Meeting of the Board of Governors
and the Federal Advisory Council
May 11, 2012

Board members: Chairman Bernanke, Vice Chair Yellen, and Governor Tarullo

Council members: Joseph L. Hooley, Vikram Pandit, Bharat B. Masrani, James E. Rohr, Richard D. Fairbank, Daryl G. Byrd, David W. Nelms, Bryan Jordan, Richard K. Davis, Stanley A. Lybarger, Phillip Green (alternate for the Eleventh District), and J. Michael Shepherd

Summary: Members of the Federal Reserve Board ("Board") met with the Federal Advisory Council ("the Council"), a statutorily created advisory group that is composed of twelve representatives of the banking industry (one member from each Federal Reserve District). The Council ordinarily meets four times a year to provide the Board with information from the banking industry's perspective.

The Council discussed the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Council presented its views on the Board's proposed rulemaking concerning incentive compensation arrangements (Docket No. R-1410); stress testing, including stress tests required by the Board's proposed rulemaking on enhanced prudential standards (Docket No. R-1438); financial stability; and potential risks to U.S. banks arising from Europe's financial difficulties. During the discussion on incentive compensation, some members expressed concern about the number and categories of employees who would be subject to scrutiny under the proposal but whose responsibilities would not expose the bank to material risk.

The information collected from the Council at the meeting is summarized in the attachment. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

(Comments related to Board rulemakings under the Dodd-Frank Act are provided below.)

Stress Tests:

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

- In the February FAC meeting, the Council discussed the disclosure framework for CCAR and other stress testing requirements with the Board. The Council believes the Board subsequently struck the right balance with its approach to recent CCAR public disclosures, providing a perspective on bank performance under stress without creating unintended consequences or placing unnecessary focus on "baseline guidance." The Council believes that Section 165 stress test disclosures should be modeled after these successful CCAR disclosures, including the use of a template consistent with the information employed in CCAR and the disclosure of only severe stress scenario results.
- In that same spirit, we offer several recommendations today to ensure a more accurate and effective capital planning and management process, as CCAR evolves. The Council seeks significant enhancements in three key areas: 1) accuracy and rigor of modeling approaches; 2) openness of information exchange between banks and the Federal Reserve during the CCAR process; and 3) flexibility in capital plan management between CCAR exercises, as long as banks achieve target baseline and post-stress capital ratios.

High-Stakes Decisions with Imperfect Information

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

Accuracy and Rigor of Modeling Approaches

- Increased modeling accuracy would reduce concerns about the lack of transparency in both the current Federal Reserve's models and the overall process. Based on the information available to banks, we believe that the Federal Reserve's CCAR models may rely on assumptions that are too general or simplistic. In some cases, the Federal Reserve's results were based on analytic or calculation errors that were material.
- *The Federal Reserve should ensure methodological completeness and consistency*. Here are some examples that appear to have been the experience for more than one of the participating banks:
    - The Federal Reserve's models, in many cases, produce higher losses than the banks' own models. However, when the Federal Reserve increased the losses in many portfolios, it did not decrease the amount of risk-weighted assets to reflect the higher losses in the stress scenario. At a minimum, each dollar of additional losses should directly reduce risk-weighted assets and, therefore, increase capital ratios due to the smaller denominator.
    - The Federal Reserve applied an effective tax rate of 35% to all of the participating banks. This approach ignored the very different tax rates that apply to different institutions in practice and the additional expenses used to achieve the lower rate.
    - Some banks' accounting practices capture recoveries expenses as an operating expense. The Federal Reserve's model, however, captured expenses relating to recovering charged-off debt in its net charge-off estimates. Because the Federal Reserve's model was not consistent with these banks' own accounting practices, recoveries expenses were double counted, leading to lower capital numbers.
    - Areas like these can be improved by refining models to capture the full complexity of tax and accounting issues and by averting key omissions.
- *The Federal Reserve should consider both industry-level models and banks' actual historical loss performance in order to properly credit (or penalize) differences in important bank-specific strategies and customer selection.* The Federal Reserve has alluded to the blunt estimates used by some banks for home prices and mortgage losses. Analogously, "generic" industry-wide models miss subtle but important distinctions among lenders and across portfolios and segments. In calculating stress scenario losses, the Federal Reserve relied on an industry-level model that accounted for many variables that differentiate performance but did not capture differences in important, bank-specific factors, such as customer selection, credit line assignment, account management, risk management, etc. Loans from different banks that would be scored identically by an industry-level model have been observed to consistently experience varying loss performance due to these bank-specific factors. These performance differences can be independently and objectively observed. Clearly, past performance is an imperfect predictor of future performance, but we believe that the Federal Reserve has the skills and tools to utilize bank-specific historical performance, applying appropriate conservatism.

- The Federal Reserve's one-size-fits-all approach may be appropriate for assessing the health of the industry in aggregate but is not appropriate when CCAR results are applied to individual banks in a pass/fail test. A broad-brush approach is arbitrarily punitive for some institutions or portfolios and arbitrarily favorable for others, but is inaccurate for both. It is also the case that using bank-specific assumptions, where appropriate, could result in *downward* adjustments to bank capital in some cases.

Dialogue between the Banks and the Federal Reserve

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

- We welcome the Federal Reserve's commitment to a CCAR-model symposium, which would permit a full two-way dialogue between the Federal Reserve and financial institutions. Banks have on staff great technical depth with access to rich institutional histories regarding credit loss and analysis. Banks may be best positioned to assess how loan portfolios will perform under extraordinary circumstances and in relation to other portfolios.
- More dialogue about complex tax and accounting treatments may disclose key issues that can be resolved prior to next year's CCAR.
- During the tests, the Federal Reserve should maintain an open line of communication. CCAR testing involves hundreds of variables and complexities for each institution. An open dialogue during the process can ensure that misunderstandings do not turn into major discrepancies.
- Several members recommend that the Federal Reserve permit bank boards to adjust distribution plans prior to the determination of CCAR outcomes. These members point out that capital distribution decisions are not static and that, in response to changed outcomes under the Federal Reserve's stress scenario, banks may appropriately wish to change their capital distribution decisions.

Ongoing Capital Plan Management

- The Council appreciates the rigor that CCAR contributes to companies' capital-planning processes. We understand that once the Federal Reserve has provided a notice of non-objection with respect to a capital plan, banks must manage to targeted baseline and post-stress capital levels and may not increase capital distributions, aside from limited exceptions provided in the capital plan rule. We believe, however, that *outside of increasing capital distributions*, it is in the best interest of the system to afford banks more flexibility with regard to particular capital actions, due to the dynamic nature of capital planning and capital markets and the fluidity of the underlying business, as long as the bank remains above its baseline and post-stress targets.
- We believe that the focus of banks and federal regulators should be on meeting target capital ratios, not on managing to specific capital actions reflected in a point-in-time capital plan with a nine-quarter planning horizon. For example, due to market or business

changes, a bank may wish to alter or forego a planned capital raise as long as it remains above its target capital ratios, both in baseline and post-stress scenarios. Such changes should be subject to ongoing supervisory discussions, rather than requiring capital plan resubmissions. Resubmitting formal capital plans for any and all changes could hinder efficient and effective capital planning and result in missed market opportunities, interfering with safety and soundness objectives.

Additional Recommendations

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

Incentive Compensation

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

Overview

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

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

- In determining whether a firm's incentive compensation program is appropriately balanced, it is very important to look at each program as a whole and understand how all of its elements work together. Looking at individual components or elements of compensation in isolation can give a misleading picture of the overall balance of a program, as it is an employee's compensation package as a whole that ultimately guides incentives.

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

- As the Interagency Guidance itself recognizes, there is a variety of methods that may be used for ensuring that incentive compensation programs are "balanced" and do not encourage imprudent risk taking. Methods for achieving balance at one organization may not be necessary or, alternatively, sufficient for achieving balance at another organization due to, for example, differences in plan design, business strategy, or management structures. The Council believes that it is very important for these principles to guide supervisory assessments, since there is no one-size-fits-all approach to ensuring that incentive compensation programs are balanced.
- There appears to be a growing and, in the Council's view, unnecessary tension between the incentive compensation goals of the Federal Reserve and those of shareholders. For example, it is commonly perceived that performance goals will be subject to supervisory criticism unless they are highly achievable and avoid rewarding exceptional performance. Shareholders, however, rightfully want to encourage exceptional effort and corresponding performance, and doing so should not be viewed as inconsistent with safety and soundness provided that employees also are exposed to significant downside risks should they seek to achieve above-average performance through imprudent or excessive risk taking.
- Federal Reserve guidance has discouraged the use of relative performance measures. However, that class of incentives can and should play a role, in combination with absolute performance measures and other features, in promoting sound and balanced compensation. All performance measures have strengths and weaknesses. For example, absolute performance measures can encourage employees to "swing for the fences" in years of economic growth in order to maximize their compensation in those years, knowing that absolute performance will decline in years of weaker economic performance. Relative performance measures, on the other hand, incent management to focus on the organization's longer-term performance, by ensuring that disciplined risk taking in growth years is rewarded in down years when the benefits of that discipline becomes more apparent.
- Organizations need sufficient time to implement modifications to their incentive compensation programs and educate executives, employees, and shareholders about those changes. Frequent and rapid changes to incentive compensation programs are not only difficult to implement but also run the risk of confusing participants who need to understand how the programs balance rewards and risk if the program is to be effective in appropriately guiding behavior.
    - As noted above, organizations have already made significant changes to their compensation programs in recent years, and compensation programs for 2012 have already largely been established and communicated to employees. Many organizations, however, only recently received responses to their most recent incentive compensation submissions to the Federal Reserve, and in many cases, these responses raise or highlight topics that were not previously communicated.
    - In light of the foregoing, the Council believes organizations should have the flexibility to implement additional modifications to their programs for the 2013 plan year.
    - In addition, given the magnitude of the improvements already made and those likely to be made this year, the Federal Reserve should allow these new structures to operate for a few years before requesting further substantial changes to program design. This would allow both organizations and the Federal Reserve to assess the effectiveness of

these program changes, both individually and in the aggregate, in balancing potential incentives for improper risk taking before determining whether additional changes are necessary or appropriate.

- As ongoing supervision transitions to the Reserve Banks, it would be helpful for the Federal Reserve's experts to remain available to provide guidance to, and respond to questions from, banking organizations as well as available for information requests to provide greater clarity as to the information being sought (which should reduce the incidence of multiple requests).

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

Financial Stability

- There are several consequences of the Basel III Liquidity Coverage Ratio requirements that have the potential to impact stability:
  - Banks are likely to reduce their holdings of government agency securities by ~30% (or >$1T) since these securities are deemed to be Level 2 assets.
  - Banks are likely to choose to minimize deposits for which they must assume 50% or more runoff (e.g. corporate time deposits), because they would substantially deteriorate banks' leverage ratios. These deposits (which may represent ~$1T) would need to find homes outside the regulatory system.

Europe and U.S. Banking

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

- The proposed Basel III liquidity ratios, as currently drafted, consider only government securities as "highly liquid," creating an incentive for banks to hold government securities, even if other types of assets, including asset-backed securities or corporates, are more liquid and lower risk. The proposed approach also fails to provide a suitable approach to using the liquidity buffer in times of stress. As Governor Tarullo recently indicated, "[a]s currently constituted, the LCR might have the unintended effect of exacerbating a period of stress by forcing liquidity hoarding."[2]
- A consistent bias against high-quality, non-U.S. sovereign exposures (including high-quality EU sovereign debt) in U.S. regulatory proposals (such as the Volcker Rule, Section 165 single-counterparty credit limits, and uncleared swaps margin requirements) could disrupt global efforts to mitigate systemic risk.
- The Dodd-Frank prohibition against regulatory use of credit ratings makes designating high-credit-quality sovereigns more difficult. A possible solution would be to recognize in regulations as high-credit quality both sovereign debt and central bank exposures that are

[2] http://www.federalreserve.gov/newsevents/speech/tarullo20120502a.htm.

from countries with high OECD ratings, that have not defaulted in the past, that are not currently receiving IMF assistance, and that are actively traded.