Minutes of the Financial Stability Oversight Council

June 16, 2023

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, Chairman, Federal Deposit Insurance Corporation (FDIC)
Gary Gensler, Chair, Securities and Exchange Commission (SEC)
Rostin Behnam, Chairman, Commodity Futures Trading Commission (CFTC) (via videoconference)
Gregg Gelzinis, Advisor to the Director, Consumer Financial Protection Bureau (CFPB) (acting pursuant to delegated authority)
Sandra L. Thompson, Director, Federal Housing Finance Agency (FHFA)
Michael J. Hsu, Acting Comptroller of the Currency, Office of the Comptroller of the Currency (OCC) (via videoconference)
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) (via videoconference)
Steven Seitz, Director, Federal Insurance Office (FIO), Department of the Treasury (non-voting member)
Adrienne Harris, Superintendent, New York State Department of Financial Services (non-voting member)
Elizabeth K. Dwyer, Superintendent of Financial Services, Rhode Island Department of Business Regulation (non-voting member) (via videoconference)
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
Nicholas Steele, Director of Analysis, 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, Chief of Staff

Commodity Futures Trading Commission
Rahul Varma, Acting Deputy Director, Division of Market Oversight (via videoconference)

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

Comptroller of the Currency
Jay Gallagher, Senior Deputy Comptroller for Supervision Risk and Analysis (via videoconference)

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
Richard Crump, Financial Research Advisor, Macrofinance Studies (via videoconference)

Office of Financial Research
Sriram Rajan, Associate Director, Research and Analysis Center

Federal Insurance Office
Philip Goodman, Senior Insurance Regulatory Policy Analyst

New York State Department of Financial Services
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 (via videoconference)

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

PRESENTERS:

Update on Financial Stability Vulnerabilities

- *Elizabeth Klee, Senior Associate Director, Division of Financial Stability, Federal Reserve*
- *David Bowman, Senior Associate Director, Division of Monetary Affairs, Federal Reserve*

Commercial Real Estate Developments

- *David Bates, Director for Commercial Credit Risk Policy, OCC*
- *Camille Schmidt, Chief of Risk Insights and Analytics, FDIC*
- *Andrew Felton, Deputy Director, Systemic Risk, FDIC (available for questions)*
- *Melissa Love-Greenfield, Deputy Comptroller for Systemic Risk Identification and Support, OCC (available for questions)*

Developments in the Banking Sector

- *Michael Barr, Vice Chair for Supervision, Federal Reserve*

Executive Session

The Chairperson called the executive session of the meeting of the Council to order at approximately 12:58 P.M. The Chairperson began by outlining 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 financial stability vulnerabilities, (2) a presentation on developments in the commercial real estate market, (3) an update on developments in the banking sector, and (4) a vote on the minutes of the Council's meeting on April 21, 2023.

1. Update on Financial Stability Vulnerabilities

The Chairperson introduced the first agenda item, an update on financial stability vulnerabilities. She introduced Elizabeth Klee, Senior Associate Director of the Division of Financial Stability at the Federal Reserve, and David Bowman, Senior Associate Director of the Division of Monetary Affairs at the Federal Reserve.

Ms. Klee stated that the presentation would focus on the Federal Reserve's semiannual Financial Stability Report (FSR), published most recently in May 2023. She said that following the publication of the Federal Reserve's November 2022 FSR, events had been dominated by the failures of Silicon Valley Bank (SVB), Signature Bank, and First Republic Bank. She said that as stress in the banking sector materialized, financial market volatility had increased and liquidity was strained in some markets. She noted that the shock to confidence may weigh on credit conditions, and she said that the Federal Reserve was closely monitoring developments.

Ms. Klee stated that market participants contacted by the Federal Reserve were focused on inflation and tighter monetary policy. She noted that respondents surveyed after the failure of SVB cited banking-sector concerns, particularly the potential interaction with commercial real estate. She said that respondents also cited geopolitical risks, particularly tensions between the United States and China.

Ms. Klee said that valuation pressures in corporate markets had risen slightly and that market liquidity had been strained in some markets in March. She said that while commercial real estate prices had fallen slightly, valuations still remained high. She noted that while rising borrowing costs had contributed to a deceleration in house price increases, house price valuations remained near historical highs. She stated that business and household debt had grown more slowly than nominal gross domestic product, and that measures of business leverage remained high. She said that while household balance sheets remained strong, consumer debt delinquency rates had increased. She noted that credit card debt, after slowing appreciably during the pandemic, had increased at a double-digit pace.

Ms. Klee stated that between 2020 and 2021, banks had experienced deposit inflows of $4.7 trillion, nearly $3 trillion of which were uninsured, and had increased their securities holdings by $2.3 trillion. She said that as interest rates rose in 2022, banks' fair-value losses on fixed-rate assets increased. She said that the May FSR described significant events in the banking sector in March 2023, when poor management of interest rate and liquidity risks led to the failures of SVB and Signature Bank and to official interventions. She said that immediately following the bank failures, mid-sized and regional domestic banks experienced deposit outflows, while U.S. global systemically important banks experienced inflows. She said that in recent months, investors remained concerned about regional banks. She noted that bank deposit rates had been rising, including for retail deposits. She said that other types of borrowing had expanded, reflecting increased reliance on Federal Home Loan Bank advances, the discount window, and the Federal Reserve's Bank Term Funding Program. She said that while risk-based capital ratios for the U.S. global systemically important banks remained high, other measures were mixed.

Ms. Klee stated that hedge fund leverage continued to be elevated, particularly for the largest hedge funds. She noted that private credit funds had experienced substantial growth, and she said that prime money market mutual funds (MMFs) remained vulnerable. She said that as short-term rates continued to increase, assets under management in prime MMFs had increased by $220 billion, or 44 percent. She said that MMFs experienced risk-off flows following the failures of SVB and Signature Bank, with government MMFs experiencing inflows and prime MMFs experiencing a short-lived increase in redemptions. She noted that bond and loan mutual funds remained exposed to liquidity risks and had experienced a sharp drop in assets under management in 2022.

Mr. Bowman then provided an update on the transition from U.S. dollar LIBOR on June 30, 2023. He said that, following coordinated efforts to prepare for the transition from LIBOR, the financial stability risks around the LIBOR transition had been addressed. He stated that while it was unlikely that there would be major disruptions associated with the June 30 transition, smaller disruptions could arise if a large number of LIBOR-based financial instruments did not communicate rate changes; a significant number of borrowers whose LIBOR-based loans had not been remediated were dissatisfied with the process or the outcomes; a significant number of clients were surprised to learn that their bilaterally cleared U.S. derivatives contracts transitioned to the overnight Secured Overnight Financing Rate (SOFR) while cash products transitioned to

Term SOFR and that they must take active steps if they wish to re-hedge; a significant number of end users had not established the legal fallbacks to their contracts or a significant number of legal challenges to implemented fallbacks arose; or contracts referencing LIBOR-based rates were forced to rely on dealer polling as a fallback mechanism.

Council members then had a discussion regarding bank demand for bank deposits, demand for bank loans, and the LIBOR transition.

2. Commercial Real Estate Developments

The Chairperson then turned to the second agenda item, a presentation on developments in the commercial real estate (CRE) market. She introduced Camille Schmidt, Chief of Risk Insights and Analytics at the FDIC, and David Bates, Director for Commercial Credit Risk Policy at the OCC.

Ms. Schmidt discussed how developments in CRE were impacting depository institutions. She said that banks serve an important role in providing loans for CRE, and she noted that bank-held CRE had consistently increased in recent years, with non-farm, non-residential CRE representing the largest portion. She said that a growing number of banks, most of which have under $10 billion in assets, have CRE concentrations. She noted that a large number of banks with less than $10 billion in assets hold CRE assets totaling over 300 percent of their tier 1 capital. She noted, however, that asset quality metrics remained relatively stable.

Ms. Schmidt stated that the banking industry was preparing for potential challenges related to CRE. She noted that the vacancy rate for office and multifamily properties was rising. She said that these factors could present risks during the refinancing process. She said that vacancy rates were also high in some multifamily markets. She said that the retail and industrial sectors had more modest vacancy rates generally, with some exceptions, such as shopping malls. She stated that CRE merits ongoing supervisory attention. She noted that bank examinations prioritize the highest risks, often focusing on CRE for banks with CRE concentrations. She described the FDIC's examination methodologies, including various monitoring efforts. She noted that when issues are discovered, they may lead to supervisory recommendations or matters requiring board attention. She noted that FDIC subject matter experts monitor and report on CRE and that the FDIC would continue to monitor CRE.

Mr. Bates focused his remarks on the CRE exposures of the 32 banking institutions with over $100 billion in assets. He said that the CRE category of most significant concern was office, which comprises 19 percent of CRE holdings for banks with over $100 billion in assets. He said that while there had been an increase in multifamily loans being classified (i.e., assets that are exposures rated substandard, doubtful, or loss), this sector was nonetheless supported by continuing demand. He said that additional potentially related exposures on bank balance sheets included $144 billion of collateralized loan obligations, $216 billion of guaranteed commercial mortgage-backed securities, and $44 billion of non-guaranteed commercial mortgage-backed securities.

Discussing portfolio performance, Mr. Bates stated that there had been an increase in nonperforming loans, largely due to office properties. He said that loan-to-value ratios for office properties were generally 45 to 50 percent, leaving excess collateral and margin in the event of devaluations. He said that bank portfolios nonetheless merit further monitoring. He noted that, among banks with over $100 billion in assets, CRE concentrations were generally smaller in the larger banks within this group. Discussing CRE risk indicators, he said that there had been an increase in classified office commitments. He said that of the office properties maturing in the medium term, office vacancies were most significant in larger urban and metropolitan areas.

Mr. Bates then described certain supervisory actions that the OCC was undertaking with respect to CRE for banks with over $100 billion in total assets, including ad hoc reviews of risk ratings, collateral valuation practices, credit risk reviews, stress testing, problem loan workouts, and concentrations. He concluded by discussing recently issued OCC examiner guidance, including several OCC bulletins.

Following the presentation, the Chairperson noted that in the Council's 2022 annual report, the Council had recommended that supervisors and financial institutions continue to monitor CRE exposures and ensure the adequacy of credit loss allowances. She said that, consistent with this recommendation, she supported the Federal Reserve's statement in the May FSR that it had increased monitoring of the performance of CRE loans and expanded examination procedures for banks with significant CRE concentration risks.

Council members then had a discussion regarding concentrations of CRE in smaller banks, federal banking agencies' supervision and monitoring of banks with CRE exposures, and risks in the multifamily market.

3. Developments in the Banking Sector

The Chairperson then introduced the next agenda item, an update on developments in the banking sector.

The Chairperson stated that the banking sector was sound and resilient, although she noted that some institutions had continued to come under pressure. She said that it would be important for the Council, while monitoring these risks, to also consider the causes of the bank failures that had occurred in 2023 and how the Council can apply the lessons learned. She commended the banking regulators for their efforts and said that she looked forward to continued progress. She then asked the federal banking regulators to share their perspectives on recent developments and on how to strengthen the system. She introduced Michael Barr, Vice Chair for Supervision at the Federal Reserve, to offer remarks.

Mr. Barr stated that overall, the banking sector was sound and resilient. He then described potential risks on the horizon. He noted that increased deposit rates were leading to compression in banks' net interest margins. He also noted risks related to CRE, particularly the office and hotel sectors. He said that the market would be attentive to bank earnings to be announced in July, including with respect to deposit stability and profitability. He also cited impacts of the real economy on banks, particularly credit tightening. He noted that the Federal Reserve and the

FDIC had issued reports on SVB and Signature Bank, respectively, and he said that the Federal Reserve was committed to addressing the weaknesses identified in its report. He said that the Federal Reserve was also assessing the regulatory framework. He said that recent events had shown that previous estimates regarding the probability of default were incorrect and that estimates of losses given default did not account for contagion risks. He said the Federal Reserve, the FDIC, and the OCC were working to finalize the Basel III capital regulations.

The Chairperson then turned to Martin Gruenberg, Chairman of the FDIC. Chairman Gruenberg said that stabilization had occurred in the banking sector following the failure of First Republic Bank. He noted, however, that risks remained, including rising interest rates, a slowing economy, concentrations of uninsured deposits and unrealized losses, and CRE exposures. He said that regulators must continue to monitor these risks. With respect to regulatory issues, he noted that the banking agencies were working on finalizing the Basel III capital regulations and that the FDIC would seek to establish a long-term debt requirement for more banks. He also said that uninsured deposits require supervisory attention.

Council members then had a discussion about the need to remain vigilant regarding potential risks; federal regulators' monitoring of firms within their respective jurisdictions; and flows in bank deposits and money market mutual funds in the first quarter of 2023.

4. Resolution Approving the Minutes of the Meeting Held on April 21, 2023

BE IT RESOLVED, by the Financial Stability Oversight Council (Council), that the minutes attached hereto of the meeting held on April 21, 2023 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.

5. Other Business

Sandra Lee, Deputy Assistant Secretary for the Council at Treasury, briefly described several current efforts of Council Secretariat staff. She said that staff would provide an update on the work of the Council's staff-level Nonbank Mortgage Servicing Task Force at the next Council meeting. She said that staff also expected to update the Council soon on ongoing efforts regarding climate-related financial risks. Finally, she noted that the Council had received requests from stakeholders to extend by 30 days the public comment periods for the Council's proposed financial stability risk monitoring framework and its proposed interpretive guidance on nonbank financial company designations. The Council will extend the comment periods on the two proposals.

The Chairperson adjourned the meeting at approximately 2:29 P.M.