Minutes of the Financial Stability Oversight Council

September 4, 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) (by telephone)
Heath P. Tarbert, Chairman, Commodity Futures Trading Commission (CFTC)
Kathleen Kraninger, Director, Consumer Financial Protection Bureau (CFPB)
Mark Calabria, Director, Federal Housing Finance Agency (FHFA) (by telephone)
Joseph Otting, Comptroller of the Currency, Office of the Comptroller of the Currency (OCC)
Rodney Hood, Chairman, National Credit Union Administration (NCUA)
Thomas E. Workman, Independent Member with Insurance Expertise
Dino Falaschetti, Director, Office of Financial Research (OFR), Department of the Treasury (non-voting member)
Steven Seitz, Director, Federal Insurance Office (FIO), Department of the Treasury (non-voting member) (by telephone)
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 of the Treasury
Brent McIntosh, General Counsel
Bimal Patel, Assistant Secretary for Financial Institutions
Eric Froman, Assistant General Counsel (Banking and Finance)
Kipp Kranbuhl, Principal Deputy Assistant Secretary for Financial Markets
Howard Adler, Deputy Assistant Secretary for 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
Jeffrey Dinwoodie, Senior Counsel and Policy Advisor for Market and Activities-Based Risk

Commodity Futures Trading Commission
Jaime Klima, Chief of Staff

Consumer Financial Protection Bureau
Christopher Mufarrige, Senior 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

Federal Reserve Bank of New York
John Williams, President and Chief Executive Officer (by telephone)

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

Federal Insurance Office
Kevin Meehan, Senior Insurance Regulatory Policy Analyst (by telephone)

Texas Department of Banking
Michael Townsley, Policy Counsel, Conference of State Bank Supervisors (CSBS)

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:

Proposed Interpretive Guidance on Nonbank Financial Company Designations

- *Howard Adler, Deputy Assistant Secretary for the Council, Treasury*
- *Stephen Ledbetter, Director of Policy, Office of the Financial Stability Oversight Council, Treasury (available for questions)*
- *Mark Schlegel, Attorney-Advisor, Treasury (available for questions)*

2019 Annual Report

- *Stephen Ledbetter, Director of Policy, Office of the Financial Stability Oversight Council, Treasury*
- *James Bohn, Senior Professional, Federal Reserve Bank of Boston*

Nonbank Mortgage Origination and Servicing

- *Chuck Cross, Senior Vice President, Nonbank Supervision and Enforcement, CSBS*
- *Karen Pence, Deputy Associate Director, Division of Research and Statistics, Federal Reserve*
- *Kevin Silva, Manager, Enterprise Risk Metrics, FHFA*
- *Kevin Byers, Senior Director, Nonbank Supervision and Enforcement, CSBS (available for questions)*
- *Margaret Cai, Senior Financial Analyst, Office of Financial Analysis, Modeling, and Simulations, Division of Housing Mission and Goals, FHFA (available for questions)*

LIBOR and Alternative Reference Rates

- *David Bowman, Senior Associate Director, Division of Monetary Affairs, Federal Reserve*
- *Peter Phelan, Deputy Assistant Secretary for Capital Markets, Treasury*
- *Sayee Srinivasan, Deputy Director, Risk Surveillance, Division of Clearing and Risk, CFTC*
- *Chloe Cabot, Policy Advisor, Office of Financial Markets, Treasury (available for questions)*

Fiscal Year 2020 Council Budget

- *Samantha MacInnis, Director of Operations, Office of the Financial Stability Oversight Council, Treasury (available for questions)*

Executive Session

The Chairperson called the executive session of the meeting of the Council to order at approximately 3:32 P.M.

The Chairperson began by welcoming Howard Adler to his first meeting as Deputy Assistant Secretary for the Council at Treasury. 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) the Council's proposed interpretive guidance on nonbank financial company designations; (2) the Council's 2019 annual report; (3) nonbank mortgage origination and servicing; (4) the London Interbank Offered Rate (LIBOR) and alternative reference rates; (5) a vote on the Council's fiscal year 2020 budget; and (6) a vote on the minutes of the Council's meeting on May 30, 2019.

1. Proposed Interpretive Guidance on Nonbank Financial Company Designations

The Chairperson then introduced the first agenda item, a presentation on the Council's proposed 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 Council approved the proposed interpretive guidance on March 6, 2019. The Chairperson turned to Howard Adler, Deputy Assistant Secretary for the Council at Treasury, for the presentation.

Mr. Adler noted that the public comment period for the proposed interpretive guidance had closed on May 13, 2019. He briefly summarized the public comment letters received in response to the proposal. Mr. Adler noted that commenters expressed views on how to implement the activities-based approach set forth in the proposed interpretive guidance, the Council's proposed procedures related to transparency and engagement, the appropriate role of primary regulators in Council analyses, and other topics. Mr. Adler highlighted potential changes to the proposed interpretive guidance in response to the public comments, and provided an update on the anticipated timing for completing and issuing the final interpretive guidance.

2. 2019 Annual Report

The Chairperson then introduced the next agenda item, the Council's 2019 annual report. He introduced Stephen Ledbetter, Director of Policy in the Office of the Financial Stability Oversight Council at Treasury, and James Bohn, Senior Professional at the Federal Reserve Bank of Boston.

Mr. Ledbetter provided an overview of the organization of the annual report. He also described the process for developing the report, including discussions and collaboration among Council members and member agencies. Mr. Bohn then highlighted certain topics that the report may address. Mr. Ledbetter provided an update regarding interagency staff deliberations about the report.

Council members then asked questions and had a discussion about certain topics that may be included in the report.

3. Nonbank Mortgage Origination and Servicing

The Chairperson then introduced the next agenda item, nonbank mortgage origination and servicing. The Chairperson noted that nonbanks have significantly increased their market share in mortgage originations and servicing since the financial crisis, and that they generally originate mortgages with higher-risk characteristics than banks. He then introduced Kevin Silva, Manager of Enterprise Risk Metrics at the FHFA; Karen Pence, Deputy Associate Director of the Division of Research and Statistics at the Federal Reserve; and Chuck Cross, Senior Vice President for Nonbank Supervision and Enforcement at the CSBS, for the presentation.

Mr. Silva stated that the presentation would address nonbank mortgage company business models, industry trends, fragilities, and regulatory frameworks. He described business models of nonbank mortgage originators and servicers. He noted that nonbank business models can vary significantly, including originator/servicers (which originate mortgages and retain servicing), originators (which originate mortgages but do not retain the servicing), mortgage servicing right (MSR) investors (which purchase MSRs but outsource the servicing to a subservicer), and subservicers (which perform servicing as third-party vendors). He then described the growth of nonbanks' market share in mortgage origination and servicing since the financial crisis. He stated that nonbanks originated approximately half of all mortgages in 2019, and that approximately 45 percent of outstanding mortgages are serviced by nonbanks. He also described the proportion of mortgages originated or serviced by nonbanks that are held by Fannie Mae or Freddie Mac or that collateralize mortgage-backed securities guaranteed by Ginnie Mae. He also described several trends in the nonbank mortgage origination and servicing industry, and noted that nonbanks generally originate riskier mortgages than banks, as measured by borrowers' debt-to-income ratios, loan-to-value ratios, and credit scores.

Ms. Pence then described certain reasons for the increase in nonbank mortgage origination and servicing. She explained banks' apparent reluctance to extend mortgage credit to riskier borrowers, for reasons including the expense of servicing loans in default, and legal and reputational risks of delinquencies and foreclosures. Ms. Pence also identified other potential reasons for the increased nonbank market share, including differences in overhead costs of mortgage origination; capital treatment of MSRs; and the deployment by nonbanks of financial technology. Ms. Pence then highlighted potential risks related to nonbank mortgage originators and servicers, including through exposures of counterparties (including Fannie Mae, Freddie Mac, Ginnie Mae, and banks) and contagion risk from many nonbanks and the resulting potential for dislocation in the housing and mortgage market during periods of stress. She then described fragilities in nonbank business models, including a reliance on short-term funding and an obligation to continue to make payments to holders of a mortgage-backed security when a borrower does not make a payment on a mortgage underlying the security.

Mr. Cross then explained additional fragilities of nonbanks, stating that these firms generally have few resources to absorb shocks. He cited nonbanks' debt-to-equity ratios and liquidity. He then described the regulatory framework applicable to nonbank mortgage originators and servicers. He noted that the regulatory framework for these nonbanks is fragmented among federal and state regulators. He also noted questions regarding the adequacy of existing requirements for addressing potential risks. He explained that policymakers have taken steps to begin to address these concerns, and he highlighted actions taken by the FHFA, Ginnie Mae, and the CSBS to evaluate or enhance existing requirements related to capital, liquidity, and counterparty risk.

Council members asked questions and had a discussion, including regarding the reasons banks do not more extensively underwrite mortgages to borrowers with lower credit scores; mortgage servicing requirements imposed by Fannie Mae, Freddie Mac, and Ginnie Mae; default levels experienced during the financial crisis; nonbank mortgage servicers' levels of capital and liquidity; risks to banks from their exposures to nonbank mortgage originators and servicers; potential regulatory enhancements; challenges in the bankruptcy of a failed nonbank mortgage servicer; potential market impacts from the failure of multiple nonbank mortgage servicers; and regulators' data-sharing efforts.

4. LIBOR and Alternative Reference Rates

The Chairperson then introduced the next agenda item, LIBOR and alternative reference rates. He introduced Peter Phelan, Deputy Assistant Secretary for Capital Markets at Treasury; David

Bowman, Senior Associate Director of the Division of Monetary Affairs at the Federal Reserve; and Sayee Srinivasan, Deputy Director of Risk Surveillance in the Division of Clearing and Risk at the CFTC.

Mr. Phelan stated that the presentation would address the progress that the Alternative Reference Rates Committee (ARRC), the official sector, and markets have made in the transition from LIBOR to alternative reference rates. He then described progress in implementing this transition, including the identification of the Secured Overnight Financing Rate (SOFR) as the ARRC's preferred alternative reference rate; the publication of contractual fallback language for certain types of financial instruments; the publication of an ARRC white paper on SOFR-linked adjustable-rate mortgages in July 2019; and the publication in August 2019 by the International Swaps and Derivatives Association (ISDA) of preliminary results of its consultation related to pre-cessation issues for LIBOR.

Mr. Phelan then described aggregate exposures to U.S. dollar LIBOR by asset class. The exposures included $190 trillion notional amount of derivatives, $3.4 trillion of business loans, $1.8 trillion of bonds, $1.8 trillion of securitizations, and $1.3 trillion of consumer loans. Mr. Phelan stated that while the largest exposure is in derivatives, their transition to an alternative rate would be facilitated by changes to ISDA protocols. He noted that the ISDA protocol would allow for the replacement of LIBOR in uncleared derivatives when both parties sign the new protocol and that adoption of this protocol would be vital to the transition. He stated that while the notional amount outstanding of cash products appears small in comparison to that of derivatives, they pose a greater challenge for the transition, for example due to weak contractual fallback provisions that do not provide a feasible path to an alternative rate. He also noted that consumer products entail unique challenges in the transition, due to legal and practical difficulties.

Mr. Bowman then described market activity. He stated that activity in SOFR futures markets has grown and that SOFR swaps activity has also begun to increase, but that SOFR derivatives volumes were still small compared to derivatives linked to the federal funds rate or LIBOR. He noted that the ISDA protocol allowing for the replacement of LIBOR should encourage SOFR liquidity by linking longer-dated LIBOR swaps and SOFR swaps. He cited issuances of SOFR-linked debt, including by the Federal Home Loan Banks, and stated that Fannie Mae and Freddie Mac were developing the capacity to accept SOFR adjustable-rate mortgages. He noted, however, that many nonfinancial companies were not yet paying attention to the transition. He also noted that most cash products continue to use LIBOR and stated that finding a solution for legacy debt and securitization products will be difficult. He stated that the ARRC is considering potential legislative solutions.

Mr. Phelan then described government agencies' areas of focus and progress. He noted that in April 2019, the ARRC had submitted a request to Treasury and the Internal Revenue Service (IRS) for guidance on topics related to the transition of LIBOR-linked contracts to SOFR. Mr. Phelan stated that guidance from Treasury and the IRS on this issue would be forthcoming. He also noted that Treasury was evaluating the possibility of issuing a Treasury floating-rate note linked to SOFR. He then stated that Treasury was engaging in outreach with stakeholders as attention to the LIBOR transition increases.

Mr. Srinivasan explained that authorities have been working with the ARRC on various rules under Title VII of the Dodd-Frank Act to facilitate the transition away from LIBOR. He stated that there is a coordinated effort with the Federal Reserve, the FDIC, and the OCC to address issues related to margin for uncleared swaps. He noted that the CFTC was also coordinating internationally, including at the Financial Stability Board. He stated that certain derivatives clearinghouses were important to the ARRC's transition plans and that the CFTC was working to support their efforts. He noted that the CFTC was continuing to work with the ARRC on providing market participants with regulatory relief related to other derivatives-related requirements.

Mr. Bowman then stated that the Federal Reserve had been discussing potential developments related to LIBOR with the U.K. Financial Conduct Authority (FCA) and the CFTC. He noted the potential that the FCA might judge LIBOR to be non-representative soon after year-end 2021 and that LIBOR would then become unavailable for certain new financial products for European Union–supervised entities. He stated that the Federal Reserve was working with its supervised entities and was monitoring their preparations for the transition. He explained that the Federal Reserve would increase its supervisory expectations over time. He stated that the Federal Reserve was focused on ensuring a smooth transition away from LIBOR. He noted that a number of Council member agencies would be issuing proposed guidance regarding margin relief for legacy swaps, which would remove impediments to signing the ISDA protocol or moving away from LIBOR. Finally, he stated that authorities must continue to encourage supervised entities to take action sooner rather than later.

Mr. Phelan concluded by identifying certain issues for the Council's consideration, including potential additional steps for coordination of regulatory and supervisory actions to encourage a timely transition away from LIBOR, and potential further engagement among Council members and member agencies on this issue.

Members of the Council then asked questions and had a discussion, including regarding the potential implications if the FCA finds that LIBOR is non-representative in 2022; the transition away from LIBOR products in the cash market; and the importance of consumer education on this topic.

5. Fiscal Year 2020 Council Budget

The Chairperson then introduced the next agenda item, the Council's fiscal year 2020 budget.

The Chairperson presented to the Council the following resolution approving the Council's budget for fiscal year 2020.

BE IT RESOLVED, by the Financial Stability Oversight Council (the "Council"), that the Council's budget for fiscal year 2020 attached hereto is 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.

6. Other Business

The Chairperson then noted recent developments related to the end of the membership of the United Kingdom (U.K.) in the European Union (Brexit). He described European governments' preparations and ongoing discussions regarding Brexit.

7. Resolution Approving the Minutes of the Meeting Held on May 30, 2019

BE IT RESOLVED, by the Financial Stability Oversight Council (the "Council"), that the minutes attached hereto of the meeting held on May 30, 2019 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 4:45 P.M.