Minutes of the Financial Stability Oversight Council

March 6, 2019

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)
Joseph Otting, Comptroller of the Currency, Office of the Comptroller of the Currency (OCC), and Acting Director, Federal Housing Finance Agency (FHFA)
J. Mark McWatters, 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) (by telephone)
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)
Brent McIntosh, General Counsel
Craig Phillips, Counselor to the Secretary
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 (by telephone)
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
Michael Gill, Chief of Staff

Consumer Financial Protection Bureau
Hallee Morgan, Attorney-Advisor

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

Comptroller of the Currency
Morris Morgan, Senior Deputy Comptroller and Chief Operating Officer

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 (by telephone)

Office of Financial Research (OFR)
Kipp Kranbuhl, Acting Assistant Secretary for Financial Institutions, Treasury
Stacey Schreft, Deputy Director for Research and Analysis

Federal Insurance Office
Keven Meehan, Senior Insurance Regulatory Policy Analyst

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
A. Valerie Mirko, General Counsel, North American Securities Administrators Association

PRESENTERS:

Nonfinancial Corporate Credit

- *Ted Berg, Senior Financial Analyst, OFR*
- *Dan Li, Section Chief, Financial Intermediaries Analysis, Division of Monetary Affairs, Federal Reserve*
- *Charles Press, Senior Financial Institution and Policy Analyst, Division of Monetary Affairs, Federal Reserve*
- *Peter Phelan, Deputy Assistant Secretary for Capital Markets, Treasury (available for questions)*
- *Richard Farber, Senior Advisor, Treasury (available for questions)*

Interpretive Guidance on Nonbank Financial Company Designations

- *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)*

Executive Session

The Chairperson called the executive session of the meeting of the Council to order at approximately 2:03 P.M.

The Chairperson began by welcoming Kipp Kranbuhl, Acting Assistant Secretary for Financial Institutions at Treasury, who was managing the OFR. The Chairperson also noted that Steven Seitz had been named the Director of FIO and was therefore 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 of the meeting included (1) an update on nonfinancial corporate credit and (2) a discussion of proposed amendments to the Council's interpretive guidance on nonbank financial company designations.

1. Nonfinancial Corporate Credit

The Chairperson then introduced the first agenda item, an update on nonfinancial corporate credit. The Chairperson introduced Ted Berg, Senior Financial Analyst at the OFR; Dan Li, Section Chief of Financial Intermediaries Analysis in the Division of Monetary Affairs at the Federal Reserve; and Charles Press, Senior Financial Institution and Policy Analyst in the Division of Monetary Affairs at the Federal Reserve.

Mr. Berg explained that the presentation would address (1) four key vulnerabilities that have emerged due to the low-interest rate environment and the long credit cycle and (2) the increasing importance of nonbank lenders, particularly in leveraged loans, and exposures of banks to corporate credit markets. He stated that investor demand had resulted in a record amount of debt issuance, and a post-crisis low in leveraged loan and high-yield bond credit spreads, during 2018. He noted that one vulnerability is the deterioration in the credit quality of investment-grade debt, which he stated could lead to widespread credit-rating downgrades. He explained that over half of investment-grade corporate debt outstanding consisted of bonds rated BBB, the lowest-rated investment-grade category—a record high. He noted that bonds rated BBB are most susceptible to downgrades to high-yield, and that the risk of downgrades could therefore be higher than in previous credit cycles. He estimated that during the next downturn, downgrades of investment-grade debt could range from roughly $300 billion to $1 trillion, with the latter being a low-probability, worst-case scenario. A large downgrade wave could be disruptive to financial markets if investors with strict investment-grade mandates were forced to sell downgraded debt. He then noted that another vulnerability arose from high debt growth and leverage. He noted that many nonfinancial sectors had experienced debt growth well in excess of earnings growth over the previous five years. He also noted that a large percentage of non-investment grade companies were highly leveraged (with a ratio of gross debt to earnings before interest, taxes, and depreciation exceeding 6x). He then described a vulnerability relating to high debt-serving burdens, based on interest coverage ratios. He noted that debt-serving burdens were high in many sectors, particularly technology, healthcare, consumer staples, and energy. Finally, he described a vulnerability related to the rapid growth in leveraged loans. In particular, he noted that the proportion of covenant-lite loans, which feature limited investor protections compared with other leveraged loans, was at a record high.

Ms. Li then explained that nonbank lenders had increased in importance in leveraged loan markets, with the share of newly issued institutional leveraged loans held by collateralized loan obligations (CLOs) increasing from 48 to 61 percent since 2006, and the share held by loan mutual funds increasing from 10 to 19 percent during the same period. She explained that loan mutual funds were more likely to be forced sellers due to the daily redemption they offer investors. She noted that there had been flows out of loan mutual funds in December 2018, but that funds had navigated the stress by selling loans at a discount and absorbing losses with cash buffers and bank credit lines, and that there had been no reports of these funds halting redemptions.

Mr. Press further described CLOs' investments in institutional leveraged loans. He noted that CLOs had weathered the financial crisis better than certain other types of funds, and that changes in CLOs' structures since the crisis, such as shorter reinvestment periods, had reduced CLOs' riskiness somewhat. He also noted that, unlike mutual funds, CLOs do not have redemption risk and therefore would not generally be forced to sell assets. He then described banks' exposures to leveraged loans, including direct exposures arising through holdings of leveraged loans and CLOs and indirect exposures from banks' loans to third parties that have leveraged loan exposures. He noted that some exposures can be difficult to assess. He concluded by stating that vulnerabilities related to corporate debt had grown and leverage was at an all-time high, creating the potential for higher default rates and lower recovery rates in the next downturn compared to previous cycles.

Council members asked questions and had a discussion, including regarding the types of entities holding leveraged loans, and the extent to which they have hedged their exposures; liquidity requirements and other existing regulations applicable to loan mutual funds; and the extent to which market participants hold short positions in financial products tied to leveraged loans. Council members also discussed the extent to which leveraged loans are originated by banks and nonbanks, and banks' direct and indirect exposures to leveraged loans. In addition, Council members discussed the importance of the Council's and regulators' continued engagement on these issues.

2. Interpretive Guidance on Nonbank Financial Company Designations

The Chairperson then introduced the second agenda item, a discussion of proposed amendments 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 (Dodd-Frank Act). The Chairperson noted that during the public session of the meeting, the Council would vote on proposed interpretive guidance and a final rule requiring the Council to seek public comment before adopting amendments to its interpretive guidance on nonbank financial company designations. The Chairperson asked Council members if they wished to make any comments on the interpretive guidance or rule. Council members then discussed the proposed interpretive guidance, including the potential uses of nonbank financial company designations; the engagement among Council member agencies during the process of drafting the proposed interpretive guidance; how to implement the proposed activities-based approach set forth in the proposed interpretive guidance; and the appropriate role of primary regulators in Council analyses.

3. Other Business

The Chairperson then noted that he had held discussions the previous week with officials in London and Paris regarding the end of the membership of the United Kingdom (U.K.) in the European Union (Brexit). He noted the continuing uncertainty regarding Brexit, and the potential for dislocations if the U.K. left the European Union without a withdrawal agreement. He also described various potential next steps for the U.K. government, and noted that Treasury will continue to monitor these developments.

The Chairperson adjourned the executive session of the meeting at approximately 2:46 P.M.

Public Session

The Chairperson called the open session of the meeting of the Council to order at approximately 2:52 P.M.

The Chairperson then outlined the agenda for the open session, which included (1) proposed amendments to the Council's interpretive guidance on nonbank financial company designations and a final rule requiring the Council to seek public comment before adopting amendments to its interpretive guidance on nonbank financial company designations, and (2) a vote on the minutes of the Council's meeting on December 19, 2018.

1. Interpretive Guidance on Nonbank Financial Company Designations

The Chairperson then introduced the first agenda item. He stated that the proposed interpretive guidance the Council was considering would make significant changes to how the Council identifies, assesses and responds to potential risks to U.S. financial stability. He stated that under the proposal, the Council would adopt an activities-based approach that would rely on the expertise of existing regulators to address potential risks. The Chairperson stated that the proposal would also enhance the Council's process for evaluating individual nonbank financial companies for designation by increasing transparency and analytic rigor. He stated that the Council would also vote on a final rule requiring the Council to issue any future amendments to its interpretive guidance on nonbank financial designations for public comment, before adopting changes.

The Chairperson then turned to Bimal Patel, Deputy Assistant Secretary for the Council at Treasury, for a presentation.

Mr. Patel stated that the proposed interpretive guidance that the Council was voting on would replace the Council's existing interpretive guidance on nonbank financial company designations. He noted that the Council was also voting on a final rule that would require any future changes to the Council's interpretive guidance on nonbank financial company designations to be issued for public notice and comment.

Mr. Patel stated that the proposed interpretive guidance describes the approach the Council intended to take in prioritizing its work using an activities-based approach. He stated that it also includes reforms to enhance the analytical rigor and transparency in the processes the Council intended to follow if it were to consider making a nonbank financial company designation, including cost-benefit analysis, the consideration of the likelihood of a company's material financial distress, and pre- and post-designation off-ramps to designation. He noted that the proposed interpretive guidance states that the Council would pursue entity-specific nonbank financial company designations only if a potential risk or threat to U.S. financial stability cannot be addressed through an activities-based approach.

Mr. Patel noted that the proposed interpretive guidance emphasizes the importance of market discipline as a mechanism for addressing potential risks to U.S. financial stability. He stated that the activities-based approach was designed to leverage the expertise of primary financial regulatory agencies and allow them to address identified potential risks. He stated that it was also designed to reduce competitive distortions from government intervention by addressing risks in a consistent manner.

Mr. Patel stated that the proposed interpretive guidance would establish a two-step process for the activities-based approach. First, the Council would monitor markets to identify and assess potential risks to U.S. financial stability. Second, the Council would work with relevant regulators to seek the implementation of actions intended to address the potential risks. Mr. Patel stated that only if a potential risk or threat cannot be addressed through an activities-based approach would the Council potentially evaluate a nonbank financial company for a potential designation.

Mr. Patel stated that the proposed interpretive guidance would also make several changes to enhance the analytical rigor and transparency of the nonbank financial company designation process. He stated that, in order to make the designation process more efficient, the proposed interpretive guidance would condense the current three-stage designation process into two stages, by eliminating the current stage 1. He stated that in order to enhance analytical rigor, the Council would perform a cost-benefit analysis under the proposed interpretive guidance prior to making a designation. Mr. Patel noted that only if the expected benefits to financial stability from the determination justify the expected costs would the Council make a designation. He stated that the Council would also assess the likelihood of a nonbank financial company's material financial distress when evaluating the company for a potential designation.

Mr. Patel stated that to promote transparency, the proposed interpretive guidance would increase the Council's engagement with companies and their existing regulators before and during the designation process. He stated that the increased engagement would provide a company with a potential pre-designation "off-ramp." He noted that the proposed guidance also includes procedures intended to clarify the post-designation "off-ramp."

The Chairperson then invited comments on the proposed guidance from members of the Council.

Jerome Powell, Chairman of the Federal Reserve, stated that the proposed amendments to the interpretive guidance did a good job of explaining to the public how the Council planned to address systemic risks. He stated that he supported the activities-based approach for addressing systemic risk, and also supported releasing the proposal for public notice and comment. Chairman Powell stated that the approach in the proposed interpretive guidance represented a disciplined framework for approaching financial stability. He noted that the Council's annual report effectively uses an activities-based approach because it focuses on potential emerging threats and vulnerabilities associated with activities in major financial markets. He stated that there are many cases when designating companies will not reduce market fragilities. He stated that the activities-based approach envisions constructive engagement with the primary regulators that have the tools and expertise to address such market fragilities. He noted that the activities-based approach focuses on monitoring a wide variety of risks and assessing how the risks might be propagated through the financial system. He noted that the proposed guidance also preserves nonbank financial company designations, which should be used sparingly, but which remain an important tool for addressing financial stability risks. He concluded by stating that the proposed interpretive guidance would benefit from public input.

Jay Clayton, Chairman of the SEC, stated that he agreed with Chairman Powell's remarks. He stated that he also agreed with the principles of transparency, engagement, active monitoring of risk, and collaboration across Council members embodied in the proposal. Chairman Clayton stated that he believed the approach described in the proposed interpretive guidance would have worked well in the past in identifying some of the risks that previously came to fruition, and that he would like to hear from the public about whether they believe the proposal back-tests well.

Jelena McWilliams, Chairman of the FDIC, thanked the Council for its transparency and for soliciting public comment on the proposal. She praised the emphasis in the proposal on primary regulators' duties and obligations under the relevant organic statutes and mandates. She stated that the interpretive guidance took a thoughtful approach in taking into account primary regulators' available supervisory tools and considering whether those tools would be sufficient to manage systemic risk before proceeding to the next stage of the designation process.

Kathleen Kraninger, Director of the CFPB, expressed her support for the prior comments by Council members. She stated that the cost-benefit analysis proposed in the interpretive guidance was a good-government principle and a hallmark of the activities that the CFPB is undertaking.

J. Mark McWatters, Chairman of the NCUA, stated that the activities-based approach requires the Council to follow the money and look for areas of over-concentration in risky, dubiously underwritten assets, loans, investments, and other ill-conceived financial activities. He stated that there was a common denominator in the savings and loan crisis, the developing-country debt crisis, the dot-com crisis, and the 2008-2009 financial crisis: these events were triggered by over-concentration in poorly underwritten assets. Chairman McWatters said that the approach under the proposed interpretive guidance matches what has occurred in the marketplace, and that this approach segues well into addressing nonbank financial institutions. He stated that American International Group, Inc., had received a $180 billion bailout during the financial crisis because it was over-concentrated in dubious credit-default swaps and other derivatives activities. He concluded by stating that if the Council identifies such over-concentration and activities, it should not hesitate to designate entities that are engaged in those activities, if the primary regulator is not doing its job and Congress is not looking for a structural change.

Thomas Workman, the Council's independent member with insurance expertise, stated that the proposed interpretive guidance was the first time he had seen any substantive structure behind the idea of an activities-based approach. He stated that the proposed interpretive guidance incorporated the elements that need to be considered when applying a system-wide approach, while keeping in mind the relationship with the primary regulator and being mindful of the Council's statutory obligations.

Joseph Otting, Comptroller of the Currency and Acting Director of the FHFA, stated that he supported the proposal to revise the Council's interpretive guidance, which was consistent with the recommendation in Treasury's November 2017 report on Council designations. He stated that the proposed interpretive guidance would shift the Council's approach away from the designation of individual companies and toward an activities-based approach that relies on the expertise of the primary regulator to address an identified risk. He stated that the additional procedural steps built into the designation process were positive changes, citing the consideration of the likelihood that a company would experience material financial distress and the analysis of benefits and costs. He stated that the proposal ensured that the Council will continue to serve its primary function in a transparent, efficient, and effective manner.

Christopher Giancarlo, Chairman of the CFTC, stated that the Council's value proposition is to bring together the expertise of its different member agencies. He stated that the proposed interpretive guidance would bring the primary regulator and the other regulators together to look at activities, determine whether they are likely to present financial stability risk, and consider whether steps should be taken. He stated that he believed the proposed interpretive guidance improved as the Council incorporated input from the member agencies.

Eric Cioppa, Superintendent of the Maine Bureau of Insurance, stated that state insurance regulators believe the most appropriate approach to addressing financial stability risk is for the Council to work in conjunction with existing regulators to identify risks and use regulators' authorities to address the risks in the first instance. He stated that the proposed interpretive guidance reflects these concepts, and that he supported the proposal and supported the proposed changes to the designation process and the annual review process for designated companies. He noted that the revised process would offer a robust exit ramp for designated firms and would provide designated firms and their regulators more transparency into the reasons for any firm-specific designations.

Following the discussion, the Chairperson presented to the Council the following resolution approving the proposed interpretive guidance regarding nonbank financial company designations:

WHEREAS, the Council's duties under section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA") include monitoring the financial services marketplace in order to identify potential threats to U.S. financial stability, recommending to the Council member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies, identifying gaps in regulation that could pose risks to the financial stability of the United States, and making recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among financial companies and markets; and

WHEREAS, section 113 of the DFA authorizes the Council to determine that a nonbank financial company shall be supervised by the Board of Governors of the Federal Reserve System (the "Federal Reserve") and shall be subject to prudential standards if the Council determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States; and

WHEREAS, on April 3, 2012, the Council issued a final rule, with accompanying interpretive guidance (the "2012 Interpretive Guidance"), that describe the manner in which the Council intended to apply the statutory standards and considerations, and the processes and procedures that the Council intended to follow, in making determinations regarding nonbank financial companies under section 113 of the DFA; and

WHEREAS, the staffs of the Council members and their agencies have prepared proposed interpretive guidance (the "Proposed Guidance") that would replace the 2012 Interpretive Guidance and that describes the approach the Council proposes to take in (1) prioritizing its work to identify and address potential risks to U.S. financial stability using an activities-based approach, and (2) enhancing the analytical rigor and transparency in the processes the Council would follow if it were to consider making a determination under section 113 of the DFA; and

WHEREAS, the staffs of the Council members and their agencies recommend that the Council approve and publish the Proposed Guidance.

NOW, THEREFORE, BE IT RESOLVED, that the Council hereby approves the Proposed Guidance and authorizes the Chairperson, or his designee, to cause the Proposed Guidance to *be published in the Federal Register, in a form and manner acceptable to the Chairperson, or his designee, and to otherwise make it available to the public as the Chairperson deems appropriate.*

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 Proposed Guidance to ensure that it can be published in the Federal Register; to extend the due date for public comments on the Proposed Guidance; and to take such other actions and issue such other documents incident and related to the foregoing as the Chairperson, or his designee, deems necessary or appropriate to fulfill the Council's objectives in connection with its publication.

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 then presented the Council with the following resolution approving the final rule regarding opportunities for notice and comment on the Council's interpretive guidance regarding nonbank financial company designations:

WHEREAS, on April 3, 2012, the Council issued a final rule (the "2012 Rule") and accompanying interpretive guidance that describe the manner in which the Council intended to apply the statutory standards and considerations, and the processes and procedures that the Council intended to follow, in making determinations regarding nonbank financial companies under section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA"); and

WHEREAS, section 111(e)(2) of the DFA authorizes the Council to adopt such rules as may be necessary for the conduct of the business of the Council; and

WHEREAS, the staffs of the Council members and their agencies have prepared an amendment (the "Final Rule") to the 2012 Rule to provide that the Council shall not amend or rescind its interpretive guidance on nonbank financial company determinations under section 113 of the DFA without providing the public with notice and an opportunity to comment under the Administrative Procedure Act; and

WHEREAS, the staffs of the Council members and their agencies recommend that the Council approve and publish the Final Rule.

NOW, THEREFORE, BE IT RESOLVED, that the Council hereby approves the Final Rule and authorizes the Chairperson, or his designee, to cause the Final Rule to be published in the Federal Register, in a form and manner acceptable to the Chairperson, or his designee, and to otherwise make it available to the public as the Chairperson deems appropriate.

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 Final Rule to ensure that it can be published in the Federal Register, and to take such other actions and issue such other documents incident and related to the foregoing as the Chairperson, or his *designee, deems necessary or appropriate to fulfill the Council's objectives in connection with its publication.*

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 December 19, 2018

BE IT RESOLVED, by the Financial Stability Oversight Council (the "Council"), that the minutes attached hereto of the meeting held on December 19, 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 3:08 P.M.