

AGENDA

Meeting of the Federal Advisory Council
and the Board of Governors

Friday, September 2, 2011

Item 1: Current Market Conditions

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

Overview

Continuing high unemployment, under-employment and news of public and private sector layoffs have negatively affected consumers' confidence about their future incomes. A seemingly moribund housing market and excessively volatile financial markets have taken their toll on consumers' view of their personal wealth. This consumer uncertainty has translated into reduced domestic demand, which, in turn, has retarded new investment and job creation. Piling on to the mix is recognition of the slowing global demand from both developed and developing economies that is exacerbated by austerity measures brought on by the necessity to de-lever and the lack of belief in positive political leadership.

The competitive environment for available lending opportunities is very intense. As a result, loan structure and pricing continue to deteriorate, reflecting behaviors typically seen later in credit cycles. Additionally, members report that lenders have been retaining larger portions of credits by increasing hold limits in an effort to deploy capital in the face of low quality loan demand.

Until this self-reinforcing cycle of weak demand and risk aversion due to the uncertainty of expectations and a lack of confidence in the future is broken, we do not see real stimulus for improvement in bank loan and financial markets. To be sure there are always pockets of opportunity for banks to make loans (e.g., the current opportunities in agricultural lending and continuing opportunities for refinancing at both the consumer and business levels), but a general return to a robust, healthy bank market is dependent on an economic turnaround.

(A) Small Business Lending:

Has credit availability for, and demand for credit from, small businesses changed significantly over the past three months? Have there been changes in lending standards for these borrowers?

- Members expressed a strong congruence of opinion on the status of small business lending; the supply of small business credit is expansive while the demand for small business credit is indecisive and limited. Some members do report year-over-year growth in demand (both in applications for new loans and approved loans) but still well below pre-crisis levels.

- Members reported that small business lending standards remained largely unchanged during the quarter although several members mentioned that competitive pricing pressures were being felt. Members observed that the Small Business Lending Fund (SBLF) has at its earliest stages contributed to the competitive structure and pricing pressure in small business lending.

(B) Commercial Real Estate Lending:

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

- Council members conveyed several consistent themes about the CRE market: operating fundamentals have continued to improve for several categories of CRE, particularly multi-family and office; CRE loans are generally performing better than earlier anticipated; demand for new lending in certain categories is growing; but, the outlook for continued improvement in CRE is one of caution tempered by fear of another economic downturn. A low interest rate environment has aided in refinancing existing projects that has further led to stabilized rents, lease rates and occupancy. The Washington-to-Boston corridor continues to be the most active market for CRE development but opportunities were noted in other large, gateway cities around the country.
- Several members observed a reversal in the rebirth of the CMBS market during the second quarter contrasted against the optimism exhibited in first quarter. Several announced deals were pulled, spreads have widened, and some evidence of weakened metrics in existing CMBS has occurred. Life insurance companies continue to have interest in well sponsored, high equity situations but are extremely selective. International investors are noted as relatively active sources of permanent financing.

(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 in the past three months?

- Members report good availability of credit for construction of multi-family, student housing and bespoke credit tenant development. Again, the Washington-Boston corridor is the most competitive marketplace among lenders. Demand by multi-family developers is clearly the strongest in the sector, and banks are actively working with well-respected, trusted developers. Demand in the other areas of the sector remains weak. There is practically no reported appetite for lending to single-family residential construction projects.

(D) Agricultural Lending:

Have there been any recent changes in agricultural lending?

- Members with active agricultural lending books report robust supply conditions for farmland, crop and livestock financing. Demand for borrowing is somewhat subdued as producers are reported to be flush with cash following strong global demand and USD levels that stimulate exports. For similar reasons, members also report a reduction in the use of leverage for the acquisition of farmland, which they point out tends to minimize fears of a bubble occurring in this asset sector.

(E) Update on Home Mortgage Lending:

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

- A majority of members noted the significant decline in Treasury rates in the past month and the attendant lowering of mortgage rates. Most noted that refinance applications rose accordingly, but there was limited to no movement in purchase mortgage applications. Refinance activity now accounts for 80% of all mortgage related financings. Several members commented that even refinance activity remains relatively nuanced and cited the MBA refinancing index which has not yet reached 5000, the high-water mark for last year as evidence. Members cite overly conservative appraisals, increased mortgage insurance rates, increased mortgage servicing expenses, and regulatory induced limits on banks' risk appetite as factors negatively impacting the home mortgage market.



(F) Mortgage Foreclosures:

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

- Members generally reported no change or only slight improvement in the status of foreclosures during the past quarter. However, industry research indicates that the slowdown in foreclosures is not a result of improving economic conditions or increased loan modifications. Instead, it is a result of a slowdown in the processing of filings in the wake of the robo-signing scandal and specifically attributable to increased regulatory scrutiny and audits of servicers' foreclosure processes and procedures, including vendor management and title documentation, the federal and state agencies investigation into the foreclosure practices of five large banks, and a flurry of new state and local laws adding new loss mitigation and foreclosure requirements.

Item 2: Mortgage Foreclosures and Debt Overhang in the Housing Markets

Are there any actions that that can be taken by government to expedite the recovery of the housing markets?

- Make it easier for current homeowners to stay in their homes:
 - Liberalize HAMP modification guidelines, including:
 - Relax the Front End Debt-to-Income ratio,
 - Increase loan modification limits, and
 - Evaluate the impact of loan-to-value on the Net Present Value Test.
 - Allow homeowners to refinance more than once under HARP.
 - Preserve the mortgage interest deduction.
- Promote home ownership for individuals:
 - Provide incentives, such as tax breaks and subsidized mortgages, to individuals who purchase foreclosed homes.
 - Remove or reduce the post-foreclosure waiting period before a borrower becomes eligible for a GSE loan based on the circumstances of the original default.
 - Amend the proposed QRM (Qualified Residential Mortgage) rules, which have the potential to restrict availability and increase the cost of home mortgages.
 - Extend the super conforming loan limits for another year to keep liquidity in the markets.
 - Review all loan programs for opportunities to introduce bank judgment for certain “near-qualified” borrowers.
- Encourage and incentivize investors to enter the market:
 - Mandate that all servicers must register foreclosures with a central clearinghouse and keep a sign posted on every foreclosed property, disclosing contact information for the servicer and the deed holder of the property.
 - Provide incentives, such as tax breaks and subsidized mortgages, to investors in geographic regions where inventory-to-sales ratios are out of balance.
 - Make FHA funding available to investors.

- Take steps to allow foreclosures to come to market sooner:
 - There should be a deadline for the completion of audits and remediation for banks subject to the OCC Consent Order. The standard for "financial harm" and "remediation" should be narrowly defined with the focus on substantive servicing deficiencies directly resulting in substantive harm to borrowers. Borrowers who are in default and did not qualify for loan payment assistance should proceed to foreclosure without delay.
 - Mandate uniformity of state foreclosure rules and processes.
 - Evaluate the role of the courts in the foreclosure process.
- Establish higher standards for deed holders of foreclosed properties:
 - Require that all foreclosed properties be brought to code and sold in a reasonable period of time, or
 - If a property is not brought to code (after some determined period of time), require that it be razed.
- Avoid actions that could further delay the recovery:
 - GSEs and financial institutions do not have the competencies required to become landlords on a large scale, however unique "rent-to-own" programs (along with incentives) should be evaluated.

Item 3: Basel III

(A) The Basel Committee has released its consultative document, "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement" (<http://www.bis.org/publ/bcbs201.htm>). What are the FAC's views on the policy measures set out in this document? In particular, what are the Council's views on the measurement of concepts like size, interconnectivity, substitutability, complexity, and cross-jurisdictional activity? Do the proposed indicators measure these concepts well or is there a better set of indicators? How well do these indicators capture the systemic risks associated with large financial institutions? What type of adjustments to portfolios and business strategies would large financial institutions make if these indicators become the basis for a systemic risk capital surcharge?

Overview

Robust capital requirements, including reforms intended to improve regulatory capital requirements both quantitatively and qualitatively, are a fundamental element of bank safety and soundness and a systemic risk mitigant. However, it would be premature to adopt the global systemically important bank ("G-SIB") surcharge proposal at this time or, for that matter, a capital surcharge for those banking organizations that are subject to a heightened regulatory and supervisory regime under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Furthermore, we have several concerns with the structure and components of the G-SIB surcharge proposal. In summary, we believe that any capital surcharge proposal should be postponed until a more considered evaluation of its relative benefits, disadvantages and necessity in light of other evolving regulatory and supervisory policies is feasible.

- At the present time, U.S. banking organizations are confronting an extraordinary, and globally unique, array of new regulatory requirements. It is premature to consider additional capital surcharges until there is sufficient time to assess the aggregate impact of Basel III and other regulatory and supervisory requirements.
 - Basel III sharply increases the amount of required capital, as a result of both major quantitative and qualitative changes, and introduces, for the first time, new short-term and longer-term liquidity standards.
 - Large U.S. banking organizations also will be subject to a wide array of special regulatory requirements under the Dodd-Frank Act including the Volcker Rule, fundamental changes to the regulatory regime for derivatives, “living will” requirements and, importantly, the comprehensive and effective resolution program that is intended to end “too big to fail.”
 - The combination of Basel III’s new liquidity requirements (which will require banks to increase their holdings of liquid debt instruments) and the loss of the so-called accumulated other comprehensive income (AOCI) filter is likely to introduce substantial volatility in the capital ratios of both large and small banks. As a result, banks will be forced to maintain substantial “uncertainty buffers” over stated regulatory requirements to avoid adverse consequences.
 - The imposition of a capital surcharge in addition to the new Dodd-Frank resolution regime also may effectively “double-up” regulatory costs for U.S. banks even though both policies are designed to address the same problem.
 - An extended development period would give policymakers time to develop reliable, standardized datasets and a transparent calculation methodology, both of which are necessary to properly assess the impact and effectiveness of a potential surcharge and to allow banks to properly engage in long range capital planning.
- Regarding the specifics of the G-SIB proposal, no system for measuring systemic importance will be perfect. The proposal, including its five broad categories of indicators (size, interconnectedness, substitutability, complexity and cross-jurisdictional activity), represents a thoughtful effort towards assessing an institution’s global systemic footprint. However, there are weaknesses with the structure of and the individual systemic indicators included in the proposal. These weaknesses make it unlikely that the proposal will appropriately reflect the true risk of firms and could, in some instances, create incentives to increase firm-specific or systemic risk.
 - For example, because the calculation methodology is based on the relative score of a G-SIB within the universe of G-SIBs (rather than an absolute score that takes into account other banking or financial organizations), it is possible that actions by G-SIBs as a group to substantially reduce their level of risk as measured by the indicators would not equate to any reduction in the capital surcharge for these firms.
 - In addition, the proposed size, cross-jurisdictional activity, interconnectedness and complexity categories use indicators that are based on a gross, rather than a risk-adjusted, measure of assets, derivatives or other exposures. This risk insensitive approach will misstate the risk posed by individual firms and, all else being equal, encourage firms subject to the G-SIB surcharge to hold higher-risk assets and exposures.

- Other significant concerns include the following:
 - Size, the most important category (in terms of both weighting and incorporation into other indicators), is not necessarily directly correlated to risk or the consequences of failure, particularly for firms that are subject to an orderly resolution regime like those embodied in Title II of the Dodd-Frank Act or in the Federal Deposit Insurance Act.
 - The cross-jurisdictional activity category may penalize reasonable geographic diversification and does not take into account whether cross-jurisdictional assets and liabilities are funded in local currencies (which would reduce cross-jurisdictional risks and complexity). In fact, the proposal could encourage G-SIBs to fund assets in foreign jurisdictions with home country liabilities even though match funding foreign assets with local jurisdiction liabilities is less risky and more readily resolvable.
 - The substitutability category includes two indicators that may not effectively measure systemic importance. The assets under custody indicator fails to recognize that, in the United States at least, the assets under custody of a failed bank are segregated from the bank's own assets and remain fully available to the bank's customers. Similarly, experience indicates that the underwriting functions of particular firms are readily substitutable.
 - In the complexity category, the OTC derivatives indicator does not take account of legally enforceable netting agreements, and the AFS indicator may penalize a bank for increasing its holdings of liquid debt securities to satisfy Basel III's new liquidity rules, resulting in a designation criterion that does not accurately capture firm-specific or systemic risk.
- At a time when the economy is still troubled, the Federal Reserve should be cautious about undermining its monetary policy with regulatory policies that curtail bank lending.
 - Banks today hold large liquidity reserves, and the lending issue currently is more one of demand rather than supply. Nonetheless, the potential of even more sharply increased capital requirements inserts an inherent conservatism into lending decisions.
 - Moreover, a capital surcharge on G-SIBs or large banking organizations more broadly will likely act as a disincentive to any bank otherwise interested in acquiring a large troubled bank. The surcharge could have other structural impacts on the financial system. For example, it is not clear that small banks will be able to enter some of the business lines targeted by the proposal (such as clearing, underwriting and derivatives) and, thus, any surcharge may encourage the shift of important businesses to the shadow banking system or less regulated segments of the financial sector.
- Capital policies should be applied in a way that maintains the competitiveness of U.S. banks and recognizes the differences among banking organizations.
 - In order to ensure that U.S. financial institutions remain competitive in global financial markets, any surcharge that ultimately is agreed to on the international level for G-SIBs should serve as the cap for any surcharge established by U.S. regulators for G-SIBs.
 - The floor of any globally agreed-upon G-SIB surcharge should serve as the *maximum* of any potential surcharge for banking organizations that have \$50 billion or more in total assets but are not themselves G-SIBs. However, even if a surcharge framework

were to be established for this latter group, a number of organizations within this group should warrant a zero or, at most, a de minimis surcharge since they present little, if any, risk to financial stability.

(B) How would the Council assess the impact of additional capital requirements on smaller banks?

- The new Basel III capital rules will require the inclusion of Other Comprehensive Income (OCI) in the computation of regulatory capital, requiring that the after-tax unrealized losses on a bank's Available-For-Sale (AFS) securities portfolio reduce a bank's tier one capital dollar for dollar. This is a dramatic change from previous regulatory capital rules that ignored market value changes in a bank's bond portfolio. As a result, community and midsize banks will be forced to hold significant levels of additional capital to cover this volatility.
- Community banks do not trade their investment portfolios – they hold them to maturity, which means that unless the issuer cannot pay, the full amount of the investment is returned, regardless of interest rate variations in market value over its life. Most community bank investments are in securities with small risk of nonpayment, including U.S. Treasuries, mortgage backed securities issued by U.S. Government Agencies and municipal securities. Yet, community and mid-tier banks will be required to hold tier one capital for the entire after-tax unrealized losses in their bond portfolios caused by changes in interest rates.
- Current regulatory capital rules (prior to Basel III) already cover the appropriate issues related to securities' market values. For example, if banks are engaged in trading of their investment portfolios, accounting rules require that they be placed in a trading account and regularly marked to market in the income statement (and therefore, capital). Also, any changes in a security's market value that are deemed to be other than temporary (for example, due to a credit event) are required to be recognized in the income statement (and again, translated into capital).
- Any capital benefit from changes in OCI from timely investing creating an unrealized gain in the portfolio would be illusory, as this gain will evaporate, along with the capital benefit, as the bonds ultimately move to maturity. Alternatively, selling the securities to monetize the gain will have to be done at the expense of the above-market yields that created the gain, thereby reducing future net interest income. In light of this, consider whether supervisory authorities would, or should, allow tier one capital that results from unrealized portfolio gains to be utilized for long-term uses such as financing acquisitions or stock buy backs. However, few would doubt that capital shortfalls caused by unrealized portfolio losses will result in an immediate supervisory mandate to correct the situation with long-term tier one equity.
- From a supervisory perspective, community banks are already required to have systems to measure and manage interest rate risk, generally referred to as the "ALCO process." The risks, and the tools to manage them, are straightforward and well understood by bank management and regulators. While this system has operated safely for decades, the new Basel III rules will change all that. Community and mid-tier bank managers who wish to invest the deposits entrusted to them in the same manner as in the past will now be required to attempt to manage the market value volatility of a part of their balance sheet. Few are

equipped to do so. Already, we are seeing the largest banks offering hedging programs that attempt to arbitrage accounting rules in such a way as to remove the capital exposure from the investment portfolio market volatility. While this will prove to be another source of fee income for large banks as they implement and attempt to manage these programs for the community bank universe, many would question if the management and boards of community banks can understand, let alone monitor, such programs. In addition, regardless of the efforts and imagination of investment bankers, public accountants have demonstrated an almost limitless capacity to find problems with hedging programs under FAS 133. As the saying goes, “it’s not if you have an accounting problem with FAS 133, it’s when.”

- Other ways that community and midsize banks could respond will also have negative implications. Moving securities into Held-to-Maturity (HTM) status currently avoids having to mark-to-market these securities. However, too much reliance on this category may significantly reduce liquidity at a time when Basel introduces new liquidity requirements. Also, there is no guarantee that the accounting profession will not change the accounting rules for HTM securities in their constant march toward mark-to-market accounting. Banks that significantly reduce the duration of their securities portfolios in order to reduce their capital volatility will suffer the lower operating margins that come with lower yields. Others may instead forgo investments in highly-rated securities in favor of long-term fixed rate loans that are not marked to market, increasing the overall risk profile of those banks.
- This new element of the Basel III capital rules perhaps attempts to address the sharp drop in the value of more exotic, private label securities during the financial crisis. These securities were produced by Wall Street and were held by many major banks. In fact, Federal Reserve H-8 data from 2007Q2 shows that the largest banks held well over 50 percent more Other Non-Federal Securities as a percentage of assets than smaller banks. The new rules cause a disproportionately negative impact on community and mid-tier banks that have, for years, responsibly managed their investment portfolios as a core, high quality asset class. Those portfolios performed admirably during the financial crisis. However, an examination of historical yields for the 5-year U.S. Treasury security over the last 50 years shows significant volatility. One period in the early 1980s during the Federal Reserve’s dramatic inflation fighting efforts saw an increase in the 5-year yield of almost 6 1/2 percent. This would result in a market value reduction of almost 30 percent for a portfolio with a similar duration. The capital impact of this marked-to-market would be devastating to well-run community banks even though the interest rate impact is temporary and reverses as the bonds approach maturity. In addition, during this period, banks with proper ALCO management did not see a significant reduction in reported earnings even though bond portfolio values declined.
- America’s community and midsized banks fulfill an important role in the nation’s economy. In fact, a recent Federal Reserve Bank of Dallas publication noted that community banks hold close to 60 percent of small business loans outstanding. However, community banks are seeing a diminishing pool of asset classes available to them. Today, credit card portfolios reside at the major banks. Most mortgages are made by GSEs, and commercial real estate holdings are under increasing pressure (not to mention the squeeze on non-interest income.) The Basel III rules on OCI will effectively foreclose the use of bond portfolios by community bank as a significant earning asset class that takes advantage of natural hedges in their balance sheets to go out the yield curve and achieve prudent

spread income. This will result in fewer bank investments, especially municipals, mortgage-backed securities and medium and long-term treasuries. Authorities should seriously consider modifying the Basel III rules related to the capitalization of OCI. They could do this by weighting the OCI by the risk weightings currently assigned to the securities which give rise to it (just as various credit risk weightings for different asset classes have been used in Basel for years), eliminating it altogether or by exempting community and mid-sized banks from the new OCI standard.

Item 4: The Shadow Banking System

Concerns have been raised that new regulations might drive banking activity into the shadow banking system. However, there are few detailed descriptions of what would actually happen or, indeed, what is meant by the shadow banking system. How does the Council define the shadow banking system and are there specific examples of how banking activity has migrated to it?

What is Shadow Banking?

- According to a Federal Reserve Bank of New York staff report on Shadow Banking (staff report 458, June 2010), shadow banks are financial intermediaries that conduct maturity, credit and liquidity transformation without access to central bank liquidity or public sector credit guarantees. Examples of shadow banks include finance companies, asset-backed commercial paper (ABCP) conduits, limited-purpose finance companies, structured investment vehicles, credit hedge funds, money market mutual funds, securities lenders, and government-sponsored enterprises.
- The Council would broadly define the shadow banking system as that portion of the market that exists outside of or just barely inside the perimeter of the regulated financial system and offers products and services that can be direct substitutes for regulated bank products. That perimeter may shift over time depending on where the regulated boundaries are drawn.
- The current regulatory environment does not address the shadow banking system in a material way, and most of the work currently being implemented is within the regulated banking system. One area of concern is that Basel III requirements may shift activities into the shadow banking sector, while higher capital charges may encourage banks to engage in riskier activities to justify the higher levels of capital.
- “Alternative electronic payments” are also often conducted outside of traditional regulated banks. The nineteen laws that explicitly regulate payments, including consumer protections and Bank Secrecy Act/Anti-Money Laundering, are not consistently applied to alternative providers.

Examples of the Shadow Banking System include:

- Retailers, such as WalMart and Kmart, offering check cashing, bill payment, money transfers, and prepaid cards. As banks stop offering or start increasing fees on certain products due to rules, such as the debit interchange cap, consumer protection laws, AML, etc., this area may grow over time.

- There are now over fifty alternative electronic payments companies, the largest of which is PayPal.
- Start-up businesses turning to hedge funds to get loans after being rejected by banks worried about making risky loans. (Source: *NYT's Dealbook*)
- Private investment firms, such as Athas Capital Group and New Penn Financial, offering home loans to borrowers who did not meet banks' requirements. (Source: *Wall Street Journal*)
- Non-bank finance companies, such as Annaly Capital and Fortress Investment Group, stating that they can provide credit far more profitably and flexibly than banks hamstrung by regulation. (Source: *Financial Times*)
- Main Street Bank in Kingwood, Texas announcing it will give up its banking charter and sell its branches in order to engage in small business lending outside of the bank regulatory environment. The resulting company will be funded by private investment firms, including the firm run by Paul Allen, co-founder of Microsoft. (Source: *Wall Street Journal*, August 10, 2011 C1)

What Can Regulators Do to Mitigate Risk?

- Most importantly, regulators should ensure that there is a level playing field for all financial intermediaries to make sure that risks are properly monitored and regulated.
- The new regulatory bodies that have been created, specifically the FSOC and the CFPB, should define and oversee shadow banking activities “in parallel” with banking activities.
- Regulators should encourage, rather than discourage, banks from participating in global payment services and other consumer financial services innovations, allowing for the creation of competition for the likes of PayPal.
- Regulators should review the emerging payments companies to identify gaps, including consumer protection and security. Regulations need to evolve to keep pace with rapid industry and technological changes to ensure greater consistency and avoid security gaps.
- The shadow banking sector has always developed new and unforeseen products and processes. As a result, the identification of the shadow banking system's responses to these regulatory proposals needs to be dynamic.
- The Dodd-Frank Act could both help and hurt in resolving the *shadow banking system* issue. In the wealth management space, Dodd-Frank helps by placing consumer investment products under a brighter spotlight. Similarly, the Dodd-Frank mandate to identify financial products and services and systemically important payment systems helps consumers and banks alike.
- On the other hand, additional regulations that increase the cost of providing banking services without materially reducing risk may have the effect of driving consumers into the shadow banking system. This could have the unintended consequence of actually creating more risk within the system.

Item 5: US Banking and the European Debt Crisis

What is the Council's assessment of the effects of a prolonged European Debt crisis on the U.S. banking industry?

The European Union is facing an accelerating deterioration of market confidence. Concerns include:

- Fundamental solvency of smaller peripheral countries (Greece, Portugal, Ireland) has rapidly expanded to liquidity stress for larger countries (Italy, Spain) and could progress into sovereign downgrades of their largest economies (France, Germany).
- The policy responses of the seventeen member countries have been uncoordinated, timid and slow.
- European Bank Stress Tests lacked credibility concerning consistency by country and sovereign debt valuations.
- Markets generally believe that European banks:
 - Have not written down problem assets as quickly as U.S. banks due to higher loan/deposit ratios,
 - Have not raised enough capital versus U.S. banks – and are currently undercapitalized, and
 - Are more reliant on interbank wholesale funding markets versus U.S. banks.
- ECB operations, policies and funding abilities are complex and difficult to understand, creating uncertainty and risk.
- Europe's businesses are more reliant on their banks for credit lines than in the U.S., so European bank issues could have a bigger impact on credit availability, and therefore, jobs and GDP growth.

As the result, major European banks¹ are under increasing market scrutiny and stress.

- Stock prices are down on average 23% during the month of August.
- Related 5-year CDS spreads have widened 57% over the same period.
- Interbank U.S.\$ funding levels are being materially reduced and duration greatly decreased.
- Five-year debt issuance is 90% complete versus 2011 targets, but spreads have doubled since June 30, 2011.
- Usage of ECB secured lines is increasing.
- U.S. money market funds with Eurobank exposures have greatly increased liquidity and reduced term and exposures.

Impact on U.S. financial industry of a prolonged European debt crisis:

Negatives:

- May impact U.S. bank equity prices and debt costs due to contagion.
- Low European interest rates and less loan growth reduce U.S. banks' European operations net interest income (NII), although balance sheet sizes may expand.
- Potentially higher loan losses on European exposures.
- Reduces activity and increases counterparty risks between U.S. and European banks.
- Reduces money market fund activity from U.S. to Europe.
 - Potential "break the buck" risk, although liquidity is very high.
- Increased regulatory burden and uncoordinated actions.

¹ Barclays, HSBC, BNP, Soc Gen, CS, UBS, DB, Commerzbank, Unicredito

Positives:

- U.S. banks may be able to increase European market shares due to “flight to quality” and acquisition opportunities.

Potential actions in Europe to support banks:

- Banks raise more common equity in capital markets.
- Governments announce willingness to provide, if necessary, common or convertible preferred equity.
- ECB definitively states it will, if required, fully support the banks’ funding needs, will loosen collateral requirements and extend term to 1 to 2 years.

Item 6: Economic Discussion

(A) What does the Council believe to be the reasons for the pace of the economic recovery?

Overview

The U.S. economy has delivered the weakest two-year period of economic growth following any recession in the post-war era, despite unprecedented monetary and fiscal stimulus. Recent headwinds have increased the potential for a “double-dip” recession. Academic research has found that recessions caused by banking/financial crises are deeper and longer, and recoveries are much slower, typically taking 4 to 5 years. However, significant economic and regulatory uncertainty (see figure 1), ineffective or harmful public policies, Washington fiscal dysfunction, and frequent media coverage (including European and US debt issues) are contributing to the current lack of confidence.

The U.S. housing market remains far from recovery

- The bubble and misallocation of resources in the credit and real estate markets during the prior expansionary period were significant, and housing markets have not recovered.
 - Mortgage debt relative to GDP remains inflated, even as most other loans reflect consumer de-leveraging/tighter credit standards (see figure 2).
 - Expectations are for continued price declines, reducing demand and new construction.
 - Homeowner vacancies remain high.
- Roughly two million homes are currently in foreclosure, and many more homes owned by delinquent borrowers will enter foreclosure in the coming quarters. Resolution is needed for the “foreclosure moratorium” and related lawsuits to remove the overhang of existing homes.
- Mortgage lending remains weak despite lower home prices and record low interest rates due to
 - The overcorrection in mortgage credit with very tight underwriting,
 - Substantial disruption at GSEs and persistent regulatory uncertainty, and
 - Falling appraisals.

Unemployment remains elevated due in part to continued structural issues

- Employers are not expressing intentions to hire or invest in their business due to the uncertain environment, which include:
 - The volume and complexity of regulations and potential new regulations;
 - Long-term healthcare costs;
 - Tax policy uncertainty.
- There have been necessary reductions in government spending, especially at the state and local level.
- Many years of an underperforming education system has left too many Americans ill-equipped for the jobs of the 21st Century. The increases in college costs and student debt are unsustainable.
- Technological advancement and international competition are reducing employment demand for less educated employees.
- The extended period of unemployment insurance benefits has reduced incentives for some workers to take positions at lower compensation levels.
- Dislocations caused by the steep recession have caused mismatches between open positions and skills of the currently unemployed workforce.
- Higher raw materials costs (especially energy) with little ability to pass through costs encourage a trimming of the cost of production through more stringent staffing controls.
- Too many public sector resources and policies have been diverted to objectives that do not foster more robust job and economic growth.

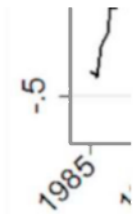
Weak consumer and business sentiment factors are restraining U.S. growth

- Consumer sentiment measures continue their downward trend as they were adversely impacted by the U.S. debt crisis and increased volatility in the markets.
- High unemployment and downward pressure on household net worth, especially due to declining house values, continues to weaken consumer confidence.
- Businesses sentiment scores are also declining, largely due to recent consumer behavior, lower future government spending and the European economic crisis.
- Consumers and businesses continue to borrow less and save more given their high levels of uncertainty.
- Retail and credit/debit card sales remain surprisingly strong as more creditworthy and higher income consumers are less impacted by the continuing real estate and jobs issues. However, credit card borrowing remains at low levels as consumers continue to deleverage.

Government policy focus and political infighting have hindered recovery

- Legislative and regulatory changes, especially the massive Health Care and Dodd-Frank bills, have discouraged business spending, lending and investment.
- Much of the stimulus package was not invested productively to increase the long-term performance of the economy but added significantly to the U.S. debt.
- Lack of progress dealing with the long-term issues of health care expenses, underfunded entitlements and pensions and higher education costs prolong the environment of uncertainty.
- Inappropriate amount of energy spent assigning blame for the current conditions has not added to confidence.

- The debt ceiling debate, S&P downgrade and long-term fiscal concerns have reduced confidence.
- Not a direct domestic government policy issue, but the potential spillover from the European crisis may be adversely affecting the U.S. economic recovery.



Notes: Index of Policy-Related Economic Uncertainty composed of 4 series. Included are monthly news articles containing uncertain or uncertainty, economic or economy, and policy relevant terms (normalized by the number of articles containing “today”), the number of tax laws expiring in coming years, and a composite of quarterly measures of the interquartile range of estimates of federal government expenditures and 1 year CPI from the Philadelphia Fed Survey of Forecasters. Components are normalized to mean 0, variance 1. Index covers January 1985-July 2011.

Source: “Measuring Economic Policy Uncertainty” by Scott Baker, Nicholas Bloom and Steven J. Davis, August 2011

Figure 2: 5-Year Cumulative Change in Consumer Loans

	\$B (7/11)	5-Year % Change	FICO < 660	FICO > 660
First Mortgage	8,137	20%	22%	20%
Student Loan	736	96%	84%	108%
Auto	707	-10%	-23%	-3%
Bank Card	537	-15%	-37%	-5%

Source: Moody's; data 7/05 to 7/11

(B) How would you assess overall economic conditions in your region? Are there significant differences across sections or regions?

Positive indicators appear to vary region to region with most of the strength coming from the energy-producing regions. Favorable prices for agriculture produce and land have benefited regions that were not impacted by drought or flooding. Fiscal tightening by state and local governments is negatively impacting both spending and employment.

- Economic activity in the Midwest continued to expand slowly in June and early July. Consumer and business spending edged up and manufacturing production continued to expand, with disruptions in supply chains due to the Japanese disasters subsiding. More specifically, Detroit manufacturing improvements are leading to job gains and lower multi-family vacancy rates.
- In New England, the best growth and lowest unemployment is in areas with technology-based industries and highly educated workforces; old industrial areas with lower skilled workers are lagging. One concern in the region is that New England's export activity remains skewed towards Europe (at least for merchandise exports).
- Washington D.C. has an unemployment rate of 5.8%, significantly below the national level, although the proposed reduction in the federal budget may increase layoffs in the region.
- In Texas, real estate developments seem to be faring unusually well, and residential rental vacancies are down.
- Conditions in the Southeast (specifically FL, NC and SC) remain mixed due to the residential real estate overhang. Further, state and municipal cutbacks are beginning to have negative impacts.
- The ninth district saw disruptions in the prior period due to widespread flooding and the temporary Minnesota state government shutdown that started on July 1.
- The South Atlantic's economy is struggling to gain traction and appears to be underperforming compared to national averages. Some states in the region remain particularly vulnerable to Federal budget tightening. Moody's put Virginia and Maryland on downgrade watch due to their exposure to the federal government.
- Government employment in Tennessee has fallen sharply this year, helping to maintain an unemployment trend higher than the national average.
- Employment conditions in the Kansas City district are better than the national average, with relatively stable housing markets and robust growth in the oil and gas industries.

Item 7: Particular Indicators

(A) Inflation: Are the prices of products and services rising more or less quickly (or declining more) than in the recent past? Are the prices for the products and services you purchase rising more or less quickly?

- Several members noted increases in consumer price inflation over the last year, at least early in the year, while others noted relatively stable consumer prices. Any recent consumer price inflation is attributed primarily to energy and food prices, though one banker also noted increased rents (due to demand resulting from falling home ownership), clothing (due to weaker dollar) and autos (due to Japanese supply chain disruptions). Several members noted that early 2011 inflationary pressures have eased significantly in recent months.
- This was corroborated by a recent study by PriceStats², using technology that monitors pricing of roughly five million items sold through online retailers, which confirms a significant slowdown in consumer inflation since May 1st of this year. Over the first four months, PriceStats data shows average monthly inflation of 55 basis points. From May to mid-July, surveyed prices became significantly more volatile, with monthly average increases of 25 basis points. From July 15 to August 4, the data shows a significant decline in prices, at a monthly equivalent of 10.3 basis points. PriceStats attributes this decline to a variety of factors, including commodity (particularly gasoline) prices, but views a slowdown of consumer demand as a significant factor as well.
- For purchased goods and services, members generally reported modest to-no price inflation. Suppliers are generally perceived to have little ability to raise prices in the current environment, and negotiation for services, particularly IT, is very competitive. However, suppliers' input prices are increasing, which suggests supplier prices will increase once the economy recovers sufficiently for them to pass on these increased costs.
- One member noted significant trends by banks to increase prices for financial services, due to higher regulatory costs, fee constraints and low loan demand. These trends include higher fees for services that include "material" banker interaction (such as wire transfers) and new or increased fees for routine services (such as paper statements, some types of ATM services and other seemingly insignificant fees, such as check card replacement fees). This member also noted that free checking accounts are in jeopardy and will likely disappear over time, both for individuals and small businesses.

(B) The Valuation of the Dollar: How have the recent changes in the value of the dollar affected your business or your customers' businesses?

- Overall, members did not believe the changes in the valuation of the dollar had a material impact on either their or their customers' business.

² PriceStats (<http://www.pricestats.com/>) is a provider of high-frequency global inflation indices, using software that scans the underlying code on public websites to capture the full array of products sold by online retailers. The technology monitors price fluctuations on roughly five million items sold by hundreds of online retailers in more than 70 countries. The methodology is grounded in research by MIT professors Alberto Cavallo and Roberto Rigobon and their Billion Prices Project. PriceStats recently partnered with State Street Global Markets (SSGM), and continues to partner with SSGM's academic partner, State Street Associates (SSA). Additional information is attached in the appendix.

- Increased prices for imported raw materials could be compressing margins for some customers, but it is not clear whether these increases can be attributed to a weak dollar versus other factors. It was noted by many that the weaker dollar has benefitted exporters.
- Members have seen increased interest in foreign exchange (FX) services by customers and noted that customers are generally more aware and sensitive to the possible impacts of exchange rates. Customers who generally buy foreign currency on a spot basis are evaluating use of forwards. One member reported some customers are requesting the ability to clear commercial payments in non-dollar major currencies.

(C) Housing: How have house prices changed in recent months? Have there been any changes in housing activity overall in your region?

- While members reported some signs of stabilization, at least prior to the most recent market shocks, there appears to be no overall improvement in housing markets. Members noted some regional differences, ranging from the relatively stable markets, such as Texas, to markets that showed signs of improvement, such as the Midwest and New England, to markets where downward trends continue, such as California and Florida. Observations made by various bankers include:
 - Prior to recent market shocks, selling prices of non-distressed homes had stopped declining.
 - Home prices are likely to decline further as the “shadow inventory” creeps into market.
 - Rental prices are gaining momentum across the board, improving returns on real estate investments and attracting investors.
- Member observations for more specific geographic area:
 - In Massachusetts, sales have remained flat, prices have weakened, average days on the market have increased since May, and inventory has increased slightly.
 - Midwest housing starts ticked up in the second quarter, but overall residential housing construction remains weak.
 - In California, prices continue to trend downward while sales of distressed properties account for almost half (47%) of total home sales. The low-end market is the most stable with the middle market the most volatile. The high-end market is fairly stable, but at lower price levels than a year or two ago.
 - Texas did not experience the run-up/melt-down of housing prices common in other regions, and prices remain comparatively stable vis-à-vis the rest of the country. Occupancy rates in apartment complexes are high, which is usually a forerunner of increased home sales.
 - Home prices in the ninth District have stabilized. Home sales in Minneapolis-St. Paul and Billings, MT were up from last year’s post-tax-credit lull, and June pending sales in Sioux Falls, SD increased from last June. Residential construction appears to be increasing.

(D) Labor Markets: How have the labor markets in which you operate changed in recent months? In particular, assess the degree of job loss (how much and in which industries). Has there been any significant job creation? What changes to wages have Council members observed since the last meeting?

- Overall, members did not observe significant job creation. Most members reported increases in hiring in technology, manufacturing, and medical and healthcare, while

downsizing continues in as finance, insurance, education and government. Acceleration in employment growth appears to be regional in nature and not necessarily mirrored nationally. There is some competition for the most qualified employees in the financial services segment, but overall hiring in the sector is either stagnant or declining. Wages remain stable, with only moderate wage increases

(E) Consumer Confidence: Is the Council seeing signs of improved consumer confidence and increased consumer spending? What is the outlook for consumer credit losses?

- Despite some signs of improvement early in the year, consumer confidence remains weak. Recent events (e.g. the debt limit battle, S&P downgrade, stock market volatility and EU crisis) have resulted in an additional sharp drop in consumer confidence. Overall, consumer balance sheet deleveraging continues, and consumer spending, while increasing somewhat, remains low, with some reported exceptions. Consumer confidence and spending appear higher for higher-income earners, with low- and mid-income earner remaining cautious and uncertain. The risk of a negative wealth effect in the second half of 2011 from the recent decline in equity prices could further depress consumer spending. The 7th District reported increased consumer spending in July, as consumers took advantage of retailers' efforts to clear inventory. The personal savings rate is relatively high (5.4% in June).
- The consensus view is that consumer credit losses have trended lower in recent months, as poor performing loans made at the height of the credit bubble gradually make their way off banks' balance sheets. Members expect this trend to continue going forward. One member reported consumer credit began to expand in May for the first time since September 2008.

Item 8: Monetary Policy

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

- The Council generally believes the Federal Reserve's very accommodative monetary policy is appropriate given the weak economic conditions, high unemployment rate and the fact that further fiscal stimulus currently appears unlikely to occur. The recent debt ceiling agreement appears to have further damaged economic growth in the short run as it cut federal spending, especially in 2013, and will be exacerbated if current tax cuts are allowed to expire simultaneously.
- One objective of current monetary policy that appears to have been achieved is to avoid deflation in the aftermath of the crisis in residential and commercial real estate. Stabilizing long-term inflation expectations appears to be a crucial element of that policy. With inflation expectations near the long term objective of the FOMC, the risk of further deflationary expectations has been substantially reduced. In addition, the risk of inflation appears very low with the continued large output gap. With downside risks rising, deflation risk could reemerge.
- In addition, potential FOMC actions (additional bond purchases, removal of interest on bank reserves) and increased regulatory and capital requirements will create a particularly

challenging environment for financial institutions over the next 12-24 months.

Specifically, the following areas of concern should be noted:

- Net interest margin compression: Loans that were originated in the higher interest rate environments of 2006 and 2007 are approaching maturity and banks are faced with reinvesting this principal cash flow at rates 200 to 300 basis points lower than current yields. As asset yields decline, opportunities to lower deposit yields are limited, thereby causing material net interest margin compression over time.
- Increased credit and interest rate risk: Economic conditions, low interest rates, limited loan demand, high levels of deposits and competitive pressures are causing banks to underwrite some loans on terms and with structures that may pose problems in the future. Credit spreads are tightening to pre-recessionary levels. Loan durations are lengthening as banks respond to client demands for long term, fixed rate loans at today's very attractive low rates. While asset duration is increasing, liability duration is shrinking as clients move away from longer term products to shorter liquid options. This combination is increasing long-term interest rate risk, hurting bank earnings and making the upfront cost of hedging prohibitive.
- While the FOMC's accommodative monetary policy is clearly warranted by current economic conditions, there is a view that the FOMC should be more aggressive in trying to stimulate the economy in light of high and persistent levels of unemployment and the current lack of further fiscal stimulus.
- However, some members did not see committing to these extraordinarily low rates for two years in the most recent policy announcement as constructive.
- Finally, one member believes the current monetary policy of the Federal Reserve is unconscionable due to the negative impact it is having on those who have worked and saved their entire lives and that this policy needs to be changed immediately.

Inflation Turnaround

Roberto Rigobon

August 5, 2011

PriceStats is a provider of high-frequency global inflation indices that offer insights into key macroeconomic variables. The indices are generated using software that scans the underlying code on public websites to capture the full array of products sold by online retailers, including food, beverages, electronics, apparel, furniture, household products, prescription drugs, over-the-counter medicines, and entertainment products. The technology monitors price fluctuations on roughly five million items sold by hundreds of online retailers in more than 70 countries. The PriceStats methodology is grounded in the extensive body of research of MIT professors Alberto Cavallo and Roberto Rigobon and their Billion Prices Project at MIT. Cavallo and Rigobon have leveraged this research and their expertise in monetary economics to develop the PriceStats indices.

Through the partnership between PriceStats and State Street Global Markets, this unique body of inflation research will be incorporated into advisory research analyses and investment strategy publications across major asset classes and distributed through State Street Global Markets' proprietary client research portal, IR³. The partnership, which is housed within State Street Global Markets' academic affiliate, State Street Associates, will benefit from 13 years of experience in bringing leading academic research in finance and economics to sophisticated institutional investors around the world.


In this brief note we would like to share with you the trends we have been detecting in our data for the USA – looking not only at the aggregate information but also at the detailed data.

What are the inflationary trends we are detecting in our indexes?

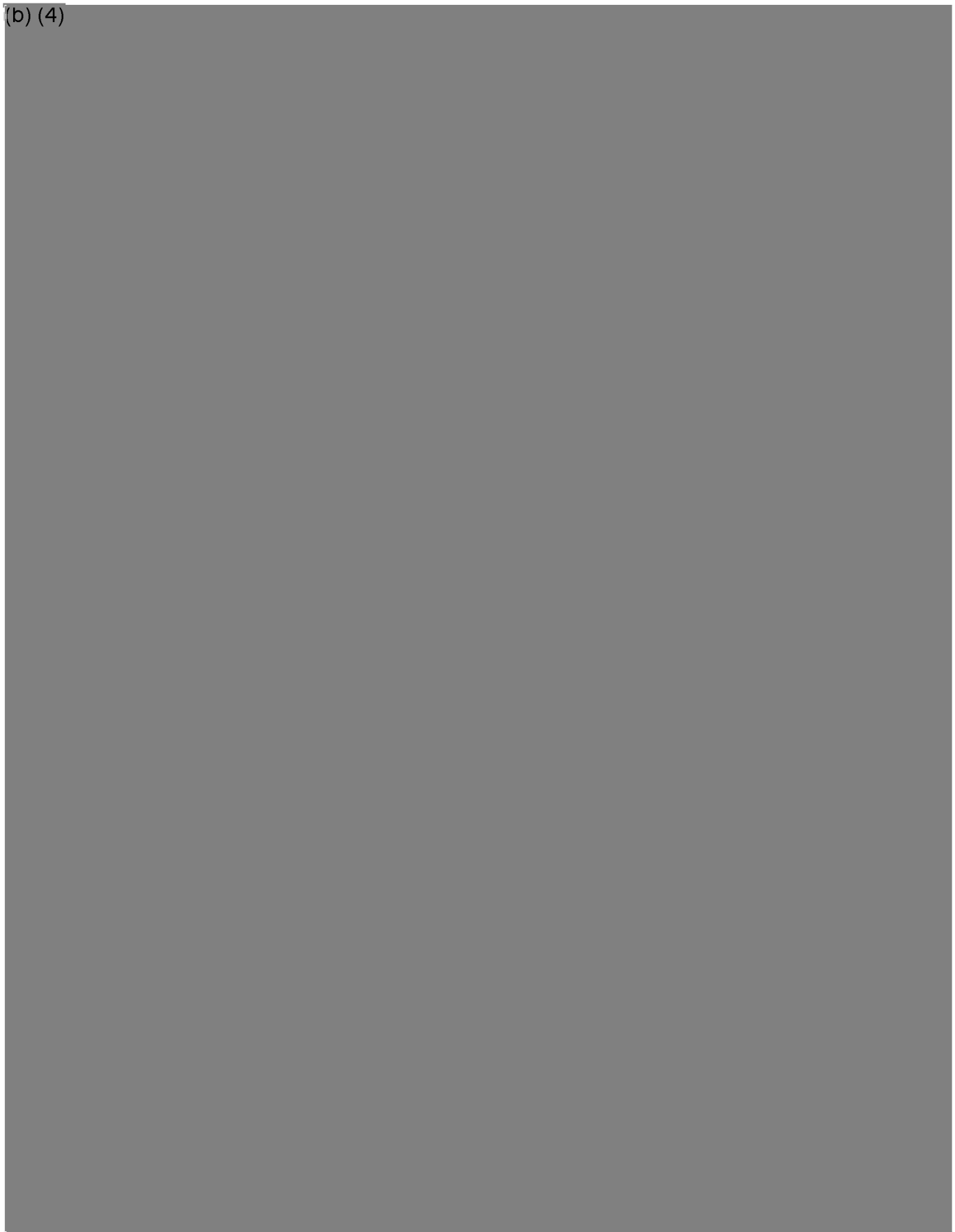
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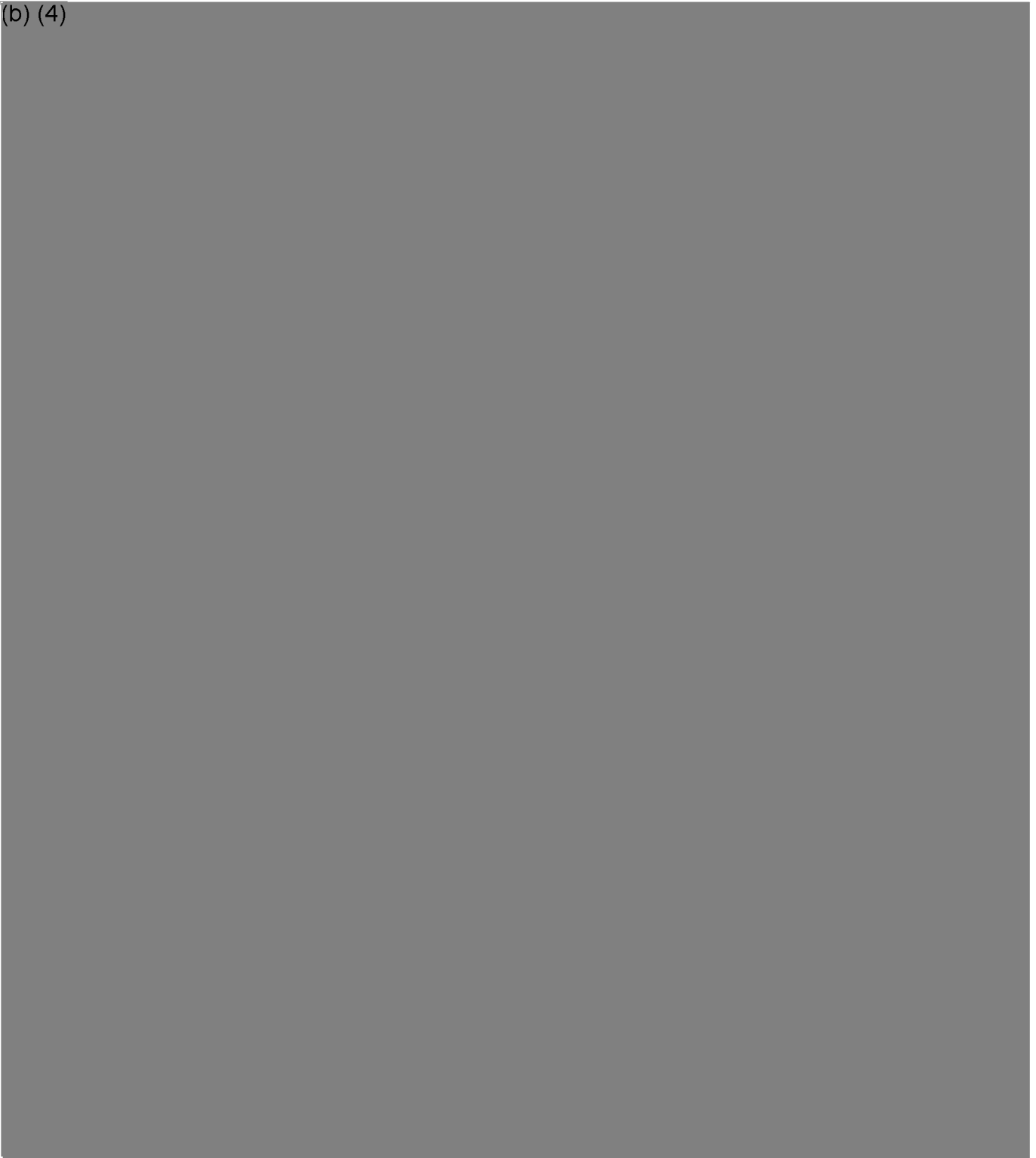
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