Meeting Between the Board of Governors
and the Federal Advisory Council
September 3, 2010

Board members: Chairman Ben Bernanke, Governor Elizabeth Duke, and Governor Daniel Tarullo

Council members: Ellen Alemany, Robert P. Kelly, R. Scott Smith Jr., Henry L. Meyer, Richard D. Fairbanks, Richard G. Hickson, David W. Nelms, Bryan Jordan, Richard K. Davis, Richard W. Evans Jr., and Russell Goldsmith

Summary: The Federal Reserve Board met with the Federal Advisory Council ("the Council"), a statutorily created advisory group that is composed of twelve representatives of the banking industry (one member from each Federal Reserve District). The Council ordinarily meets four times a year to provide the Board with information from the banking industry's perspective.

During the meeting, the Council discussed the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Act"), and the Council presented views regarding aspects of the Act in a question-and-answer format. The information collected from the Council at the meeting is summarized in the attachment. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

Implementation of the Dodd-Frank Act

> ***(A) Systemic Importance****:*
> **What criteria would the Council propose for determining whether a financial firm is systemically important? When is a firm "predominately engaged" in financial activities?**

What criteria would the Council propose for determining whether a financial firm is systemically important?

- The application of standards must be flexible, since many factors may define a firm as systemically important. The Financial Stability Oversight Council (FSOC) should use its discretionary authority to consider all factors and scale its oversight accordingly. It is critical to balance financial system stability against economic growth, and innovation and competitiveness at the regional, national and global levels.
- There is merit in considering the sliding scale system for assessing systemic risk as described in the August 2009 Federal Reserve Bank of Cleveland *Policy Discussion Paper*. The paper considers four factors other than size that, individually or collectively, can make a financial institution systemically important: contagion (interconnectedness), correlation (exposure to common risk factors), concentration (of a particular market or payment system) and conditions (context).

<u>The Council believes the following should also be considered:</u>

- Size in terms of assets and market capitalization, although size alone should not be used to identify or to manage oversight of systemically important institutions.
    - The enhanced prudential oversight from the FSOC should be scaled to those companies and businesses which do represent increased systemic risk so that firms with lower risk business models are not disadvantaged.
    - Factors to consider include the percentage of nationwide assets held, the nature of financial assets, asset ownership versus management, and equivalent measures for insurance companies and non-banks participating in financial services, including payment systems.
- Balance sheet composition, leverage, and disconnect between a firm's asset and liability structures are important systemic risk indicators.
- Similar activities should be subject to the same standards (e.g. capital, oversight), irrespective of the type of firm that engages in them.
- The degree of interconnectedness of a particular financial institution with firms, markets and products is a key indicator for measuring systemic importance. Interconnectedness factors that determine systemic importance include:
    - Probability that a firm's failure could materially disrupt financial markets or have a negative impact on the economy.
    - Since interconnectedness cannot be defined by size alone, regulators should evaluate institutions using criteria that measure the impact of cross-defaults in the industry or significant disruptions to sectors or regions of the economy as a result of the failure of a particular institution. Previous examples of systemic disruptions from financial failures could be studied to better define these criteria.

When is a firm "predominately engaged" in financial activities?

- According to the Dodd-Frank Act and the Bank Holding Company Act, an institution is "predominately engaged" in financial activities if at least 85% of consolidated annual gross revenues are derived from, or 85% of its consolidated assets are related to, activities that are financial in nature. This includes securities underwriting, dealing and market making and merchant banking activities.

The Council believes there are other determinants, such as:

- More than 50% of a firm's pre-tax income originates from financial activities.
- A company having money or financial instruments as its primary or secondary product. These activities include the taking or brokering of deposits; the underwriting, trading, selling or otherwise dealing in fixed income or equity securities; the lending of money; the offering of insurance in any form; and the creation, brokering, selling or dealing in derivative contracts with an underlying basis of a loan, deposit, commodity, currency or any other good or service.
- The firm derives significant revenue from, or views itself as affecting, the extension of financing or buying or selling of financial assets or contracts on financial assets as a principal, broker, or advisor…or is a major non-bank player in the payments system.
- A firm actively competes against other financial institutions by offering products of similar features even though its principal source of revenue or profits may differ.
- When viewed comprehensively, a firm is part of a horizontally or vertically integrated set of businesses that constitute a supply chain of related activities that link retail consumers with banks and/or capital markets.

***(B) Capital and Liquidity Regulations for systemically "Significant Institutions" (SIs):* How should capital and liquidity regulations differ for SIs relative to other financial institutions?**

- The Council supports the principles and timeframes regarding a global capital framework that Secretary Geithner laid out in his August 2nd speech at New York University, which are:
  - the strengthening of capital and liquidity requirements and the maintenance of a level global playing field;
  - a reasonable transition period to meet the new minimum requirements and several years beyond that to build up any capital buffers in excess of the new minimums.
- We recognize that the Dodd-Frank Act requires in some areas (e.g. risk-based capital requirements) and permits in others (e.g. short-term debt limits) prudential standards for SIs that are more stringent than the standards and requirements applicable to institutions that do not present similar risks. Basel III may compound these requirements for SIs by increasing overall capital levels, limiting what constitutes regulatory capital and imposing liquidity requirements.
- Within the sometimes conflicting mandates of the Dodd-Frank Act and Basel III, we would urge the Board to avoid using blunt, "one size fits all" approaches to prudential regulation (e.g. using simplistic criteria such as size) and instead pursue a sliding scale or continuum approach, with differing requirements that reflect the relative systemic risks of different

business models and activities. Consistent with the Council's report in September 2009, we believe that regulators should build upon the concepts contained in the FRB Cleveland Policy Discussion Paper titled "On Systemically Important Financial Institutions and Progressive Systemic Mitigation".

- We believe that the most important to create a continuum framework for capital and liquidity standards. The significant factors to focus on in this continuum are the underlying activities of an institution; criteria based on the institution in aggregate, such as size, should not be used.
  - Traditional commercial, consumer and small business lending and banking ("main street banking") represent stable forms of business with relative lower levels of systemic risk and should not face special capital surcharges.
  - Activities that give rise to systemic risk, such as contagion, in the capital markets through significant derivatives exposure or excessive concentrations in key financial markets should draw the strongest regulatory requirements.
- Such an "activity-based" approach is consistent with multiple provisions in the Dodd-Frank Act that require differentiation between institutions based upon a variety of factors. But even more importantly, such an approach is critical to ensuring that "main street banks" can continue to provide credit and other vital banking services to consumers, small businesses and corporations. We need to avoid overly conservative and blunt requirements that may:
  - curtail supply and cause the cost of credit to rise even more than it will due to Basel III requirements and other changes;
  - result in inefficient distinctions whereby institutions that are just above a certain boundary (say $50 billion in assets) face materially different regulatory requirements than comparable institutions that are just below the boundary;
  - potentially drive traditional-banking activities into the "shadow banking" system as a result of the higher requirements on more well-regulated financial institutions.
- The stress testing regime, resolution plan and credit exposure report requirements mandated by the Dodd-Frank Act going forward could provide valuable information in support of designing and implementing such a capital and liquidity risk continuum. We would also encourage regulators to establish metrics and closely monitor market responses to ensure their efforts are having the intended effects.
- Finally, we would strongly urge that regulators should not set the tactical details of new Dodd-Frank requirements in stone prematurely, because other key initiatives, such as Basel and recent proposals from the FASB, will significantly impact the capital and liquidity requirements of U.S. institutions.

(C) Resolution Procedures:
What is the best way to design a resolution procedure so that no SI is "too big to fail"?

- Ultimately, ensuring that no systemically important firm is "too big to fail" will rely on the prudential and other standards promulgated under Title I of the Dodd-Frank Act. Orderly liquidation may not be possible if there is a reoccurrence of widespread systemic issues like those experienced in 2008.

- There needs to be as much certainty as possible with regard to how all creditor classes will be treated in liquidation. Lack of certainty could lead to a "run on the bank" earlier than would otherwise occur, making orderly liquidation difficult to execute.
- If the resolution process deviates materially from the rules of bankruptcy, creditors and stakeholders of non-financial institutions will not know where they stand in resolution and will require higher returns for capital and debt.
- One suggestion is the creation of trigger points with certain prescribed actions and responses so that as an institution begins to weaken those triggers are activated. The actions and responses would result in outcomes that would make an orderly liquidation easier to execute.
- Another suggestion was to achieve orderly liquidation by breaking an SI into two entities, a “good bank” and a “bad bank,” perhaps maximizing value received in order to help offset the cost of liquidation.
- In determining the resolution procedure, transparency and certainty of process are critical. Care must be taken to maintain confidence in the U.S. financial system to ensure that U.S. financial institutions are not disadvantaged relative to foreign financial institutions regarding access to capital and liquidity.

***(D) Payment Systems*:**
What are the Council’s views concerning payment network exclusivity and interchange fees?

- The Durbin Amendment fundamentally changes the economic and operational framework on which the debit card marketplace operates today and has the potential to be negative for banks, consumers and small retailers.
- Debit Interchange represents an estimated $14-15B in revenues a year for banks (the highest fee revenue for checking accounts after overdraft fees are reduced). Any material reduction will likely result in no-fee checking accounts and debit rewards for most consumers being eliminated and a potential hit to bank profitability.
- An opportunity exists to enhance network competition and create a level playing field for all payment providers (including non-bank providers like PayPal). Need to avoid “unhealthy competition” that either (a) drives networks out of business or (b) creates perverse incentives.
- A number of critical “feasibility considerations” have been identified and will need to be addressed:
    - Although small banks are technically exempted, their pricing is also likely to be negatively impacted. The regulators need to clarify if small banks are exempted from all or just some of the provisions.
    - Will rules require “individualized” interchange rates that can change at undetermined intervals?
    - New transaction routing requirements
    - Practicality of “Cost Analysis”
    - Bank, network, acquirer and retailer POS systems may need substantial modifications
    - Litigation exposure
- Timeframes, scope and lack of clarity in the statute pose significant challenges.

Interchange Fees

- The Council expressed concerns that a pure "cost based" approach will reward inefficiency: PIN vs Signature incentives? Higher pricing for higher cost issuers?
- The Durbin amendment allows banks to receive interchange fees that are "reasonable and proportionate" only to incremental costs for authorization, clearance, settlement and fraud prevention. There are other expenses associated with making the debit system highly efficient and convenient for consumers including maintenance, investments in new software, research and development, overhead, costs of reissuing cards, security breach costs, losses due to compromised cards and the cost of data security programs.
- Council members expressed concerns that rigid price controls may hurt consumers. New fees, elimination of popular product features such as rewards and reduced incentives to introduce innovative features were highlighted as possible consequences. Council members expressed concern that merchants will not pass along their savings to consumers, as results from some foreign markets confirm.
- If fraud costs cannot be recovered, liability for fraud or non-sufficient funds is likely to shift to merchants. Debit cards will become more like checks.

Payment Network Exclusivity

- Council members noted economic benefits of consolidating debit card volumes on one network through exclusivity agreements (although interchange regulation may negate much of this benefit in the future).
- A number of banks may need to contract with alternative networks to meet the standards of the Durbin amendment. Members raised concerns about the validity of existing long term agreements.
- It is unclear whether multiple non-affiliated networks will be required, beyond just a prohibition of exclusive network contracts. Is one signature network plus one non-affiliated PIN network sufficient or required?
- Signature debit volume represents 65% of all volume but signature routing choice by merchants seems technically challenging. There is concern about merchant categories where PIN is not accepted (such as most internet and phone transactions).
- Council members expressed concern that the level of merchant discretion to direct transaction routing is unclear, and in addition to operational challenges, the transactions could have serious fraud implications. The Council suggests that the FRB should clarify that merchants are permitted to route transactions only over networks that the issuer has contracted with in order to protect bank customers.
- Council members also commented that small merchants may be disadvantaged for two reasons. First, only larger merchants have "unbundled" pricing which may directly benefit from interchange reductions, and second, "merchant choice" may come at a cost to the smallest merchants as it may be necessary to provide costly customized routing tables.

Important Considerations

- Set "reasonable and proportionate" to incremental costs sufficient to cover fixed costs and a reasonable profit

- The FRB should study of what “reasonable and proportionate” pricing means including investigating alternatives provided by other regulated industries (such as insurance and telecommunications).
- Consider a “template” for allowable costs plus a safe harbor for “reasonable and proportionate” mark-up to cover full costs plus a reasonable return to maintain viability of the business.
- Set network routing rules that encourage competition and are practical to implement.
- Allow sufficient implementation time to avoid disruptions or noncompliance.

(E) Implementation Concerns:
Many provisions of the Dodd-Frank Act must be implemented within the next 18 months or less. Does the Council have concerns about implementation of any specific provisions? Are there aspects of the Act that should be implemented earlier than prescribed to help the economic recovery?

Does the Council have concerns about implementation of any specific provisions?

General Concerns:

- The Council has enormous concerns about ongoing regulatory uncertainty and its impact on customers, employees and shareholders.
- In spite of the above, members do not support accelerating implementation of most specific provisions:
  - The Dodd-Frank Act was not intended to help economic recovery but to help prevent future crises.
  - The short time frame for implementation does not allow for full cost-benefit analysis, assessment of cumulative effect/unintended consequences, coordination with other regulators or necessary input from industry.
  - We recommend ample comment periods and sufficient transition periods for compliance to minimize the potential impact on the economic recovery as banks grapple with the new regulatory regime and its accompanying expense.
  - Self-effectuating provisions, without regulatory guidance, may create more confusion and uncertainty. We recommend that banks should be held harmless for good faith implementation.
  - The Council recommends that regulators should ask Congress for extensions where needed.

Major Systemic Risk Regulation Concerns:

- Systemic Risk Council mandate, goals, organization and information requirements should be clear, efficient and not duplicated with other regulators
- Identify “systemically important” nonbank financial institutions as soon as possible to level the playing field
- Regarding any heightened prudential standards to be applied to systemically important institutions:
  - Execution of authority to differentiate among institutions should be clearly delineated and transparent, not ad hoc
- Harmonize regulations internationally so that US firms are not competitively disadvantaged

- Harmonize Collins Amendment requirements on capital and liquidity with Basel III
- Living Will requirements should be reasonable and harmonized with FDIC proposals to limit duplication

OTC Derivatives Regulation:

- Clarify “major swap participant”, “commercial end user”, business conduct requirements towards “special entities”, transition rules and treatment of existing contracts

Volcker Rule:

- Clarify “proprietary trading” and “other funds” as private funds which carry restrictions on sponsorship and ownership.

FDIC Assessments:

- “Total assets” assessment will incent balance sheet reductions (e.g. liquid asset buffers, low yielding loans). The methodology should use a risk-weighted assets approach.

Bureau of Consumer Financial Protection:

- The new Bureau needs to clarify the scope, intent and burden of its rulemaking authority on financial institutions with respect to the authority of prudential regulators, e.g., over OCC and Federal Reserve “regulated persons”. Until the rules are clarified, no enforcement action should be taken. There are also concerns that the new agency could limit product choice, reduce lending and allocate credit.

Are there aspects of the Act that should be implemented earlier than prescribed to help the economic recovery?

- Treasury should quickly exempt FX from OTC derivatives regulation. OTC derivatives regulations/exemptions need to be in place quickly to encourage use of prudent risk management tools, thereby reducing system risk.
- Restore public confidence by addressing impediments to securitization, e.g., the role of the credit rating agencies (ABS) and particularly GSEs (MBS).