

RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, September 6, 2019

Item 1: Current Market Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Has the Council observed any notable developments since its last meeting for loans in such categories as (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, and (g) homes? Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in aggregated data?

General Outlook

- Increasing uncertainty regarding the trade war with China, combined with a slowing global economy, has increased volatility in financial markets. Equity markets have experienced significant volatility since the prior meeting, with the S&P 500 trading down over 2.5% on three of the seventeen trading days since the Federal Reserve rate cut on July 31. Overall, the S&P 500 is down 4.47% between July 31 and August 23. The yield curve has flattened and inverted, with the spread between 2-year and 10-year Treasuries going negative.
- A strong domestic labor market and healthy consumer spending continue to support the expansion. Consumers have remained confident and willing to spend as wage growth continues to outpace inflation.
- With a flattening to inverted yield curve, competition for loans across all sectors has increased.
- Overall economic outlook, while slowing, continues to remain positive. Business investment outlook continues to remain positive but could dissipate in the second half of 2019, as continued geopolitical uncertainty combines with a concern over the availability and quality of labor.

Has the Council observed any notable developments since its last meeting for loans in such categories as (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, and (g) homes?

(a) Small and medium-size enterprises (SME)

- The National Federation of Independent Business reports its Small Business Optimism Index rose 1.4 points in July reversed a decline in June.
- Loan demand continues to be strong; however, customer optimism is beginning to be impacted by concerns about tariffs, rising costs in the supply chain, and the ability to fill skilled job positions.

(b) Commercial real estate (CRE)

- CRE loan growth, while positive, has continued to slow to 4.2% year-over-year in June, the slowest pace since 2013.
- Overall, there is a tone of caution in the CRE markets as the industry evaluates what the extended cycle and inverted yield curve mean for the sector. The reduction in interest rates will continue to support the environment of low capitalization rates and elevated property values.
- Nonbank lenders continue to gain market share by providing more aggressive structures and more competitive pricing. While banks remained the most active in overall national CRE lending activity, measured by market share at 39% for both Q1 and Q2 2019, debt funds and REITs (increased their market share of Q2 originations from 14% in Q1 to 26% in Q2. Insurers increased their market share of Q2 originations from 16% in Q1 to 26% in Q2, with the offset in commercial mortgage-backed securities (CMBS) lenders.
- Delinquency levels continue to remain low and stable.

(c) Construction

- Construction lending continues to be positive but is slowing due to weakness in single-family construction. The balances of construction and land development loans at banks grew 3.2% year-over-year in June, which is down from 6.9% growth in 2018.
- Construction costs continue to be elevated due to high prices for raw materials combined with labor shortages; however, in certain geographies on the West Coast, the impact of labor costs due to shortages has stabilized.
- Delinquency levels continue to remain at or near historically low levels.

(d) Corporations

- Commercial and industrial (C&I) loan growth improved in Q2 and continues to be solid, with C&I loans increasing 7.5% year-over-year in June 2019 (H.8); however, this growth is the slowest in eight months.
- Amid reports of increased competition from nonbanks for loans to large- and medium-size firms, bank lending standards on C&I loans eased in the third quarter of 2019. Demand was also lower, declining for the fourth consecutive quarter amid lower reported need for investment funding. This decrease is consistent with a near-two-year low in CAPEX (capital expenditure) expectations reported by the Federal Reserve Bank of Kansas City's manufacturing survey in July.

(e) Agriculture

- Agriculture lending has slowed, as loans secured by farmland (H.8) increased less than 4% year-over-year in June 2019, a three-year low.
- Overall risk remains elevated. Family-owned farms continue to be under pressure due to weather impacts on crop yields, growing concern over tariffs and their impact on commodity and equipment prices, and the cost of land and labor due to a growing shortage of migrant labor.
- While government subsidies are helpful, the sentiment is that tariffs have damaged agriculture trade for years to come.
- Some traditional agriculture lenders are tightening credit standards.

(f) Consumers

- Outstanding household debt increased by 1.4% in the second quarter of 2019, marking the twentieth consecutive quarter of growth. Home equity applications and balances continue to trend lower due to decreasing mortgage rates, tax law changes, and customers' shift to unsecured debt, as nonbank unsecured debt continues to grow.
- Consumer confidence was relatively unchanged in August following an increase in July. Consumers' assessment of current conditions improved further, with consumers' assessment of their present situation at the highest level in nearly 19 years. In spite of trade and tariff tensions, consumers have remained confident and willing to spend.

(g) Homes

- Home lending has improved as a result of lower mortgage rates, as the 30-year fixed rate mortgage fell below 4.00%. Mortgage applications were up 49% year-over-year in early August, led by refinance applications, which were more than double the level from a year earlier.
- The market continues to remain favorable and provide credit for residential mortgages, with a net 37% of banks reporting higher demand following seven straight quarters of lower demand.

Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in aggregated data?

- While customer sentiment throughout all Districts continues to remain positive, there is more caution about future slowing rates of growth.

- With respect to lending, while overall economic activity and key economic indicators would indicate a robust lending environment, the level of uncertainty due to trade and tariff concerns, equity market volatility, the volatile and inverted interest rate environment, Brexit, and the pending election have led many financial institutions to reduce their forecasts for loan growth heading into 2020.
- The Council continues to note a shortage of labor when it comes to skilled trades, agricultural workers and commercial drivers. Such shortages, believed to be a result of a tight overall job market and the current immigration policy, are noted by many clients in explaining the limitations on their ability to grow.

Item 2: Emerging Risk

As the long-lived current expansion continues to unfold, are there particular areas in which Council members see economic or financial risks beginning to emerge?

Given the intertwined nature of markets, monetary policy, and government, any significant unexpected event could reverberate and pose a threat to the economy. Many of the emerging risks herein were discussed by the Council in February and May and have been updated based on new information or the shifting of risk since the last meeting. Council members continue to monitor global trade and geopolitical tensions, corporate and government debt, and cybersecurity as key areas of risk. Members and other financial institutions in their Districts also highlighted risks related to the LIBOR transition and the labor markets.

Backdrop of heightened geopolitical uncertainty and increasing economic warning signals

Council members remain concerned about heightened geopolitical tensions (i.e., U.S.-Iran, NATO-Russia, China-Hong Kong, and India-Pakistan) and recent trends in economic indicators. Equity markets were volatile in August, with at least nine trading days of 1% moves in the S&P 500. The ten-year and three-month Treasury rate spread continues to be negative, and the 10-year and 2-year Treasury yield curve inverted in August for the first time in over a decade. Interest rates in Europe and Japan continue to be at or near zero, and China and the U.S. recently lowered rates. The Business Confidence Index has continued a downward trend, and capital expenditure forecasts are contracting. According to one Council member's survey, small and mid-size businesses have become more pessimistic about economic growth due to trade policy and the fading impact of the 2017 tax cut. Consumer sentiment remains strong compared to historical averages but has recently declined and is retreating to January levels, due in part to concern over monetary and trade policies. Though warning signals are present, unemployment remains historically low (below 4%), and wages continue to rise.

Growing corporate debt with signs investors are becoming more risk averse

For the past several meetings, the Council has discussed the increase in U.S. nonfinancial corporate debt,¹ as well as a significant increase in the level of BBB-rated investment-grade debt since the start of the business cycle.² BBB spreads have widened since July but remain well below the spreads from last two recessionary peaks. A similar trend is observed in high yield spreads. Members remain concerned about the potential for widespread downgrades if the economy contracts.

In the leveraged lending space, Council members continue to be concerned that covenant-lite lending (80% of loans), higher leverage multiples, and more prevalent dividend recapitalization loans (in which customers

¹ Federal Reserve Bank of St. Louis: 38% increase to \$9.9 trillion 1Q14-1Q19, outpacing GDP growth of 23% in the same period (as measured by nonfinancial debt to nominal GDP; prior reference was specific to corporate-sector GDP).

² ICE BofAML BBB US Corporate Index: 369% increase since January 2009 and over 50% of the investment-grade market.

recoup equity) could pressure credit availability and liquidity in an economic downturn. Council members acknowledge adequate liquidity and report a shift in risk sentiment to a more conservative stance, as investors seek higher-quality assets. This shift, exemplified by the recently observed market withdrawals of four deals worth a total of \$825 million, will likely cause money to flow back to the regulated banking system. It is also notable that current market conditions should allow for the refinancing of past leveraged deals at favorable rates.

In addition to nonbank lending funded by the capital markets and the growth in leveraged lending, a shift to passive investment vehicles in the equity markets, such as to exchange-traded funds, could impact liquidity during a market disruption. To the extent that these new trends could result in reduced liquidity, they present heightened concern to Council members.

Cybersecurity threats related to trade actions, sanctions, and cloud computing continue to evolve

The Council remains concerned about cybersecurity threats, and several Council members consider this item as their top risk. Some firms are experiencing increased probing and exploitation activity related to tariff announcements. There has also been an uptick in credential harvesting and phishing directed at wire transfers, bill-pay services, checking accounts, and credit cards in response to ongoing economic sanctions. Though sophisticated attacks are not yet common, cyber-enabled fraud has become a preferred method for organized crime. Recent ransomware attacks on U.S. states, cities, and local municipalities cause some Council members to question overall response readiness. Financial services firms continue to work together to combat evolving threats and protect consumer information through groups such as the Financial Services Information Sharing and Analysis Center (FS-ISAC) and its Sheltered Harbor initiative.

Only a small fraction of financial services firms currently operate in the public cloud, despite its competitive advantages of agility, cost control, time to market, and reduced operational risk. Most firms run a hybrid model of “on premises,” software as a service, and private cloud. More broadly, third-party processors and vendors who host software as a service require evaluation to determine their ability to control and protect their data.

There is growing concern about threats from insiders who have access to critical systems, both on-premises and through services provided. Several Council members noted tension between their organizations’ need for innovative, accelerated change and the time required to design effective security and controls. They also expressed continued challenges related to attracting cyber professionals who have the right blend of technical, communication, and change management skills.

Item 3: Student Loans

While earning a college degree may be more necessary than ever to enable an individual to achieve sufficient earnings, the financial risks associated with attending college have also grown. Issues concerning how to finance college and how to assist individuals with their student debt have become a focus of policy discussions. How does the Council see the current public debate over these issues, and what changes seem feasible? What should be the banking industry’s and government’s role in college finance going forward?

The dollar amount of student debt has grown roughly five-fold since 2004 and now stands at \$1.5 trillion, making it the second-highest category of consumer debt behind home mortgages. Approximately 80% of this debt is for borrowers who are out of school. This type of debt affects 45 million borrowers.

This surge in student debt has become a public policy concern because the repayment burden that it is imposing on students and their families is compromising the quality of their lives; more broadly, it may be impinging on economic growth.

As the cost of higher education rises and student debt follows, the impact on these borrowers’ finances is taking its toll. Student debt holders are spending roughly 20% of their salary to repay debt. This debt burden is not just affecting recent college graduates or people abandoning their education but is also impacting people into their 40s and even into their 60s. Over a third of the debt balance is in the hands of

people between 35 and 49 years old. With this overall effect, default rates on student debt are rising annually, now reaching 11% for loans 90+ days delinquent or in default. For the overall economy, this debt situation across the demographic spectrum likely means slower household formation, less spending on housing and cars, and less saving for retirement.

One significant factor contributing to the recent increase in student debt is passage of the Health Care and Education Reconciliation Act of 2010. This act terminated the Federal Family Education Loan Program (FFEL) that had governed the student and parent lending program since 1965. Through the FFEL program, the federal government guaranteed student loans made by the banks. Starting in 2010, the government shifted exclusively to direct lending.

Under the government's direct lending program, no credit decision is made, no consideration is given to whether a borrower is pursuing a degree and employment that will allow the borrower to afford the debt being incurred, and no disclosure is made to the borrower regarding the APR, total interest to be paid over the life of the loan, required monthly payments, etc. In fact, under the government program, the student receives an "award" letter that can be very confusing as to whether the student is receiving a grant or scholarship instead of actually getting a loan that must be repaid after leaving school.

Based on the foregoing, the Council is concerned about the number of Americans who are overextended with college debt, the continuing increase in the cost of a college education, and government lending to students who are unaware of the impact of the debt they will hold when they leave school. This problem is growing with each school year, and it will continue to grow until the system undergoes some structural changes.

Furthermore, the current student lending system seems unsustainable. It leads to students unknowingly taking on unsupportable levels of debt, which in turn fosters disproportionate inflation in the cost of college and a misallocation of educational resources, which in turn increase the level and burden of student debt.

The public debate over whether the government should forgive student loans does not address the underlying problem. The government could forgive student debt outstanding at a given point in time, but soon the next class would be ready to enter college and start the cycle over again.

Admittedly, achieving meaningful reform of the current system will be difficult. Nonetheless, Council members believe there are changes that could be implemented to help improve the student loan system:

1. More fully engage financial institutions
 - a. Foster private market financing for creditworthy borrowers
 - b. Encourage banks to refinance student debt
2. Help incoming students make better borrowing decisions
 - a. Provide better consumer disclosures regarding the terms of the loans and repayment
 - b. Provide financial education for high school students and their parents as a prerequisite for taking out a loan
 - c. Impose reasonable caps on the amount of loans a student can take out
3. Increase and simplify government subsidies to higher education
 - a. Increase government grants, Pell grants, and scholarships for at-risk students
 - b. Expand and simplify the Public Loan Forgiveness program.
 - c. Enable borrowers to deduct interest on student loans for tax purposes.
 - d. Make employer reimbursements toward employee student debt tax exempt for the employee

In conclusion, with student debt growing each year and becoming a burden on more Americans and the American economy, we need to redirect the public debate from loan forgiveness to how we address the growing debt. Debate should focus on the issues of rising college tuition, better financial education for borrowers, and a credit-based loan program.

Item 4: Alternative Currencies

Facebook’s announcement of the future launch of Libra, a global cryptocurrency designed to provide a stable and low-cost medium of exchange for consumers and merchants, raises a number of interesting questions. In particular, what does the Council think about the prospects for, and the impact of, so-called stablecoins? If Libra or some other alternative payments system is successful, what would be the consequences for the banking industry? Should the providers of such currencies be regulated like banks (e.g., requirements for BSA/AML compliance, consumer transaction privacy, and protections from fraud or theft)?

Summary: Stablecoins and other cryptocurrencies represent potentially interesting innovations to the payment systems. However, as many Council members highlighted, they introduce a number of risks for consumers, financial institutions, and governing bodies. As mediums of exchange or payment methods for high-volume commercial transactions, cryptocurrencies, such as Bitcoin, have significant shortcomings in areas such as volatility, cost, speed, security (particularly at translation points), acceptance and transparency. Stablecoins seek to address these shortcomings and aim to reduce or eliminate the volatility inherent in uncorrelated cryptocurrencies that lack intrinsic value.

When stablecoins are tied to a specific fiat currency, they become little more than tokens or surrogate representing the underlying currency. In this scenario, they may have utility as tools for improving transaction speeds and recordkeeping. When a “stable” coin is not associated with a specific fiat currency but with a basket of currencies, volatility is reduced but not eliminated. This volatility can be high when users are in emerging markets where their underlying currency will float in relation to the stable coin basket. Unless and until all income and all inputs in the creation of goods and services are denominated in a single currency, this risk will persist. It is by no means certain that an alternative currency would achieve the stated goal of being a low-cost and stable medium of exchange. The need to convert fiat to stable coin through exchanges may make it no less expensive, more accessible, or faster for consumers. Users would effectively be converting domestic transactions into “cross border,” adding translation costs through “authorized dealers” as well as adding exchange-rate risk. Ecosystems for stablecoins exhibit similarities to those used for prepaid cards or other payment products, but stablecoins seem to have limited utility as a high-volume domestic payment method. While having an instantaneous, cross-border option on a platform could be useful, many alternatives for international payments already exist today. In the end, it is currently unclear what problem stablecoins are trying to solve beyond functioning as a bridge between one fiat currency and another (or a basket of others).

The successful implementation of an alternative payments system has the potential to disintermediate some customer activity from banks. Some Council members have suggested that, as consumers adopt Libra, more deposits could migrate onto the platform, effectively reducing liquidity, and that disintermediation may further expand into loan and investment services. If alternative currencies are widely adopted, one could envision a scenario similar to the development of Alipay and WeChat Pay in China, wherein the utilization of closed-loop systems limits monetary authority and financial institution visibility into transaction activity. This lack of authority and visibility eventually led the People’s Bank of China to implement (1) regulations on clearing, for transparency purposes, and (2) capital requirements for balances. In extremis, alternative currencies could usurp the prudential authority of states to manage their economies and markets.

Facebook’s announcement of Libra reinforces the need for thoughtful discussion among governing bodies and members of the financial community regarding the future of alternative currencies. Ultimately, the discussion should be followed by the creation of a dynamic regulatory framework, likely global in nature to avoid gaps, that is designed to safeguard consumers and governments and preserve the integrity of the global financial system.

Impact on Banks: Fintech companies have and continue to innovate and potentially disintermediate bank customers by offering bank-like products that emulate deposit/checking accounts. A successful launch of stablecoins/wallets could have the following impacts on the banking industry:

- Possible decrease in payment volumes (initially in cross-border and potentially expanding to domestic volumes) and associated revenues
- Possible decrease in demand deposit accounts being used for everyday purchases, as users maintain balances in Libra
- Possible decrease in client engagement within certain segments, perhaps causing some customers to leave the banking system altogether
- Need for banks to increase interest rates on savings and checking products to encourage customer retention
- Possible challenge to the bank business model built on privacy

Regulatory Considerations: Around 52% of, or 170 million, U.S. citizens were considered active Facebook users in 2018. Facebook is potentially creating a digital monetary ecosystem outside of sanctioned financial markets – or a “shadow banking” system. The “Libra Association” structure has the potential to reduce the ability of states to monitor, manage, and influence local economies. A common belief among Council members is that anti-money-laundering, know-your-customer, and other applicable regulatory measures should be applied to Libra or similar wallets/currencies prior to launch. Further, digital solutions that are holding customer funds should be subject to regulations such as the Consumer Financial Protection Bureau’s Prepaid Rule (at a minimum), as well as Regulation E and potentially capital requirements. Regulators should consider:

- Contingency measures in the event of total failure at scale (should Libra reach a critical mass of users and activity, whereby its failure would threaten the global financial system)
- Oversight and regulation of Libra exchanges
- Licensure requirements
- Capital requirements and compliance
- Impacts on monetary policy and inflationary influences in developing economies
- The probable creation of a new shadow banking channel
- Other emerging and future risks, including the utilization of currency for illegal and nontransparent activity
- Impact on tax collections

Regulators around the world have raised concerns around Libra:

- United States: “A wider use of new types of cryptoassets for retail payment purposes would warrant close scrutiny by authorities to ensure that they are subject to high standards of regulation.” – Randal Quarles, Chair of the Financial Stability Board and Vice Chairman for Supervision of the Federal Reserve³
- England: [If Libra was immediately popular with users] “it would instantly become systemic and will have to be subject to the highest standards of regulation.” – Mark Carney, Governor of the Bank of England⁴
- France: “Facebook’s planned global ‘Libra’ cryptocurrency must respect anti-money laundering regulations and it must seek banking licenses if it offers banking services.” – Francois Villeroy de Galhau, Governor of the Bank of France⁵

³ *Financial Times* (FT.com), “Global regulators deal blow to Facebook’s Libra currency plan.”

⁴ BBC.com, “Mark Carney on Facebook’s digital currency Libra.”

⁵ Reuters.com, “Facebook’s Libra must obey anti-money laundering rules: French central banker.”

- Germany: “They [stablecoins] could undermine the deposit-taking of banks and their business models.”; “This might disrupt transaction banking and financial market intermediation.” – Jens Weidmann, president of the Deutsche Bundesbank⁶
- EU Central Bank: “It is out of the question to allow them to develop in a regulatory void for their financial service activities, because it’s just too dangerous.”; “We have to move more quickly than we’ve been able to do up until now.” – Benoit Coeure, member of the Executive Board of the European Central Bank⁷

Item 5: The End of LIBOR

U.S.-dollar LIBOR, the reference rate underlying many financial transactions in the United States, may cease permanently after 2021. What risks to banks and their customers do Council members see arising from, and what steps are banks taking to address, the potential cessation of LIBOR? Does the Council see any particular challenges when addressing this change?

LIBOR currently supports over \$200 trillion of loans and derivatives globally and is used as a benchmark for nearly all financial products. The banking industry considers the discontinuation of LIBOR a certainty and is actively preparing for transition to an alternative reference rate. The Council recognizes the transition to the Secured Overnight Financing Rate (SOFR) as the predominant replacement rate to U.S.-dollar LIBOR (USDL); however, risks and challenges remain and must be addressed for an orderly transition.

Risks to banks and their customers from LIBOR cessation:

- The banking industry's funding costs may not bear a stable relationship to SOFR. USDL is a credit-sensitive rate that represents banks' funding costs; SOFR is a risk-free rate, reflecting rates on overnight borrowings secured by U.S. Treasury securities. USDL represents an average of the unsecured wholesale borrowing costs of a representative set of global banks; as such, it has a credit risk premium component embedded within it. During times of economic or market stress, bank lending rates linked to USDL have moved in alignment with the banking industry’s cost of funds. Conversely, at such times, spreads to risk-free rates on unsecured bank funding tend to increase, reflecting heightened credit and liquidity risk premiums. SOFR could decrease disproportionately compared with other market rates during periods of stress, reflecting a flight to safety by investors. A drop in the yield on banks’ loan assets, combined with an increase in their cost of funds, could lead lenders to materially change the pricing on U.S. dollar lending commitments (in the case of funded loans) or to reduce the liquidity made available to clients through unfunded lending commitments.
- SOFR’s lack of a credit component could impact bank industry liquidity in a significant economic downturn. A scenario in which loan yields decline while funding costs increase could be materially exacerbated if borrowers were to access undrawn lines of credit. This scenario is the bigger risk of a transition that does not provide a supplemental credit-sensitive benchmark spread that can be added to SOFR for lending and unfunded commitments. Currently, these USDL-linked lines are intended to be used by companies to pay employees or manage expenses during normal times. However, in the event of a significant economic downturn or recession, the availability of low-cost credit in the form of revolving facilities linked only to SOFR would likely encourage drawdowns on those lines, reducing industry liquidity.
- The transition increases industry legal risk associated with the fact that the implementation may, even if unintentionally, lead to value transfer among certain clients. In addition, legacy fallback provisions may be inadequate or impractical, creating litigation exposure.

⁶ Reuters.com, “European central bankers claim oversight over Facebook’s cryptocurrency.”

⁷ Bloomberg.com, “Facebook’s Cryptocurrency Plan Draws ECB Warning on Regulation.”

- Hedging risk will increase due to inconsistent fallback approaches between the Alternative Reference Rates Committee (ARRC) and the International Swaps and Derivatives Association (ISDA). Given the close tie between lending and derivatives at regional banks, inconsistent fallback provisions (LIBOR-cessation triggers) between credit (ARRC approach) and swap markets (ISDA approach) may lead to deals that are not appropriately hedged. This risk will be present during the transition period before LIBOR is fully retired.
- Vendor availability to implement required system changes may impact smaller, less influential institutions and create a significant market disadvantage for them.
- The Council notes that awareness of the LIBOR transition among financial and nonfinancial customers is still developing and should be monitored.
- The sales force will be heavily involved in renegotiating customer contracts within a compressed time frame, as existing and new contracts may comprise over 50% of commercial loans for some institutions.

What steps are banks taking to address the cessation of LIBOR?

- In order to address the absence of a SOFR credit component:
 - A group of banks is considering working on a standard dynamic credit adjustment to the SOFR index to help preserve the credit component currently inherent in USDL for use with USDL-linked loans on bank balance sheets.
 - Other banks are exploring the use of Ameribor as an alternative to LIBOR for USDL-linked loans on bank balance sheets. Ameribor, an unsecured overnight borrowing rate that complies with benchmark standards of the International Organization of Securities Commissions, is based on actual market transactions between financial institutions and, as such, contains a credit component.
- The industry is broadly engaged with various working groups (including those related to the AARC) to voice concerns and assess the best means to address the matters at hand. Individual banks appear to be approaching the transition from different perspectives, based on their relevant risks; however, most efforts would:
 - Create a LIBOR Transition Project with a proper governance structure
 - Develop an impact assessment that identifies, quantifies, and updates the bank's LIBOR exposures
 - Identify fallback language for all existing LIBOR exposures
 - Actively classify and track fallback language for new LIBOR exposures
 - Strengthen fallback language where possible
 - Review and analyze LIBOR replacement reference rates
 - If possible, execute test trades with LIBOR replacement rates to ensure internal systems can handle and properly calculate these alternative rates
 - Participate in industry groups to remain up-to-date on all new developments

Does the Council see any particular challenges when addressing this change?

- The lack of a viable alternative index that currently possesses a term structure is an operational challenge for institutions and clients that complicates making a value-neutral and risk-neutral transition
- Servicing systems are not ready to service SOFR (compounded daily in arrears.) This challenge is made even more difficult when accounting, tax, and regulatory implications of the transition remain unknown.
- There are numerous issues around structured products (ABS, CMBS, etc.), as decision making and approval rights are often spread among multiple investors.

Item 6: Financial Stability Oversight Council (FSOC)

To identify systemic risks in the financial services industry, FSOC is going to review financial activities, rather than designate systemically risky financial services companies to receive special regulatory treatment. In the Council's view, what makes a financial activity systemically risky?

Background

- In March 2019, the FSOC issued a notification of proposed interpretive guidance to replace existing guidance regarding nonbank financial company determinations. The most significant change included a shift from prioritizing the designation process from entity-specific to an activities-based approach. This approach would identify systemically risky activities for supervision by existing regulatory authorities and would only seek an entity-specific designation if the FSOC believes that a potential risk or threat cannot be addressed through an activities-based approach.
- As part of this approach, FSOC will examine a diverse range of financial products, activities, and practices that could pose a risk to “financial stability,” defined as “a risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy.”⁸
- The types of activities FSOC indicates it will evaluate include “activities related to the extension of credit, maturity and liquidity transformation, market making and trading, and other key functions critical to support the functioning of financial markets.”⁹

In the Council's view, what makes a financial activity systemically risky?

- The Council supports a move away from using arbitrary thresholds as a proxy for systemic risk and sees merit in the proposed shift to an activities-based risk analysis that rigorously explores the potential for an exposure, financial activity, or market to transmit risk to the financial system.
- Systemic risk is commonly defined as the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by correlated movements among most or all of the parts.
- The Council identified a number of characteristics that make a financial activity systemically risky, including complexity, interconnections, risk transfer, maturity, leverage, and the potential impact on market liquidity.
 1. Complexity can result in systemic risk when risk exposures are not fully understood or well modeled in the risk frameworks of significant market participants, including rating agencies and purchasers.
 2. Interconnections can include common third parties or activities, including custodial banking services, clearing and settlement activities, and wholesale funding markets. These activities are largely uncollateralized and can result in the failure of one financial institution directly impacting numerous others.
 3. Risk-transfer activities, designed to mitigate risk at an individual financial institution, can increase systemic risk as the originator securitizes and distributes risk throughout the system. Such risk-transfer activities can incentivize greater risk-taking by creating distance between risk ownership and origination.
 4. Materially new products or services should be monitored and evaluated for systemic risk, as the risk management practices in place have not had an opportunity to mature and fully appreciate the potential risk posed.
 5. A relatively high level of leverage can result in systemic risk, as it increases the magnitude of potential losses and creates additional interconnections between institutions.

⁸ Financial Stability Oversight Council. *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies; 12 CFR Part 1310*. Published March 13, 2019.

⁹ Ibid.

6. Finally, any activity that impacts the money markets or could result in a meaningful impact to overall market liquidity should be evaluated for systemic risk.

- These characteristics also reflect some of the key measures leveraged in the G-SIB analytical framework (i.e., interconnectedness, substitutability, complexity), and the FSOC is encouraged to ensure that the activities-based approach closely parallels this framework. Such consistency will further deepen the understanding about systemic risk and provide regulated firms with increased clarity regarding managing systemic risk.
- In addition to the identified characteristics, the Council called out speculative trading and derivatives activities for purposes other than hedging a “natural” position as activities that, if large enough in size or risk exposure, could result in systemic risk worthy of evaluation by FSOC.
- While it is essential for FSOC to identify and monitor activities that could result in systemic risk, regulators should also be careful to ensure that any activities-based regime does not stifle financial innovation by imposing overly burdensome regulation or supervision on an activity that could meet market needs without introducing new or increased risk to the financial system.
- Another broader element of systemic risk consideration should be those activities that have the highest correlation to eroding consumer confidence and resulting changes in consumer behavior.

Item 7: Employment and Inflation Dynamics

What are the labor market conditions in Council members’ Districts? What strategies are employers using to hire and retain good employees? Are employee wages rising, and if so, how fast? Are wages rising for all income groups? Does the Council see any evidence that price inflation is picking up? Have Council members seen any direct effects of higher tariffs in their Districts?

What are the labor market conditions in Council members’ Districts?

Council members believe that employment conditions continue to remain strong throughout the nation, with low levels of unemployment and a continuing, albeit slowing, trajectory of monthly payroll growth. Most recently, the unemployment rate registered 3.7% as the labor force participation edged up, while payrolls rose 164,000, signaling ongoing strength in the labor market as employers hire despite persistent fears of a broader economic slowdown. As a result, Council members also feel that the labor market remains tight and, in turn, intensely competitive for high-quality employees as companies continue to struggle to attract and retain skilled labor. Encouragingly, recent gains in labor force participation, should they persist, may help to alleviate some of this pressure. Additionally, current increases in payrolls appear to be slowing, which could alleviate additional stress on the tight labor market.

What strategies are employers using to hire and retain good employees?

Council members across all Districts describe tight labor markets and competition for good employees, prompting employers to expand their strategies to attract and retain talent. Although competitive salaries and benefit packages continue to be a major consideration, companies are performing employee engagement surveys to better understand employee desires, resulting in changes to health and wellness programs, programs for student debt relief, and changes to leave and time-off policies. Additionally, companies are utilizing other wide-ranging strategies, including:

- increased diversification of potential employee-source pools
- modifications to traditional work environments and schedules
- a focus on high-quality, high-impact on-boarding processes
- development of meaningful career paths
- use of internal career fairs
- use of exit interviews to determine the root causes for attrition

Are employee wages rising, and if so, how fast?

While employee wage growth continues to see annualized gains in excess of 3%, the pace of acceleration appears to be slowing from prior levels. Average hourly wages for private-sector workers advanced 3.2% in July from a year earlier. A separate report from the U.S. Department of Labor shows a recent wage-growth slowdown, as the employment cost index (ECI), which measures wages and benefits, rose 2.7% in the second quarter from a year earlier, slightly lower than the first quarter's 2.8% annual rise. Nonetheless, Council members maintain that while wage growth continues, the level of growth remains relatively subdued, given low unemployment rates.

Are wages rising for all income groups?

Council members report wage increases for all income groups, though the increase has not been uniform. In particular, wages for those in the lowest 25% of average wages have shown above-average growth relative to other income groups. While many states increased the minimum wage for hourly employees, many companies chose to raise their own minimums to \$15/hour. Characteristics differing by geography (urban versus rural) and by industry (high-tech versus manufacturing) are resulting in uneven pressure on wage growth.

Does the Council see any evidence that price inflation is picking up?

Amidst tight labor conditions and the longest economic recovery in U.S. history, Council members see little evidence to suggest that price inflation is picking up. Virtually all inflation-related indices continue to point to a modest inflationary environment. Most recently, inflation as measured by the consumer price index (CPI) has been weighed down by a decline in energy products, notably oil. Excluding energy, core consumer price inflation was stronger than expected in July, as several components that had been putting downward pressure on inflation for several months rebounded sharply. Owners' equivalent rent, a key measure of the price of shelter, remained steady compared to June. Overall, core inflation remains modest, averaging 2.2% year-over-year. Council members believe that upward pressure on wages and rising input costs may lead to higher inflation in the future, but have not so far.

Have Council members seen any direct effects of higher tariffs in their Districts?

The vast majority of Council members conclude that, while tariffs have had volume implications for select U.S. goods, there has been little visibility of pricing impacts as a result of tariffs, reflecting the relatively small portion of American spending that goes to goods rather than services. Nonetheless, recent escalation in the trade war and additional tariffs could have pricing implications in the future for consumers. Previous tariffs impacted predominately intermediate goods, whereas new tariffs will be extended to finished goods, such as toys, clothing, and consumer electronics. This more direct consumer exposure gives the new round of tariffs the capacity to more meaningfully impact U.S. inflation and consumer spending than earlier rounds did and will likely bear watching.

Item 8: Monetary Policy

How would the Council assess the current stance of monetary policy? Does the Council foresee any impact or significant financial disruption to the financial system if interest rates move outside their current range?

How would the Council assess the current stance of monetary policy?

The Council believes that current monetary policy is in the "neutral" range, neither overly accommodating nor overly restrictive, and appropriate given the current economic and market dynamics.

While economic data in the U.S. remains solid, in terms of GDP growth, labor markets, and inflation levels, the overall economy is expected to grow at a slower rate on a forward basis. This trend could be further impacted by increasing risks factors, including slowing global economic growth, the ongoing trade tensions, and the potential for a "hard" Brexit. Many central banks have recently cut rates based upon their view of slowing global financial conditions.

The Council generally believes movement in the federal funds rate should be based on the direction and trending of the economy and inflation. The Council feels strongly that the independence of the Federal Reserve is viewed as a stabilizing force and that its actions should continue to be data driven.

Does the Council foresee any impact or significant financial disruption to the financial system if interest rates move outside their current range?

The Council believes that an upward move in rates outside of the current range is not warranted, given the current data and increasing risk factors, and such a move would be potentially disruptive to the future performance of the economy.

The council further believes that a neutral to moderately more accommodating interest rate policy is appropriate and will continue to provide support for economic and market growth and confidence, given current data and existing risk factors.