to the financial crisis. He then described trends in mortgage rates. He stated that rates peaked at 18 percent in the early 1980s and had since declined, recently dipping to 2.7 percent, the low over the last 50 years. He stated that mortgage rates usually move closely with the 10-year constant maturity Treasury rate, but that that relationship had broken down since 2020. He then described trends in applications. He noted that refinance applications had decreased since their peak during the pandemic but were up considerably since January 2019, and that purchase applications had approximately returned to their level at that time. He noted that the refinance applications had sustained the mortgage sector and mortgage servicers. He then described mortgage origination shares for Fannie Mae, Freddie Mac, and other originators.

Mr. Doerner then described issues that FHFA was monitoring. He noted that foreclosure and eviction moratoria during the pandemic had helped protect borrowers, and that foreclosures had not increased as they did during the financial crisis. He noted, however, that mortgage delinquencies could be masked by forbearance status. He then stated that house affordability, as measured by the ratio of house prices to rent, had increased during and immediately after the financial crisis, then declined for a number of years, and had strongly decreased recently. He noted that new listings for houses had fully recovered from the decrease early in the pandemic, and that the average days on market was low compared to previous years. He also noted that inventory was being outpaced by the speed of home sales and that the median price per square foot continued to rise across markets.

He concluded by stating that the market was late in the housing cycle but in a better position than prior to the financial crisis. He also noted that the previous year had created new challenges, with record-low mortgage rates and escalating prices that were raising concerns regarding affordability and access to credit. Finally, he noted that uncertainty remained about future house price growth.

Acting Director Thompson then noted that the presentation had highlighted housing affordability as a concern, particularly due to a shortfall of supply, and that Fannie Mae and Freddie Mac were working to address those issues. She also noted that the mortgage industry was preparing for borrowers to exit mortgage forbearance.

Members of the Council then had a discussion, including regarding commodity prices and

housing insecurity.

3. Climate Report Update

The Chairperson then turned to the next agenda item, an update on the Council's report to be issued under the Executive Order on Climate-Related Financial Risk, issued May 20, 2021 (the Climate EO).

The Chairperson noted that the Council had heard an update at its previous meeting on three priorities, including climate change. She noted that since then, the staffs of Council members and member agencies had made progress to establish the Council's climate-risk working group and to begin developing the report under the Climate EO. She then turned to Stephen Ledbetter, Director of Policy in the Office of the Financial Stability Oversight Council at Treasury and Executive Director of the Council, and Eric Juzenas, Counselor to the Under Secretary for Domestic Finance at Treasury.

Mr. Ledbetter noted that staff had created an interagency working group on climate as a forum for discussion of climate-related issues, including the report to be issued under the Climate EO. He then described the anticipated timeline for preparing the report.

Mr. Juzenas then described the proposed structure of the report, based on the terms of the Climate EO. He noted that the report would address issues including climate-related financial disclosure and the measurement and monitoring of climate-related risks to the financial system. He stated that the report would be developed together with the Council member agencies.

Members of the Council then discussed the report and member agencies' actions and plans regarding climate-related risks. The Chairperson stated that there would be a further update on the report at the Council's next meeting.

4. Resolution Approving the Minutes of the Meeting Held on June 11, 2021

BE IT RESOLVED, by the Financial Stability Oversight Council (the "Council"), that the minutes attached hereto of the meeting held on June 11, 2021 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 11:18 A.M.