Minutes of the Financial Stability Oversight Council

April 8, 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)
Rostin Behnam, Chairman, Commodity Futures Trading Commission (CFTC)
Rohit Chopra, 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
James Martin, Acting 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)
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
Eric Froman, Assistant General Counsel (Banking and Finance)
Sean Hoskins, Acting Director of Policy, Office of the Financial Stability Oversight Council

Board of Governors of the Federal Reserve System
Andreas Lehnert, Director, Division of Financial Stability

Federal Deposit Insurance Corporation
Rae-Ann Miller, Associate Director, Risk Management Policy

Securities and Exchange Commission
Amanda Fischer, Senior Counselor

Commodity Futures Trading Commission
David Gillers, Chief of Staff

Consumer Financial Protection Bureau
Gregg Gelzinis, Advisor to the Director

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

Comptroller of the Currency
Blake Paulson, Senior Deputy Comptroller for Supervision Risk and Analysis

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, Research and Analysis Center

Federal Insurance Office
Philip Goodman, Senior Insurance Regulatory Policy Analyst

Texas Department of Banking
Karen Lawson, Senior Vice President for Policy, Conference of State Bank Supervisors

Rhode Island Department of Business Regulation
Kay Noonan, General Counsel, National Association of Insurance Commissioners

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

PRESENTERS:

Digital Assets Update

- *Sandra Lee, Deputy Assistant Secretary for the Council, Treasury*
- *Jonathan Rose, Senior Economist, Federal Reserve Bank of Chicago*

Update on Financial Stability Developments

- *William Bassett, Senior Associate Director, Division of Financial Stability, Federal Reserve*

- *Rahul Varma, Associate Director, Division of Market Oversight, CFTC*
- *Richard Haynes, Deputy Director, Division of Clearing and Risk, CFTC*

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 began by welcoming three new Council members: Martin Gruenberg, Acting Chairman of the FDIC; James Martin, Acting Director of the OFR; and Elizabeth Dwyer, Superintendent of Financial Services for the Rhode Island Department of Business Regulation. 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) an update on digital assets, (2) votes on the minutes of the Council's meetings on February 4, 2022 and February 28, 2022, and (3) an update on financial stability developments.

1. Update on Digital Assets

The Chairperson turned to the first agenda item, an update on digital assets. She introduced Sandra Lee, Deputy Assistant Secretary for the Council at Treasury, and Jonathan Rose, Senior Economist at the Federal Reserve Bank of Chicago.

Ms. Lee began by noting that the Council identified digital assets as a Council priority at its meeting on February 4, 2022. She stated that since that meeting, member agency staff had engaged closely and had begun preliminary work on the Council report being prepared in response to the Executive Order on Ensuring Responsible Development of Digital Assets, issued on March 9, 2022. She stated that staff would continue collaborating on the drafting of the Council report.

Mr. Rose stated that the Executive Order called on the Council to produce a report outlining financial stability risks and regulatory gaps posed by various types of digital assets and providing recommendations to address those risks. He described preliminary interagency work by staff of member agencies related to the report, including the identification of potential risks posed by digital assets. He said staff would assess a variety of issues regarding digital assets and would seek to develop a common understanding of the potential risks to financial stability they could pose. Mr. Rose also described anticipated next steps in the process for developing the Council's report under the Executive Order.

Council members then had a discussion about member agencies' work to assess potential financial stability risks posed by digital assets, including historical comparisons, interconnections with the banking system, and interagency coordination.

2. Resolutions Approving the Minutes of the Meetings Held on February 4, 2022 and February 28, 2022

BE IT RESOLVED, by the Financial Stability Oversight Council (the "Council"), that the minutes attached hereto of the meeting held on February 4, 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.

BE IT RESOLVED, by the Financial Stability Oversight Council (the "Council"), that the minutes attached hereto of the meeting held on February 28, 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.

3. Update on Financial Stability Developments

The Chairperson turned to the next agenda item, an update on financial stability developments. She introduced William Bassett, Senior Associate Director of the Division of Financial Stability at the Federal Reserve, to discuss recent developments related to U.S. financial stability.

Mr. Bassett began by providing an overview of the Federal Reserve's framework for assessing financial stability. He noted that it distinguishes between shocks, which are difficult to predict, and vulnerabilities, which are channels by which shocks can be amplified. He stated that the four key vulnerabilities in the framework are asset valuations and risk appetite; nonfinancial leverage; financial leverage; and maturity and liquidity transformation, also known as funding risk.

Mr. Bassett noted that high asset valuations can increase vulnerabilities by making it easier for investors to take excessive risks. He also noted the volatility in equity prices and the increase in excess bond premium over the last year.

With respect to commercial real estate, Mr. Bassett stated that property prices and rents were rising, with some sectors that were disproportionately affected by the pandemic, including office, hotel, and retail, remaining weak. He then turned to residential real estate, noting that house price valuations had risen substantially. He stated that most new mortgage debt was being added by borrowers with prime credit scores, unlike the early 2000s. He noted that the ratio of overall private nonfinancial-sector debt to income appeared to be in line with most of the past decade. He also noted that household balance sheets had improved and that delinquency rates remained low even for lower-rated borrowers. He also stated that bank capital remained high.

Mr. Bassett then addressed the leverage of other financial firms, stating that hedge fund leverage was likely above its pre-pandemic levels, although comprehensive and timely data was not available. He said that leverage among life insurance companies was near the highest levels in recent decades, but their risk-based capital ratio was not. He also described trends related to life insurance companies, mutual funds, and other nonbank financial institutions.

Mr. Bassett concluded by stating that the appetite for risk remained ample; vulnerabilities associated with nonfinancial and financial leverage appeared to be moderate; underlying funding market vulnerabilities appeared unchanged, although liquidity in some markets had been strained; and economic strains arising from the Russian invasion of Ukraine could intensify.

The Chairperson then introduced Rahul Varma, Associate Director of the Division of Market Oversight at the CFTC, and Richard Haynes, Deputy Director of the Division of Clearing and Risk at the CFTC, to discuss commodity market developments.

Mr. Varma provided an overview of the impact on commodity markets of the Russian invasion of Ukraine. He noted that prices for key commodities, including oil and wheat, had been increasing before the invasion and rose sharply after the invasion. He stated that commodity prices, which had been hovering at approximately 20 percent over their pre-invasion levels, had recently moderated slightly, especially for oil, in part due to releases from the Strategic Petroleum Reserve. He stated that while premiums for upside risk protection had increased after the invasion, they had recently moderated somewhat.

Mr. Varma stated that commodity markets, including for wheat and crude oil, were experiencing extreme volatility. He stated that agricultural markets faced a number of risks, including related to Ukrainian exports, fertilizer price increases, and the risk of weather events that could impact production.

Mr. Varma then addressed risk factors impacting energy and metals markets. He stated that prices in the U.S. domestic natural gas market had increased significantly since the Russian invasion of Ukraine. He also noted that Russia is the largest exporter of oil in the world. He also stated that Russia supplies approximately 40 percent of global palladium, and that prices had increased significantly since the invasion. He said that prices for other industrial metals, such as steel and aluminum, had also increased and stocks of these commodities had declined. He concluded by stating that options markets indicated that market volatility would likely remain elevated in the near term.

Council members then had a discussion about commodity price volatility in non-U.S. markets.

Mr. Haynes then provided an update on cleared markets. He stated that aggregate margin at clearing members had increased since the beginning of 2022 to approximately $700 billion. He noted that the largest margin increases had occurred at clearinghouses that clear physical commodities, particularly energy and agricultural products. He said that aggregate margin levels had decreased somewhat from recent highs in late February and early March. He also discussed increases in variation margin, which had recently peaked at approximately $50 billion, five times prior average levels. He stated that although margin calls were elevated, all margin had been paid on time and in full. He said that the CFTC continued to engage with central counterparties (CCPs) to monitor markets.

Mr. Haynes stated that in 2020, margin increases had occurred across major asset classes, while in 2022 they were concentrated in exchange-traded derivatives, energy contracts, and related markets. He noted that margin levels are strongly influenced by market volatility. He also noted that margin as a percentage of contract value was high in 2022 for certain commodities, including Dutch natural gas, the ruble, and wheat. He also stated that while in 2020 there had been a significant increase in initial margin at both U.S. and non-U.S. CCPs, in 2022 initial margin demand had shifted more to non-U.S. CCPs. He concluded by noting that non-bank-affiliated clearing members, which often clear commodities, had seen significant increases in margin over the preceding months.

Members of the Council then asked questions and had a discussion, including regarding financial exposures to Russia and hedge fund leverage.

The Chairperson adjourned the meeting at approximately 11:02 A.M.