

## RECORD OF MEETING

### Federal Advisory Council and Board of Governors

Friday, September 20, 2013

#### **Item 1: Current Banking Market Conditions**

##### **What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally?**

- Loan demand is tepid due to uncertainty around the economic outlook, regulatory burdens, health care and tax reforms, geopolitical risk, and sovereign deficit spending.
- Senior bank leaders at the recent Barclay's investor conference consistently noted that loan demand is softening and mortgage banking revenue is evaporating faster than expected. This consensus has led some analysts to lower quarterly earnings forecasts for several regional banks.
- Both consumers and businesses have deleveraged over the past few years and remain more selective about new borrowing and capital expansion.
- Loan volumes are dominated by refinance activity. New loan volumes are concentrated in mergers and acquisitions, capital distributions, and share repurchases.
- Excess capacity remains in the banking sector and in the institutional markets. Loan tenor, structure, and pricing continue to drift negatively. With large inflows of funds seeking yield and variable pricing, there is greater structuring weakness in the institutional markets.
- The outlook for the loan markets is uncertain and no near-term changes are expected.
- The financial markets appear to be dominated by decreasing liquidity as some dealers are no longer making a market in certain asset classes. It is clear that dealers are less willing to hold sizable inventories of bonds.
- The financial markets have been adversely impacted by ever-changing regulatory metrics, such as leverage capital requirements, Basel III's Liquidity Coverage Ratio ("LCR"), and the liquid asset buffer. The response to these ratios may cause downstream implications for other financial institutions and municipalities, with SIFIs less willing to use their balance sheets to provide secured funding (repurchase agreements) or to book municipal deposits.
- While many analysts have argued that a small reduction in monthly asset purchases still represents an extremely accommodative monetary posture, the markets' recent price movements suggest otherwise. Thus far, even the threat of lower Federal Reserve purchases paired with an increase in selling has had a major negative impact on the bond market.
- Increases in longer-term rates have caused a flip from unrealized gains to unrealized losses in longer-duration investment portfolios, which could ultimately impact consolidation in the industry.

***(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?**

- Small business owners' willingness to undertake new ventures or expand existing businesses is inhibited due to uncertainty, particularly around rising health care costs and potential tax increases. The National Federation of Independent Business (NFIB) reported in July that 52% of small business owners explicitly stated that they did not want a loan and 30% reported that their credit needs were fulfilled.
- Another NFIB survey reported that only 9% of respondents indicated that the current environment was a good time to expand. That group's Small Business Optimism Index actually dropped slightly in August from July.
- Anecdotal discussions with small business owners suggest that the Health Care Reform Act provisions may be inhibiting business expansion and driving changes to the workforce structure (temps and part-time jobs rather than full-time employment) in an effort to avoid breaching the 50-employee threshold.
- There continues to be ample lending capacity to meet borrower needs in this space. This excess capacity has resulted in a fierce amount of competition, mainly related to loan structure, which has been observed across the size spectrum (from community banks to larger institutions). Companies with strong financial positions, in particular, are able to command some variances to standard underwriting requirements.
- There are indications that some small business owners who had planned to sell/retire but delayed their plans as a result of the recession are now gearing up to resume their plans.

***(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?**

- According to the Mortgage Bankers Association, in 2Q 2013, commercial and multifamily mortgage origination volumes rose 7% over the previous year and 36% over 1Q 2013.
- According to the July 2013 Federal Reserve Board's Senior Loan Officer Opinion Survey, banks generally eased their lending policies for CRE loans and experienced strong demand over the previous three months.
- The underlying commercial real estate fundamentals continued their modest recovery for most major property types through mid-2013. While the recovery is widening in scope and geography, it is not equal in strength. Properties in tertiary markets, while improving, are lagging larger markets.
- Improved fundamentals have led historically stressed loan portfolio vintages, underwritten prior to the recession, to recover and led more recent vintages to outperform original underwriting. The recent uptick in the 10-year Treasury has yet to have a noticeable impact on the marketplace.
- The commercial real estate recovery has been highly property-type specific:
  - Multifamily assets continue to attract the highest level of investor and lender interest. This property type has recovered fully from the recession and there is an oversupply of credit availability. The multifamily industry continues to have strong underlying

market fundamentals, but potential overdevelopment and deteriorating credit standards pose the greatest threat to this sector. Recent figures show that the pace of recovery has moderated.

- Retail properties have experienced a very tepid recovery, with underlying market fundamentals providing little support for new construction. However, we are seeing some demand for new grocery-anchored centers and single credit tenant properties.
- Office properties, like retail assets, continue to experience a very slow recovery. The office market segment is highly dependent on the employment outlook and investors remain skeptical about this segment of the macroeconomic picture. Office vacancy rates have improved only marginally over the last several years and remain at levels that do not broadly support new supply. Office-space efficiency gains place additional downward pressure on the sector, as large employers are looking for ways to cut costs.
- Industrial assets have experienced a moderate recovery to this point, but investors and lenders are optimistic about the second half of 2013 and 2014. Industrial properties, particularly in port cities and transportation hubs, have seen increased investor interest this year.
- The hotel industry has continued its strong fundamentals recovery that began in 2011. “Revenue per Available Room” now exceeds pre-recession levels and investor interest has returned. Lenders have also returned cautiously with conservative underwriting standards.
- Although performance is improving, the CRE market still faces pressures from underlying economic challenges. In addition, CoreLogic estimates that over \$373 billion in commercial mortgages will mature in 2013. Some borrowers may have difficulty refinancing due to the decline in property values and the slow recovery.

***(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?**

- According to the Federal Reserve Bank of Atlanta, more banks are reporting year-over-year growth in their construction and development portfolios, with 48% reporting positive growth. The Fed’s July Beige Book noted that construction activity grew at a moderate-to-strong pace in all Districts.
- The supply and availability of credit for commercial real estate construction projects remain ample for well-structured and well-positioned projects. However, this supply and availability varies by both property type and location. As an example, there is an oversupply of credit for several preferred property types (particularly multifamily, including senior care facilities) within the marketplace, and loan terms available for these opportunities are becoming more aggressive as lenders compete for this business. Large multifamily construction loans for experienced developers in major metropolitan areas regularly attract multiple lenders competing for the business on increasingly liberal terms. Conversely, the availability of credit for speculative office or retail development remains subdued, but the investor demand for this type of property is also limited.
- There has been an increase in both demand and credit availability for single-family construction loans in 2013. Many of these local and regional developers are financially

strong, having withstood the recession, and are commanding aggressive loan terms in their deals.

- Rising activity in private sectors has helped to offset a steep decline in public-sector development spending tied to budget cuts.

***(D) Agricultural Lending:***

**Have there been any recent changes in agricultural lending?**

- Farm debt outstanding at all commercial banks rose 4.4% (to \$133 billion) in 1Q 2013, the largest year-over-year jump in the first quarter since 2009.
- Demand is tailing off due to grain prices and expected lower crop yields, which are the result of higher levels of rainfall in the Southeast and reduced planted acres in the western states. Demand for financing of crop storage has been significantly reduced by a drop in carry-over due to last year's drought, the timing of current crop sales from farmers, and the general decline in price levels.
- Farm loan portfolios at banks are being reshaped due to competition, according to the July Agricultural Finance Databook, a publication of the Federal Reserve Bank of Kansas City. Market share shifted more toward large banks in 2Q 2013, which could be due to favorable loan terms and higher average loan amounts available at larger banks.
- Repayments are improving modestly, reducing delinquency and net charge-offs. However, we are expecting a weakening in repayments due to declining income.
- Consensus is that farmland values are expected to remain at current levels for now; however, attention should be paid to early warning indicators of a potential bubble.
- The recent increase in farmland values is being driven by factors such as higher commodity prices, record farm profits, and favorable crop export demand. Bankers cite the overall wealth level of the farm sector, supported by several years of strong income, as the primary driver of farmland values.
- Agricultural lending's future will be driven by developments in global demand. China, for example, is increasingly looking to the U.S. for agricultural commodities.

***(E) Consumer Lending:***

**What changes have you seen in consumer lending?**

- Consumer credit continued its recent growth in June, rising by \$13.8 billion, slightly above the six-month average, which represented a 5.9% annualized increase over the previous year. The growth was driven entirely by nonrevolving credit.
- Banks are showing a greater willingness to lend. Demand shows some strengthening, believed to be the result of some improvement in consumer confidence and improved equity markets.
- Auto lending continues to see solid growth. Competition, both prime and subprime, is fierce. Competitors are showing a willingness to lengthen terms, and pricing in the prime space is extremely thin. There is no evidence, however, that growth is a function of disproportionate lending to riskier borrowers. While originations to borrowers with the lowest credit scores have increased, they are just recently approaching historically normal levels and are below those of the years leading up to the financial crisis.

- Home equity lending has begun to see a shift from closed-end, first lien volumes to second lien Home Equity Line of Credit (HELOC) volumes. HELOC introductory rate specials are being used to attract clients.
- Credit card growth is generally flat. Consumers are not showing a propensity to take on more debt; competitors are looking for ways to be the “card of choice.”

***(F) Home Mortgage Lending:***

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

**What is happening to house prices?**

- According to CoreLogic, between May and August of 2013, the 30-year fixed-rate mortgage rose to 4.39%, an increase of just over 100 basis points, which is the largest rise in the long-term rate since mid-2004.
- As expected, the rise in rates will dramatically slow the mortgage origination volume. As an example, at one large regional bank, refinances accounted for roughly 50% of applications in the previous three months but dropped to 30% in August.
- The purchase market will not be able to fully replace the loss of refinance volume. The Mortgage Bankers Association expects total originations for 2013 to be down 10% from 2012.
- According to the Mortgage Bankers Association Mortgage Credit Availability Index, mortgage credit availability increased in July for the fourth consecutive month. Increases in the index are indicative of a loosening of credit.
- In general, home values are firming, although this varies greatly by market and region.
- Pricing on jumbo loans has recently been at, or even below, pricing on conforming loans. While this may reflect lenders’ willingness to price larger loans based upon the total value of the client relationship, it is also reasonable to conclude that the market is reacting to the increase in guarantee fees attached to conforming loans.
- There is a consensus that heavy regulatory burdens, including the Ability-to-Repay/Qualified Mortgage Rule, Mortgage Servicing Rules, and CFPB activities, are impacting home lending. There are reports of some community banks who deem this lending segment simply too unpredictable and risky. There is also strong evidence that while there will be the ability to originate residential mortgages under the new Ability-to-Repay standard, many if not most will seek to meet the higher Qualified Mortgage standard to mitigate regulatory, legal, and reputational risks.

***(G) Mortgage Foreclosures:***

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

- The modest trend of a decline in foreclosures continues. June 2013 was the twentieth consecutive month with a year-over-year decline in the number of homes in some stage of foreclosure.
- According to the Mortgage Bankers Association, the percentage of loans on which foreclosure actions were started during 2Q 2013 decreased to the lowest level since 1Q 2007 and was less than half of the all-time high reached in September 2009.

- Rising home prices should incent borrowers who are not severely underwater in a property to attempt to remain current. Some members report a decline in requests for loss mitigation.
- Timelines for foreclosure sales continue to improve in nonjudicial states. Judicial states continue to struggle, although we are starting to see some of the logjam of court delays begin to improve slowly.

## **Item 2: Basel III and Supplemental Leverage Ratio**

**The Board and the other federal banking agencies recently implemented the Basel III capital reforms and proposed a supplemental leverage ratio for the eight largest systemically significant U.S. banking organizations.**

**What changes in banks' portfolios and activities does the Council anticipate in response to these new regulations?**

### *Final Basel III Capital Rule:*

- Large U.S. banks are ready for Basel III and significant further focus on the impact of risk-based capital regulations is not necessary. Changes to large bank portfolios and activities are likely limited to the following areas:
  - Available For Sale (AFS) portfolios will likely shorten in duration as banks seek to reduce the amount of gains/losses from interest rate moves reported in Other Comprehensive Income (OCI) that will now be recognized in capital.
  - There will likely be a shift in derivative activities with corporates, pension funds, and sovereigns to European banks because the European implementation of Basel III rules exempts exposure to these counterparties from the Counterparty Valuation Adjustment (CVA) add-on capital charges.
- For smaller banks, the modifications to the U.S. final rule, particularly the reversion to the Basel I 50/100% risk weighting for residential mortgages, the one-time opt-out of inclusion of OCI in capital for non-advanced approaches banks, and the permanent inclusion of trust preferred securities in tier 1 capital were helpful. However, the complexity of Basel III requirements continues to pose challenges and significant costs for small banks, and in general, the new capital rules will likely increase the cost of credit and reduce its availability.

### *Enhanced Supplementary Leverage Ratio:*

- The impact on banks from the proposed U.S. Supplementary Leverage Ratio (SLR) is different and more severe. Under the current proposal, the U.S. SLR becomes the dominant capital constraint for large U.S. banks given that banks are already well in excess of risk-based capital requirements. This presumably was not the intended consequence. There is a significant risk that the very effective and thoughtful CCAR process will be less important in time as the more simplistic leverage calculation drives management's behavior.
- The most significant issue with the SLR is its crudeness as a measure of risk: it takes no account of balance sheet liquidity or asset quality and creates the incentive to focus on

higher-return assets at the expense of liquid, low-risk, lower-return alternatives. Indeed, the SLR may constrain the absolute size of banks' activities but in doing so may well harm many highly desirable product areas, including Treasuries, fixed-income and equity securities, and corporate lending.

- The implication of the SLR is that banks will focus on gross balance sheet size as the most relevant capital constraint. As a result, management will likely take action that drives some or all of the following:
  - Reduction in balance sheets via inventories of liquid low-risk assets, notably inventories of U.S. Treasuries and Agencies. The reduction in inventories held on bank balance sheets ultimately reduces the effectiveness of monetary policy.
  - Unwillingness to accept deposits during times of stress, particularly those associated with securities payments and settlement activities.
- In addition, these actions may:
  - Adversely impact liquidity of securities as dealers reduce bond inventories given the increased cost of repo financing and balance sheet constraints of secured lenders.
  - Increase the financing costs for repo and other secured financing transactions as lenders require higher returns to satisfy their cost of capital for on-balance-sheet exposures.
  - Reduce the availability and increase the pricing of lending commitments to corporations.
- Implementation of the SLR is also likely to result in increased compression of outstanding derivative notionals, which is consistent with policy objectives. (Note: Compression is where two or more parties identify trades that naturally offset and agree to terminate the related transactions at little or no cost to all parties.)
- Unfortunately, a looming issue is the meaningfully different approach taken by the international regulators through Basel III.
- Under the proposed Basel III SLR, repo netting is disallowed, requiring a gross-up of borrowing (repo) and lending (reverse) transactions. U.S. GAAP provides for repo netting under FIN 41 subject to a strict set of conditions that include identical maturities, identical counterparty, settlement through an identical clearing agent, and equal subjection to legally enforceable set-off in the event of default. The importance of repo netting is discussed in more detail in the next section.
- The proposed Basel III SLR also increases the gross asset amount associated with derivatives by eliminating the netting benefit of collateral from the calculated asset amount. This approach is inconsistent with the demonstrated benefits of high-quality collateral in reducing banks' exposure to counterparties in the event of default. However, it is important to note that while the Basel III rule drives a higher denominator (notional balance sheet), the required leverage ratio of 3% is notably lower than the U.S. level of 5% at holding companies and 6% at depositories.

**What are the likely effects on financial markets, including the repo market, from changes in international leverage requirements?**

- The recently proposed changes to the international version of the Basel III SLR could have a significant adverse impact on financial markets, including securities lending activities. In contrast to the proposed U.S. SLR, which recognizes U.S. GAAP netting of securities

financing transactions (e.g., repo), the international proposal disallows such netting, thereby increasing the amount of gross assets recorded in the denominator of the capital ratio. Balance sheet netting is a cornerstone of the securities lending market because it allows dealers to recognize the legal right to offset borrows and loans with the same counterparty and because it is based on a set of strict criteria established by accounting standards bodies.

- Disallowing netting for securities financing transactions will materially increase the break-even return on such transactions because significantly more capital would be required to support these low-margin, fully collateralized lending agreements. It is noteworthy that both large and small banks are likely to suffer from the adverse effects associated with the disallowance of repo netting.
- For dealers, this may mean:
  - Reduced inventories reflecting higher financing costs and limited ability to pledge securities as collateral.
  - Market making would have wider bid-offer spreads with less liquid/less deep securities markets, driving increased price volatility.
  - Reduced margins at smaller banks as they exit from repo markets and shift their borrowing to higher-cost medium- and long-term funding sources.
- For investors, this may mean:
  - Increased transaction costs associated with buying and selling securities and reduced availability of inventory selection.
  - Increases in rates charged to finance holdings.
- For corporate and government borrowers, this may mean:
  - Increased cost of financing through publicly traded debt due to increased market frictions.
- Analysts estimate that large European banks are currently ~50 basis points below the 3% leverage ratio minimum and will be forced to reduce balance sheets by ~€700 billion and raise ~€50 billion of new capital to meet existing Basel III leverage requirements. The proposed modifications to the international rule would require further reductions in balance sheets and additional capital raises. Consistent with analysts' assessments, two of the largest Eurozone banks have publicly announced plans to reduce their inventories of securities and related financing transactions, derivatives, and, most notably, liquidity pools by ~€380 billion (\$500 billion). Needless to say, were the international view to be implemented with the higher U.S. leverage ratio of 5%/6% required by U.S. regulators, there would be a dramatic restructuring of U.S. balance sheets with very material consequences to securities trading, bank lending, and the broader financing markets.

### **Item 3: Nonbank SIFI Designation**

**The Financial Stability Oversight Council recently made determinations that certain nonbank firms are systemically important financial institutions (SIFIs). What is the Council's view of the process for SIFI designation? Does the process adequately address the concerns raised about SIFIs?**



### *Summary*

- Council members generally agree that, conceptually, the process established by the Financial Stability Oversight Council (FSOC) is a reasonable means of identifying nonbank SIFIs. Some members, however, have concerns with the implementation of the FSOC process, the potential inclusion of certain types of market participants (particularly asset managers), and the suitability of applying existing or currently proposed U.S. heightened prudential standards to nonbank SIFIs. In addition, several Council members object to the \$50 billion asset-based test for bank SIFIs under the Dodd-Frank Act.
- While Council members agree that addressing risks posed by nonbank SIFIs is an important regulatory goal, it is too soon to tell whether the current FSOC process will adequately meet this goal.
- In general, the Council supports heightened prudential standards for designated bank and nonbank SIFIs, but urges U.S. regulators to ensure that such standards are proportional to the systemic risks presented by the SIFI and appropriately tailored to individual industry segments.

### *Nonbank designation process*

- Council members generally agree that the FSOC's framework for nonbank SIFI designation, which involves a three-stage process for winnowing down a broad range of financial institutions and includes various avenues for potential nonbank SIFIs to challenge the designation, is appropriate in concept.
- In practice, however, the process appears to suffer from a lack of full transparency, both for the public and for firms being considered as possible SIFIs. There is some concern that, in contrast to the Basel Committee's G-SIB process and the International Association of Insurance Supervisors' process for G-SII process, which strongly emphasize public, indicator-based approaches for designation, the U.S. FSOC process may rely too much on nonpublic supervisory assessment of qualitative factors.

### *Asset management*

- The potential designation of asset managers as nonbank SIFIs remains a key unresolved issue. The FSOC continues to study this issue, and has consulted market participants as part of a study, but has not yet released a study or proposed approach for public review and comment.
- Traditional asset managers invest on behalf of clients, not with their own balance sheets, and generally pose less risk to the financial system than firms that principally engage in core financial intermediary activities, such as lending, insuring against loss, or securities underwriting and dealing.
- Alternative asset managers, such as hedge funds, can be large, highly leveraged, and interconnected and should be evaluated for systemic risk.

### *Prudential standards for nonbank SIFIs*

- While the Council supports designation of nonbanks as SIFIs, members are concerned that the largely bank-focused heightened prudential standards for SIFIs currently in effect or proposed by U.S. regulators will be inappropriate for nonbanks. For example, both insurance companies and asset managers operate under dramatically different business models and regulatory regimes than banks, and applying bank-like regulations (capital,

liquidity, credit concentration) to such firms would threaten their business model and would not appropriately target whatever systemic risks they may pose. U.S. regulators should provide substantial additional clarity with respect to the regulatory implications of nonbank SIFI designation and, if needed, develop new heightened prudential standards relevant to nonbank market participants.

#### *Bank SIFI designation*

- Several Council members raised concerns with the \$50 billion asset test mandated in the Dodd-Frank Act for designation of bank SIFIs. In contrast to the FSOC's nonbank SIFI process, banks by statute are designated as SIFIs based solely on asset size, which may not be a strong indicator of systemic importance or risk. Council members support a more risk-based approach to bank SIFI designation, which will likely require a statutory change to the Dodd-Frank Act.

#### **Item 4: GSE Reform**

**Two legislative paths to reforming government-sponsored enterprises have recently been proposed: the Corker-Warner Bill in the Senate and the Hensarling Bill in the House. What are the Council's views on these legislative approaches to reform Fannie Mae and Freddie Mac? The Hensarling Bill also makes significant changes to the Federal Housing Authority and proposes a new legislated framework for covered bonds. How does the Council view these proposed changes?**

#### *Overview*

- The Council is in broad agreement that legislative changes should be made to both the governance and operational structure of the GSEs and are nearly unanimous in believing that the Corker-Warner Bill provides the more preferable framework to that end. Specifically, the Corker-Warner proposal would (i) mitigate the problems of the current system while putting private capital in the lead position; (ii) maintain some form of support from the federal government by providing an explicit backing against catastrophic losses, thereby maintaining the continued viability of a 30-year mortgage product; and (iii) more likely be enacted given its bipartisan support.
- In contrast, the Council believes that the Hensarling proposal goes too far in diminishing important components of affordable housing and would be disruptive of the nascent rebound in the current housing market.
- Lastly, the Council is supportive of exploring a legislative framework for covered bonds.

#### *GSE Reform*

- At the May meeting, Council members were asked their views on the best way to reform Fannie Mae/Freddie Mac or to create viable alternatives, on what is the appropriate role of government in housing finance, and on how a transition to a new model should take place. While Council members agreed that GSE activities should be curtailed over time, the Council noted the difficulty in maintaining a policy consensus on the appropriate

legislative action to accomplish this. Many Council members favored maintaining some form of a government backstop. Council members also agreed that the road to reform would be difficult.

- The two legislative proposals have similarities but also clear differences in how to reform GSEs. Both would wind the GSEs down over a five-year period. The Hensarling Bill would establish a market utility to set standards for securitization of residential mortgages and operate a securitization platform. The legislation does not provide for any federal guarantee of these securities. The Corker-Warner Bill would establish an independent federal agency that would provide a limited back-end federal guarantee on “qualified” residential mortgage securities. The private issuer would assume a first-loss position of no less than 10% of the volume of the security. Any potential losses associated with the federal guarantee would be funded by fees assessed against issuers.
- The introduction of both bills is seen as an encouraging development, and members continue to be in agreement that the ultimate wind-down of Fannie Mae and Freddie Mac is an appropriate objective given the conflict inherent in managing shareholder-owned corporations benefiting from implicit government guarantees.
- Council members also favor an orderly transition and the maintenance of some form of federal backstop, citing concerns about disrupting the housing market recovery. The Corker-Warner Bill appears to allow for the continuation of that goal, which the implied guarantee of the GSEs represented. All members agree that the government’s role should be limited and that access to all creditworthy borrowers must be ensured. Most favor the maintenance of an explicit government backstop to underpin standard, lower-risk mortgage products.

#### *FHA Reform*

- Members agreed that the FHA’s market share has grown too high, and they support legislation that refocuses the FHA back toward its mission of enhancing availability of credit to first-time and low-income borrowers. Some concern was expressed that increasing down-payment requirements and reducing the percentage of insurance coverage on individual mortgages over time might hinder the FHA from serving its historic mission of addressing the mortgage needs of a broad array of lower-income and first-time homebuyers. With regard to both GSE reform and proposals to change the FHA, members also noted that care should be taken to avoid an abrupt change such that the economy is not damaged.

#### *Covered Bonds*

- Members noted that the market for covered bonds is untested in the U.S. but has been successful in Europe. Members generally see the use of covered bonds as a financing source that is worth exploring but also advise that it would be prudent to introduce the financing concept on a limited, closely monitored basis. Some concern was also expressed that any recourse to issuers could present concerns to the FDIC and the deposit insurance fund.

## **Item 5: Europe**

### **What is the Council's assessment of the current situation in Europe? What is happening to U.S. banking activity in Europe?**

#### *Overview*

The situation in Europe is stabilizing as central bank commitments and accommodative policy have reduced the risks of substantial economic contraction. Banks are deleveraging, and a political consensus on regulatory policy is developing despite the structural weakness of the European Union, divergent regional economic performances, and competing national interests.

#### *European Economies*

- Short-term financial instability risk has declined markedly in the last year aided by the ECB's long-term refinancing operations and commitments to Outright Monetary Transactions. Nevertheless, economic challenges persist in Europe. Progress is uneven and fragile with continued fiscal fragmentation.
- The European Union reported modest GDP growth in the second quarter following six consecutive quarters of contraction. There was considerable divergence in national results between such core countries as Germany and France and those in southern Europe that continue to experience slow or negative growth, high unemployment, and an increasing ratio of sovereign debt to GDP. The contraction since the beginning of the crisis is startling: Greece -23%; Italy -8.3%; Portugal -7.9%; and Spain -6.5%. Unemployment rates also differ widely, with recent German unemployment at 6.8% and Greece at 27%.

#### *Regulatory Coordination*

- Notwithstanding the strains on political cohesion and broad differences in economic outlook, a consensus on bank regulatory coordination is developing. Following general promises of enhanced oversight, the European Parliament conferred on the ECB primary supervisory authority over the 130 largest European banks beginning in the fall of 2014. Officials recognize the importance of a resolution mechanism to a comprehensive supervisory system, but the development of a strengthened institutional framework is proceeding more slowly in the face of legal challenges and the additional scrutiny associated with any scheme where taxpayer funds may be called upon to support cross-border resolutions.

#### *U.S. Banking Activity in Europe*

- Banks in Europe continue to pursue aggressive deleveraging programs through capital augmentation and shedding of less attractive assets. Leading banks in core European economies have achieved Basel III-compliant capital positions, but the Eurozone remains vulnerable to reduced credit availability as the contraction of bank lending is not being fully replaced by capital markets.
- Council members report that American banks remain cautious about the sustainability of the European recovery and are not acting aggressively to provide the credit withdrawn by continental banks. Investment banking arms of U.S. banks are providing increased services to European clients and are assisting financial firms in capital raising and asset dispositions.

## **Item 6: Student Lending**

### **How will the recent student lending legislation affect the banking industry?**

- Student loan market trends were last discussed by the Council as a part of its February 2012 agenda.
  - The Student Aid and Fiscal Responsibility Act of 2010 replaced private student loan programs that were guaranteed by the federal government with a program where loans were made directly by the Department of Education. As a result, most banks pulled out of the student loan market.
  - Federal loans now account for approximately 95% of originations with outstanding loans now exceeding \$1 trillion.
  - The share of 25-year-olds with student debt increased from 25% in 2003 to 43% in 2012, and over the same time period the average student loan balance among 25-year-olds with student debt grew by 91%. In 2012, for the first time in at least 10 years, 30-year-olds with no history of student loans were more likely to have home-secured debt than those with a history of student loans.
  - 90+ day delinquency rates for federal loans have increased from less than 10% of all borrowers in 2004 to approximately 17% of all borrowers, even with increasingly lenient repayment and forgiveness options. The long-term impact on the federal deficit may prove problematic.
  - Total tuition and room-and-board rates for full-time undergraduate students at degree-granting institutions increased by 32% from the 2005-06 to the 2011-12 academic year. High availability of subsidized federal loans granted without underwriting, ability-to-pay considerations, or full loan disclosures is thought to have made students and parents less price sensitive, which in turn has helped enable colleges to raise tuition faster than income growth.
- The Bipartisan Student Loan Certainty Act of 2013, which was signed into law in August, changed the interest rates for federal loans, lowering rates for most student and parent borrowers while largely reversing the pending increases for the lowest-priced loans.
  - Beginning July 1, 2013, interest rates for undergraduate, graduate, and professional loans will be set at origination for the life of the loan at a rate based on the 10-year Treasury note yield and a spread, subject to limits.
  - Lower rates on new federal loans will make it more difficult for banks to supplement direct federal loans. Accordingly, banks are continuing to exit the student loan market, and the federal government may have to play an even bigger role in funding new loans, thus reducing consumer choice and options.
  - While lower rates provide some relief to borrowers, the larger unaddressed issue is the rising cost of education and related principal increases in student loans, which impact the banking industry as creditworthiness deteriorates and borrowing capacity and consumer demand for auto, home, and other purchases declines. A generation of college graduates with a lack of expendable income could negatively impact the overall economy for years to come.
- In summary, too many students are graduating (or dropping out of school) with an unsustainable level of federal student debt. This bubble has many parallels to the subprime/housing bubble and is now having a significantly negative impact on students, the

economy, and taxpayers. Expiration of the Higher Education Act at the end of this year provides a natural opportunity to address structural issues in the current student loan market. Solving these structural issues should be based on constructive dialogue between regulators, lenders, and lawmakers.

### **Item 7: Low Interest Rates**

#### **How would the Council assess the impact of the current low-interest-rate environment on banks' risk management practices and on the composition of their balance sheets?**

- The low-interest-rate environment has narrowed profit margins on bank lending and has led to a shift in balance sheet composition. Historically, bank lending has accounted for approximately 75% of total bank credit, while security holdings have comprised the other 25%. Since the financial crisis, lending as a share of total bank credit has fallen and securities have risen. As higher-yielding assets have matured and lending has remained weak, banks have seen erosion in net interest margin.
- As banks have shifted from crisis mode to growth mode, the search for earning assets, stretch for yield, and pursuit of near-term net interest income has intensified. Accompanying this trend, most market participants have a view that the credit environment today is somewhat benign and that credit metrics are strong for new originations. The outlook for credit quality is quite positive, leading many market participants to a false sense of security on credit quality while masking potentially significant interest rate risk.
- Deposit inflows have been strong throughout this time period with little competitive pressure, helped early in the crisis by the TAG program and subsequently by the desire for safety and lack of higher-yielding "risk-free" alternatives. We believe many banks may not be as prepared for potential deposit outflows to higher-yielding instruments and business expansion activities as rates rise and the economy improves, resulting in a negative impact on capital, especially in light of new rules requiring greater liquidity and capital ratios.
- Our view of how this is playing out is:
  - *Heavy competition and often irrational practices in middle-market C&I lending:* Price and structure deterioration has been accelerating over the past several quarters. Given the modest economic recovery, we see continued caution among borrowers and, therefore, fewer new lending opportunities but significant refinance/repricing activity. This paucity has led to pricing compression across the credit spectrum. From S&P industry data, we have seen average spreads in C&I lending compress by 40 basis points (or 15% of the average spreads) since the market peak of late 2009 to levels not seen since 2004, and we expect further compression to occur. Structure deterioration is also evident by observing new institutional issue covenant structures, where "covenant-lite" deals have grown significantly over the past year. The same trends are occurring in traditional on-balance-sheet C&I lending as well.
  - *Fixed-rate on-balance-sheet lending, often at longer terms:* We have observed more willingness on the part of lenders to offer longer-term, fixed-rate loans to both consumer and commercial borrowers. We have seen this trend generally from smaller market participants.

- *Securities portfolio extension and increased loss risk:* The significant movement and volatility in long-term rates at the end of May/beginning of June highlighted the interest rate, duration extension, and Available for Sale (AFS) securities value at risk across the banking industry. The average AFS securities' unrealized gain/loss positions have swung to a loss for banks with assets less than \$50 billion as of 2Q 2013 after strong net gain positions, according to SNL and call report data.

Net Unrealized Gain AFS Securities					
	2Q13	1Q13	2Q12	% chg 1q13 to 2Q13	% chg 2Q12 to 2Q13
<\$10B	\$ (1,194,587)	\$ 6,567,694	\$ 7,131,988	-118.2%	-116.7%
\$10B - \$50B	\$ (39,128)	\$ 2,101,230	\$ 2,267,465	-101.9%	-101.7%
>\$50B	\$ 4,332,228	\$ 24,596,160	\$ 21,170,444	-82.4%	-79.5%

Source: SNL, Fed H.8 data

- Here are some statistics for banks with less than \$1 billion in assets (~91% of banks) and \$1-\$10 billion in assets (~8% of banks) as of June 30, 2013:

#### **Banks Under \$1 Billion in Assets**

# of Institutions — 6,126  
 Average Assets — \$222.1 million  
 Average Risk-Weighted Assets — \$146.2 million (66% of total assets)  
 Average Investments — \$50.9 million (23% of total assets)  
 Average AFS Investments — \$46.1 million (90% of total investments)  
 Average Unrealized AFS Net **Loss** — \$185 thousand (-0.4% of AFS)

#### **Banks from \$1 to \$10 Billion in Assets**

# of Institutions — 543  
 Average Assets — \$2.6 billion  
 Average Risk-Weighted Assets — \$1.8 billion (69% of total assets)  
 Average Investments — \$570 million (22% of total assets)  
 Average AFS Investments — \$495 million (87% of total investments)  
 Average Unrealized AFS Net **Loss** — \$567 thousand (-0.11% of AFS)

- To estimate the potential volatility due to interest rate shock, we used a sample of over 1,000 banks and thrifts to approximate market value changes.

#### **Projected % Change in Market Value (as of June 30, 2013)**

Rate Shock	Sample Banks	U.S. Treasury	
		3-Year	4-Year
up 100 bps	-4.6%	-2.9%	-3.8%
up 200 bps	-8.8%	-5.7%	-7.5%
up 300 bps	-12.9%	-8.5%	-11.0%

- In general, we would expect that, for a moderate increase in rates, these types of portfolios would have interest-rate-driven price exposure comparable to that of a 3-year Treasury. But as rates rise 200 or 300 basis points, certain securities extend duration, and this would result in price risk more comparable to that of a 4-year Treasury. Additionally, while this analysis provides a good estimate of how an average bank in these size ranges may perform, some institutions will be impacted to a much greater degree. Many banks are currently holding much larger securities portfolios relative to loans due to the scarcity of loan demand.
- These three key trends, coupled with the much improved credit quality performance and deposit flows, may be leading to more short-term focus on improving net interest income, net interest margins, and loan growth at the expense of sound long-term balance sheet and interest rate risk management. Although it is difficult to fully assess interest rate risks and balance sheet management tactics (fixed vs. float lending, securities durations, etc.), some insight may be gathered by looking at asset sensitivity (or 1-year repricing gap of assets-to-liabilities divided by assets) changes and net interest income/net interest margin trends. Looking at call report data we see the following:

Asset Sensitivity (1-yr Gap to assets)						
	Median			Wtd Avg		
	2Q13	1-Yr chg	3-Yr chg	2Q13	1-Yr chg	3-Yr chg
<\$10B	8.3%	1.1%	6.1%	11.2%	0.4%	5.1%
\$10B - \$50B	21.1%	-2.2%	2.3%	26.7%	-0.6%	4.2%
>\$50B	35.8%	4.4%	7.8%	35.2%	2.3%	7.8%

	Net Interest Income (\$000s)			Net Interest Margin		
	2Q13	1-Yr chg	3-Yr chg	2Q13	1-Yr chg	3-Yr chg
<\$10B	\$ 19,946,745	0.7%	10.6%	3.78%	-12	-8
\$10B - \$50B	\$ 8,888,512	6.6%	26.5%	3.70%	-3	0
>\$50B	\$ 66,911,505	-1.1%	1.2%	2.99%	-21	-41

- On asset sensitivity, a general observation may be that banks with higher percentages will generally have higher levels of floating rate loans and more low-cost core deposit funding. The opposite would generally be true for banks with lower or negative percentages. In the short term, this may generally mean that net interest income and net interest margins would be higher, grow faster, and experience less margin compression for low asset-sensitive banks vs. high asset-sensitive ones. The data may show a potential risk for banks less than \$10 billion (and to a certain extent \$10-\$50 billion banks) in the longer term, though shorter-term performance may look better.
- In summary, we believe that the Board should actively monitor the behavioral impact of an extended low-interest-rate environment on bank lending (pricing, structure, fixed/floating), liquidity gathering, balance sheet composition including securities mix, and interest rate risk management to assess the systemic risk to the industry as rates do eventually rise.



## **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?**

- Council members report continued economic recovery in their Districts, but gains are generally modest and economic outlook is dispersed by geographic region. Moreover, Districts report generally similar trends for industrial activity; trends in housing and employment vary significantly by region.
- Across most regions, manufacturing appears in line with positive trends reported by the ISM Manufacturing survey for August. Manufacturing activity in the Midwest has benefitted from gains in the auto industry as the average age of the auto fleet reached historic highs and financing remains widely available. Georgia (and to a lesser extent Louisiana) appears to be the beneficiary of various manufacturing plant relocations. Notable exceptions include the New England region, which continues to be impacted from muted growth in the Eurozone (a principal export market). While broad strength is seen in western states, California is experiencing slack due to unbalanced growth in Asia and weak demand for technology equipment, although third-quarter indicators are showing modest uptrends in both activity and sentiment measures. Notably strong West Coast segments are semiconductors, aerospace, and construction materials.
- Agriculture remains stable, with an expectation for commodity prices to fall. The health of the industry is expected to remain robust with sound balance sheets – the result of several years of strong food commodity price levels.
- Broadly, the oil and gas sectors have been positive contributors to economies in Louisiana, Texas, and North Dakota, with benefits extending into housing and employment. California, which had an overall .2% increase in unemployment, notes energy worker shortages. Wyoming has been adversely affected by falling coal prices.
- Housing strength is especially geographically dependent. In California, despite rising mortgage rates, housing activity continues to advance, as seen in rising mortgage purchase applications and near historic lows in new and existing home inventories. Conversely, much of the Eastern Seaboard appears to have missed the rapid recovery in home prices seen on the national level. Only Florida, Georgia, and the District of Columbia have registered double-digit gains as of June 2013. The hangover inventory of Florida housing has now been absorbed, often by institutional purchasers for use as rental. With the exception of New York, Massachusetts, and Maine, annual price gains in the New England and Middle Atlantic markets remain below 5% year-over-year. Home prices in Delaware and Mississippi have fallen slightly from last year; gains in some eastern states appear to be decelerating in recent months.
- Multifamily housing in several regions continues to be strong both in demand and new construction.
- Whereas the national foreclosure rate has improved to below 6% as of 2Q 2013, home foreclosure inventory in several states along the Eastern Seaboard has registered less than half the improvement seen nationally. In New Jersey, New York, and Vermont, the seriously delinquent rate peaked earlier this year but remains above 2009-2010 levels.

- While unemployment appears to be trending lower nationally, several Districts, particularly on the East and West Coasts, report slowing employment growth and in some cases rising unemployment.
- Anecdotal discussions with small business owners suggest that the Health Care Reform Act may be inhibiting business expansion and driving changes to workforce structure wherein temps and part-time employees are preferred over full-time employees in an effort to avoid breaching the 50-employee threshold.
- Concerns were expressed over recent data suggesting that high-quality full-time jobs lost in the recession are being replaced by lower-paying part-time jobs in the recovery. A recent Chamber of Commerce survey reported half of its respondents intended to reduce hours, reduce full-time employees, or replace full-time with part-time employees.
- Multiple regions report that negative impacts from federal spending cuts are beginning to materialize, especially in defense contractors, universities, and hospitals.

**Item 9: Monetary Policy**

**How would the Council assess the current stance of monetary policy? Please include the following matters in this assessment:**

**(a) the effectiveness of the FOMC's forward guidance on the duration of the current highly accommodative stance of monetary policy; and**

**(b) how best to ensure clarity and continuity for such communications in the future.**

- The current stance of monetary policy remains highly accommodative, with the target federal funds rate remaining at a record low of around zero and the Fed continuing to purchase large quantities of Treasury securities and MBS, which provides additional accommodation. The Council members believe that this monetary policy stance is warranted given that both inflation and employment are below the Federal Reserve's long-run objectives.
- To date, forward policy guidance has been an important and generally effective tool in maintaining the current stance of policy and preparing the markets for the expected gradual withdrawal of accommodation as economic conditions warrant. Indeed, the Fed has been effective in convincing markets that it is unlikely to raise the federal funds target rate anytime soon and, as a result, the term premium in the short-to-intermediate part of the yield curve remains very low by historical standards. The market has largely incorporated into its expectations that the FOMC will announce some QE3 tapering at the September 2013 meeting (with a minority view expecting action at the October 2013 meeting), with new QE3 purchases ending completely by approximately mid-2014. The FOMC's forward guidance regarding its plan to keep the federal funds rate exceptionally low at least until the unemployment rate falls below 6.5% as a result of job growth (expected to be late 2014 or early 2015 depending on forecasts), and until the 1-2 year outlook for the inflation rate increases to 2.5% or above, has been effective in keeping money market rates anchored near zero.

- However, despite this communication to the marketplace, anticipation of Fed tapering has already unwound the beneficial effect of quantitative easing on lowering long-term bond yields. The Federal Reserve's asset purchase program is estimated to have reduced the 10-year Treasury yield by about 80-120 basis points. Since early May, the 10-year Treasury has risen from a low of 1.65% to an average of 2.65% in August. The level in late August was slightly below 2.90%. As such, it appears that Fed tapering and an end to QE3 are effectively fully priced into financial markets.
- Effective communication around forward policy actions is particularly important in the current environment because of the continued fragility of the economic recovery, the expected upcoming transition to a new Federal Reserve Chair, and the need to coordinate (and understand the potential reactions to) forward guidance with respect to both asset purchases and the federal funds target rate. In recent months, the FOMC has made it clear that the start, duration, and speed of accommodation tapering will be dependent on the economy's path towards convergence with the FOMC's central tendency forecast. This data-dependent conditionality is a reasonable approach to monetary policy in the current environment, but it also has the potential to create confusion because markets will draw their own conclusions from the data and, therefore, market volatility can increase. Council members noted that this confusion and volatility has been exacerbated by the somewhat cloudy and conflicting statements made by FOMC members about the likely path and triggers for the withdrawal of accommodation through reduced asset purchases and increases in the federal funds target rate, as well as the fact that there is expected to be a change in leadership at the FOMC in the coming months. In the Council's view, greater consistency, simplicity, and clarity concerning the FOMC's forward guidance would both improve the effectiveness of the guidance in achieving its objectives and reduce the potential for unintended consequences.
- For example, looking forward to when tapering begins, it would be beneficial for the FOMC to take proactive steps to anchor expectations for the near- and medium-term path of policy in order to minimize potential confusion regarding the wind-down of asset purchases. It would be helpful for the FOMC to explain why the amount of initial tapering was chosen and to provide, to the fullest extent possible, clear guidance on the likely number, size, and timing of additional tapers expected. It also would be helpful for the FOMC to provide additional clarity regarding which input/forecasts will be considered in assessing whether the 1-2 year outlook for the inflation rate has breached the committee's 2.5% threshold.
- Similarly, greater clarity would be helpful regarding how the FOMC expects to respond when the unemployment rate reaches the 6.5% level identified, as some uncertainty exists as to whether reaching this threshold would result in an increase in the federal funds target or a reassessment of that target. Some members suggested that one way to increase clarity would be to combine the current unemployment rate guidance with date-based guidance indicating when the 6.5% threshold is expected to be reached. The date-based guidance could be updated periodically (such as quarterly) based on incoming data.

**12:00 Luncheon for Council and Board Members in the Board Room**