

**Meeting of the Board of Governors and the Federal Advisory Council
December 5, 2014**

Participants: Chair Janet Yellen, Governor Daniel K. Tarullo, Governor Jerome Powell, and Governor Lael Brainard (Federal Reserve Board members); Scott Anchin, Mark Carey, Andrew Figura, Robert Frierson, Jinai Holmes, Mark Libell, Maria Martin, Wayne Passmore, Robin Prager, Wanda Quick, Trevor Reeve, Nancy Riley, Paula Scharf, Chaehee Shin, and Matthew Thompson (Federal Reserve Board staff)

Richard E. Holbrook, James P. Gorman, Scott V. Fainor, Paul G. Greig, Kelly S. King, O.B. Grayson Hall Jr., David W. Nelms, Ronald J. Kruszewski, Patrick J. Donovan, Jonathan M. Kemper, Ralph W. Babb Jr., and J. Michael Shepherd (Council members); 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 presented its views on bank liquidity regulation, including the recently finalized liquidity coverage ratio and potential effects of implementing a net stable funding ratio. 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

Item 4: Bank Liquidity Regulation

Implementation of the Liquidity Coverage Ratio (LCR) will begin next year, while the Net Stable Funding Ratio (NSFR) has been recently finalized by the Basel Committee. What is the Council’s view of the potential impacts of the LCR and NSFR? Would higher liquidity buffers have been effective in preventing or significantly reducing the social costs of the 2008 financial crisis? Going forward, how will these measures affect (1) the resilience of banks to liquidity pressures; (2) banks’ business models; (3) the liquidity and functioning of the market for U.S. Treasuries, including the availability of financing for such securities through repurchase agreements; and (4) other short-term funding markets? Will these measures have more general, longer-term effects on financial products, financial markets, or the macroeconomy?

What is the Council’s view of the potential impacts of the LCR and NSFR?

- The introduction of the LCR and NSFR comes as a result of insufficient liquidity on bank and broker-dealer balance sheets during the 2008 financial crisis. While addressing the evident weakness in liquidity regulation is quite important, LCR and NSFR may result in many unintended consequences to the banking industry, the global economy, and various segments of the capital markets. Further, it is important to note that these consequences have the potential of compounding the impacts caused by other regulations being rolled out as a part of Basel III (B3) and the Dodd-Frank Act.
- The overall implementation of liquidity rules will make institutions better equipped to handle financial stress. However, the combination of LCR and NSFR with other rules, including the Supplementary Leverage Ratio and Volcker Rule, while increasing bank liquidity, may result in reduced liquidity in the capital markets. The decline in tri-party repos and stock lending and the recent Treasury market dislocation are all early signs of reduced capital market liquidity.
- Beyond the changes in liquidity rules and other regulatory initiatives since the financial crisis, the question remains whether, collectively, these initiatives would meet the challenge of the next financial crisis – especially given the restrictions imposed by Dodd-Frank on the Fed’s ability to act as a lender of last resort.
- Certain types of assets and liabilities will be favored by the LCR and NSFR. The following table includes a list of the major winners and losers from each category. Demand (or lack of demand) for these products will have an impact on the pricing and value of these assets or liabilities in the B3 world. We would expect to see asset yields decrease for U.S. Treasuries, GNMA Securities, and other high quality liquid short-term securities. In contrast, we would expect to see asset yields increase for loans, lines of credit, and riskier securities.

<u>Assets</u>		<u>Liabilities</u>	
<u>Winners</u>	<u>Losers</u>	<u>Winners</u>	<u>Losers</u>
U.S Treasuries	Commercial Loans	Consumer Deposits	Large Corporate Deposits
GNMA Securities	Committed Lines of Credit	Small Business Deposits	Short-Term funding
Short-Duration Securities	Corporate Debt Securities	Long-Term funding	Municipal Deposits
	Municipal Securities*		

*Note: The regulators have hinted at a relaxation of the liquidity guidelines related to municipal bonds in the future.

Would higher liquidity buffers have been effective in preventing or significantly reducing the social costs of the 2008 financial crisis?

- The financial system during the 2008 financial crisis undoubtedly suffered due to a lack of liquidity and liquidity regulation. Had they been in place, the LCR and NSFR would have certainly provided for a higher percentage of quality liquid assets on balance sheet and would have limited the reliance on shorter-term funding. However, these ratios do not address the serious decline in asset prices (across liquid assets as well) that ultimately created a capital hole that could not be corrected at many institutions. Moreover, it does not seem likely that these ratios would have “unfrozen” the interbank lending market. There may have been less reliance on the interbank market (because of NSFR), but interbank lending would likely have still been a very important component of the banking system (and we expect that to continue).
- In our view, the ratios would not have saved the financial institutions that failed during the onset of the crisis. However, the increased liquidity may have provided for more time to diminish the risks associated with liquidating assets, resolving defaults, etc. This may have reduced some of the social costs associated with the crisis, but it would not have been significant.

Going forward, how will these measures affect the following?

(1) the resilience of banks to liquidity pressures;

- The LCR and NSFR should make banks more resilient to liquidity pressures going forward, but the regulations do not provide any certainty that banks will withstand a full liquidity crisis again. There is no way of definitively knowing that the high quality liquid assets (HQLAs) will maintain liquidity in future cycles. Furthermore, there is already some question as to whether the liquidity hierarchy within LCR reflects the true liquidity observed in today's marketplace (for example, GNMA securities qualify as level 1 while FNMA and FHLMC securities qualify as 2A, despite similar if not greater liquidity for FNMA and FHLMC).
- There is some concern that the LCR and NSFR ratios will create a self-fulfilling liquidity freeze in the interbank market when liquidity stress begins. The transparency of LCR and NSFR ratios, and the advertised stress on these ratios during a crisis, may act to create further reluctance to lend in the interbank market.

(2) banks' business models;

- The new liquidity regulations will require banks to hold more HQLAs and obtain longer-term, costlier forms of funding. As discussed previously, this requirement will work to decrease revenues and increase the cost of doing business. As a response, banks will inevitably react to mitigate the negative impacts associated with the ratios. We expect banks to implement balance-sheet strategies to offset lost earnings (replacing traditional lending with riskier assets in some cases) and to exit lines of business that may be less profitable. We expect banks to exit certain products, such as customer repo sweeps, and certain client types, such as municipalities and financial entities, due to the liquidity costs associated with the business.
- Larger banks will also start gearing more of their activities to fee-producing activities and businesses with continued emphasis on cost-cutting in nonessential areas.

(3) the liquidity and functioning of the market for U.S. Treasuries, including the availability of financing for such securities through repurchase agreements;

- The rulings will require that banks hold more level 1 assets, which include U.S. Treasury securities. This will result in banks holding a larger portion of the U.S. Treasury market, which we expect will ultimately *decrease* the level of liquidity for Treasuries. The greater demand for Treasuries will create an artificial downward pressure on Treasury yields, which could artificially impact the pricing of other asset classes. All the while, the U.S. government obtains lower financing costs, while banks suffer lower revenues.
- As banks will need to hold more Treasuries as unencumbered assets, fewer Treasury securities will be available for repo financing. In general, banks will be better served holding the securities for liquidity purposes versus as collateral for repurchase agreements. Additionally, the “unwind rule” in LCR is prohibitive to the use of repurchase agreements. In addition, we believe there will be fewer counterparties for institutions needing to monetize HQLA via repurchase agreements during a liquidity crisis.

(4) other short-term funding markets?

- Banks will rely less on short-term funding markets but will be more likely to lend to short-term borrowers. This should reduce short-term borrowing costs in the market. However, the repurchase agreement marketplace will certainly be disrupted as these transactions are now subject to the “unwind rule,” which is detrimental to a bank’s HQLA calculation.

Will these measures have more general, longer-term effects on financial products, financial markets, or the macroeconomy?

- Financial Products:
 - Banks will likely exit (or significantly reduce extension of) products that are punitive to the LCR or NSFR calculation. These products include customer repurchase agreements, lines of credit (unused), certain deposit product types (municipal deposits), and even lending in general (as more assets on the balance sheet need to be HQLA).

- Financial Markets:
 - Banks will be required to stockpile HQLAs (specifically level 1 assets) and obtain longer-duration funding sources. Furthermore, all of these banks will be seeking to accomplish this at the same time. We expect that this will drastically change asset and liability valuations as the key players flood the markets.
 - We also stress the potential impact that LCR and NSFR could have on the ability of marketmakers to maintain deep and effective secondary markets for securities that are not considered HQLA (corporate debt securities and equity securities).
- Macroeconomy:
 - The LCR and NSFR will without question reduce the velocity of credit in the global economy. This will have a disparate impact in markets that already experience lesser availability to credit. Additionally, the rules may result in a transfer of risk to the unregulated shadow banking market, which by definition is less regulated, less transparent, and less measurable (with its implications for reduced ability on the part of regulators to read and control the money supply) and could come around to cause significant financial issues in the future.