Minutes of the Financial Stability Oversight Council

December 14, 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) (via videoconference)
Martin Gruenberg, 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, 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)
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)
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 (via videoconference)
Andreas Lehnert, Director, Division of Financial Stability

Federal Deposit Insurance Corporation
Susan Baker, Corporate Expert, Division of Complex Institution Supervision and Resolution

Securities and Exchange Commission
Amanda Fischer, Chief of Staff

Commodity Futures Trading Commission
David Gillers, Chief of Staff

Consumer Financial Protection Bureau
Gregg Gelzinis, Advisor to the Director

Federal Housing Finance Agency
George Sacco, Senior Analyst, Division of Housing Mission and Goals

Comptroller of the Currency
Jay Gallagher, Senior Deputy Comptroller for Supervision Risk and Analysis

National Credit Union Administration
Elizabeth Eurgubian, Director of External Affairs and Communications

Office of the Independent Member with Insurance Expertise
Charles Klingman, Senior Policy Advisor

Federal Reserve Bank of New York
John Williams, President (via videoconference)
Richard Crump, Financial Research Advisor, Macrofinance Studies (via videoconference)

Office of Financial Research
Michael Passante, Chief Counsel

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 (NAIC)

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

PRESENTERS:

Nonbank Mortgage Servicing Task Force Update
- *Kaitlin Hildner, Senior Policy Advisor, Office of the Financial Stability Oversight Council, Treasury*

- *Karen Pence, Deputy Associate Director, Division of Research and Statistics, Federal Reserve*
- *Greg Keith, Senior Vice President and Chief Risk Officer, Ginnie Mae (available for questions) (via videoconference)*
- *Alanna McCargo, President, Ginnie Mae (available for questions)*
- *Sam Valverde, Executive Vice President and Chief Operating Officer, Ginnie Mae (available for questions) (via videoconference)*
- *Britt Van, Special Advisor, Ginnie Mae (available for questions)*

Hedge Fund Working Group Update
- *Ron Alquist, Principal Economist, Office of the Financial Stability Council, Treasury*
- *Alexandra Somers, Senior Policy Advisor, Office of the Financial Stability Council, Treasury*
- *Michelle Beck, Senior Financial Analyst, Division of Investment Management, SEC (available for questions)*
- *Elizabeth Fitzgerald, Assistant Director, Division of Trading and Markets, SEC (available for questions)*
- *Adam Minson, Advisor, Supervisory Policy, Federal Reserve Bank of New York (available for questions) (via videoconference)*

Climate-related Financial Risk Committee Update
- *Yue (Nina) Chen, Chief Climate Risk Officer, OCC*
- *Sini Matikainen, Senior Policy Advisor, Office of the Financial Stability Oversight Council, Treasury (available for questions)*
- *Daniel Wong, Senior Financial Analyst, OCC (available for questions)*

Cybersecurity Developments
- *Todd Conklin, Deputy Assistant Secretary for Cybersecurity and Critical Infrastructure Protection, Treasury*

2023 Annual Report
- *Sandra Lee, Deputy Assistant Secretary for the Council, Treasury*
- *Paula Tkac, Executive Vice President and Research Director, Federal Reserve Bank of Atlanta*

Executive Session

The Chairperson called the executive session of the meeting of the Council to order at approximately 2:59 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 the Council’s Nonbank Mortgage Servicing Task Force, (2) an update on the Council’s Hedge Fund Working Group, (3) an update on the Council’s Climate-related Financial Risk Committee, and (4) a presentation on cybersecurity developments.

1. Nonbank Mortgage Servicing Task Force Update

The Chairperson introduced the first agenda item, an update on the Council's Nonbank Mortgage Servicing Task Force. She said that the update would provide a follow-up to the task force's presentations to the Council in April and July, when staff presented on the risks generated by nonbank mortgage servicing and the challenges federal agencies and state regulators face in adequately addressing such risks. She welcomed Alanna McCargo, President of Ginnie Mae, for the discussion. She then introduced Kaitlin Hildner, Senior Policy Advisor in the Office of the Financial Stability Oversight Council at Treasury, and Karen Pence, Deputy Associate Director of the Division of Research and Statistics at the Federal Reserve, for the update.

Ms. Hildner stated that in July 2023, staff had briefed the Council on recent actions taken by federal agencies and state regulators to mitigate nonbank mortgage risks and the challenges they faced in adequately addressing those risks. She noted that since then, the Council's Nonbank Mortgage Servicing Task Force had conducted further collaboration and analysis.

Ms. Pence then stated that Ginnie Mae, Fannie Mae, and Freddie Mac face operational risk from nonbank mortgage servicers. She noted that a significant portion of the mortgage market is now serviced by nonbanks. She also stated that many nonbank mortgage servicers are highly leveraged and rely on short-term funding. She stated that in case of the failure of one or more large nonbank mortgage servicers, it would be challenging quickly to transfer the mortgage servicing to another servicer.

Ms. Hildner then noted that the Council has a range of authorities for addressing potential risks, including coordinating among agencies and making recommendations to regulators. She noted that the Council's recently issued Analytic Framework for Financial Stability Risk Identification, Assessment, and Response (the Analytic Framework) states that the Council may take different approaches to respond to a risk and may use multiple tools to mitigate a risk. She stated that the task force was evaluating a number of topics, including proposals to prepare for and manage the potential failure of a nonbank mortgage servicer, and to increase nonbank mortgage servicers' capacity to withstand solvency and liquidity strains. She noted that nonbank mortgage servicers are subject to the jurisdiction of multiple regulators, including state regulators and the CFPB, and she discussed the legal and operational challenges that can result from this structure. She then discussed the limitations of existing authorities, such as Ginnie Mae's Pass-Through Assistance Program, or PTAP, which was most recently made available to relieve liquidity pressures for Ginnie Mae issuers during the pandemic, for relieving liquidity pressures for solvent companies. She concluded by discussing potential actions to address the identified risks.

The Chairperson stated that state and federal agencies can take actions to better prepare for potential servicer stress events, and to improve the resilience of the sector to reduce the likelihood of failures. She noted that the Council had identified the risks associated with nonbank mortgage servicing for several years. She noted the importance of continuing to consider ways to address the risks.

Members of the Council then asked questions and had a discussion, including regarding the importance of addressing the identified risks, the potential use of agencies' existing authorities to address the identified risks, and interagency information sharing.

2. Hedge Fund Working Group Update

The Chairperson introduced the second agenda item, an update on the Council's Hedge Fund Working Group. She noted that previous working group presentations had identified potential financial stability risks associated with hedge fund activities. She stated that the presentation at this meeting would address recent developments in hedge fund-related risks and current and potential policy initiatives related to those risks. She then introduced Alexandra Somers, Senior Policy Advisor in the Office of the Financial Stability Oversight Council at Treasury, and Ron Alquist, Principal Economist in the Office of the Financial Stability Oversight Council at Treasury, for the presentation.

Ms. Somers stated that she would present on the Hedge Fund Working Group's risk assessment, with a focus on the reemergence of the basis trade. She stated that hedge fund leverage, borrowing, and counterparty risks had increased in recent quarters. She also noted that the basis trade had garnered significant attention in recent months. She stated that the Treasury cash-futures basis trade is a trading strategy that seeks to generate profits from the price difference between a Treasury futures contract and the cheapest-to-deliver cash Treasury security. She stated that in normal market conditions, basis trading may increase Treasury market efficiency by translating demand for Treasury futures contracts into demand for Treasury securities, reducing market segmentation, and improving overall market liquidity. She noted, however, that the basis trade can also increase fragilities in the Treasury market in the event of funding shocks or a breakdown in historical correlations. Ms. Somers explained that leveraged hedge funds' net short Treasury futures positions had increased rapidly.

Mr. Alquist then stated that he would address hedge fund vulnerabilities, current policy initiatives, and other options for consideration. He noted that if correlations between Treasury cash instruments and the underlying futures contracts break down or there is a liquidity shortage during a market stress period, hedge funds that finance their trades using the bilateral repo market can be forced to liquidate their highly leveraged positions under fire-sale conditions. He noted that in this scenario, the hedge fund is not typically the source of the adverse shock but instead propagates the effects of the shock to other markets and to the hedge fund's counterparties. He pointed to market events in March 2020 as an example. He noted mitigants to these risks, including portfolio margining. He also noted limitations on available data regarding margining practices. He stated that the OFR's anticipated rule regarding the collection of data on non-centrally cleared bilateral repo, as well as supervisory efforts to enhance existing counterparty credit risk management frameworks at global systemically important banks, can provide additional information on margining practices. He stated that the reemergence of the Treasury basis trade and the growth of hedge fund borrowing had increased scrutiny of non-centrally cleared bilateral repo transactions.

Mr. Alquist then noted that agencies had been considering policies related to these vulnerabilities, including the SEC's recently approved central clearing rule and supervisors' work with banks to remediate deficiencies in counterparty credit risk management practices.

Mr. Alquist then described potential next steps that could be taken to address vulnerabilities in the sector, consistent with the Council's Analytic Framework.

The Chairperson then thanked the CFTC for sharing information for the purpose of enhancing the Hedge Fund Working Group's ability to assess current risks. She stated that she supported further analysis, including regarding potential risks related to the Treasury basis trade, industry margining practices, and supervisory and regulatory requirements.

Council members then discussed risks related to the basis trade and hedge fund margining practices, and recent rulemakings and potential actions agencies could take with respect to the risks described in the presentation.

3. Climate-related Financial Risk Committee Update

The Chairperson then introduced the third agenda item, an update from the Council's Climate-related Financial Risk Committee (CFRC). She introduced Nina Chen, Chief Climate Risk Officer at the OCC, for the presentation.

Ms. Chen noted that this presentation followed up on the presentation at the Council's meeting in July 2023 regarding the development of preliminary risk indicators for climate-related financial risk. She stated that the CFRC had worked to develop a preliminary risk-monitoring approach. She then described an illustrative risk assessment that takes into account physical and transition climate risks, financial institutions' exposures to climate risks, and risk mitigants.

Ms. Chen described physical climate risk drivers, including the increasing frequency of climate disasters causing over $1 billion in damage. She noted that climate disasters can potentially affect collateral values, recovery costs, insurance costs and availability, and financial institutions' operations. She then described financial institutions' exposures to climate risks, including through bank branch locations and real estate or agricultural lending. She then described developments in insurance markets, including increases in home insurance rates and coverage gaps for natural catastrophes and flood insurance. She noted that the overall U.S. property and casualty insurance industry's financial condition is strong notwithstanding underwriting losses in some recent years. She then described climate-related transition risks, including potential impacts the adoption of electric vehicles could have on energy markets. She concluded by stating that the CFRC would continue to develop its preliminary risk indicators.

The Chairperson noted that the CFRC's development of risk indicators is an important deliverable stemming from the recommendations in the Report on Climate-Related Financial Risk issued by the Council in 2021.

4. Cybersecurity Developments

The Chairperson then turned to the final agenda item, a presentation on cybersecurity developments. She introduced Todd Conklin, Deputy Assistant Secretary for Cybersecurity and Critical Infrastructure Protection at Treasury, for the presentation.

Mr. Conklin noted that in February 2023, Treasury had issued a report on the financial services sector's adoption of cloud services. He noted that the report identified six key gaps that would benefit from the attention of the financial services sector and regulatory agencies. He said that following the publication of the report, Treasury established a Cloud Executive Steering Group, which established workstreams focusing on various risks and benefits associated with cloud services for a range of institution sizes.

Mr. Conklin then described recent cyber incident responses by the Federal Banking and Information Infrastructure Committee. He noted that an after-action review of those incident responses was underway for the purpose of identifying gaps and promoting a scalable response to future incidents.

The Chairperson adjourned the executive session of the meeting at approximately 4:23 P.M.

Open Session

The Chairperson called the open session of the meeting of the Council to order at approximately 4:28 P.M.

The Chairperson outlined the agenda for the open session, which included (1) a presentation and vote on the Council's 2023 annual report, and (2) a vote on the minutes of the Council's meeting on November 3, 2023.

1. 2023 Annual Report

The Chairperson turned to the first agenda item, a presentation and vote on the Council's 2023 annual report. She described how the Council continued to promote financial stability in the current macroeconomic environment, as detailed in the report. She said that the U.S. financial system remained resilient, despite facing tighter financial conditions and heightened global economic uncertainty over the last year. She stated that the U.S. banking system as a whole was sound, with strong capital and liquidity positions. She said this was a testament to the reforms implemented in the aftermath of the 2008 financial crisis, the government's response to the COVID-19 pandemic, and more recent actions. She said that when two regional banking firms and a global financial firm failed in March 2023, Council member agencies acted quickly to mitigate the serious risk of contagion and to maintain confidence in the banking system. She stated that the failures of these firms underscored that vulnerabilities remain. She noted that over the previous year, the Council had continued to advance its mandate of enhancing the resilience of the financial system and monitoring a wide range of vulnerabilities, including by working with federal and state financial regulators. She said that the Council continued to assess risks arising from higher interest rates and additional financial uncertainty. She noted that this included evaluating the sensitivity of uninsured bank deposits and short-term wholesale funding, as well as potential higher credit losses. She said that the Council was evaluating and responding to potential risks in the commercial and residential real estate sectors, as well as areas of the financial system where leverage was increasing.

The Chairperson stated that the Council's 2023 annual report analyzed 14 different vulnerabilities, all of which the Council would continue to monitor and evaluate. She said that the report made recommendations in each area to further enhance the integrity, efficiency, and stability of U.S. financial institutions and markets. She then highlighted the Council's progress in several areas that she said the Council would continue to work on.

First, the Chairperson noted that in November 2023, the Council had issued its new Analytic Framework and final interpretive guidance on nonbank financial company determinations. She said that this represented a significant step forward in increasing the Council's public transparency and strengthened the Council's ability to mitigate the risks of a financial crisis that could devastate businesses and households. She noted that the Council has a range of authorities for addressing risks to financial stability. She said that the Analytic Framework makes clear that the Council's response to a risk to financial stability would depend on the nature of the risk.

Second, the Chairperson stated that since first identifying climate change as an emerging threat to U.S. financial stability two years ago, the Council and its member agencies had significantly increased their capacity to evaluate and address climate-related financial risks. She said that the CFRC was developing a framework to identify and assess climate-related financial risk, focusing on the intersection of physical risk, real estate, and insurance. She stated that this work represented an important step towards fully and durably integrating climate risk into macroprudential policy to help preserve U.S. financial stability and protect the U.S. economy. She said that the Council's work was also supported by a recently established external Climate-related Financial Risk Advisory Committee, which had held three meetings. She said that this committee, by leveraging its members' diverse backgrounds, provides the Council with information on and analysis of climate-related financial risks from a broad array of perspectives.

Third, the Chairperson noted that in this year's report, the Council identified the use of artificial intelligence (AI) in financial services as a vulnerability in the financial system. She said that as financial institutions continue to evaluate and adopt innovative technologies, uptake of AI could accelerate. She noted that President Biden's recent executive order on this topic called on agencies to enhance the safe, secure, and trustworthy development of AI. She said that the Council would continue to monitor evolving technologies to respond to emerging risks. She stated that supporting responsible innovation in this area can allow the financial system to reap benefits, like increased efficiency, but she said that existing principles and rules for risk management should also be applied.

Finally, the Chairperson stated that the Council would continue to focus on improving the cyber resilience of the financial system. She said that this would require continuous assessment of vulnerabilities along with information sharing between the U.S. government and domestic and foreign private firms. She said that she looked forward to seeing the Council make further progress in the year ahead, informed by the annual report's recommendations.

The Chairperson then introduced Sandra Lee, Deputy Assistant Secretary for the Council at Treasury, and Paula Tkac, Executive Vice President and Research Director at the Federal Reserve Bank of Atlanta, for the presentation.

Ms. Lee stated that the Council's annual report was a significant undertaking and a product of substantial interagency engagement. She turned to Ms. Tkac to summarize several of the key themes in the report.

Ms. Tkac stated that the Council's annual report identified 14 vulnerabilities in the U.S. financial system for recommendations, grouped into three broad categories: financial risks; financial institutions; and financial market structure, operational, and technological risks. She noted that the Chairperson had already discussed two of the vulnerabilities, climate-related financial risk and the use of AI in financial services. She briefly summarized the remaining vulnerabilities in the report and highlighted some of the Council's recommendations to further enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets.

Turning first to financial risks, Ms. Tkac stated that current vulnerabilities in real estate, corporate credit, and short-term funding markets have the potential to lead to disruptions in the flow of credit to households and businesses. She said that the Council recommended that supervisors, financial institutions, and investors continue to evaluate the resilience of commercial real estate loan portfolios to potential stress, monitor residential real estate exposures, and ensure adequate credit-loss allowances. She said that the increasing role of nonbank mortgage companies is tightly integrated with other residential real estate vulnerabilities. She noted that the Council recommended that where possible, relevant federal agencies and state regulators continue to coordinate closely to collect and share data, identify risks, and take additional steps available to them within their authorities to address the potential risks of nonbank mortgage companies.

Ms. Tkac stated that, with respect to corporate credit, the Council recommended that member agencies continue to monitor levels of nonfinancial business leverage. She said that the Council also supported enhanced data collection on nonbank lending to nonfinancial businesses, to provide additional insight into the potential risks associated with the rapid increase in private credit. She stated that the Council recommended that member agencies bolster efforts to make short-term funding markets more resilient, including efforts to increase the resilience of investment vehicles with similarities to money market funds. She said that the report noted that where lack of data prevents close monitoring, Council members should develop proposals to collect the necessary data. She stated that the Council also supported efforts to examine ways to improve counterparty risk management in the non-centrally cleared bilateral repo market.

Ms. Tkac stated that while the nascent crypto-asset market is not significant in its size or broad in its connection to the traditional financial system, distress in this market has the potential to transmit stress to traditional financial firms. She noted that this year, Council member agencies had addressed risks posed by the crypto-asset ecosystem through agency statements, guidance, and rulemakings. She said that the Council recommended that agencies continue to enforce existing rules and regulations. She noted that the Council also reiterated its recommendation from last year's annual report that Congress pass legislation to close gaps in the regulation of spot markets for crypto assets that are not securities and in the regulation of stablecoins. She said that the Council remained prepared to consider steps available to it to address risks related to stablecoins in the event comprehensive legislation is not enacted.

Turning to financial institutions, Ms. Tkac stated that in 2023, vulnerabilities were exposed in the banking sector that increased risks to U.S. financial stability. She said that the failure of two regional banks in the spring of 2023, while fundamentally resulting from poor risk-management practices and reliance on uninsured deposits, underscored that the activities of non-global systemically important banks can pose risks to financial stability. She said that while serious risk of contagion was mitigated by the timely actions of Council member agencies, vulnerabilities remained. She said that key lessons were learned from the turmoil in the spring that can contribute to reducing financial stability risks in the sector. She stated that the Council supported member agency efforts to examine how recent events can inform potential modifications to the regulatory framework for regional banks. She said that the Council recommended that banking agencies closely monitor uninsured deposit levels and depositor composition and collect additional data as necessary. She said that the Council also supported proposed measures to improve resolvability at large complex or interconnected banks, such as by requiring long-term debt and improved resolution plans. She noted that investment funds play a critical role as intermediaries in the U.S. financial system, promoting economic growth through efficient capital formation and providing funding to businesses across the economy. She said that the Council would continue to review the findings of its Hedge Fund Working Group as they are developed, and she noted that the Council recommended that the SEC and other relevant regulators consider whether additional steps should be taken to address vulnerabilities related to these funds.

Ms. Tkac stated that the Council also supported the ongoing work of the relevant banking supervisors to improve banks' counterparty credit risk management practices with respect to hedge funds. She said that the Council supported the initiatives by the SEC and the CFTC to improve data collection on Form PF. She noted that central counterparties (CCPs) are important entities in the U.S. financial system. She said that while central clearing of transactions serves as a safeguard against the transmission of stress through counterparty defaults, it also concentrates risk. She stated that the Council supported continued efforts by the CFTC, Federal Reserve, and SEC to enhance their oversight of CCPs designated by the Council as systemically important financial market utilities, and she noted that the Council urged regulators to continue to advance recovery and resolution planning for such entities.

Ms. Tkac noted that the United States is the world's largest single-country insurance market, with U.S. insurers providing risk-pooling services through life, health, and property and casualty insurance. She said that trends in the life and health sector, including the growth of private credit, the growth of the use of offshore reinsurance, and the growing influence of new asset management entrants in life insurance, may raise concerns. She stated that the Council recommended that FIO, along with the NAIC, work with member agencies to evaluate the potential impact of these trends on financial stability.

Ms. Tkac stated that the U.S. Treasury market plays a critical role in funding the federal government and implementing monetary policy. She said that the Treasury market functioned well during the banking stresses earlier in 2023, but she stated that disruptions of market functioning in recent years demonstrated the need for continued focus on improving resilience. She said that the Council supported the work of the Inter-Agency Working Group on Treasury Market Surveillance, including in the area of data transparency, and she noted that the Council recommended that member agencies continue to make progress on policies to improve Treasury market resilience.

Ms. Tkac stated that cybersecurity risk is pervasive throughout the economy, and she said that reducing cyber vulnerability is critical within the financial system. She noted that ransomware, malware, denial-of-service attacks, and data breaches can disrupt the operations of financial institutions. She said that the Council recommended that relevant public- and private-sector bodies continue to promote information sharing related to cyber risk. She said that the Council also recommended that relevant government agencies conduct a thorough review of recent ransomware attacks to facilitate greater understanding of the potential vulnerabilities that led to the attacks and the processes that firms and agencies took to respond to and contain them.

Finally, Ms. Tkac noted that financial institutions rely on third-party service providers for an array of services. She said that Council member agencies continued to enhance their supervisory programs for cyber-related controls in key areas such as core processing, payment services, and cloud computing. She said that the Council supported continued evaluation of the risks associated with service providers' roles in the financial sector and their potential impacts on financial stability. She stated that the Council also recommended that federal banking regulators continue to coordinate third-party service provider examinations, working collaboratively with states, and identify additional ways to support information sharing among state and federal regulators.

Following the presentation, the Chairperson called on other Council members to comment.

Jerome Powell, Chair of the Federal Reserve, stated that the annual report underscored the importance of the Council leveraging the expertise of each member agency to identify emerging threats to financial stability and make recommendations for how to address them. He said that the report's recommendations focused on risks to financial stability arising from changes in market structure, technology, and the evolving economic environment. He stated that while the financial system had proven resilient to significant adverse shocks in recent years and Council members had taken steps to strengthen resiliency, it would be important to continue to make progress in each of the areas identified in the report.

Gary Gensler, Chair of the SEC, stated that he supported the annual report. He said that the report provided a reminder that the Council has additional work to do on issues including mortgage servicing and the leverage in the Treasury market between hedge funds and banks and broker-dealers. He said that the SEC was engaged in a successful collaboration with other Council member agencies on various initiatives, including money market reform, Treasury clearing, greater transparency regarding hedge funds, and efforts to shorten the securities settlement cycle. He noted that the SEC was collaborating with the CFTC to improve reporting by hedge funds on Form PF; with Treasury to address vulnerabilities in the Treasury market; and with federal banking regulators on issues related to collective investment vehicles.

Chair Gensler stated that he believed that AI is the most transformative technology of our time. He noted that AI is already being used and providing benefits in finance, including in call centers, claims processing, trading algorithms, and sentiment analysis. He said, however, that AI also raises what he called "micro challenges" and "macro challenges." He noted that the annual report discussed micro challenges regarding the explainability and accuracy of AI models, along with their potential for bias. He said that macro challenges include the possibility that one or more AI platforms or data aggregators will come to dominate the marketplace, which he said may create risks to financial stability. He said that, given that AI relies on an ongoing demand for data and computational power, economics of scale and data network effects should be considered. Noting the market consolidation around internet search engines and cloud-based computing, he said that a base or foundational AI model may emerge that will become the platform for future development. He said that in this scenario, AI may exacerbate financial fragility, exposing individual market participants to potential risks if they make the same decision based on a base model or data aggregator. He noted that such market participants may not be aware of these risks if they are downstream in a supply chain or are financial technology startups, regional banks, or mortgage servicers.

Chair Gensler stated that the market structure of AI could encourage what he called monocultures. He stated that it could also amplify the inherent network interconnectedness of the financial system. He said that AI may play a central role in a potential future financial crisis. He said that while work on model risk management guidance generally written prior to the latest wave of data analytics would need to be updated, he did not believe this guidance would be sufficient. He said that model risk management tools, while lowering overall risk, primarily address individual firms and microprudential risks. He said that Council member agencies should consider developing additional macroprudential policies as part of a horizontal review. He said in conclusion that it would be important for Council member agencies to consider the dependencies and interconnectedness that entities or activities across the financial system may have to an AI model or base aggregator.

Martin Gruenberg, Chairman of the FDIC, stated that one of the key benefits of the annual report is that it summarizes the financial stability risks confronting the U.S. economy and financial system and enables Council member agencies to reach consensus on those risks. He said that while the banking industry in the United States had proven to be resilient, in light of the large bank failures earlier this year he welcomed the report’s discussion of several topics. He said these topics include interest rate risk and its impact on underlying vulnerabilities in the banking system related to unrealized losses on securities and loans on bank balance sheets; concentrations of uninsured deposits; and commercial real estate, particularly in the office building sector. He said that the report also underscored the importance of the work undertaken by the banking agencies to strengthen supervision as well as capital, liquidity, and resolution requirements. He stated that one of the areas of major advancement for the Council this year had been with respect to nonbank financial risks. He said that the annual report reflected robust analysis on hedge funds and nonbank mortgage service providers. He stated that the Council’s recently issued Analytic Framework and interpretive guidance on nonbank financial company determinations had set the stage for thoughtful and important risk analysis and policy proposals for addressing these risks. He said that he also welcomed the Council’s work to reinvigorate its Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee. He noted that the annual report highlighted the need to review the risks presented by systemically important financial market utilities, particularly CCPs. He noted that the report also highlighted the need for further work to safeguard the functioning of Treasury and repo markets, improve climate-related financial risk analysis and cybersecurity, and monitor digital asset risks, among other initiatives.

Michael Hsu, Acting Comptroller of the Currency, stated that he supported the Council’s annual report and its recommendations. He said that the report took an appropriately broad view of financial stability risks, striking a balance between highlighting familiar risks like commercial real estate, addressing longer-standing risks like cybersecurity and Treasury market functioning, and discussing emerging risks like AI and third-party arrangements. He said that he looked forward to working with stakeholders on addressing these recommendations to help ensure the safety of the U.S. financial system.

Rohit Chopra, Director of the CFPB, noted that earlier in the year, several large domestic banks had failed. Noting that the stress on the financial system led to emergency actions to halt the contagion, he said that Council member agencies can draw lessons from the events. He said that one lesson is that Council member agencies should have the ability to use the full range of their authorities to protect the public, and another is that a small number of market participants can create cracks in the financial system that can lead to potential chaos. He expressed his support that the annual report highlighted certain key risks and discussed the Council's authorities to address those risks. He said that while it could be tempting to focus on the risks of the past, it was clear that certain risks are continuing to grow. He said that while the Council often focuses on pools of financial assets, it should consider that large pools of data assets also present risks to the U.S. financial system.

Director Chopra stated that over the past 15 years, large technology firms in the United States, China, and other locations had been leveraging their network effects in new ways. He said that while such firms may have begun with a focus on retail or web search services, they are now operating in diverse lines of business where they have natural oligopolies. He said that these trends were also impacting the cloud infrastructure providers that undergird significant aspects of the financial system, as well as AI models that he said would power much of the decision-making in this industry. He said that large technology firms are entering into payment systems in a variety of ways, to move payments from consumers and businesses, and to move deposits or deposit-like issuances. He said that it is important to consider that some of these firms have the potential to amplify the risks that had occurred in the past and may become more severe in the future. He noted that the Council had issued its new Analytic Framework and interpretive guidance on nonbank financial company determinations, and he noted that despite previous government intervention in connection with certain firms, no nonbank financial companies were currently designated by the Council. He said that it is important that the Council make clear that this authority is not considered defunct and will be used by the Council when necessary. He also noted the designation authorities available to the Council under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. He said in conclusion that it would be important for the Council to monitor potential risks arising from certain financial firms that collect large pools of data.

Rostin Behnam, Chairman of the CFTC, stated that he supported the annual report. He said that the report highlighted the challenges to financial stability posed by changing interest rate environments over the past year and described the ongoing work by the Council and Council member agencies to protect U.S. financial stability. He said that several topics addressed in the report are particularly relevant to the derivatives markets overseen by the CFTC, including vulnerabilities associated with nonbank financial intermediation, Treasury market resilience, climate-related financial risk, and digital assets. He said that he supported the recommendation in the report that state and federal agencies continue to coordinate on developing a robust framework regarding climate-related financial risks, and he noted that the CFTC remained committed to continuing its work in this space. He also noted that the annual report reiterated the recommendation from the previous year's report that Congress pass legislation to close regulatory gaps in the regulation of crypto-asset activities in the United States. He said that he supported the report's recommendation that Congress address these gaps to ensure the entire crypto-asset market comes within the regulatory perimeter. He said that he also supported the Council's work to ensure that the Treasury market remains the deepest, most liquid market in the world. He said that the CFTC remained engaged in the activities of the Council's Hedge Fund Working Group as well as the related work of the Inter-Agency Working Group on Treasury Market Surveillance to strengthen the resiliency of the Treasury market. He noted that the report recognized that reducing cyber vulnerabilities is particularly critical within the financial system and that the report also identified, for the first time, the use of AI in financial services as an emerging vulnerability in the financial system. He said that the CFTC would continue to collaborate with the Council to meet these challenges. Finally, he expressed his support for the revitalization of the Council's Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee.

Sandra Thompson, Director of the FHFA, expressed her support for the annual report recommendation that the FHFA and NCUA be granted examination and enforcement authority over third-party service providers. She said this would be an important tool to help the FHFA ensure the safety and soundness of its regulated entities. She said that this year's annual report highlighted several challenges in housing and mortgage markets during 2023, including low inventory of existing houses for sale, extended wait times for new construction, high home prices, and mortgage rates peaking at 20-year highs in October before falling more recently. She noted that, despite these challenges, credit performance had remained strong, with foreclosures and delinquency rates at or below pre-pandemic levels. She noted that the report also highlighted the physical risk to the housing and mortgage markets of climate change and its effect on the availability of insurance. She said that multiple insurers had announced their intention to leave some key markets due to the increased risk of weather-related disasters. She said that even where insurance is still available in these markets, insurers were raising prices to cover the rising costs of such disasters, which she noted exacerbates home affordability concerns and can strain household balance sheets. She said that more borrowers will be faced with renewal concerns or difficulty obtaining affordable initial insurance policies when purchasing a home. She stated that the FHFA would continue to prioritize the safety and soundness of its regulated entities, while supporting access and affordability for aspiring homeowners and renters.

Todd Harper, Chairman of the NCUA, stated that he agreed with other Council members' comments regarding potential risks and the challenges ahead. He said that the annual report underscored the importance of the credit union industry achieving a measure of parity with the banking system with regard to the issues that are relevant to all depository institutions. He noted that the report highlighted the reexamination of the existing bank deposit insurance program and also discussed credit unions' share insurance systems, which he said provide an important service. He expressed his support for the report's recommendation that Congress restore the oversight authority of the NCUA over third party vendors. He said that this issue had become more urgent in light of events that had occurred in the preceding weeks, in which a ransomware attack at a service provider negatively impacted scores of credit unions. He noted that this issue was no longer theoretical, but real and growing. He said that it was an appropriate time to close what he referred to as a regulatory blind spot and place the NCUA on par with the authorities of other banking regulators.

Thomas Workman, the Council's independent member with insurance expertise, expressed support for the annual report.

James Martin, Acting Director of the OFR, noted that the report resulted from collaboration among Council member agencies. He said that member agencies had provided valuable input and collaborated to refine and communicate potential risks to financial stability. He said that the annual report process demonstrated the value of Council member agencies collaborating to address potential risks to financial stability, and in particular to identify risks that may span different areas.

Adrienne Harris, Superintendent of the New York State Department of Financial Services, noted the breadth of the New York State Department of Financial Services' mandate regulating banks, nonbank lenders, digital asset firms, insurance companies, and other entities. She said that some of the ongoing and the potential new and developing risks highlighted in the report are key areas of focus for state regulators. She said that the Council plays a critical role in facilitating information sharing and strategic coordination among state and federal regulators to swiftly address risks in a comprehensive manner.

The Chairperson then presented to the Council the following resolution approving the Council's 2023 annual report:

WHEREAS, the Financial Stability Oversight Council (Council) under section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is required to annually report to and testify before Congress on: (1) the activities of the Council; (2) significant financial market and regulatory developments, including insurance and accounting regulations and standards, along with an assessment of those developments on the stability of the financial system; (3) potential emerging threats to the financial stability of the United States; (4) all determinations made under section 113 or title VIII of the Dodd-Frank Act, and the basis for such determinations; (5) all recommendations made under section 119 of the Dodd-Frank Act and the result of such recommendations; and (6) recommendations to (a) enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; (b) promote market discipline; and (c) maintain investor confidence; and

WHEREAS, the staffs of the Council members and their agencies prepared the attached 2023 annual report of the Council (2023 Annual Report) pursuant to section 112 of the Dodd-Frank Act, and members of the Council have reviewed and commented on the attached report.

NOW, THEREFORE, BE IT RESOLVED, that the Council hereby approves the 2023 Annual Report and authorizes the Chairperson, or her designee, to take such action as they may deem necessary or appropriate to transmit the 2023 Annual Report to Congress and to release it to the public; and

BE IT FURTHER RESOLVED, that the Council hereby delegates authority to the Chairperson, or her designee, to make technical, nonsubstantive, or conforming changes to the text of the 2023 Annual Report and to take such other actions as they may deem necessary or appropriate to prepare the report for transmittal to Congress and release to the public.

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 November 3, 2023

BE IT RESOLVED, by the Financial Stability Oversight Council (Council), that the minutes attached hereto of the meeting held on November 3, 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.

The Chairperson adjourned the meeting at approximately 5:06 P.M.