

AGENDA

Meeting of the Federal Advisory Council
and the Board of Governors

Friday, May 11, 2012

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?

- Most members report that loan activity has ticked up slightly, though a significant portion of the activity seems to be refinancing related.
- Noted areas of increased activity include energy, healthcare, and multifamily housing.
- Uncertainty relative to healthcare legislation and tax policy and increased regulation seem to be holding back potential borrowers.
- Members report that credit is readily available and that banks' willingness to lend exceeds borrowers' desire to borrow.
- Pricing competition among banks is intense. As a result, many banks are beginning to compromise their loan profitability and structure requirements in order to book assets.

(A) Small Business Lending:

Has credit availability for, and demand for credit from, small businesses changed significantly recently? Have there been changes in lending standards for these borrowers?

- Credit remains readily available for small businesses and some members report a slight increase in demand. Uncertainty about government policies seems to be keeping a lid on loan demand.
- Fundamental underwriting standards remain in place; however, guarantee requirements are being waived and customary loan covenants are, in many cases, no longer being required due to the increasingly competitive nature of the loan market.
- As with larger loans, a large percentage of small business loan activity is from refinancing.
- Given the increasingly competitive environment and the reluctance of many business owners to undertake expansion at this time, it appears that small businesses' credit needs are being fully met by the banking industry.

(B) Commercial Real Estate Lending:

Have there been any changes in the Council's view of the challenges in the commercial real estate market? How are commercial real estate loans performing compared to your expectations?

- Commercial real estate (CRE) markets are showing improvement, primarily in the Southeast and Southwest.

- Multifamily housing is seeing the highest rate of growth, with underwriting becoming more aggressive and pricing competition for the good projects driving rates significantly downward. The demand for such housing is very strong.
- Credit underwriting, in general, seems to have gotten more aggressive; competition on rates and terms is very intense for good projects.
- Members generally report that the CRE market is performing in line with what they have been expecting at this point in the economic cycle.

(C) Construction Lending:

What is the Council's view of the availability of credit for construction and development projects? Has the Council seen any changes in the demand for construction loans recently?

- Credit is readily available for projects that are well located, accompanied by sufficient equity, and managed by experienced sponsors.
- Demand for multifamily housing construction financing is strong in nearly all parts of the country, as rental pricing reflects the dwindling number of units available for rent.
- Some members noted the availability of quality residential lots has been shrinking, leading to an increase in lot-development loan demand in some parts of the country. However, other respondents report no increased demand in this area.
- The overhang of starter-home inventories remains problematic for single-family construction.
- Demand for construction financing of student housing projects is reportedly growing, with financing readily available for well-thought-out projects.
- One member reported that credit underwriting for stronger construction projects has regressed to that seen in the 2007-2008 period.

(D) Agricultural Lending:

Have there been any recent changes in agricultural lending? What is happening to the valuations for farm land?

- Most of the members who report being active agricultural lenders also reported higher farm land prices, some seeing significant increases. Several attributed the increased prices to investors looking to place funds in hard assets. Others thought that the higher prices reflected the productive capacity of the land, the recent uptick in commodity prices, and the desire of wealthier individuals to expand their farm or ranch operation to both take advantage of the higher prices and hedge themselves against inflation.

(E) Update on Consumer Lending:

What changes have you seen in consumer lending?

- Measured by delinquencies and charge-offs, overall portfolio quality seems to be improving.
- Credit scores have remained relatively stable.
- Applications have increased, with the most notable and consistent comment being that consumers are purchasing cars and trucks in significant numbers.

- Some growth is being witnessed in student and credit card loans.
- The slow growth that is taking place in areas other than auto loans is attributed by some respondents to a continued desire on the part of the consumer to de-leverage. Cars and trucks wear out and need to be replaced, but consumers seem to be holding off on other large-scale purchases in favor of increasing their rate of savings.

(F) Update on Home Mortgage Lending:

What changes have you seen in the home mortgage market in the past three months?

- The Home Affordable Refinance Program 2.0 has resulted in a significant pickup in refinancing activity. Reportedly, some of the better mortgage credits are taking advantage of lower mortgage rates to refinance from 30-year to 15- or even 10-year terms.
- Existing homes can be purchased for significantly less than the cost of new construction. This trend appears to be deepening. Despite the lower prices, home sales in many parts of the country are still considered anemic as the true unemployment rate is precluding many would-be home buyers from the market.
- New home sales in the “move-up” market are showing double-digit percentage increases over last year, albeit over a very low base. Starter-home financings remain significantly depressed.
- Overall, there seems to be some evidence of an uptick in purchase money transactions.

(G) Mortgage Foreclosures:

What changes has the Council seen in the pace of mortgage foreclosures during the past three months?

- The initiation of foreclosure proceedings appears to have slowed slightly in many parts of the country. The overall assessment, however, is mixed. Several respondents reported their expectations that foreclosures would increase in the coming quarters, while others state that reduced delinquencies are harbingers of fewer future foreclosures.

Item 2: Stress Tests:

What lessons do Council members draw from the results of the recently completed Comprehensive Capital Analysis and Review (CCAR) stress tests of the largest banks? What suggestions does the Council have to improve the CCAR and capital plan review process going forward?

- In the February FAC meeting, the Council discussed the disclosure framework for CCAR and other stress testing requirements with the Board. The Council believes the Board subsequently struck the right balance with its approach to recent CCAR public disclosures, providing a perspective on bank performance under stress without creating unintended consequences or placing unnecessary focus on “baseline guidance.” The Council believes that Section 165 stress test disclosures should be modeled after these successful CCAR

disclosures, including the use of a template consistent with the information employed in CCAR and the disclosure of only severe stress scenario results.

- In that same spirit, we offer several recommendations today to ensure a more accurate and effective capital planning and management process, as CCAR evolves. The Council seeks significant enhancements in three key areas: 1) accuracy and rigor of modeling approaches; 2) openness of information exchange between banks and the Federal Reserve during the CCAR process; and 3) flexibility in capital plan management between CCAR exercises, as long as banks achieve target baseline and post-stress capital ratios.

High-Stakes Decisions with Imperfect Information

- The Council understands that the Federal Reserve does not want capital planning to become a mechanical compliance exercise or somehow have banks “game the system” or be perceived as doing so. We support the Federal Reserve’s goal for a rigorous and balanced approach to CCAR and believe that the Federal Reserve and banks can work together to achieve one.
- The members, however, continue to have concerns about the uncertainty and confusion generated by the significant differences between the analysis utilized by the Federal Reserve in its CCAR models and that utilized by the participating banks in their own models. Those disparities place bank boards in a highly vulnerable position. Board members are literally compelled to “fly blind,” in effect guessing about high-stakes capital distribution decisions that can tip the balance between the success of passing the CCAR and the market punishment associated with failure. Given these concerns, several members recommend that the Federal Reserve permit bank boards to adjust distribution plans prior to the determination of CCAR outcomes.
- A robust, accurate, and credible process is critical and will become even more so in the future as banks begin to publish summary results of their own, company-run stress tests. If the Federal Reserve and banking institutions can converge toward more rigorous, clear, and accurate model assumptions, we can best avert the market confusion that could arise from the publication of widely differing supervisory and company stress test results.

Accuracy and Rigor of Modeling Approaches

- Increased modeling accuracy would reduce concerns about the lack of transparency in both the current Federal Reserve’s models and the overall process. Based on the information available to banks, we believe that the Federal Reserve’s CCAR models may rely on assumptions that are too general or simplistic. In some cases, the Federal Reserve’s results were based on analytic or calculation errors that were material.
- *The Federal Reserve should ensure methodological completeness and consistency.* Here are some examples that appear to have been the experience for more than one of the participating banks:
 - The Federal Reserve’s models, in many cases, produce higher losses than the banks’ own models. However, when the Federal Reserve increased the losses in many portfolios, it did not decrease the amount of risk-weighted assets to reflect the higher losses in the stress scenario. At a minimum, each dollar of additional losses should directly reduce risk-weighted assets and, therefore, increase capital ratios due to the smaller denominator.

- The Federal Reserve applied an effective tax rate of 35% to all of the participating banks. This approach ignored the very different tax rates that apply to different institutions in practice and the additional expenses used to achieve the lower rate.
- Some banks' accounting practices capture recoveries expenses as an operating expense. The Federal Reserve's model, however, captured expenses relating to recovering charged-off debt in its net charge-off estimates. Because the Federal Reserve's model was not consistent with these banks' own accounting practices, recoveries expenses were double counted, leading to lower capital numbers.
- Areas like these can be improved by refining models to capture the full complexity of tax and accounting issues and by averting key omissions.
- *The Federal Reserve should consider both industry-level models and banks' actual historical loss performance in order to properly credit (or penalize) differences in important bank-specific strategies and customer selection.* The Federal Reserve has alluded to the blunt estimates used by some banks for home prices and mortgage losses. Analogously, "generic" industry-wide models miss subtle but important distinctions among lenders and across portfolios and segments. In calculating stress scenario losses, the Federal Reserve relied on an industry-level model that accounted for many variables that differentiate performance but did not capture differences in important, bank-specific factors, such as customer selection, credit line assignment, account management, risk management, etc. Loans from different banks that would be scored identically by an industry-level model have been observed to consistently experience varying loss performance due to these bank-specific factors. These performance differences can be independently and objectively observed. Clearly, past performance is an imperfect predictor of future performance, but we believe that the Federal Reserve has the skills and tools to utilize bank-specific historical performance, applying appropriate conservatism.
- The Federal Reserve's one-size-fits-all approach may be appropriate for assessing the health of the industry in aggregate but is not appropriate when CCAR results are applied to individual banks in a pass/fail test. A broad-brush approach is arbitrarily punitive for some institutions or portfolios and arbitrarily favorable for others, but is inaccurate for both. It is also the case that using bank-specific assumptions, where appropriate, could result in *downward* adjustments to bank capital in some cases.

Dialogue between the Banks and the Federal Reserve

More open dialogue both before *and during* the CCAR process would enhance the accuracy, rigor, and credibility of the CCAR.

- We welcome the Federal Reserve's commitment to a CCAR-model symposium, which would permit a full two-way dialogue between the Federal Reserve and financial institutions. Banks have on staff great technical depth with access to rich institutional histories regarding credit loss and analysis. Banks may be best positioned to assess how loan portfolios will perform under extraordinary circumstances and in relation to other portfolios.
- More dialogue about complex tax and accounting treatments may disclose key issues that can be resolved prior to next year's CCAR.

- During the tests, the Federal Reserve should maintain an open line of communication. CCAR testing involves hundreds of variables and complexities for each institution. An open dialogue during the process can ensure that misunderstandings do not turn into major discrepancies.
- Several members recommend that the Federal Reserve permit bank boards to adjust distribution plans prior to the determination of CCAR outcomes. These members point out that capital distribution decisions are not static and that, in response to changed outcomes under the Federal Reserve's stress scenario, banks may appropriately wish to change their capital distribution decisions.

Ongoing Capital Plan Management

- The Council appreciates the rigor that CCAR contributes to companies' capital-planning processes. We understand that once the Federal Reserve has provided a notice of non-objection with respect to a capital plan, banks must manage to targeted baseline and post-stress capital levels and may not increase capital distributions, aside from limited exceptions provided in the capital plan rule. We believe, however, that *outside of increasing capital distributions*, it is in the best interest of the system to afford banks more flexibility with regard to particular capital actions, due to the dynamic nature of capital planning and capital markets and the fluidity of the underlying business, as long as the bank remains above its baseline and post-stress targets.
- We believe that the focus of banks and federal regulators should be on meeting target capital ratios, not on managing to specific capital actions reflected in a point-in-time capital plan with a nine-quarter planning horizon. For example, due to market or business changes, a bank may wish to alter or forego a planned capital raise as long as it remains above its target capital ratios, both in baseline and post-stress scenarios. Such changes should be subject to ongoing supervisory discussions, rather than requiring capital plan resubmissions. Resubmitting formal capital plans for any and all changes could hinder efficient and effective capital planning and result in missed market opportunities, interfering with safety and soundness objectives.

Additional Recommendations

- *Timing* - To ensure the quality of the capital plan and related submissions, as well as a well-managed internal governance process, the Council recommends providing several more weeks for completion of CCAR and other supervisory stress tests. We recommend that supervisory scenarios and instructions be issued by October 15th to facilitate adequate planning and execution.
- *Regulatory Coordination* - The Council notes that in light of the proposed Dodd-Frank stress-testing rules from the Federal Reserve and other federal banking agencies, modeling approaches and information reporting requirements should be coordinated across the agencies.

Item 3: Mortgage Profitability

What is the outlook for the profitability of mortgage lending?

Overview

The Council noted recent improvement in the profitability of mortgage lending, recognizing that the profitability outlook varies for individual lenders based on business models and markets served. Members generally agreed that mortgage loan profitability is likely to decline in the future due to a variety of factors.

- The recent increase in profitability has been driven by both capacity constraints and high refinance activity. Record-low interest rates and government refinance programs are boosting demand, while industry capacity is shrinking. Several large lenders have scaled back, and numerous small lenders have exited the business in response to increased regulation and other challenges. The remaining mortgage lenders are benefitting, but the benefit is expected to decline as refinance activity winds down.
 - The Mortgage Banking Association (MBA) estimates national origination volumes of roughly \$1.0 trillion in 2012 and 2013, the lowest volume since 1997. The MBA data indicates refinance transactions accounted for 68% of all mortgage originations in 2011. Refinance transactions are expected to remain high in 2012, at 61%, but to fall to 34% in 2013.
 - Members observed that there continue to be wide differences in regional housing markets across the nation. However, the purchase market generally remains soft due to persistent elevated unemployment rates and weak, and in some cases still declining, home values. Many believe the recovery in the housing sector will take several more years.
- Members noted that future profitability will be pressured by increasing costs in both loan production and servicing. Increases are due to new and changing regulations and investor requirements. A number of institutions are grappling with managing a growing threat of litigation and fair lending complaints. The Council is concerned about the cost implications of Government Sponsored Enterprise (GSE) reform and proposed regulations for ability to repay and risk retention. According to a recent Stratmor Group mortgage lender benchmarking survey, costs to originate, process, close, and deliver mortgage loans have increased 19% since 2007. One member noted that some expect the “cost to serve” (both originating and servicing) to increase by 30-50%.
- The capital requirements due to Basel and SIFI surcharges could lead to a reduction in the profitability of mortgage lending and will affect the balance-sheet capacity for servicing assets.
- Correspondent mortgage lenders have been negatively impacted. They are presently at a disadvantage with lower-price execution and a contracting correspondent investor base. Several large correspondent investors have exited or scaled back their correspondent business, and GSEs have increased their minimum capital requirements for counterparties.
- The profitability outlook is more positive for mortgage lenders selling directly to the GSEs and GNMA with servicing retained, particularly for lenders operating in stronger housing markets. However, these lenders will need to transition from a refinance market to a purchase market.

- Mortgage lenders not prepared for an increase in purchase transactions will be under pressure to rebalance their existing capacity for lower origination volumes.

Are there steps that can be taken to improve profitability?

Consumer access to home loans at a reasonable cost will be dependent upon adequate industry profitability and capacity and the ability of regulators and lenders to manage the increasing costs of regulatory compliance and investor requirements.

- A level playing field, regardless of the size of the lender, is necessary to support a healthy competitive environment.
- Regulators need to collaborate to ensure the regulatory framework is clear, concise, and consistent. Duplicative and counterproductive mandates should be removed and regulations should be clarified and aligned.
- All the stakeholders (lenders, investors, and regulators) should collaborate to establish one set of minimum national standards for originating and servicing mortgage loans.
- Representations and warranties for mortgage transactions and servicing should be standardized to reduce inefficiencies and costs associated with repurchase disputes.
- GSE repurchase demands should be based upon defects directly attributable to the default, rather than to minor technical items. Repurchase demands should also be limited, absent any fraud, if the borrower pays as agreed for a prescribed period of time.
- The future role of the GSEs should be clarified. In the interim, retaining talent should be a priority to facilitate the implementation of new strategies.
- The Consumer Financial Protection Bureau’s efforts to simplify mortgage disclosure documents should be expanded and applied to the GSEs and private investors.

Item 4: REO Disposition

The Federal Housing Finance Authority is working with Fannie Mae and Freddie Mac on auctions of large groups of foreclosed single-family homes. What is the Council's view of this approach to REO disposition?

- The large supply of existing REO inventory and mortgages currently in the foreclosure process pose a considerable risk to the housing recovery.
- In general, members support the work being done by the Federal Housing Finance Authority to auction large groups of foreclosed single-family homes owned by the GSEs to professional property management firms but caution against over optimism.
- Key challenges mentioned by members include the following:
 - Operational risk of the property management and having a national scalable solution, as most of the property managers are localized.

- Potential negative impact on the subject property and the surrounding neighborhood, as rental properties typically lose value due to lack of “pride of ownership,” which impacts surrounding properties.
- It is not clear that private investment goals can be met via rental properties in markets where the single-family housing market has not stabilized yet.
- Council recommendations include the following:
 - Restrict auction participation to experienced, financially strong property management firms,
 - Provide conservative but attractive financing,
 - Implement favorable tax treatment on these transactions, as well as on real estate investment more broadly, such as accelerated depreciation or investment tax credits,
 - Require a minimum time period for auctioned properties to be held in order to discourage short-term investment activity, and
 - Determine if it is necessary to update real estate appraisal guidelines in order to factor in the impact the auction process may have on market values more broadly.
- Potential advantages to auctioning off large groups of foreclosed single-family homes include the following:
 - Accelerates home price stabilization and/or improvement through:
 - A reduction in the supply of homes for sale,
 - Improved maintenance, assuming a renter-occupied home will be maintained better than an unoccupied home, and
 - The creation of a new asset class that may attract private capital.
 - Increases the supply of rental properties, improving availability and affordability for individuals and families who lost their homes to foreclosure.
 - Minimizes losses incurred by the GSEs and funded by taxpayers.
 - Creates new private sector jobs.
- Potential disadvantages to auctioning off large groups of foreclosed single-family homes include the following:
 - Accelerates losses for the GSEs due to write-downs necessary to effectuate auctions.
 - Increases downward pressure on home prices in the near term.
 - Transfers a key factor in the outcome of the housing recovery to the private sector, with little-to-no ability to change course.
- Members urge that in addition to the GSE REO-to-Rental Program, additional actions must continue to be taken to facilitate and expedite the housing recovery, including:
 - Lenders must continue to aggressively pursue appropriate loan modifications,
 - Servicers must continue to be provided incentives to pursue alternatives to foreclosure, such as Freddie Mac’s Servicing Success Program, and
 - Short sales must continue to be pursued and the process must become more efficient; members support the FHFA’s efforts in this regard.

Item 5: Incentive Compensation

What are the views of Council members on the guidance being provided by Board and Reserve Bank staff with respect to incentive compensation practices at banking organizations?

Overview

The Council supports the principles outlined in the Interagency Guidance on Sound Incentive Compensation Practices,¹ including the need to ensure that incentive compensation programs do not encourage employees to take imprudent or excessive risks. Members have had a constructive dialogue with both Board and Reserve Bank staff regarding how the principles embodied in the guidance should be applied in practice. As a result of this dialogue and firms' own internal reviews, banking organizations have made a number of important improvements to their incentive compensation programs, including increasing the amount of deferred compensation (clawbacks), incorporating performance-based vesting features for executives, and improving the governance framework for incentive compensation, including risk-management reviews all the way up to the board.

After considering the feedback provided by Board and Reserve Bank staff on incentive compensation, the Council has the following observations:

- In determining whether a firm's incentive compensation program is appropriately balanced, it is very important to look at each program as a whole and understand how all of its elements work together. Looking at individual components or elements of compensation in isolation can give a misleading picture of the overall balance of a program, as it is an employee's compensation package as a whole that ultimately guides incentives.
- As the Interagency Guidance itself recognizes, there is a variety of methods that may be used for ensuring that incentive compensation programs are "balanced" and do not encourage imprudent risk taking. Methods for achieving balance at one organization may not be necessary or, alternatively, sufficient for achieving balance at another organization due to, for example, differences in plan design, business strategy, or management structures. The Council believes that it is very important for these principles to guide supervisory assessments, since there is no one-size-fits-all approach to ensuring that incentive compensation programs are balanced.
- There appears to be a growing and, in the Council's view, unnecessary tension between the incentive compensation goals of the Federal Reserve and those of shareholders. For example, it is commonly perceived that performance goals will be subject to supervisory criticism unless they are highly achievable and avoid rewarding exceptional performance. Shareholders, however, rightfully want to encourage exceptional effort and corresponding performance, and doing so should not be viewed as inconsistent with safety and soundness provided that employees also are exposed to significant downside risks should they seek to achieve above-average performance through imprudent or excessive risk taking.
- Federal Reserve guidance has discouraged the use of relative performance measures. However, that class of incentives can and should play a role, in combination with absolute performance measures and other features, in promoting sound and balanced compensation.

¹ 75 Federal Register 36395 (June 25, 2010).

All performance measures have strengths and weaknesses. For example, absolute performance measures can encourage employees to “swing for the fences” in years of economic growth in order to maximize their compensation in those years, knowing that absolute performance will decline in years of weaker economic performance. Relative performance measures, on the other hand, incent management to focus on the organization’s longer-term performance, by ensuring that disciplined risk taking in growth years is rewarded in down years when the benefits of that discipline becomes more apparent.

- Organizations need sufficient time to implement modifications to their incentive compensation programs and educate executives, employees, and shareholders about those changes. Frequent and rapid changes to incentive compensation programs are not only difficult to implement but also run the risk of confusing participants who need to understand how the programs balance rewards and risk if the program is to be effective in appropriately guiding behavior.
 - As noted above, organizations have already made significant changes to their compensation programs in recent years, and compensation programs for 2012 have already largely been established and communicated to employees. Many organizations, however, only recently received responses to their most recent incentive compensation submissions to the Federal Reserve, and in many cases, these responses raise or highlight topics that were not previously communicated.
 - In light of the foregoing, the Council believes organizations should have the flexibility to implement additional modifications to their programs for the 2013 plan year.
 - In addition, given the magnitude of the improvements already made and those likely to be made this year, the Federal Reserve should allow these new structures to operate for a few years before requesting further substantial changes to program design. This would allow both organizations and the Federal Reserve to assess the effectiveness of these program changes, both individually and in the aggregate, in balancing potential incentives for improper risk taking before determining whether additional changes are necessary or appropriate.
- As ongoing supervision transitions to the Reserve Banks, it would be helpful for the Federal Reserve’s experts to remain available to provide guidance to, and respond to questions from, banking organizations as well as available for information requests to provide greater clarity as to the information being sought (which should reduce the incidence of multiple requests).

Any final rules on incentive compensation issued under section 956 of the Dodd-Frank Act should, like the guidance, be principles based and flexible. Prescriptive and rules-based approaches are unlikely to be effective and could have unintended consequences in light of the diversity of programs and institutions.

Item 6: Financial Stability

What financial market practice(s) or types of financial institution(s) pose significant current threats to financial stability, and why? What can be done to reduce or remove these threats?

- Disintermediation has been a broad trend within the financial sector. Data from the Office of Financial Research show that the market share of nonbank financial intermediaries grew from 10% in 1980 to 45% in 2005. However, even this level of growth may understate the reality, considering that the estimate does not include hedge funds.
- Other data about the U.S. banking system show the following:
 - At 100-115% of GDP, the U.S. has the smallest banking system relative to the size of its economy compared to other G7 developed countries (and is smaller than China and comparable to Brazil).
 - U.S. bank assets represent 27% of total U.S. financial assets. This is down from 37% in 1990, indicating that a larger portion of financial activity is now being conducted outside the formal banking system.
 - The concentration of the largest three U.S. banks (relative to both the banking industry and to the size of GDP) is the smallest among the G7 and other major developed economies, and is smaller than China.
 - Data suggest that the formal banking system has matched growth in U.S. GDP and the S&P 500, and its growth has been paced with growth in the U.S. economy and the needs of U.S. global corporations.
- While we can end “too big to fail” through appropriate resolution planning, the primary issue now to be addressed is the risk posed by the shadow banking system.
- Considering that the pace of disintermediation has been increasing and a very substantial amount of activity happens away from the formal banking system, the question of market practices and types of financial institutions that pose threats to the financial system may be difficult to capture in one question.
- The primary shift underway is from a hub-and-spoke approach to a network approach. While it is too early to fully characterize this network, the ultimate risk is the failure of the network.
- There are several practices and types of institutions that pose risks to financial stability. Some of these risks are short term in nature, while others are medium- and longer-term risks.
- *Short-term risks* typically arise from a lack of confidence. In order of importance, current significant short-term risks are likely to be driven by:
 - Sovereigns, which pose the most significant short-term risks. The lack of confidence in sovereigns also has the potential to trigger risks in funding markets. In addition, the risk of Euro denomination together with the lack of a truly risk-free asset has the potential to trigger risks at a time of stress.
 - Short-term liquidity providers, including:
 - Money market funds,
 - Tri-party repos, and
 - Overall repo funding markets.

- Rating agencies, which can downgrade and generate a lack of confidence.
- *Medium-term risks* arise primarily from nonbank maturity transformation providers that are levered and rely on wholesale funding. This risk arises since these providers rely on wholesale liquidity (as mentioned above) and also because of the lack of stress-test transparency, as well as differing capital requirements. Although hedge funds carry correlated risks, they pose lower risk today as a result of reduced leverage. The Council would also continue to be concerned about certain insurance companies as a result of less transparency.
- *Longer-term risks* are posed by exchanges, clearinghouses, etc. While systemic risk is reduced as activity is transitioned to exchanges and clearinghouses, safety nets have not yet been put in place in the event of a failure of these entities.
- Market practices that may pose significant risk to financial stability are:
 - Money market funds with implicit guarantees, which leave them vulnerable to runs.
 - Tri-party repos, which carry intraday clearing and credit risk.
 - Noncollateralized derivatives (and illiquid collateral in general).
 - Noncentrally cleared credit default swaps.
 - Regulatory changes in aggregate have the potential to create disruption or secular changes in market liquidity (including single-party counterparty exposures, Volcker Rule, Other Comprehensive Income (OCI), etc.) that have the potential to reduce asset liquidity in markets. This could trigger reduced collateral values and liquidity and, therefore implicitly, liquidity in the banking system. Increased volatility and pressure on asset prices would likely result in increased mark-to-market losses in times of stress, which have the potential to weigh on banks' capital ratios.
 - There are several consequences of the Basel III Liquidity Coverage Ratio requirements that have the potential to impact stability:
 - Banks are likely to reduce their holdings of government agency securities by ~30% (or >\$1T) since these securities are deemed to be Level 2 assets.
 - Banks are likely to choose to minimize deposits for which they must assume 50% or more runoff (e.g. corporate time deposits), because they would substantially deteriorate banks' leverage ratios. These deposits (which may represent ~\$1T) would need to find homes outside the regulatory system.
 - Different rules for different jurisdictions create regulatory arbitrage from the point of view of geography, product, and institution (i.e. different capital requirements, tax treatment, etc.).

What can be done to reduce these threats?

- Product regulation, including:
 - Collateral requirements,
 - Margin requirements,
 - Clearing requirements, and
 - Product standards, e.g. MMF.
- Harmonize multifaceted regulatory changes to understand their equilibrium impact on market liquidity, collateral values, etc., as well as the impact of further disintermediation of activities to unregulated markets.
- Create greater transparency through:
 - Transitioning of additional activity to regulated exchanges and clearinghouses.

- Disclosure of stress tests for all significant entities within the financial system (including insurance companies). Detailed stress-test disclosures should be provided annually, whether it is through a stress test or other required audited disclosure.
- Individual institutions' risk measurement against a "benchmark portfolio."
- Supervision -- broaden the definition of systemically important financial institutions and include recovery and resolution planning for all.
- Continuing efforts to harmonize standards across industries and geographies.

Item 7: Europe and U.S. Banking

What prudential steps can U.S. regulators and banking institutions take to enhance the resiliency of the banking system in the face of potential spillover effects from unresolved European financial difficulties?

Overview

While U.S. banks have taken significant measures to manage the risks associated with the European financial difficulties and are well positioned to address idiosyncratic, firm-specific risks, the potential spillover and contagion risks are still significant.

The United States has a critical national interest in the European financial issues, and U.S. policymakers, including the Board of Governors and the Treasury Department, should be actively involved in the ongoing dialogues to resolve the crisis.

U.S. Banks are actively managing EU risk

- Many U.S. banks have already taken significant steps to minimize exposure to the continued European difficulties, including reducing exposures to certain European sovereigns and financial institutions, restructuring transactions to mitigate risk (*e.g.*, shorten tenor, increase collateral), and managing asset/liability balances to minimize cross-border risks.
- According to Federal Financial Institutions Examination Council (FFIEC) data, total U.S. bank exposure to the most-troubled EU countries (Portugal, Italy, Ireland, Greece, and Spain) has declined from \$244B to \$189B (a decline of 22%) from March 2009 to December 2011.
- Holdings of U.S. prime money market mutual funds in securities issued by Eurozone issuers was 14.6% in March, compared to 31.1% last May.²
- The results of the U.S. stress test attest to the resiliency of the U.S. banking system.
- The best protection for U.S. banks is strong capital and profitability.

Improved monitoring of exposures is important

- Adoption of a global Legal Entity Identifier (LEI) will increase the U.S. FSOC's and its non-U.S. counterparts' ability to monitor trends in counterparty exposure and evaluate emerging systemic risks.

² Investment Company Institute data.

- While the EU stress-testing regimes should be improved to more fully address potential risks to banks from the EU financial crisis (particularly the possibility of sovereign restructuring), the European Banking Authority’s standardized disclosure of sovereign exposures was viewed as useful to the marketplace.
- U.S. stress tests could be made more consistent by expanded, more-explicit, and uniform guidance regarding the EU situation.

Global implementation of key regulatory reform measures will help

- Consistent, well-defined regulatory and supervisory frameworks around the globe will provide legal certainty to regulated institutions, increase market confidence, and avoid systemic risks created by the potential reallocation of risk from highly regulated firms to less-regulated firms.
- In several instances, the U.S. is ahead of the EU in adopting key prudential reforms, particularly related to resolution and recovery planning. U.S. regulators may want to emphasize the importance of the introduction of an EU crisis and resolution package sooner rather than later.
- Some regulatory reforms -- particularly the movement to central clearing and more rigorous collateral practices for derivatives -- will require global adoption to be effective in reducing systemic risk and to minimize a competitive disadvantage for U.S. banks.

Some emerging aspects of U.S. and global regulatory reform could add to the risk of spillover or contagion effects

- The proposed Basel III liquidity ratios, as currently drafted, consider only government securities as “highly liquid,” creating an incentive for banks to hold government securities, even if other types of assets, including asset-backed securities or corporates, are more liquid and lower risk. The proposed approach also fails to provide a suitable approach to using the liquidity buffer in times of stress. As Governor Tarullo recently indicated, “[a]s currently constituted, the LCR might have the unintended effect of exacerbating a period of stress by forcing liquidity hoarding.”³
- A consistent bias against high-quality, non-U.S. sovereign exposures (including high-quality EU sovereign debt) in U.S. regulatory proposals (such as the Volcker Rule, Section 165 single-counterparty credit limits, and uncleared swaps margin requirements) could disrupt global efforts to mitigate systemic risk.
- The Dodd-Frank prohibition against regulatory use of credit ratings makes designating high-credit-quality sovereigns more difficult. A possible solution would be to recognize in regulations as high-credit quality both sovereign debt and central bank exposures that are from countries with high OECD ratings, that have not defaulted in the past, that are not currently receiving IMF assistance, and that are actively traded.

Ultimately need to deleverage central banks without reducing market confidence

- Assuming an immediate crisis can be addressed, central banks will need to deleverage over the coming years in a rational fashion, without creating a new market crisis.

³ <http://www.federalreserve.gov/newsevents/speech/tarullo20120502a.htm>.

- The Euro banks' dependency on the ECB's Long-Term Refinancing Operation (LTRO) creates a real danger of market dislocation as the program winds down 2.5 years from now. The Federal Reserve should be proactive in thinking through these dynamics and offer support to the ECB in developing a credible plan to secure Euro bank funding well in advance of the deadline.
- To ensure the funding is forthcoming, global regulators should use caution in applying undue restrictions on likely buyers of the debt, including banks, insurance companies, pension fund, and collective investment funds.
- In the meantime, the Federal Reserve should continue to make available dollar-swap lines, support IMF involvement where appropriate, and encourage European efforts such as the ESM (European Stability Mechanism).

Item 8: Economic Discussion

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?

- Almost all members made note of at least one or two industrial sectors or geographic regions in their respective District that are experiencing above-average economic activity and growth. This led some members to raise the question of whether broad national or regional averages and reported economic statistics are adequately capturing and reflecting these "hot spots." Industrial sectors singled out as having better than average economic performance included automotive manufacturing, Midwestern agriculture, and gas and oil energy production. At the same time, there was little-to-no mention of particular industries or geographic regions experiencing subpar performance and economic activity. Therefore, on balance, broad/reported averages may be presenting a representative picture.
- Several members noted improvements in purchase money mortgage applications that might hint at future improvements in housing. Other members commented on growth in their banks' loan volumes, but it is not clear that this specific growth could be generalized to broader regional or national trends.
- All in all, it appears that reported aggregate data are capturing actual and observed economic conditions relatively well. Hopefully, there are hidden or nascent signs of improving economic activity that cannot yet be divined, but members broadly saw the reported data as painting an accurate picture of economic activity.

Item 9: Monetary Policy

How would the Council assess the current stance of monetary policy? How have banks adapted to a prolonged period of low interest rates?

- At the February meeting, the Council viewed current monetary policy as both highly accommodative and appropriate, noting that further accommodation appeared unwarranted

absent new signs of deterioration. Members continue to hold this view, noting recent GDP and employment reports and recognizing the overwhelming national interest in promoting recovery from the recent economic crisis.

- Members cited continuing, related drags on economic recovery in housing, unemployment, and uncertainty. The current monetary policy stance is further judged appropriate in light of uncertainties stemming from the European situation and the consequences of a potential fiscal contraction caused by the scheduled expiration of the temporary tax relief and sequestration. Members called for a more coordinated approach among policymakers to address fiscal, trade, and regulatory concerns, suggesting that perhaps too much was being asked of monetary policy.
- Several members identified harbingers of inflationary pressures, including slowing productivity gains and rising rental rates. Others observed that low national borrowing rates have reduced political pressure on elected leaders to act to reduce deficits, which exposes the country to increased debt-service requirements when rates rise.
- With a strong majority agreeing that the accommodative monetary policy stance is necessary and appropriate, members expressed contrasting views on the seriousness of the implications of prolonged low interest rates for financial institutions. Declining rates initially benefited most banks, as funding costs came down more rapidly than asset yields and lower rates helped distressed borrowers meet debt-service obligations (e.g. commercial real estate). However, very low interest rates for a prolonged period put pressure on margins and the ability of institutions to generate returns to attract investments and build capital.
- Banking institutions have pursued various adaptive strategies, including:
 - Lowering deposit costs and improving funding mix;
 - Accepting diminished returns and perhaps relying on reductions in cost of risk to produce acceptable net-income results;
 - Accepting greater credit risk and lower yields;
 - Taking additional interest rate risk on investment securities;
 - Lowering operating costs;
 - Attempting to shift business models to favor activities that generate non-interest income; and
 - Reducing exposure to customers who are less profitable in a low-rate environment.
- Less diversified banks, which often are smaller, generally have fewer sources of non-interest income and feel more pressure from tight spreads. Moreover, traditional sources of fee income for smaller and midsized banks have been curtailed by changes in regulation. As financial institutions already report an eagerness to lend and deposit funding is plentiful, the stimulative effect of unattractive securities yields driving further lending is lessened. Combined with other factors, such as higher capital requirements and other regulatory costs, margin pressures can be expected to foster further industry consolidation.