RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, December 6, 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?

- Continued excess balance sheet capacity is causing loan tenor, structure, and pricing to deteriorate in many categories. Credit on short-term business loans remained accommodative according to the National Federation of Independent Business (NFIB). For sophisticated commercial clients, banks are encouraging interest rate swaps rather than committing their balance sheets to interest rate risk. Evidence of liberal terms include loans that previously required owner's unlimited guarantees now being accepted with limited or no guarantees, and companies without retained earnings leveraging by borrowing against depreciated assets.
- Business loan demand is increasing, but the rate of growth remains muted. Many businesses continue deleveraging and reflect elevated liquidity. Hindrances to corporate capital investment and expansion include an uncertain economic outlook, exacerbated by political gridlock affecting the federal debt ceiling, entitlement and tax reform, regulatory burdens, and health-care concerns. No near-term changes are expected in this outlook.
- Two categories that have continued to improve over recent months are consumer loans and commercial real estate lending. One member reported moderately increased loan activity stemming from moderate capital expenditures and small acquisitions. Interestingly, the FDIC Quarterly report for September 2013 showed the category with the largest increase to be loans to states and municipalities, which grew $7.5 billion (7.3%).
- The same FDIC report also showed that banks are very liquid: total loans amounted to 69% of deposits. Banks reported a $204.7 billion (21.7%) increase in banks' deposits with the Fed, which now exceed $1.1 trillion, or 7.9% of industry assets.
- The same NFIB report showed loan losses have continued to drop dramatically in all categories across virtually all banks: "Net charge-offs totaled $11.7 billion, down 47.4% from the third quarter 2012. Banks set aside $5.8 billion in provision, down 60.4% from 2012, the smallest quarterly loss provision reported by the industry since third quarter 1999."
- In New England, there are reports that small banks are being pushed towards consolidation by cost pressure from regulatory burdens.
- California showed stronger demand for new loans when compared with other U.S. regions.
- Members report that securities dealers are no longer making markets in certain asset classes and generally are not positioning sizable bond inventories.

- Equity markets continue to post record price levels across broad categories, based primarily on expansion of price-earnings valuations.

(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 availability for small business is abundant. Members of the Consumer Bankers Association's small business subcommittee report that smaller community banks are willing to extend out maturities to win deals and reduce rates in order to hold existing term loans from refinance.
- Members reported an easing in lending terms for small businesses in the latest quarter.
- Small business loans nationally total about $586 billion, down 18.6% from 4Q 2008. Past-due loans, non-accrual loans, and charge-offs are highest (not in dollars but in percent) in this sector, and many small businesses are struggling to maintain margins, profit, and revenue growth.
- The pace of growth in small C&I loans remained below that of larger-sized loans. As a share of total C&I loans, small loans accounted for 22% in the second quarter compared to 2007, when this share was 30%.
- Lending to medical and dental practices has shown strength. Pricing trends and liberal structure of loans in this segment was also noted as a future concern.
- The NFIB October Small Business Optimism Index was 91.6 in October 2013, down 2.3 in the month, the second consecutive monthly drop. One bank's fall 2013 Small Business Economic Outlook reports that three out of four small and midsized business owners do not intend to hire new employees or seek new loans during the six months because of uncertainty about their sales and the U.S. economy.
- Most small business owners remain concerned about uncontrollable operating costs (*e.g.*, health-care premiums).

(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?

- New lending continued to outpace maturities and dispositions in the third quarter.
- The commercial real estate market continues to reflect improved performance and sound fundamentals. Notably, part of the improvement is due to an absence of speculative construction and a very conservative lending environment from 2009 to 2012. Positive employment growth and historically low interest rates have translated into lower vacancy and generally higher rental rates. Valuation could be reduced with the prospect of higher financing costs.
- Potential areas of concern include multifamily rental housing (apartments), which has seen the most significant jump in both new construction and values, and retail properties, which continue to be impacted by Internet shopping and cautious consumer spending.
- Specific mention was again made that revival of the commercial mortgage-backed securities markets is vital to the overall availability of capital to commercial real estate

investors. Commercial mortgage-backed securities issuance has revived to $60.5 billion year-to-date September 2013, but there is continued uncertainty of Dodd-Frank Act risk retention rules, especially in light of the recently revised risk retention mortgage proposal.

- Challenges continue for financing retail and office properties, particularly those lacking credit tenants and/or long-term leases. Hotels have continued improved fundamentals, a trend that began in 2011. Revenue-per-available room (REVPAR) now exceeds pre-recession levels and investor interest has returned.

(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?

- Demand for construction loans has increased. At this point there is no expectation that demand will translate to a large increase in construction loan commitments as recently completed projects are experiencing strong leasing demand and are either quickly sold or refinanced in the secondary market.
- The supply and availability of credit for commercial real estate construction projects remains ample and increasing in some reports but varies by both property type and location. For example, there is an oversupply of credit for multifamily residential. Conversely, the credit for speculative office or retail development remains subdued.
- Members report few requests for office construction, with more requests in multifamily and retail construction.
- New residential construction lending remains at very low levels relative to pre-2008, but is returning in some metropolitan areas. Publicly traded homebuilders, including some that have recently completed IPOs, are acquiring regional homebuilders for their lot supply.
- A potential future downside risk to real estate developers may be the classification of construction loans under Basel III as High Volatility Commercial Real Estate (HVCRE) for the purposes of capital ratios.

(D) Agricultural Lending:
Have there been any recent changes in agricultural lending?

- There has been minimal change in the agricultural sector over the past quarter. Grain farmers continue to do very well and have reduced leverage overall. After a slow start, spring plantings were made and growing conditions improved. Predictions are for record harvests in many regions, but at much reduced crop prices. The cattle herd is at very low levels – 89 million heads in 2013 compared to 97 million heads in 2006.
- Commodity prices have retreated back to, or in some cases below, the cost of production, which will temper profits for this year and next year.
- Land prices continue to remain high; however, the acceleration of price inflation has slowed and for the first time in years, prices are flat and may be receding. While there are few reports of highly leveraged purchases of farmland, valuations would be impacted by a general rise in interest rates.

- Borrowing demand is generally weak, reflecting lower commodity prices, better-capitalized farming operations and processors, and strong farm income in recent years. Lower commodity prices and volatility have also reduced demand for margin calls on hedged inventory.
- Members reported concern about the lack of certainty on passage of a federal farm bill and the resulting impact on agriculture, which depends on certain federal programs for both direct support and as a safety net.

(E) Consumer Lending:
What changes have you seen in consumer lending?

- Consumer lending volume in September grew 3.1% year-over-year, and the rate of loan growth has in fact been accelerating over the last several months. Next year growth is projected to be 3.8%. While consumer lending still remains 5% below pre-recession levels, consumers appear to be moving forward with spending. The most current Federal Reserve survey reflects little growth in credit card balances, but continued growth in auto loans. Auto loans were up 12.8% in September, and with auto sales projected at 16 million units, demand should remain robust through the next year.
- Several members noted concern that current advance rates substantially exceed the ready-market value of autos at the time of purchase and that the typical term of loans continues to lengthen.
- More generally, however, consumer credit quality remains strong, having surpassed pre-recession levels. By some measures, consumers continue to deleverage: debt service to disposable income is now 15%, down from 18%. Credit card issuers continue to underwrite loans conservatively and have not reversed the significant tightening from 2008 and 2009. According to Equifax, bank card delinquency rates were just 1.8% in September, the lowest level on record.
- According to the Associated Industries of Massachusetts, one major recent development is that increasing home values have restored the option for many households to borrow against home equity rather than other categories of borrowing at less-favorable rates, such as rates for college loans.
- Guidance and rulemaking by the Consumer Financial Protection Bureau (CFPB) has created additional expenses and resource drains in an effort to meet the guidelines. Uncertainty of anticipated rules and current compliance could affect consumer lenders' goals and strategy. In auto lending specifically, the CFPB guidance has created strained relationships between lenders and dealers while each attempts to comply.

(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?

- Housing prices continue to recover, rising 11.7% year-over-year. Investor purchases were a substantial factor in reducing unsold homes.
- All 20 MSA's in the S&P/Case-Shiller Home Price Indices continue to show month–over-month and year-over-year increases; however, the rate of these increases has slowed.

- Some seasonal slowdown through the first quarter of 2014 is expected. In the third quarter of 2013, single-family home prices rose in 144 of 163 metropolitan areas according to the National Association of Realtors. The median price for an existing home was up 12.5% year-over-year in the third quarter.
- According to the National Association of Realtors, tight lending standards have been a particular impediment to single homebuyers (as opposed to couples). Historically, single buyers have made up over 30% of the housing market. In 2012 and 2013 they were just 25% of the housing market.
- The level of home purchase transactions appears to be entering a more traditional pattern of lower volume during the late fall and winter months. A shortage of existing home inventory (defined as less than six months' absorption) is appearing in a few markets. However, most markets are close to a "balanced" 6-month supply.
- Home sales slowed during the fall, and home mortgage refinance continued to slow considerably due to rising interest rates.
- Some banks have been offering 30-year fixed jumbo mortgages more than 25 basis points below GSE conforming rates, reflecting balance sheet appetite/excess capital.
- Extensive resources (human and financial) are being devoted to planning and implementation of the broad, sweeping CFPB mortgage regulations that go into effect in January 2014. Next year banks will face new regulatory guidelines with Qualified Mortgage (QM) and ability-to-repay guidelines.

(G) Mortgage Foreclosures:
What changes has the Council seen in the pace of mortgage foreclosures during the past three months?

- The pace of mortgage foreclosures continues to abate substantially, as have delinquency rates. According to CoreLogic, there were 48,000 completed foreclosures in August 2013 compared to 72,000 the previous year. Approximately 939,000 homes were in some stage of foreclosure as of August 2013 compared to 1.4 million the previous year. As of August 2013, the foreclosure inventory represented 2.4% of all homes with a mortgage compared to 3.3% in July 2012. The inventory of foreclosed homes has declined by at least 20% year-over-year for eight consecutive months.
- The Mortgage Bankers Association (MBA) reports the percentage of loans on which foreclosure actions were started during 3Q 2013 decreased to 0.61% from 0.64%, reaching the lowest level since early 2007 and less than half of the all-time high of 1.42% reached in September 2009.
- Furthermore, as of September 2013, 5.2% of residential mortgages are in serious delinquency (that is, 90 days or more past due, including those in foreclosure or REO) according to CoreLogic, which represents a 26% decline from the previous year.

<u>Item 2</u>: <u>Affordable Housing</u>

In light of cutbacks in government funding and the diminished role of Fannie Mae and Freddie Mac, how are affordable housing concerns being addressed and are there recent examples of successful affordable housing initiatives?

- Generally, consumer access to credit remains constrained for lower-income borrowers. Although banks have relaxed underwriting criteria somewhat in recent years, banks have been slow to loosen credit standards. In most markets, home affordability is at an increased level; however, lower home prices continue to make it difficult for many borrowers to refinance or sell homes.
- As the GSEs' participation has diminished, FHA's role as the primary lender in the affordable housing segment has expanded throughout the recession. More recently, some private lenders have started offering low-down-payment portfolio loan products. However, the increased role of FHA and private lenders is not sufficient to offset the decreased role of the GSEs.
- Resources through traditional affordable housing programs, such as those providing down-payment assistance, have diminished, with less government funding available for such programs. Banks are pursuing various approaches to meet the needs of their communities, including working with nonprofits focusing on affordable housing, supporting community development corporations, and collaborating with housing agencies.
- Implementation of Ability-to-Repay/Qualified Mortgage (QM) rules has the potential to significantly constrain access for non-QM loans. The 43% debt-to-income maximum for QM will likely curtail mortgage credit to low-income borrowers, and those with irregular or nonwage income may be similarly impacted. The significant costs to comply with the regulations are likely to increase rates for borrowers, further pressuring affordability.
- Moreover, while the minimum requirements for mortgage loans are still evolving, the perceived cost of servicing lower-balance mortgages combined with a somewhat higher likelihood of default could further constrain lending to low-to-moderate income borrowers.
- Statutory rate maximums (FFIEC) have reduced the ability to profitably supply credit to higher-risk borrowers, resulting in significantly reduced access to real estate financing in this segment.
- In light of more limited opportunities for homeownership, some borrowers have opted into the rental market. Fannie Mae and Freddie Mac have continued to play a significant role in financing multifamily housing, which provides housing at rental rates that are affordable to most low- and moderate-income families. However, FHFA has mandated a reduction in the GSEs' participation in this market for 2014, and additional future reductions are possible.
- The following are examples of various efforts to address affordable housing either noted or facilitated by Council members:
    1. The Federal Home Loan Bank's (FHLB) <u>Affordable Housing Program</u> (AHP) is a competitive grant program that provides FHLB member institutions the opportunity to partner with local developers and community organizations seeking to build and renovate housing for low-to-moderate-income American households.
    2. The <u>Section 42 Low Income Housing Tax Credit</u> (LIHTC) has been a long-term and successful affordable housing program. The program is currently thriving and has a relatively deep investor base that includes primarily banks and insurance companies, with growing interest from other types of investors like technology and telecommunications firms.
    3. The <u>Healthy Futures Fund</u> (HFF) is a $100 million investment fund that attempts to co-locate health-care centers with affordable housing. HFF will eventually support

the construction of six to seven affordable housing projects that are integrated with federally qualified health centers serving 75,000 people. Financing comes in the form of Low Income Housing Tax Credits, New Markets Tax Credits, and private lending capital.

4. The Bay Area Transit Oriented Affordable Housing Fund is a $50 million loan fund that finances land acquisition, development, and construction of housing and community facilities around transit hubs in the San Francisco Bay Area.
5. Mortgage Revenue Bond Programs (aka Bond Programs) are offered by Housing Finance Agencies at the state and county levels. These are first-mortgage products offered to support affordable lending to low-to-moderate income borrowers and those purchasing within targeted census tracts in an effort to increase homeownership. Bond programs offer higher Loan-to-Value first mortgages that are often utilized with a form of down-payment assistance to pay for the borrower's down payment, closing costs, and/or prepaid finance charges.
6. Down Payment Assistance (DPA) programs, in which Council members participate throughout the country, are offered by states, local municipalities, and nonprofit organizations. These programs are also referred to as community seconds, affordable seconds, or silent seconds. DPA programs come in a variety of forms such as grants, liens, or reduced sales prices; however, the typical DPA program is offered in the form a secondary lien to eligible low-to-moderate income borrowers to pay for down payment, closing costs, or pre-paid finance charges and usually has little to no interest charged, with the loan being forgiven over a period of time (*i.e.* 5 years, 10 years, etc.).
7. Mortgage Credit Certificates (MCC) programs provide low-to-moderate income, first-time homebuyers in eligible locations a federal income tax credit. The tax credit is used to reduce the amount of federal income tax homeowners pay to qualify for the loan. The MCC program is administered by a city, county, or local housing authority in the eligible geographic locations.
8. Individual Development Accounts (IDAs) programs are a matched savings program whereby the prospective Low-to-Moderate Income Borrower (LMIB) works with a municipality or nonprofit organization to save money for homeownership over a specific period of time (*i.e.* 6 months, 1 year, etc.). Upon achieving the savings goal, funds are matched at a 3:1 or 4:1 ratio to assist with down payment, closing costs, or pre-paid finance charges.
9. Portfolio Lending Products are first-mortgage portfolio lending products specific to Low-to-Moderate Income Borrowers (LMIB) purchasing in a Low-to-Moderate Income Tract (LMIT). The product is available to specific geographic locations within Community Reinvestment Act (CRA) Assessment Areas and offers financing of up to 97% Loan-to-Value (LTV) with a maximum Combined Loan-to-Value (CLTV) of 105% when a community/affordable second mortgage is utilized. Borrowers attend homebuyer education to prepare prospective homebuyers for homeownership.
10. Grant Programs provide assistance to low-to-moderate income borrowers in the form of a grant and are available to specific geographic locations within CRA Assessment Areas. The grant may be utilized to pay for closing costs and/or prepaid finance charges.

<u>Item 3</u>: <u>Liquidity Coverage Ratio</u>

The Board and other federal bank regulators recently proposed a standardized minimum liquidity requirement (liquidity coverage ratio) for large and internationally active banking organizations and systemically important nonbank financial companies designated by the Financial Stability Oversight Council. What are the Council members' views on this proposal, including its potential effects on competition, domestically and globally; on the operations of banking organizations; and on the availability of credit to businesses, households, and municipalities?

- The Council supports the objectives of the liquidity coverage ratio (LCR) proposal, which is designed to help address the liquidity problems that became evident during the financial crisis. However, the Council has a number of significant concerns with the proposal, many of which flow from the significant divergences between the U.S. proposal and the Basel III LCR framework.
- Unlike the Basel III framework, the proposal would require LCR banks to compute their ratio on a daily basis using the estimated "worst-day" net outflow over a 30-day horizon.
  - Requiring daily calculation of the LCR is both operationally burdensome and has the potential to understate available liquidity because daily variations in working capital are a normal part of sound business management. The operational burden is substantially magnified for banking organizations that are not required to report liquidity information to the Federal Reserve on a daily basis, particularly in light of the proposed January 1, 2015, implementation date.
  - Council members generally viewed the "worst-day" calculation requirement as unrealistic and punitive, especially in light of the mandated outflow/inflow rates and timing assumptions included in the proposal for the uninsured portions of retail deposits, retail deposits with terms greater than 30 days, brokered deposits, and instruments with call or notice features.
- The proposal also fails to appropriately take into account unique aspects of the U.S. financial system. For example, the 15% haircut imposed on GSE obligations and the inclusion of these obligations in the 40% cap on all Level 2 assets fails to adequately reflect the proven liquidity value and observed price behaviors of GSE obligations, even in times of severe stress. This will reduce demand for GSE mortgage-backed securities and may negatively impact the availability and pricing of mortgages. The proposal also does not appropriately reflect the important liquidity role played by the Federal Home Loan Banks in the U.S. financial system.
- Council members were especially concerned about the potential impact of the proposal on state and local governments. The proposal would inappropriately treat state and local government collateralized deposits ("preferred deposits") like repurchase agreements, forcing banks to assume these deposits are "unwound" in calculating their LCR ratio. As a result, state and municipal government will find it more difficult and more costly to maintain their banking relationships. In addition, the proposal would restrict the market for municipal securities by completely excluding all such securities from the definition of

high-quality liquid assets (HQLA), even though the Basel III framework would allow qualifying municipal securities to be treated as Level 2 HQLA.

- The proposal also would benefit from a more granular treatment of certain types of lines of credit.
    - For example, the agencies should revisit the 100% outflow assumption required for asset-based credit facilities extended to manufacturing and service companies through the use of special purpose entities. These facilities, like credit facilities extended directly to a manufacturing or service company (which receive a 10%-30% outflow assumption), support the general working capital needs of nonfinancial borrowers while allowing banks to reduce their risk through the use of a bankruptcy-remote entity.
    - In addition, the agencies should better calibrate the outflow assumption for committed lines to U.S. and foreign mutual funds to better match historical experience and the similarity of these lines to corporate funding lines.
- The proposal indicates that the "modified" LCR is intended to apply to bank holding companies that have more than $50 billion in assets, but that have simpler balance sheets, are less complex in structure, and are less reliant on riskier forms of market funding. The advanced approaches threshold used for application of the full LCR, however, captures certain regional banking organizations that would appear to meet each of these criteria, creating the potential for the differential treatment of banking organizations with similar business models and liquidity risk profiles. Council members also expressed concern that supervisory and market expectations likely would result in the LCR effectively being pushed down to institutions with less than $50 billion in assets.
- Guidance is also needed regarding the liquidity flows related to U.S. broker-dealer client money protection (*i.e.*, lock-up). Flows into and out of segregated accounts used to protect clients from broker-dealer credit risk can be a significant part of overall funding sources and uses, and their treatment under the LCR should be clarified in the final rule.
- In closing, the Council has several particular strategic questions about the LCR:
    - Why are asset levels used to determine the level of LCR compliance? There could be unintended consequences, such as implying that the larger financial institutions need more liquidity without a regard to their risk profile.
    - Could the LCR implementation water down monetary policy? Currently, much of the liquidity that has been pumped into the economy has been re-deposited at the Fed.
    - Under the LCR implementation, if corporate deposits are drawn down due to higher rates or capital expenditures, banks will have to borrow to replace Fed deposits or *cut back on lending*.
    - Why not include mortgage-backed securities? Not including those securities would reduce investment in mortgages and would not use what has been a very liquid asset.
    - Are we simply pre-funding the discount window, which was invented to take care of liquidity crises?
    - The LCR does not fund holding companies or investment companies that are wholesale funded.
    - The LCR could be our primary constraint when combined with Basel III and a potential leverage ratio requirement. This could depress our economy by restricting lending growth.

<u>Item 4</u>: <u>Shadow Banking System</u>

New regulations have raised concerns for some commentators about driving banking activities to the so-called shadow banking system. However, exactly what is meant by "shadow banking system" and how regulations might lead to this result are somewhat unclear. In the Council's view, what is the shadow banking system and are there examples of banking activities migrating to this system? How does competition from the shadow banking system affect traditional providers of banking services, particularly with regard to balance sheet funding of loans?

- The term "shadow banking system" encompasses a wide variety of entities that engage in credit, liquidity, and maturity transformation outside the insured depository system, generally without explicit access to central bank liquidity or public-sector credit guarantees and with varying degrees of regulatory oversight. The term "nonbank financial intermediation" is more representative of the expansive nature of the activities conducted in the system and includes the credit, funding, and payment activities in this space. The degree to which shadow banking entities add risk to the system is largely based on how an entity is regulated and its ability to leverage. Examples of such entities include hedge funds, securitization vehicles/conduits (including Fannie Mae and Freddie Mac), private equity firms, sovereign wealth funds, mortgage/finance companies, nonbank affiliated securities dealers, pension funds, real estate investment trusts (REITs), insurance companies, and money market funds.
- From 1945 until 2007, there was explosive growth in the shadow banking system according to information released in the Federal Reserve Flow of Funds Guide. The credit and deposit disintermediation out of the insured depository system and into this less-regulated nonbank space caused a misallocation of capital that significantly contributed to the severity of the financial crisis. Most experts agree that the shadow banking system at the height of the crisis was at least as large as the traditional banking system and the system continues to grow today.
- In a March 2012 Wall Street Journal Op/Ed piece entitled "Financial Crisis Amnesia," former Treasury Secretary Geithner wrote in support of the sweeping financial reforms noting that "a large shadow banking system had developed without meaningful regulation," pointing to trillions of dollars in short-term debt to fund inherently risky financial activity, vast derivatives markets with little transparency or oversight, and skyrocketing household debt originated with little to no supervision and poor consumer protections.
- The participants in the shadow banking system still are not subject to the same capital, safety and soundness, and consumer protection standards as their bank competitors. Many also lack the operational integrity of financial institutions that are subject to consistent regulatory oversight and supervision. Consequently, as more credit intermediation activities move toward shadow banking, financial market transparency is being reduced and systemic risk is on the rise, despite the steps taken as a result of the financial crisis.
- In recent years, capital and liquidity requirements, along with expanding consumer protection regulations, have had an impact on the balance sheet size and business mix of

regulated financial institutions. Banks have been actively reducing balance sheets, and unregulated and less-regulated nonbanks are stepping in to provide credit intermediation services that banks no longer provide or provide at lower volumes. These less-regulated shadow banking entities often offer lower-cost and less-structured loans than the risk would warrant. In addition, many nonbanks are actively marketing new payment and deposit-like offerings with minimal regulatory oversight.

- Council members and other bankers across the United States cited the following examples of financial activities currently migrating to the shadow banking system:
    - Shared National Credits – Between 2000 and 2012, nonbanks' share of the Shared National Credit program rose from 8.4% to 19.7%, with commitments up from $172 billion to $593 billion. Many of these loans are leveraged loans and are covenant-lite. Problem loans in Shared National Credits, even during the financial crisis, were largely confined to nonbank lenders.
    - Business Development Companies (BDCs) – BDCs and other investment vehicles have been quite active. For example, BDCs are buying high-yield loans at a discount from banks, resulting in loans that originated within a regulated entity becoming part of the unregulated market. The amount of U.S. BDCs, specialty finance companies, and REITs jumped from $779 billion in 2008 to $1.22 trillion in 2Q 2013 according to SNL Financial.
    - Small and Medium-Sized Enterprises (SMEs) – While large companies can access credit outside the banking system by issuing bonds or other debt in the public market, SMEs often do not possess the critical size to do so. Different market-based financing structures have emerged to enable nonbank investors to provide financing to SMEs and other borrowers. Private equity firms are building sizable middle-market loan funds.
    - Mortgage Servicing Rights (MSRs) – As a result of capital constraints, banks are selling MSRs to nonbank buyers. Shares of two of the most active buyers have plunged recently as investors and analysts have expressed concern that these firms are growing at such a rapid pace that they are becoming too difficult to manage.
    - "Peer-to-Peer" Lending – There has been a significant rise in consumer lending by nonbank entities and individuals who are not subject to the same consumer protection laws and regulatory oversight as banks. With a total portfolio of $2.7 billion, Lending Club, as an example, originated $200 million of consumer loans in September 2013, up from $77 million year-over-year.
    - "Peer-to-Peer" Lending Securitization – In an important development, a New York hedge fund in October took some of its Lending Club loans and sold them in a $53 million securitization, thereby providing the liquidity to continue to broaden this market.
    - Deposit Advance Loans – Recently finalized regulatory guidance on deposit advance products may deter banks from providing these products to deserving, qualified clients, thereby driving them to unregulated alternatives, such as payday lenders and check cashers.
    - Transaction Processing – An increasing number of consumer and business transactions are being handled by e-commerce participants. A transformation in the payment space is underway, and nonbanks are capturing this business without the same regulatory oversight as their bank competitors.

    - Nontraditional Deposit Providers – Regulations that shifted the cost of the payment system from merchants onto banks have made servicing many depository customers unprofitable. As banks increase fees, more consumers will look to nontraditional providers that on the surface may appear less expensive, but may in fact be more expensive.
    - Corporate Deposit-Like Offerings – Large corporations under an SEC registration are offering deposit-like products to consumers. As an example, a large energy company offers a short-term investment product, promoted as a "direct investment in the company's debt obligations and providing investors with a competitive floating rate of interest that is very favorable compared to alternatives like bank accounts." The product looks very similar to a traditional bank checking account.
    - Money Market Funds – Significant capital has flowed out of the banking system and into money market funds, raising questions about the comparability of supervision.
    - Credit Unions – Substantial loans and deposits are now held at credit unions, which operate on significantly different regulatory guidelines than banks.
- Consequently, as we experienced clearly in the period leading up to the Great Recession, the shadow system has two major impacts. First, the absolute risks in the asset and liability categories, such as mortgage securities, can be in and of themselves enough to create major systemic capital misallocation and destruction. Less apparent is the implicit impact on the assets and liabilities of regulated banks. Because banks compete with the shadow system in the open marketplace, assets and liabilities that are underpriced relative to the real risk (*e.g.*, triple-A mortgage securities that are really triple-F) put enormous pressure on banks to cut prices and take too much risk in an attempt to compete. We are seeing that behavior already post-crisis in key sectors, such as commercial real estate and leveraged lending. Of course, the more heavily banks are managed and regulated, the more assets and liabilities will move to the shadow system, creating more systemic risk.
- The Council believes that elements of the shadow banking system are a significant and growing source of risk. This assessment is especially true when the nonbank channels are structured to perform bank-like functions (*e.g.*, maturity transformation and leverage) and when their interconnectedness with the regular banking system is strong. Secured funding in the form of repurchase agreements and securities lending directly tied banks to the shadow banking system during the financial crisis, and it still exists today. The question for policy makers now is how traditional views of capital adequacy, safety and soundness, consumer protections, and recent financial reforms can be applied effectively across the spectrum of banks and nonbanks that collectively contribute to the stability and well-being of the U.S. financial system.
- The Council recommends that the Federal Reserve Board encourage the FSOC to move quickly to do the following:
    1. Develop a process or system that centralizes shadow banking activities such that risks can be aggregated, integrated, and correlated. For example, secured lending activities could be directed to a common utility (analogous to central clearing) that could centralize transaction data and information for reporting purposes. (Given that hedge funds greater than $150 million have to register with the SEC, this agency could be a logical place to begin such a process.)

2. Take decisive action to reduce system risks in major intermediary categories, such as money market funds. Specifically, encourage the SEC to implement the floating net asset value requirement for both institutional and retail money market funds.
3. Monitor closely the emerging shadow payment system and consider ways to reduce the systemic risks inherent in such diverse and sprawling systems.
4. Work with other regulatory agencies to finalize the risk retention rules mandated by section 941 of the Dodd-Frank Act.
5. Encourage the CFPB to hold nonbanks to the same standards as traditional banks by accelerating plans to supervise these entities.
6. More closely regulate institutions with substantial counterparty risk.

Item 5: Incentive Compensation

What are the views of Council members on incentive compensation practices at banking organizations in light of recent regulatory guidance?

Background

- Recent regulatory guidance has been provided via the banking agencies and their Interagency Guidance on Sound Incentive Compensation Practices published in June 2010. This publication provides three guiding principles relating to compensation to protect the safety and soundness of banking organizations:
    1. Balanced Risk Taking Incentives: Incentive compensation should provide employees with incentives that balance risk and reward and do not motivate them to take imprudent risks.
    2. Effective Controls and Risk Management: Processes and controls should reinforce and support these balanced incentive compensation arrangements.
    3. Strong Corporate Governance: Corporate governance should be strong and oversight by the board should be effective and active to help ensure sound compensation practices.

Key achievements

- Boards, management, shareholders, and regulators of U.S. banks all understand the importance of providing incentives that appropriately reward employees for performance and, at the same time, balance the risks they take to achieve it. Since the financial crisis, boards and management have made significant efforts to better balance risks with rewards. These changes were driven by a combination of the Federal Reserve's guidance and a shared view among boards, management, and shareholders of the benefit of mitigating inappropriate risk-taking. These changes, while not universal to all U.S. banks and not applied consistently, include the following:
    - Improving Incentive Compensation Program Design
        - Balanced Fixed and Variable Pay: Pre-crisis, base salaries were small in proportion to bonuses, which comprised a majority of total pay in the financial services industry. Post-crisis, overall compensation levels declined and base salaries increased.

        - Increased Deferrals: Since 2008, management at almost all banks has deferred compensation, and a more significant portion of variable compensation has been deferred over a multiyear period. Deferrals at large banks now range from 25% to 100% of bonuses, and awards are typically deferred over a three-to-five year period.
        - Equity and Performance-Based Awards: Banks have increased the portion of bonuses granted as equity and other forward-looking performance-based awards.
        - Clawbacks: New provisions allow banks to claw back deferred compensation in adverse circumstances (*e.g.*, financial losses, inappropriate oversight of risk, violation of risk policies, and personal misconduct).
    - Enhancing Processes and Controls
        - "Covered" Employees: Banks have established processes to identify individuals, including senior management and other "risk-taking" personnel across the organization, and to document decisions on their compensation.
        - Risk Adjustments: Banks have formalized processes to consider and document risk management and risk outcomes in incentive compensation decisions, including clawbacks of previously awarded compensation.
        - Cross-Functional Collaboration: Human resources, legal, finance, audit, and risk management personnel collaborate on the design, operation, and monitoring of incentive programs.
        - Control Function Independence: Compensation decisions for individual control functions are made independently of the businesses that they support.
    - Strengthening Corporate Governance Frameworks
        - Increased Board Engagement: Board engagement on compensation, both as a whole and at the committee level, is more robust, specifically in reviewing senior management compensation and funding of compensation plans.
        - Expanded Role of Board Compensation Committee: Compensation committees' focus has expanded beyond executive compensation to also include a review of broader-based incentive compensation programs.
        - Regular Compensation Committee Updates: Compensation committees receive frequent updates on the regulatory environment, changes to compensation programs, and compensation clawbacks.

Key challenges

- Two key challenges arise from regulation of compensation practices.
    - Multiple Regulatory Frameworks: Complying with different jurisdictional standards is a challenge for global institutions.
        - For example, the U.S. Interagency Guidance adopts a principles-based approach and recognizes there are multiple levers to balance risk and rewards, while EU rules take a more prescriptive approach to regulation by specifying required deferrals and pay mix.
        - Different compensation structures among colleagues performing similar job functions in different jurisdictions can create friction.

    - Prescriptive rules limit flexibility to design incentive programs that support the organization's specific strategy and contribute to talent-management challenges such as retention and recruitment issues.
  - Inconsistent Application of Guidance: Within the U.S., some institutions are disadvantaged relative to others as a result of inconsistent application of standards.
    - For example, there are competitive pressures from organizations (*e.g.*, hedge funds, independent asset managers) that operate in the same market as banking organizations but are not subject to the same constraints. Typically, nonregulated institutions have extremely modest or no compensation deferrals and no clawback provisions.
    - Even among regulated institutions, regulators have focused on larger institutions, specifically G-SIFIs, which can create anomalies among competitors subject to the same regulatory regime. For example, informal Federal Reserve feedback to larger banking organizations has in certain cases become prescriptive on the use of stock options, leverage, and ROE targets in performance-based incentives.

Conclusions and next steps

- Significant changes have been made to incentive programs and processes, and in many cases, the changes exceed what was anticipated or requested. These changes have led to drastically different compensation structures and levels for employees. More importantly, these compensation practices are contributing to a meaningful change in behavior, particularly among financial institutions.
- The Council strongly believes a principles-based approach is constructive, fair, and commercial and will lead to a greater balance between risk and rewards at banking organizations.
- Given the significant changes to compensation to address regulator input, the Council believes that time should be allowed for such changes to be fully implemented, digested, and understood by both regulators and banking organizations before any further guidance or changes are proposed.

Item 6: Corporate Governance

How has corporate governance at banking organizations changed since the financial crisis and the Dodd-Frank Act?

- Council members, regardless of the size of their institution, agree that corporate governance practices at banking organizations have changed dramatically since the financial crisis and enactment of the Dodd-Frank Act.
- Boards of directors of banks have assumed many duties that go beyond their traditional oversight role, often in areas formerly delegated to management. Many more items, such as CCAR, DFAST, and Living Will submissions, require specific board approval. Boards provide much more detailed oversight of compensation practices and are highly focused on safety and soundness issues. Boards are increasingly willing and able to constructively challenge management, requiring much more detailed knowledge and documentation of

such decisions. Direct communication between board members and regulators has increased. Boards also play a useful role in helping create an appropriate "tone at the top."

- The most significant increase in board responsibility relates to risk management. Boards now approve risk appetites and monitor risk tolerance limits. Most boards routinely conduct in-depth reviews of market, credit, liquidity, and funding risks, with increased focus on operational and reputational risk, as well as detailed reviews of capital plans, stress tests, scenario analyses, and Living Wills. Boards also have greater direct lines of communication with the Chief Risk Officer and other senior management.
- The heightened duties of the board in recent years have had both positive and negative consequences.
    - On the positive side, boards have become more knowledgeable about their organizations than pre-crisis, and the increased level of detail in board oversight strongly reinforces accountability for strong corporate governance practices by management.
    - On the negative side, the level of detail required by the board has become unwieldy, creating potential obstacles to the board's ability to focus on its key strategic oversight role. Council members raised several specific matters related to placing inappropriate requirements on bank boards, including:
        - Under new OCC regulatory directives, bank directors are under a heightened duty to more thoroughly vet and approve contracts with third-party vendors involving critical services, even when vendors are affiliates;
        - MRAs ("Matters Requiring Action") now not only require oversight by the board but also directly implicate the board in their resolution;
        - Smaller banks, particularly those operating through multiple charters, are increasingly challenged to meet regulatory corporate governance requirements disproportionate to their risk profile;
        - The greatly increased time commitments and specialized skills required to serve on today's bank boards also makes recruiting board members more difficult; and
        - Council members share a general concern that the increased level of granularity in regulatory expectations of boards could blur the line between management's responsibility and board of director oversight.
- We believe that regulators could institute a number of measures that would ensure that bank boards of directors provide appropriate oversight of and direction to bank management while maintaining focus on the risks that are most significant at a given institution.
    - Evolve to a more principles-based versus prescriptive approach to regulatory oversight;
    - Avoid "One-Size-Fits-All" prescriptions for boards. It is important that director responsibilities be proportionate to and focused on the sizing of actual risks faced by an institution so as to guide what items require review and approval at the board level as opposed to at the management level. For example, Reg H, which requires annual review and approval by the board of physical security at banks, may be less relevant to banks with few premises and retail activity;
    - Distinguish between regulatory mandates that require explicit board commitment versus those that require board oversight of management;

- Improve guidelines for boards on what constitutes the exercise of their responsibilities from a regulatory standpoint; and
- Review the myriad overlapping director obligations promulgated by regulatory bodies, and seek to rationalize or perform cost/benefit analysis.

What is the appropriate role for the board of directors to play in ensuring a banking organization's compliance with regulatory requirements?

- Bank boards of directors should provide strong oversight of a banking organization's compliance with regulatory requirements, but they should not be responsible for day-to-day management of such efforts.
- The board's duties start by establishing a "tone at the top" for the corporation as a whole, setting forth the clear expectation that regulatory compliance is not a specialized function, but rather a key component of the organizational culture that pervades everything the company does.
- In addition, and more specifically, the board should:
    - Monitor compliance with material regulations, and expect management to present and review material proposed regulations;
    - Require management to establish regulatory compliance programs that clearly articulate the position and objectives of the board;
    - Monitor whether management has the appropriate resources and expertise to comply with current and pending regulations, and verify that funding for compliance is adequate;
    - Review material regulatory breaches and their resolution, and ensure that steps have been taken to avoid regulatory gaps in the future;
    - Be aware of major pending regulatory initiatives (*e.g.*, Basel III, Supplemental Leverage Ratio, Volcker Rule, etc.) and require regular updates on the bank's progress in complying with such regulations; and
    - Be aware, through direct dialogue with regulators or review of material regulatory exams, of major areas of regulatory and supervisory focus.

Item 7: 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' responses reflected broad geographical and industry dispersion in economic outlook. While national economic activity continues to expand at a modest-to-moderate rate, concerns linger, especially over the federal government shutdown and the debt ceiling debate.
- Manufacturing appears in line with the positive trends reported by the ISM Manufacturing Survey for October. Manufacturing production in the Midwest continues to grow at a faster rate than national production, driven mainly by the auto and aerospace industries. Auto-related manufacturing could encounter challenges as financing availability diminishes

due to regulatory scrutiny around fair lending for auto loans and leases, and as demand for vehicle replacement diminishes.

- Rising interest rates are inhibiting mortgage volumes, and there is not expected to be enough purchase activity to replace the drop-off in refinancing. Concerns exist over the impact that the Dodd-Frank Act's Ability-to-Repay Rules may have on new mortgage and refinancing activity. Some estimates suggest that 20% of existing mortgages would not have qualified under the new regulation. In Florida, institutional investors are leaving the housing market given the impending regulations on qualified mortgages.
- Increasing global agricultural production is leading to softer commodity prices in the North Central Region. In recent history, strong commodity prices enabled producers to strengthen their balance sheets, which should allow them to weather the storm at least for the short run. In the West, agricultural sales and production continue to expand. Strong foreign demand for wine grapes has pushed up grape prices.
- The impact of the recent government shutdown on regional economies is not yet visible in the data. It is believed that the shutdown had a serious impact on business confidence and, at the least, had a disruptive effect during the month of October. The most severe impact is likely to be concentrated in the D.C.-Virginia-Maryland area, which employs the highest share of federal employees in the country.
- Anecdotal discussions with small business owners in the Mideast Region suggest that the Affordable Care Act provisions and the specter of uncontrollable operating costs associated with health care 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 exceeding the 50-employee threshold.
- A lingering impact of the recession is that employers are resistant to hire people who cannot be fully productive at once. Inexperienced young entrants and the long-term unemployed thus tend to be shut out of employment. This is unlikely to prove a sustainable policy as baby boomers retire.
- 2013 holiday sales are expected to be up 3.0 to 3.5% from a year ago, despite a holiday shopping season that will be five days shorter than last year due to a "late" Thanksgiving. The gain in sales is in part because 2 million more people have jobs, stock prices are up nearly 20%, house prices are up by more than 10%, and gasoline prices are lower by 20 to 25 cents per gallon during this upcoming holiday season compared to one year ago.

<u>Item 8</u>: <u>Monetary Policy</u>

How would the Council assess the current stance of monetary policy?

- Recognizing the high quality of information and analytical resources available to the Federal Reserve, Council members defer to the judgment of the FOMC that its current, extraordinarily accommodative monetary policy remains necessary to ensure a sustained recovery, to provide a cushion against unforeseen developments, and to compensate for the ineffectiveness of other parts of the government.
- Although the modest recovery continues, considerable risks remain, especially as unemployment rates stay above target, reported inflation is very low, the U.S. economy performs below capacity, and uncertainty and lack of confidence restrain business

investment and consumer spending. The current monetary policy stance is judged appropriate in light of these risks and possible contractions as the Congress debates debt and fiscal policy. The Council also notes the importance of continuity in the Federal Reserve's approach to monetary policy as Board and other FOMC leadership changes take place.

- Having employed an unprecedented array of special measures to respond to the financial crisis and subsequent recession, it is understandably prudent that the Federal Reserve is reluctant to remove accommodative supports until it is confident of the recovery. It would be challenging to earn back market confidence if extraordinary actions had to be reinstituted following a downturn after accommodation was withdrawn precipitously.
- As the Board's actions are working to solidify the recovery and QE is allowing substantial deleveraging without a double-dip recession, Council members urge the FOMC to give additional weight to countervailing concerns, which had to be discounted in more perilous times. In particular, Council members noted that:
    - the impact of low rates over a long period has pressured retirees and other savers;
    - some financial institutions appear to be taking undue interest rate risk in reaching for yield;
    - the possibility of negative, unforeseen consequences increases the longer unconventional policies are pursued and new measures show diminishing effectiveness;
    - an increasingly larger Federal Reserve balance sheet will make it harder to drain bank reserves without fueling inflation down the road; and
    - large-scale asset purchases may disrupt price discovery.
- Council members support the Federal Reserve's announced plans to withdraw accommodation gradually, retaining the reinvestment program for some time after new purchases are halted, with eventual normalization as repurchases also are phased out.
- Communication has been substantially enhanced and improved in the last five years. Council members believe that forward guidance will remain an essential part of effective monetary policy as the FOMC moves toward a more normal rate environment. Signposts such as targeted unemployment and inflation levels are especially useful as they allow market participants to react to new developments based on their assessment of the implications for future policy.
- Commitment to transparency in volatile times can subject communicators to accusations of indecision. The number of participants in the FOMC's deliberations brings both wisdom and regional insights but also risks some incoherence in messaging. The Council recognizes the importance of communication and the value of coordination as the FOMC works to guide market expectations in anticipation of tapering.

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