Financial Sector Advisory Council

Meeting Minutes

2:00 pm, May 29, 2024

Financial Sector Advisory Council Meeting

Council Attendees

Dawn Fitzpatrick, Soros Fund Management (Council Chair)
Hayley Boesky, BofA Securities
Frank Brosens, Taconic Capital Advisors
Gabriel Casillas, Barclays Capital
Chris Edmonds, Intercontinental Exchange
David Finkelstein, Annaly Capital Management
Travis Machen, Morgan Stanley
Mark Seidner, PIMCO
Allison Thacker, Rice Management Company

Federal Reserve Bank of Dallas Directors in Attendance:

Christian Perez Giese, CBRE

Federal Reserve Bank of Dallas Staff in Attendance:

Lorie Logan, Sam Schulhofer-Wohl, Seth Searls, Mike Schetzel, Karel Mertens, David Teeples, Tommy Alsbrooks, Jeff Garrett, Jody Stanley, Alessio Saretto, Jim Dolmas, Pia Orrenius, Enrique Martinez-Garcia, Alex Richter, Anthony Murphy, Tyler Atkinson, Kunal Patel, Ron Mau, Ali Ozdagli, Amy Chapel, Lorenzo Garza, Juan Marquez

Discussion of Economic and Policy Outlook:

Council members observed that the distribution of short-term rate outcomes implied in options on interest rate futures was quite narrow, especially compared with the elevated interest rate uncertainty a year ago. Members suggested that lower short-term rate uncertainty was a positive sign for economic activity, as declines in the probability of rate increases had improved investment sentiment, while declines in the probability of rate cuts partly reflected reduced recession risks.

Members also noted that investors were broadly more certain about the outlook for economic fundamentals that could affect the rate path, especially inflation. A few also thought that the Federal Open Market Committee (FOMC) was likely to be more patient than usual in the face of near-term data surprises, and they cited communications from the April/May meeting as raising the bar for the FOMC to pursue rate increases.

On inflation, members generally saw a trajectory of slow but steady moderation, citing the rebalancing labor market as well as some incipient signs of softer consumption and a pullback in investment by small firms. However, a few members warned of a risk that inflation could reaccelerate due to factors such as geopolitical frictions or a tight market for services. It was noted that investors were not generally positioned for a reacceleration of inflation, and that the materialization of this risk could lead to large market losses.

Finally, the council discussed the extent to which current levels of interest rates, and broader financial conditions, were restrictive. A few members noted that retail and some institutional metrics of equity positioning were at unusually elevated levels, a potential reflection of strong risk appetite. Other members argued that if short-term interest rates were to remain near current levels for an extended period, banks would face increasingly challenging operating environments.

Discussion of Private Credit:

The council highlighted the rapid expansion of private credit, especially in the United States, where it has contributed to a longer-standing trend of bank disintermediation. Members discussed drivers of this growth, including the unintended impact of the 2013 interagency guidance on leveraged lending as well as shifts in activity stemming from the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act and aspects of the Securities and Exchange Commission's approach to regulating public markets.

Members also discussed how the growth of private credit had influenced monetary policy transmission. Although private lending employs variable-rate structures, the growth of private credit was viewed overall as somewhat attenuating the pass-through of higher rates to the economy by contributing to easier credit conditions. In particular, the asset class had drawn strong inflows from investors who sought higher yields as short-term interest rates rose or who were attracted to relatively stable asset valuations. These large inflows supported tighter credit spreads, weaker terms and underwriting standards, and more credit availability, including for firms with weaker credit fundamentals.

The council then discussed risks that private credit poses to the financial system. Members noted that private credit is generally in financing vehicles that are less leveraged than banks, but they also highlighted several sources of vulnerability. These included infrequent marking of asset valuations to market amid a lack of regulatory standard for recognizing losses; limited prudential regulation; and low visibility into deal terms and lack of standardized data. Members indicated that stable valuations have enhanced near-term measures of risk-adjusted returns, which have attracted certain investors, but that this marking practice merely delays the realization of losses and could result in an underpricing of risks.

A few members observed that the asset class has never endured a full credit cycle at its current scale, so there was uncertainty about how nonperforming debts would be serviced or worked out during a downturn. It was noted that insurance companies have especially high exposures to private credit and thus may be particularly vulnerable to a turn in the credit cycle.

Discussion of Other Risks in the Financial System:

Members cited a broad range of economic, market, and geopolitical risks. A few members judged that economic trends were increasingly bifurcated, with lower-income households facing larger challenges from higher interest rates. Some members suggested that economic conditions may require the Federal Reserve to maintain higher interest rates for longer than markets are currently pricing, and that such a rate path could challenge households, businesses, and overall economic activity. Members also discussed the U.S. long-term fiscal outlook, potential shifts in immigration and trade policies, and possible spillovers from geopolitical conflicts.