Meeting of the Board of Governors and the Federal Advisory Council
February 6, 2015

Participants: Chair Janet Yellen, Vice Chairman Stanley Fischer, Governor Daniel K. Tarullo, Governor Jerome Powell, and Governor Lael Brainard (Federal Reserve Board members); Robert Adams, William Bassett, Ramon Bullard, Mark Carey, Andrew Figura, Robert Frierson, Sarah Gosky, Jason Hinkle, Andrew Levin, Maria Ling, Ann McKeehan, Margaret Miller, Wayne Passmore, Robin Prager, Wanda Quick, Trevor Reeve, David Reiser, Louise Roseman, Paula Scharf, Michelle Smith, Brian Tabit, Stacey Tevlin, Joanne Wakim, and Jeffrey Walker (Federal Reserve Board staff)

Richard E. Holbrook, James P. Gorman, Scott V. Fainor, Paul G. Greig, O.B. Grayson Hall Jr., Frederick H. Waddell, Ronald J. Kruszewski, Patrick J. Donovan, Jonathan M. Kemper, Ralph W. Babb Jr., and John G. Stumpf (Council members); Herb Taylor (Secretary); Shani Schechter (Deputy Secretary)

Summary: Members of 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.

The Council discussed the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act and presented its views on the Board's proposed rulemaking concerning risk-based capital surcharges for global systemically important banking organizations ("G-SIBs") (Docket No. R-1505). During the discussion, some Council members expressed concern about how the Federal Reserve might revise the Comprehensive Capital Analysis and Review to incorporate the G-SIB surcharge.

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

Capital Surcharge

What is the Council's view of the recently proposed capital surcharges for the largest, most systemically important U.S. bank holding companies?

- Recent years have seen multiple regulatory efforts – along with proactive measures taken by financial institutions – to achieve systemic safety and soundness. These steps have included, among others: the introduction of Basel III and the Financial Stability Board's original buffer to Basel III for global systemically important banking organizations (G-SIBs); the recently recast supplemental leverage ratio (SLR) for U.S. regulated entities; total loss-absorbing capital (TLAC) requirements; the liquidity coverage ratio (LCR); the net stable funding ratio (NSFR); and the Comprehensive Capital Analysis and Review (CCAR) and Comprehensive Liquidity Analysis and Review (CLAR) processes (the last of which are now governing constraints for most institutions). For some time, the Federal Reserve has explicitly signaled the need to revisit the formula for calculating G-SIB capital surcharges. Following the recent publication of the proposed surcharge, or buffer, the Council is grateful for this opportunity to comment.
- The Council reiterates its support for prudent capital standards that target firm-specific risk, mitigate systemic contagion, and align the risk- and leverage-based capital requirements governing G-SIBs. In that regard, the proposed buffer is another important step toward protecting systemic integrity. Although the surcharge addresses these goals, certain components of it may yield results that are inconsistent with the spirit of the proposed regulation, thereby causing unintended consequences. G-SIB capital standards are one tool among many to mitigate systemic risk; as such, calibrating G-SIB surcharges with various new prudential standards will be critical to their success. One area of particular concern is the proposal's addition of a liquidity component to determining capital charges (replacing Method 1's Substitutability with Method 2's Short-Term Wholesale Funding, or STWF) just as liquidity regulations undergo clarification themselves. Indeed, none of the cited liquidity rules existed in final form even a year ago.
- As a governing theme, the Council encourages consistency with existing standards prior to finalizing the proposed surcharge to ensure that the buffer achieves its objective. The Council also offers the following thoughts for consideration.

METHOD 1

Component	Ratio
1. Size	Bank / Industry
2. Cross-Jurisdictional Activity - Cross-jurisdictional claims - Cross-jurisdictional liabilities	
3. Interconnectedness - Intra-financial assets - Intra-financial liabilities - Total marketable securities	
4. Substitutability - Assets under custody - Payments - Underwritten transactions in debt equity	
5. Complexity - OTC derivatives notional value - Level 3 assets - Held for trading and AFS assets minus HQLA	
Average of 5 category averages	

METHOD 2

Component	Ratio
1. Size	Bank / Industry
2. Cross-Jurisdictional Activity - Cross-jurisdictional claims - Cross-jurisdictional liabilities	
3. Interconnectedness - Intra-financial assets - Intra-financial liabilities - Total marketable securities	
4. Short-Term Wholesale Funding - Maturity / duration - LCR liquidity characteristics	Bank / RWAs
5. Complexity - OTC derivatives notional value - Level 3 assets - Held for trading and AFS assets minus HQLA	Bank / Industry
(Average of 4 category averages plus STWF)*2	

- A central principle of prudential regulation is to incentivize behavior among boards and management that mitigates operational and financial risk. This principle is evident in almost all regulation: holding lower-risk assets reduces risk-weighted assets (RWAs); holding larger volumes of high-quality liquid assets (HQLAs) raises LCR; and shrinking one's balance sheet reduces SLR. In this regard, the proposal's approach to risk sensitivity is problematic. In current form, G-SIBs cannot manage their risk profiles to achieve lower capital requirements that in turn drive business performance. Some examples of risk insensitivity in the proposal include:
    - **Relative Calculation**: The G-SIB methodology relies on a bank's relative risk indicators within total industry risk indicators. This fails to account for the scenario in which a bank reduces its risk but does so proportionally to the rest of the industry: in that case, the stated goals of reducing idiosyncratic and systemic risk are achieved but a G-SIB's surcharge remains static. This could be addressed by permitting total industry risk indicators to decline in response to enhanced prudential risk management.
    - **Euro-Dollar Volatility**: Since G-SIB international risk indicators are euro-denominated, U.S. G-SIBs' relative risk indicators fluctuate with normal-course euro-dollar volatility. This yields potentially higher capital requirements with no commensurate increase in actual bank risk and is particularly problematic for large U.S. money-center banks. As an alternative, the standard could control for foreign exchange volatility by integrating five-year exchange averages rather than spot rates.
    - **RWA Denominator**: Given that Method 2 substitutes a bank's RWAs as the ratio denominator for STWF, if a G-SIB simultaneously reduces STWF and RWAs, its surcharge remains static. If a G-SIB reduces RWAs and does not reduce STWF, its G-SIB surcharge could increase. By reconsidering the denominator to incentivize prudent use of STWF, the proposal would reflect both the industry's effort to reduce reliance on it and the enhanced regulatory standards governing liquidity.
- At a more granular level, the Council believes modifications to deposits, secured funding, and short sales as defined in the calculation of STWF in Method 2 will more appropriately align this proposal with other recently introduced rules to manage liquidity. These modifications include:
    - **Deposits**: The proposal penalizes G-SIBs that rely on wholesale and brokered deposits by taxing them at comparatively higher rates. In the case of fully insured affiliated brokered deposits, for example, this approach does not properly align with market behavior in stress scenarios or LCR assumptions.
        - The proposal imposes high capital charges on all brokered deposits, regardless of the source. Instead, the proposal should follow the LCR's calibration, which distinguishes between fully-insured affiliate brokered deposits (10% run-off assumption in the LCR) and less stable forms of brokered deposits.
        - The proposal taxes wholesale deposits at 50% (for nonfinancial counterparties) and 100% (for financial counterparties). These calibrations are punitive – particularly in the case of nonfinancial counterparty deposits, which support normal-course business activity necessary for economic growth – as well as unnecessary – since the LCR already requires banks to hold substantial liquidity pools against these deposits to guard against the risk of sudden deposit withdrawals in market stress conditions.

- **Secured Funding Transactions**: Method 2 imposes significant charges on secured funding transactions that present two issues. First, they conflict with the calibrations of existing prudential regulations developed by international standard-setting bodies based on empirical reviews. Second, they fail to reflect the durability of transactions secured by high-quality collateral even in periods of market stress. Specifically, the proposal conflicts with basic assumptions of existing liquidity and funding regulation, namely the NSFR (which applies a 5% funding requirement on Level 1 assets) and the LCR (which considers Level 1 assets the highest-quality liquidity resource available). Reducing these charges better aligns the proposal with other regulatory standards and market realities.
- **Short Sale Coverage**: Method 2 includes the value of securities borrowed by a G-SIB to facilitate short sales. Such securities borrowing activities should be excluded from the G-SIB methodology for several reasons:
  - When a G-SIB borrows securities externally to cover short sales, it provides cash to an agent securities lender; as such, the G-SIB is providing funding rather than receiving it.
  - A single securities-borrowing transaction between two G-SIBs will be double-counted as STWF: once by the agent securities lender receiving cash and a second time by the G-SIB providing cash.
  - Short coverage is already extensively covered by SEC regulation (which requires a permitted purpose), as well as new prudential funding and liquidity regulations like the LCR and NSFR.

- An additional substantive issue with the surcharge proposal is its role within the CCAR process. The Federal Reserve has indicated that it is considering how to revise CCAR to incorporate the G-SIB buffer, which could result in a shift away from the generally applicable capital standards currently governing the process to firm-specific G-SIB requirements. It is a significant issue that the Council recommends be raised for consideration at a future meeting of the Board of Governors.
- As a final point, the Council is of the strong view that the desire for safety and soundness should be balanced against relative differences in capital and liquidity standards between the United States and the rest of the world. Those differences have become increasingly pronounced as the Federal Reserve has introduced higher supplementary leverage ratio requirements, standardized risk-based capital floors, imposed the most robust stress-loss testing through CCAR and CLAR, and now proposed higher G-SIB capital buffers. The obvious and very helpful benefit of these collective actions is the resultant relative strength of the U.S. financial system, which is consistent with and necessary for a strong and growing economy. However, there are two potentially constraining factors to be considered in understanding the cumulative impact of regulatory efforts:
  - The degree to which the best-in-class capital and liquidity standards governing U.S. G-SIBs inhibit lending, market-making, or the provision of liquidity by the financial sector, all of which are critical for sustained economic growth; and
  - The extent to which the standards limit the ability of large public banks to generate sufficient returns, rendering the sector unattractive to investors and in turn creating unusual opportunity for the unregulated shadow banking sector.