AGENDA

Meeting of the Federal Advisory Council
and the Board of Governors

Friday, February 3, 2012

Item 1: Stress Testing

What is the Council's view on the proposals for stress tests, including the disclosure of stress test results?

Overview

The Council believes that regular stress testing is a critical and valuable aspect of ongoing risk management, capital planning, and supervisory oversight of all banks, large and small. The Supervisory Capital Assessment Program (SCAP) and Comprehensive Capital Analysis and Review (CCAR) 1.0 were both effective stress-testing exercises that bolstered confidence in the banking sector, supported improved risk and capital management, and enhanced the safety and soundness of the banking sector and individual banks. Appropriate disclosure of stress-testing results can help to achieve policy objectives by fostering transparency, market insight, and discipline.

The Council supports the policy objectives and most aspects of the proposed rule to expand and implement stress testing as an ongoing and integral part of bank risk management and supervision. However, we believe that the disclosure requirements of the proposed rule go well beyond the statutory mandate of the Dodd-Frank Act. Therefore, the requirements should be modified to ensure that policy objectives are achieved without creating market confusion or introducing unnecessary risks to the safety and soundness of individual banks and the banking sector as a whole. We also support minor modifications to the proposed rule to harmonize assumptions, processes, and disclosures across the various agencies charged with conducting stress tests.

Specifically the Council recommends that:

- The disclosures do not include expected results under the baseline scenario.
- The disclosures for the adverse and severely adverse scenarios be limited to summary-level disclosures for the cumulative nine-quarter period, rather than the details for each quarter end.
- The Federal Reserve increase the transparency to the banks of its analysis, modeling techniques, and assumptions used to analyze the banks under the supervisory stress tests.
- The disclosures be made at the times when banks are normally issuing their quarterly financial results.

Proposed Section 165 disclosure requirements essentially would result in the Federal Reserve and the banks giving forward-looking guidance over nine quarters, creating unnecessary and potentially significant safety and soundness risks.

- The proposed rule mandates detailed P&L disclosures for the nine-quarter period for baseline, adverse, and severely adverse scenarios. These disclosures are proposed to be on a quarterly basis by the Federal Reserve, and it is unclear whether the disclosures mandated for the banks are cumulative or for each quarter during the period. For institutions in excess of $50 billion in assets, the Federal Reserve will disclose the results of its annual stress tests and the institutions themselves are required to disclose twice a year the results of their company-run stress tests. Institutions with assets between $10 billion and $50 billion will be required to disclose company-run stress tests results annually.
- The level and specificity of disclosure for the baseline scenario is the equivalent of requiring banks, every six months, to provide earnings guidance and detailed P&L forecasts for the following nine quarters and would create significant and unnecessary risks for banks and the banking sector. These forward-looking statements would be used by investors to develop expectations regarding planned capital actions, key strategic initiatives, including M&A activity, and competitively sensitive business and product plans. In some cases, the institutions may be forced to disclose future plans either to dispel unreasonable expectations or to explain differences between the disclosures of the Federal Reserve and of the institution itself.
- Differences between actual results and the expectations set forth in the required baseline disclosures could create significant and unnecessary risks to the safety and soundness of banks and potentially lead to exposure to other liabilities. The required disclosures would become "checklists," and banks that failed to deliver short-term results consistent with the checklists could face significant volatility, spiraling negative perceptions and sentiment among investors and customers, and the sudden loss of liquidity from a loss of confidence among depositors and counterparties.
- These unnecessary risks are the primary reason that over the past two decades there has been a steady evolution away from providing EPS guidance, let alone the more detailed level of guidance and forward-looking statements required by the proposed rule.
- Furthermore, from a safety and soundness perspective, these required disclosures would likely compel the banks to prioritize the achievement of short-term results to meet checklist expectations over more appropriate longer-term risk management and sustained long-term results.
- The required disclosures could lead to confusion under the well-established current market disclosure framework and potentially result in liability under the securities laws. For example, disclosure of baseline scenarios – effectively forward-earnings guidance – may create a duty to update that guidance.
- The Council believes that the underlying public policy goal of providing transparency and market discipline around capital resilience under stress can be achieved without mandating that banks give specific P&L guidance under the baseline scenario.
- The Council strongly believes that the policy objectives of transparency and market discipline can be achieved by the summary level disclosure of *cumulative* impacts for the nine-quarter period under the adverse and severely adverse stress scenarios only (i.e., *not* for the baseline and *not* for each of the nine quarters). This recommendation applies to both the Federal Reserve and bank disclosures. Therefore, we strongly recommend that the proposed rule be revised to require only this level of disclosure by the Federal Reserve or the banks, rather than detailed quarterly P&L and capital expectations over all three

scenarios. We recommend disclosure format, content, and level of detail similar to the successful disclosures provided in the SCAP process.
- Further, the Council recommends the gradual and thoughtful implementation of new disclosures of both company-run and Federal Reserve-run stress-test results. Because of the considerable risks and lack of precedent, initial disclosures (beginning with the disclosures the Federal Reserve may make in March 2012 in connection with CCAR 2.0) should focus on high-level, cumulative, summary information rather than detailed expectations and de facto guidance. Over time, as market participants become more familiar with stress testing and related disclosures, and as banks and supervisors build experience, expertise, and mutual understanding of one another's modeling and analysis, specificity and content of disclosures can be increased as appropriate. In contrast, reducing or pulling back from detailed disclosure precedents in the event of unanticipated risks and consequences is likely to be much more difficult.
- Finally, we recommend that the Federal Reserve foster ongoing discussions with other bank regulatory agencies, OFR, SEC, and financial companies to identify all potentially unnecessary safety and soundness risks, as well as all significant considerations under securities law to ensure appropriate harmonization with well-established and proven existing disclosure expectations and obligations.

Disclosure of both supervisory and company-run stress tests must be harmonized to avoid potential confusion among investors, bank counterparties, depositors, and the public.
- Differences in assumptions and modeling across supervisory and company-run stress tests are very likely. Resulting market confusion potentially could undermine, rather than enhance, confidence in the banking sector. This may compel banks to explain the discrepancies, potentially adding further confusion and eroding confidence.
- Current CCAR practices and the proposed rule do not provide banks with sufficient transparency of supervisory modeling assumptions and analysis to facilitate appropriate understanding and ability to explain potentially different results.
- The Council recommends greater interaction between supervisors and banks as well as increased debriefing and lead time ahead of public disclosures to improve transparency and enable banks to provide appropriate explanations and communications with markets and investors.
- The Council also recommends that the Board consider what internal control and governance systems will be required within the Federal Reserve to support and ensure the accuracy of the Federal Reserve's ongoing disclosures. Robust internal controls and greater interaction between supervisors and banks could minimize the risk of market participants acting on potential errors. A Federal Reserve disclosure that contains errors could lead to a significant disruption in the market confidence of the impacted institution.

New disclosures required by the proposed rule will interact with an existing and well-tested disclosure regime. Coordination of the timing and sequencing of new and existing disclosures would improve transparency and facilitate greater understanding among market participants.
- Existing securities law and the timing of quarter-end and year-end reporting will impact banks' ability to appropriately communicate with markets regarding new disclosures under the proposed rule. In short, SEC regulations prohibit the selective disclosure of material financial information (e.g. disclosing only selected items that might be misleading on their

own rather than providing comprehensive financial disclosures). For this reason, most public companies restrict interactions between banks, analysts, and investors during "quiet periods," which generally begin two weeks before the end of each quarter and continue through the public earnings announcement (usually two to four weeks after the end of each quarter). Under the proposed rule, the Federal Reserve and banks would be required to provide disclosures that would likely be deemed selective disclosures during established quiet periods. Such timing would significantly impede banks' ability to fully communicate and explain disclosures that could, in turn, decrease transparency and diminish market participants' ability to understand the disclosed information. This issue would be exacerbated if the Federal Reserve chooses to publish baseline projections for each quarter-end in the planning horizon.

- The Council believes that modifications to the proposed timing of disclosures would fully support the policy objectives of enhanced disclosure without creating the difficulties and risks that could arise because of requirements and restrictions under existing securities law.
- The Council proposes allowing banks to have enough time to coordinate stress-test disclosures with disclosures of quarterly financial results.

While the Council believes that the proposed disclosures present the greatest risks to safety and soundness, we also have several recommendations for incremental improvements to the proposed rule to enhance the effectiveness and efficiency of the stress-testing process.

- *Improve transparency.* Increasing the direct interaction between banks and the modeling teams would help prevent misinterpretations. This is particularly important as the Federal Reserve's modeling results will be disclosed, which raises the stakes on modeling errors due to miscommunication or misunderstanding. Greater communication would also help the Federal Reserve better answer the question of how resilient a bank is versus how well it "took the test."
- *Ease operational burden from artificially compressed timelines.* Providing scenarios earlier would allow for more complete modeling and thoughtful responses. Alternatively, shifting the timeframe so that it does not overlap with holidays and end-of-year activities would also allow for higher quality output with less operational strain on institutions.
- *Jointly work with all stakeholders to develop "best practices."* Validating key approaches and assumptions with experts and then benchmarking them would lead to better outcomes and a safer system. For example, establishing an annual stress-test, best-practices conference or forum would allow banks and Federal Reserve modelers to learn from each other and converge on best practices and common assumptions. This knowledge sharing would lead to new insights, better answers, and a continuous refinement of approaches.
- *Coordinate across the regulatory community.* Aligning stress-test procedures and assumptions across the Federal Reserve, OCC, and FDIC will ensure that holding companies and bank subsidiaries are subject to a consistent set of requirements. There are also opportunities to leverage existing regulatory data repositories where available and to coordinate with the FDIC with respect to how stress tests are leveraged with required resolution and recovery plans. Finally, regulators should consider ways to tailor stress-testing requirements to lessen the impact on smaller institutions when appropriate.

Item 2: 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

Numerous economic metrics and indicators of market activity have recently been positive. Recently reported measures of the unemployment rate, manufacturing activity, and sales of new and existing homes indicate positive change and have given rise to an optimism that conditions are improving. Consumer sentiment appears to reflect a higher degree of confidence, albeit this may only reflect the (so far) mild winter weather conditions. Broad indexes of domestic stock markets have risen significantly while interest rates have remained at historic lows. Inflation appears to be under control. In addition, the U.S. has thus far escaped any significant European flu.

These perceptions of improving economic and financial conditions, however, are not yet translating to improved credit demand and/or significant loan growth. Both consumer and commercial markets remain quiescent. Small business owners remain extremely cautious about expanding their use of leverage. Meanwhile, consumers continue to deleverage in the face of diminishing wealth and limited growth of disposable income. Most recently, the Federal Reserve's signal that it intends to hold interest rates low through early 2014 has confirmed for many that truly improving economic conditions are still a ways in the future.

Our view is that asset growth and a return to healthy profitability in the banking sector, particularly for those banks with limited sources of revenue outside of consumer and commercial lending, will remain constrained until the consumer deleveraging process reaches an equilibrium, consumer demand is restored, and economic uncertainty is minimized.

In the past few meetings, we have highlighted declining underwriting of and pricing for credit. Although there are still pockets of deterioration in certain areas of the country and in certain products, the Council overall reports some degree of stabilization over the past few months.

(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?

- Council members stated that credit for small businesses is widely available and that there is vigorous competition among banks to supply credit to qualified small business borrowers. However, eight of the Council members report that demand by small businesses for new credit facilities is weak, stagnant, and subdued. Small business owners continue to be very cautious towards new debt financing for any purpose, relying on internally generated funds or deferring capital and/or operating expansion in the face of economic uncertainties. Two Council members reported some modest increase in loan demand attributable to the healthcare, energy, and information technology sectors. In addition, three Council members reported modest growth in small business bookings due their refinancing of

existing debt in place at other banks. Finally, some Council members have seen an uptick in loan applications; however, these members also reported a deterioration of the financial and credit profiles of applicants and a very low pull-through rate.

- There was no report of changed lending standards. Council members stated that lending standards have remained consistent quarter-over-quarter.

(B) Update on 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 in the Northeast and West Coast areas generally reported positive trends and outlook for CRE, including the demand for financing in the office sector. Elsewhere, Council members indicated that CRE demand growth was occurring predominantly in the multifamily and build-to-suit sectors. Commercial office and retail properties in non-gateway cities are challenged with high vacancy rates and declining valuations.
- Most members reported that existing CRE assets are performing in line with expectations. Market location is crucial when forecasting over or under performance.

(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?

- The majority of Council members reported a strong demand for the financing of multi-family construction projects. They noted this trend is due to a rise in demand for rental units alongside single-family foreclosures and the increasingly difficult qualifying standards for home ownership. This trend is expected to continue until the single-family housing markets stabilize.
- In other sectors, with the exception of acquisition and land development, Council members indicated that construction financing is available for well-sponsored projects with strong equity participation. Of special note was the demand for and the supply of financing for hospitality projects and build-to-suit retailers (e.g., Walgreen and CVS).
- Several members expressed concern over the currently limited amount of long-term takeout financing of these projects normally provided by the CMBS market and life insurers. Council members also noted the withdrawal of European banks from participation in the commercial real estate construction financing market and the relative stabilization of lending terms.

(D) Agricultural Lending:

Have there been any recent changes in agricultural lending?

- The consensus view of the Council was that the agriculture economy is strong and there is vigorous competition to lend. Demand for net new loans remains low as profitable farmers/producers payoff existing loans and maintain operations with internally generated funds. Difficult weather conditions in the fourth quarter in the South have created some

tight supply conditions in certain commodities, while overall global demand for foodstuffs continues to expand. In general, it was felt that production capacity has increased sufficiently to somewhat stabilize commodity prices, but there is a risk that rising farmland prices may not be sustainable. Mitigating that concern is the view that farmers (although perhaps not land speculators) enter this period of the cycle with manageable levels of financial leverage.

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

- There was no clear consensus regarding consumer lending. Some members report that demand for consumer credit is increasing but the credit quality of applicants is weak. Other members reported that consumer credit demand is weak. Consumers appear to be favoring longer-term, fixed-rate first mortgages at today's low rates over HELOCS and HELOANS with their exposure to prime rate volatility. There is also some increase in unsecured consumer installment loan applications, but it is unclear if applicants can meet qualifications. Auto loans have continued at a good pace.

***(F) Update on Home Mortgage Lending*:**
What changes have you seen in the home mortgage market in the past three months?

- Home mortgage lending continues to be dominated by refinancing activity. The ability to qualify is the primary issue in the mortgage market. Members point to the relaxed standards of HARP 2 as a potential stimulant to refinancing activity due to the ability to refinance higher LTVs and limitations on repurchase risk to participating originators.

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

- Members reported that foreclosures have slowed. Those members with mortgage servicing operations note that legislative or judicial actions in several states have stalled or slowed the foreclosure legal process. They also note increasing and continuing efforts to work with delinquent borrowers to keep them out of foreclosure through loan modifications and short sales.
- An insightful comment of one member notes that delays in the foreclosure process that allows a delinquent borrower to stay in his home for an extended period provides rationalization to his neighbor to engage in a strategic default that may not have been considered previously.

<u>Item 3</u>: Student Loans

What is the Council's view on recent trends in the student loan market?

Current Student Loan Markets

- College enrollments have been increasing and so have the costs.
  - Undergraduate student enrollments grew 5% per year for the last five years to a total 26 million for the 2010-11 academic year.
  - Published tuition and fees at public four-year institutions increased 8% on average per year, doubling over the last nine years. Significant recent increases are due, in part, to reductions in state government subsidies.
- Recent growth in student loan debt, to nearly $1 trillion, now exceeds credit card outstandings and has parallels to the housing crisis.
  - Significant growth in subsidized lending in pursuit of a social good (higher education vs. expanding home ownership).
  - Resulting upward pressure on asset prices (tuition vs. home prices).
  - Lack of underwriting discipline ("no-doc" direct loans vs. "no-doc" mortgages).

Federal Student Loans

- Approximately $104 billion, or 95% of the roughly $112 billion in annual student loan originations, is comprised of federal student loans. This represents a 139% increase over the last decade (inflation adjusted).
  - Banks are no longer involved in originating federal student loans as it is now done directly through the Department of Education.
  - Ability to repay/underwriting is not a factor for Stafford loans (~75% of total). These require no credit bureau or cosigner, and loan limits do not vary between schools and majors (including for-profit vs. non-for-profit schools).
  - The program does not have oversight similar to that performed by financial regulators (e.g., Federal Reserve, OCC, FDIC, FHFA, and CFPB).
  - From the fiscal period 2005 through 2009, the two-year cohort default rate of federal loans increased from 4.6% to 8.8%. For the latest cohort year, for-profit schools comprise almost half of the total borrower defaults.

Private Student Loans

- The remaining 5% of student loan originations is composed of $6 billion in private student loans – a 19% increase (inflation adjusted) over the last ten years.
  - Following the financial crisis and regulatory changes, the number of private student loan providers has dropped from 80 in 2007 to fewer than 15 today.
  - School financial aid advisors and private lenders encourage students to maximize less expensive alternatives (e.g., scholarships, grants, federal student loans) before utilizing private student loans, although the generally variable priced private loans are currently similar in price to the fixed rate unsubsidized government loans.
  - Private student loans are typically originated after an examination of a borrower's creditworthiness. This would include an examination of the student and of the cosigner (which over 70% of private loans have).

    - Oversight is provided by federal banking regulators and now the CFPB. Significant new disclosure and right-to-cancel requirements are applied to private student loans but not direct loans.
    - Private loans have recently had better and more stable loss performance relative to federal loans.
- Private education loans remain essential in supporting educational choice, especially for middle-income families.
    - With the cost of college now exceeding $40,000 per year at many institutions, the need for private education loans to supplement direct loans fulfills a need not fully met by federal programs.
    - Any additional policy changes (e.g., changes to bankruptcy treatment) made to improve consumer protections on private education loans should not operate to discourage the availability or increase the price of private education loans to students who legitimately need them.

New Developments

- A Congressionally mandated CFPB report on the industry is in the works.
    - The CFPB is in the process of preparing a report, due July 2012, that should produce new information on the market and consumer behavior related to use of private student loans.
    - The report will also include policy recommendations.
    - Although the report may appear valuable to policymakers, it will risk being insufficient due to the exclusion of federal loans. Sound policy necessitates examination of both federal and nonfederal student loans.
- President Obama has recently proposed reforms that include:
    - Shifting aid away from schools that do not restrain tuition increases.
    - “College scorecards" to help families find appropriate schools and makes the CFPB's college "shopping sheet" mandatory.
    - Reward schools that take steps to improve graduation rates and keep costs affordable.

Important Public Policy Issues to Address

- Is the current structure of the federal direct student loan program helping fuel growth in the cost of education?
- Should there be more disclosure consistency between federal and private student loans?
- Should ability to pay or other underwriting standards be applied to federal student loans as they are with all other major loan types?
- What would be the impact of greater forbearance flexibility on private loans?
- What are the impacts on consumers and the economy of significantly higher debt levels during the early years of household formation?
- What is the ultimate impact of the federal student loan program on tax-payers/the deficit?
- How can we best coordinate and implement the input on college affordability from all stakeholders (e.g., colleges, government, private lenders, families)?

Item 4: **Home Loan Modifications and Foreclosures**

(A) What can be done to more quickly resolve the problems associated with mortgage borrowers who are underwater, in default, or in foreclosure?

Loan Modification

- Restrict or limit consumers from applying for loan modifications multiple times. Consumers are beginning to reapply for loan modifications as a foreclosure-stalling tactic.
- Restrict the number of days a conforming borrower has to provide documentation required to apply for a loan modification. The Department of Housing and Urban Development limits the borrowers response time to ten days or the loan modification request is terminated. As the government-sponsored entities (GSEs) have no limit, borrowers can use this as a means to delay the foreclosure processes.

Short Sales

- Eliminate documentation requirements for modification qualification for borrowers that have no desire or ability to keep their home and wish to pursue a short sale.
- Allow lenders to approve short sales, within certain guidelines, without having to wait for GSE approval.

Foreclosure

- Review foreclosure laws and procedures to lower costs and shorten time frames that borrowers can remain in property without paying principal, interest, taxes, and insurance.
- Promote stability in government-sponsored programs and the standardization of foreclosure rules that would allow servicers to more efficiently identify the appropriate solution for each borrower.
- Resolutions are faster and less expensive in states that do not have judicial foreclosure laws.

Are there "best practices" by some institutions that are resulting in faster resolutions? Should the government take steps to encourage these practices?

- More institutions are recognizing that the housing market is not going to recover quickly and that “kicking the can down the road” is not in the best interest of the industry or the nation. This is resulting in a greater emphasis on short sales in order to avoid the expense and deferred resolution associated with foreclosures.
- It has been observed that re-default rates on loan modifications are lower for borrowers who have worked with (non-outsourced) loss-mitigation specialists that have become familiar with the borrower's particular circumstances.
- Qualified borrowers remain impacted by three basic principles: ability, stability, and willingness to pay. Loan modification success is highly correlated to the degree of debt service relief; the loan modification tactic (principal reduction or interest rate reduction) does not matter unless the willingness is present.

What other steps can be taken?

- Convene stakeholders (regulators, GSEs, financial institutions, real estate professionals, and investors) vested in the expedient and economic resolution of the issue and evaluate the short list of solutions that have the potential to produce an acceptable outcome given the scale and criticality of the issue.
- There are three main groups that hold the majority of mortgage debt in America: 1) GSEs, 2) banks, and 3) private-label MBS. As a result, in mid-2008, the Federal Reserve of St. Louis estimated that "…by [2007], more than 20 percent of the mortgage market was funded by private-label MBS." Solutions must be found to deal with mortgage borrowers who are underwater, in default, or in foreclosure in this significant segment of the mortgage market. Little progress has been accomplished to date.
- Create tax incentives and provide CRA credits to encourage institutions to facilitate more short sales in order to expedite clearing the market of housing inventory.
- In general, getting more help to troubled borrowers sooner is important to stemming the inflow of mortgages needing resolution. One suggestion is a government/GSE program that would allow certain creditworthy borrowers who are current with their payments, but underwater with high LTVs, the ability to refinance into lower rates to improve their cash flow before they become distressed. Likewise, a program (such as outlined by the President) where a borrower with a privately held mortgage could refinance into a loan backed by the FHA would complement the previously announced Fannie/Freddie refinance expansion (HARP).
- We strongly support the Administration's recently announced change to the HAMP program that allows the Treasury to pay principal reduction incentives to the GSEs if they allow servicers to forgive principal in conjunction with a HAMP modification.
- Create a deed-in-lieu program with a rent-to-own feature, avoiding the delay and expense associated with foreclosure, while allowing more homeowners to stay in their homes. Such a program could dovetail with the Administration's recently announced HAMP program changes, which in part appear to be focused on expanding the availability of rental options in lieu of foreclosure.
- Create a shared-appreciation program that would set the current mortgage at a level more affordable for the homeowner, while allowing the mortgage holder the opportunity to participate in the future appreciation on the sale of the property.
- We look forward to evaluating the full details of the Administration's recently announced HAMP program changes; the provisions appear to expand both the availability and degree of debt-service relief for borrowers.

(B) Does the Council have any additional suggestions to address the disposition of foreclosed single-family properties that are owned by banks or the government?

- In general, there is broad agreement that a solution capable of addressing the scale of the issue is not only lacking but also necessary.
- There is support for government assistance in pooling and packaging REO properties for sale to investors who want to purchase properties for large-scale rental opportunities. Benefits mentioned include:
  - Higher likelihood of attracting more qualified operators,

- More efficient and less-costly transactions,
  - Careful selection of geographic markets to avoid further destabilization,
  - Potential government-sponsored financing, and
  - A new foundation in which private investors could also participate in large rental programs, with the presence of approved, skilled property management partners.
- Other suggestions related to investors/banks include:
  - Provide favorable tax treatment for investors, such as accelerated depreciation, on the purchase of REO properties. Investors who receive this benefit could be subjected to minimum hold periods.
  - Relax GSE and FHA limits on the number of REO properties owned by a single investor.
  - Provide incentives for banks to contribute (directly or indirectly) into rental property programs.
- Other suggestions related to individuals include:
  - Develop GSE programs that incentivize banks to lend on REO properties; for example, exempt foreclosure sales from the Qualified Residential Mortgage and risk-retention rules.
  - Provide special financing for individuals (reduced rates or extended term) who purchase and occupy REO properties as their primary residence.
  - Provide CRA credit and/or tax incentives to lenders on sales of REO properties below book value.

Item 5: Regulatory Measures of Creditworthiness

The federal banking agencies have proposed some alternative standards of creditworthiness to be used in place of credit ratings to determine the capital requirements for certain debt and securitization positions covered by the market risk capital rules. What is the Council's view of this proposal?

- The Council supports the banking agencies' overall goal of strengthening the regulatory capital framework and reducing the degree to which regulatory risk weights or capital charges are determined solely on the basis of credit ratings. The members also recognize the challenges associated with developing alternatives for the use of credit ratings in the capital rules and elsewhere.
- However, the Council believes that significant adjustments to the proposal are needed to ensure that any alternatives to credit ratings properly reflect the risk of exposures and the differences in risk among exposures both across and within asset classes. Moreover, we believe that the agencies should take the time necessary to ensure that the proposed alternatives are properly structured and calibrated. This is especially true since the agencies have indicated that the alternatives developed as part of the market-risk rulemaking will be applied to the banking book as well. Given the importance and complexity of the proposal, the agencies also should consider extending the comment period.
- The Council strongly believes that any alternatives developed for regulatory capital purposes and implemented in the United States must be risk sensitive. That is, within and

across classes of exposures, the amount of required regulatory capital should accurately reflect differences in relative risk. Otherwise, the capital rules may unintentionally create incentives for banking organizations to hold *riskier* assets, much as the very broad risk-weighting categories in the original Basel I capital rules provided incentives for banks to purchase the riskier assets within these broad risk-weighting categories.

- The Council recognizes that appropriately risk-sensitive rules may result in adjustments – both upwards and downwards – to the risk weights for particular exposures or types of exposures. Nevertheless, the Council believes that risk-sensitive capital rules are the best way to protect the safety and soundness of banking organizations, prevent systemic risks that can arise from distorted incentives, and deter regulatory arbitrage.
- The following highlights some of the most important concerns of Council members with the proposal:

Securitization exposures. Several aspects of the proposed Simplified Supervisory Framework Approach ("SSFA") weaken the SSFA's ability to accurately distinguish between the risk of different securitizations and tranches.

- For example, K_G, which is used to calibrate the capital charge, does not sufficiently take into account the difference in quality among different pools of assets in the same asset class. Moreover, it is unclear from the proposal whether or how credit enhancements, like overcollateralization and funded reserves, may be taken into account in assessing the risk of a securitization position.
- The proposed supervisory floor, moreover, would assign the same risk weight to all tranches above K_G once cumulative losses exceed K_G, regardless of the seniority or "thickness" of the tranche, both of which bear importantly on the probability and severity of potential losses on the position held. Further, the sizable "steps" in the floor overstate the incremental increases in risk, particularly with respect to more senior tranches, as cumulative losses begin to exceed K_G. These very large steps likely will have substantial procyclical effects as cumulative losses approach these breakpoints and do not recognize that risk decreases for many positions as the securitizations mature.
- Applying the capital charge to the par value or acquisition cost of a securitization, rather than to its carrying value, also will result in a regulatory capital "double hit" for those exposures' losses, which flow through earnings or regulatory capital.
- It is not clear how revolving securitization structures and FFELP student loans would be treated under the proposal.

Exposures to sovereign debt, banking organizations, and public-sector entities.

- Under the proposal, the OECD Country Risk Classification ("CRC") would be used to determine the risk weighting for sovereign debt positions. In addition, the risk weight for banking organization and public-sector entity (such as state and local governments) exposures would be based on the CRC assigned to the country where the banking organization or public-sector entity ("PSE") is chartered or incorporated.
- CRCs, however, may not accurately measure sovereign credit risk. For example, the OECD methodology for assigning CRCs are focused on transfer and

convertibility risk and on the potential for force majeure events (e.g. war, expropriation) to disrupt the payment on obligations. Moreover, all OECD-member sovereigns that are a "high-income country" are assigned the most favorable classification even though there may be important gradations of risk among these countries.

- The proposal also does not appear to adequately recognize that the risk profile of banks and PSEs within a particular country, and the different classes of debt issued by these entities, can vary significantly. For example, the proposal would assign the same risk weight to the senior and subordinated debt issued by a banking organization, despite the higher risk posed by subordinated debt.

Public company exposures. Under the standard approach, all exposures to public companies would receive a uniform 100% risk weight. Preliminary analysis by one large institution suggests that the alternative indicator-based approach would result in exposures to many investment-grade corporate issuers being assigned the same risk weight as exposures to non-investment-grade issuers. Moreover, neither approach takes into account potential differences in the level of seniority or collateral support among the debt issues of a particular issuer. Accordingly, the proposal unintentionally creates incentives for banking organizations to invest in riskier, rather than safer, corporate debt.

Item 6: Strengthening Regulation and Supervision of Large Bank Holding Companies

(A) Risk-based capital, leverage, and early remediation

i. *Risk-based capital and leverage requirements*
What is the Council's view on the proposals for risk-based capital and leverage requirements?

While we are supportive of the overall framework of risk-based capital and leverage requirements in order to promote and enhance systemic stability, the Council does have concerns with specific requirements and their implementation:

- The rules should be consistent across nonbank covered companies and jurisdictions to ensure a level playing field and prevent the risk from shifting from regulated U.S. banks to the shadow banking system, different jurisdictions, or financial institutions regulated under different regulatory structure.
    - In addition, the impact of mandated capital thresholds that vary by global significance may have uncertain implications including, perversely, funneling wholesale and retail deposits toward the GSIBs at the expense of non-GSIBs and even more so to non-covered banks.
- There continues to be the need to calibrate capital methodologies and risk weightings to balance market stabilization and economic growth:
    - Procyclicality of the framework could inadvertently create a bias favoring the "haves" and disadvantaging the "have-nots" disproportionately to their underlying risk.
    - The liquidity proposal encourages covered companies to hold large amounts of sovereign debt (as "low risk" assets), while the credit requirement forces additional

    capital charges on that same sovereign debt, reducing banks' private-sector lending capacity.
  - Infrastructure, project, and trade-finance risk weightings and leverage-ratio requirements make these activities less likely. This may be particularly important as European banks deleverage.
- The inclusion of Other Comprehensive Income (OCI) will require that the after-tax unrealized losses on banks' Available For Sale (AFS) securities portfolio reduce a bank's tier 1 capital dollar for dollar. This may result in meaningful volatility in capital and may require banks to hold additional buffers. While this affects all banks, it may have a disproportionate impact on custody and community banks since they hold a meaningful portion of their balance sheets in high-quality investment securities.
  - While banks can respond by moving securities into Held-to-Maturity (HTM) status, which allows them to avoid marking to market these securities, this may overly reduce liquidity at a time when Basel introduces new liquidity requirements.
  - As a result of a diminishing pool of asset classes available to them, as well as the need to hedge deposits, community and midsized banks rely on high-quality bond portfolios as a significant earning asset class. Counting OCI as capital effectively increases the capital requirement and potentially increases the incentive to hold higher risk (and therefore higher-return) securities on the balance sheet instead of current medium- and long-term Treasuries, mortgage-backed securities, and municipals. One suggestion is to weight 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) or eliminate it altogether.
- The Council notes the importance of ensuring proportionality in the capital planning process and believe that components of the Basel Committee on Banking Supervision capital surcharge framework do not properly measure the systemic riskiness of a company, appear to provide equal weight to size and risk, and do not reflect differences in business models and activities:
  - The proposed methodology aggregates cross-jurisdictional assets and liabilities, double counting the footprint of a bank, when in fact a locally matched balance sheet is inherently less risky and less systemically disruptive upon failure.
  - Under the proposed methodology, banks could collectively reduce their systemic importance and yet not reduce the capital surcharge applicable to them.
  - Many of the services provided by GSIBs (e.g., deposit taking, lending, and underwriting) are in competitive markets with substitutes at minimal switching costs. Such services should have a much smaller significance as an indicator for a GSIB's systemic riskiness. Furthermore, the proposal does not give credit for local subsidiaries ring-fenced by local regulators.
  - The proposal creates the incentive to concentrate activities and assets that are not penalized under the methodology, thereby creating a "herding behavior" and amplifying the potential for systemic disruptions (e.g. encourages concentration in shorter-term and higher-quality credit assets, meaning qualified borrowers will be incented to borrow on a short-term basis).

- Other concerns:
  - The proposal is silent on the topic of the Basel SIFI surcharge. We believe this reflects the need for a common understanding and acceptance among regulators and market participants.
  - Tier 1 common is a more conservative definition of capital than tier 1 capital, yet the threshold of "well capitalized" for the first is set at 5% while the other is at 4%. A bank holding company would breach the first well before the second.
- While the leverage ratio provides a good foundational backstop to prevent over leveraging, it is restrictive at 15:1 and could incent banks with low-risk strategies to migrate their strategies out the risk curve away from the institution's core competencies where they have less experience.

ii. ***Early remediation requirements***
What is the Council's view on the proposals for early remediation requirements?

Main comments

- The Council strongly supports a principles-based remediation regime that strengthens troubled institutions.
- Banks and nonbanks should compete on a level playing field. Therefore, consideration should be given to having the FSOC identify at least a first set of nonbanks that will be subject to the early remediation framework before it becomes effective.
- Level 1 Heightened Supervisory Review, as proposed, is highly discretionary. We believe it should be based on an institution's CAMEL rating (or a CAMEL-like rating for institutions where CAMEL ratings do not apply), where a CAMEL rating of 3 should correspond to Level 1 designation. This will avoid applying the designation in a "hair trigger" fashion. The Federal Reserve should confirm that a Level 1 determination would remain confidential supervisory information and not be disclosed. The Federal Reserve should also consider whether the Level 1 threshold encompasses certain matters best addressed via the existing day-to-day supervisory process.
- The early remediation framework should generally serve to augment existing prompt corrective action standards and processes, rather than as a means of promoting industry reorganization.
- Level 2 Initial Remediation should not require regulators, as the proposal currently does, to take all remedial actions specified but instead give them the flexibility to choose among remedial actions as appropriate and act with a proportional response to particular circumstances. It should be emphasized that no "one size fits all" remediation structure should ever be substituted for sound regulatory judgment.
- While market indicators are an appropriate tool for the regulators to consider, specific numerical triggers should be avoided to prevent potential market manipulation. Market indicators in Level 1 Heightened Supervisory Review in particular should not be viewed in a vacuum as they may not necessarily indicate an institution is under duress.
- The impact of the remediation is uncertain, but when combined with capital volatility, it may trigger unnecessary actions during times of rapidly increasing interest rates.

- The stress test standard in Level 2 Initial Remediation should apply only if an institution falls below the 5% common ratio in three consecutive quarters or 4.5% in one quarter (with a demonstrated inability to reach 4.75% in the next quarter).
- The current triggers refer to Basel I standards for well- and adequately capitalized definitions. It is critical that these triggers, once reissued under Basel III's significantly higher capital requirements and accompanying buffers, continue to be calibrated at levels consistent with those currently contemplated under the existing framework (therefore, the cutoff for what is considered well-capitalized should be well below 7%).
- A dynamic process should identify a clear path that allows institutions to exit from remediation status as quickly as possible when conditions improve.
- Implementation will be time consuming and costly for institutions of all sizes.

Additional comments

- The early remediation requirements allow broad regulatory discretion ranging from heightened supervision to a recommendation that an orderly liquidation authority be invoked. This may result in significant market confusion and uncertainty during crisis periods.
- Early regulatory intervention, including any breach of triggers or mandatory actions, should be treated as confidential supervisory information. Public disclosure of early regulatory intervention could exacerbate or hasten the failure of a distressed institution.
- Early remediation regimes, triggers, and requirements employed by different regulatory agencies should be harmonized to avoid incongruous outcomes.
- It is unclear whether the framework will hinder the ability of a bank holding company to ensure the safety and soundness of an insured depository subsidiary and how the framework will integrate with the FDIC's prompt corrective action framework for subsidiary depository institutions.
- The proposal would be improved by further direction on the meaning of "signs of weakness" and "multiple deficiencies" in the triggers in order to offer guidance to banks and help ensure consistent treatment while maintaining supervisory discretion.

(B) Liquidity and credit limits

i. *Liquidity requirements*

What is the Council's view on the proposals for liquidity requirements?

- Members generally welcome the liquidity requirements proposed by the Federal Reserve and believe that they represent a considerable improvement over the more prescriptive and risk-insensitive Basel III approach. It was noted that the industry has made significant strides in improving the management of liquidity risk and that the Federal Reserve's approach reflects, in many respects, current "best practices." Also, the intended approach is likely to prove effective in addressing weaknesses in liquidity management standards that may serve to exacerbate financial crises.

- Members expressed particular support for the Federal Reserve's approach to defining assets eligible for inclusion in the required liquidity buffer. This includes the incorporation of both agency MBS and other high-quality assets that meet certain specified criteria. Some members expressed the view that FHLB advances should also be included as a source of contingent funding.
- Many members expressed the view that the Basel III LCR incorporates overly severe draw-down and run-off assumptions. This includes the treatment of committed facilities to collective investment funds and municipal entities, as well as middle-market, non-operating deposits. Therefore, they welcome the Federal Reserve's emphasis on the use of internal stress testing, informed by each firm's particular activities, exposures, and risks.
- Some members expressed concern regarding the significant operational and compliance burdens associated with the Federal Reserve's approach and noted the importance of weighing expected benefits with likely costs. This includes significantly greater reporting, analysis, and documentation requirements, as well as further integration of liquidity-risk-management processes into balance-sheet forecasting. Further, it was emphasized that the intended governance requirements are highly prescriptive and may impose burdensome new obligations on board of directors that may more appropriately be undertaken by senior management.
- Members expressed concern about a level playing field. There should be consistency between the Federal Reserve and Basel III liquidity requirements, and therefore, U.S. supervisors are encouraged to work with their international peers to address limitations in the current Basel III approach. This includes a more proportional framework for defining eligible high-quality liquid assets and better calibration of net cash outflows.
- One member expressed concerns that regulators may over time seek to create a GSIFI-like adjustment for the liquidity buffer, which may deviate from a predominantly quantitative approach.

ii. *Single-counterparty credit limits*
What is the Council's view on the proposals for single-counterparty credit limits?

Overall Comments

- Members broadly support the policy goal of limiting excessive amounts of credit concentration within the financial system. They also generally support the development and use of robust processes for the measurement of aggregate counterparty credit exposure on an enterprise-wide basis.
- Some members are concerned that the Federal Reserve's intended approach lacks risk sensitivity and that there is insufficient information regarding the potential impact of the rule on market liquidity and credit availability. The Council recommends a thorough impact assessment, along with attempts to align the rule as closely as possible with prevailing market standards.
- Members expressed broad concerns regarding the significant operational and compliance obligations inherent in the Federal Reserve's approach, including substantial information technology expenditures. This may require an extended implementation timeline for some aspects of the rule.

Specific Issues

- Several members strongly urge the Federal Reserve to expand the scope of its proposed U.S. sovereign exemption to include high-quality foreign obligors, notably central banks. In addition, some members expressed concern that the intended definition of single counterparty for state and local obligations is too broad, covering exposures that are more accurately assessed on a non-aggregated basis. One member suggested that state and local exposures should also benefit from an exemption.
- Members noted inconsistencies in the methodology for measuring credit exposure in the Federal Reserve's proposal compared to existing regulatory requirements and industry practice and expressed support for the optional use of regulator-approved internal models as an alternative to a "look up" table approach.
- Members raised specific concerns regarding the treatment of bank-owned life insurance/corporate-owned life insurance policies, the "cliff effect" of the 10% limit between the largest firms and the need for clarifications to ensure that the limits do not conflict with banks' increasing role in the Dodd-Frank Act-mandated central clearing of derivatives.
- One member is concerned that certain aspects of the Federal Reserve's proposed rule, such as credit extended in connection with payment, clearing, and settlement functions or in connection with indemnified securities lending, could limit the ability of firms to support financial transactions undertaken in the normal course of business to facilitate routine, day-to-day investment-related activities on behalf of investors.
- Members have concerns with the complexity of the proposal, including specific concerns with the requirement to count posted collateral as credit exposure to the issuer, the "attribution rule" requirement to track and count possible indirect credit exposures through third parties, and the requirement to access data from nonconsolidated entities that trigger the "control" test.

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?

- Inflation increased modestly during 2011 and was fairly broad based with increases in food, housing, apparel, recreation, and education. In the fourth quarter of 2011, inflation moderated to 3.0% year over year. An increase in prices in non-energy related goods and services were offset by a similar decrease in energy prices, with limited net change. Core inflation (excluding food and energy) was up 2.2% year over year and projected core inflation was 1.9% for 2012. ABA's Economic Advisory Committee forecasts 2.0% CPI growth for 2012. Producer prices were flat in the fourth quarter. Cleveland Reserve Bank data suggests 2-5 year inflation expectations are near an all-time low of 1.25%.
- The consensus of the members was inflation expectations remain low, though segment variations existed. Members stated wage pressure remains low, health care costs are rising less rapidly, and energy and cotton cost pressures continued to ease, though upward pressure existed for certain commodities, such as steel and food. Elevated wholesale costs

continue to be passed through to customers, though there is a slowdown in the pass-through rate. Most companies lack pricing power necessary to bring about price increases. One member reported rents were firming as homeownership falls and demand for rental housing increased.

- Two members reported pricing pressures in agricultural commodities, and elevated input costs for farmers and associated farmland prices. Cash down payments account for around 20% of farmland financing.
- A member stated a number of their district manufacturers were planning to raise prices in 2012.
- Overall, elevated unemployment rates and some increases in productivity continue to dampen inflation. Retailers noted extensive discounts and promotions during the holiday season. Rasmussen Reports national telephone survey found 42% of respondents are at least somewhat confident and 11% very confident that the Federal Reserve will be able to keep inflation under control and interest rates down. Interestingly, 51% lack confidence in the stability of the banking industry.
- One member stated companies that trade inflation-sensitive commodities or purchase them for raw materials (e.g., scrap dealers, heavy manufacturing) have shortened their inventory days on hand. Wage inflation for skilled labor has been the main concern of local companies. Revenues have been climbing but so have the cost of inputs. Oil field service inflation is receding due to low natural gas prices, which is also a bit of a boom for petrochemical businesses and they are expanding rapidly. Anecdotally, an HVAC firm stated customers are forcing payment terms out to 90/120 days.
- Some members reported higher costs for consultants and new compliance personnel.
- Shelter inflation accounts for over 40% of the core CPI. A proprietary model suggests an easing in shelter inflation from 1.8% currently to 1%. Prices for goods account for another quarter of the core CPI. The model forecasts goods prices will stabilize in 2012 and that inflation will fall from 2% to zero (driven in part by auto prices). Other major components (medical care, recreation, etc.) are projected to ease further from the current 2.5%. Together, these components suggest a benign core inflation outlook.

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

- After falling to its lowest level on record in July 2011, the trade-weighted value of the dollar increased about 6%. The dollar strengthened against the euro in a safe-haven bid away from Europe but weakened against the yen and commodity-based currencies, such as the Canadian and Australian dollar. One member expressed concern that should European debt problems ease, reversing flight to safety, or fears of U.S. debt problems intensify, foreign purchases and the value of the dollar could reverse. One member forecasted the dollar to appreciate another 2% through the first half of 2012 as European troubles intensify, before reversing course and erasing the gains by year-end. The member expected a further 3% depreciation of the dollar in 2013.
- The changing value of the dollar has had varying impacts on customers. A few members reported no material impact to customers. Others reported the weaker dollar has provided a modest benefit to corporations with significant foreign operations and exporters. The heavy equipment industry benefits from strong global demand and industry contacts stated

expectations for 2012 are for this to continue. Several manufacturing contacts expressed concern about potential weaknesses in China and Europe. Appreciation of the Chinese yuan has slowed from earlier in the year and Chinese foreign exchange reserves fell on balance over the last four months.

- One member noted some anecdotal reports of slower exports to European countries. Another stated that the strengthening of the dollar against the euro is seen as less of a problem than the slowdown in European economies. The European recession may have cost New England an estimated 0.5% of GDP. The Chicago District reported some weakness in demand from customers in Europe, but demand from developing countries remained strong in November and December.
- In Texas, the dollar's recent advance has slowed exports, primarily to Mexico, and reduced Mexican consumer purchases in border communities.
- One member reported that some companies are looking at making foreign capital expenditures to establish an operating presence in international markets (e.g., Europe, Chile, Argentina, China, and Vietnam). Some domestic manufacturers have indicated they are increasingly winning sales against other lower cost foreign competitors when they can demonstrate clear value differentiation in their products.

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

- National housing prices showed signs of stabilization in the middle of 2011 (albeit at depressed levels) but recently appeared to be drifting lower once again. According to Core Logic, there was a 1.25% decline in housing prices in November, but excluding distressed properties, prices were up 0.42%.
- Housing continues to be a mixed bag. Some members report a decline in housing prices and sales activity, while others observe stability or appreciation. Regarding housing prices, members stated: "continued deterioration but at a much slower rate," "increased slightly in the third quarter," "bottoming in housing prices," and "some regions either halted or turned slightly positive."
- According to the ABA, the national housing inventory was six months in November 2011, nearly 20% below levels one year ago and considered at a reasonably healthy level. In New England, housing prices have weakened marginally but are rising in desirable communities. Prices continued downward in the Mid-Atlantic region. Midwest housing starts showed some improvement, reversing the downward trend experienced in the third quarter. Some housing softness was reported in Memphis, Knoxville, and Nashville. Much of Florida's prices are drifting sideways. No significant change in Mississippi, but housing inventories are falling in Alabama and Atlanta (down 61% from their peak in September 2007), with prices continuing to decline there as well. New Orleans and Baton Rouge markets are fairly active, particularly in highly desirable areas (up 5%). Northwest Arkansas is improving, while Little Rock is flat to down. Conditions within Texas varied as well. Dallas-Fort Worth experienced a slowing of the price decline, with some pockets of pick-up in new home permits. San Antonio and Austin have had stable house prices and an increase in new construction. Houston and Corpus Christi reported significant increases in construction and existing home sales, with the somewhat higher prices related to oil shale drilling activity in the Eagle Ford Shale. The Rio Grande Valley has yet to show a

rebound. In contrast, a rebound in pricing is evident in San Francisco and Orange County, though depressed conditions remain in Inland California.

- Overall, residential construction is still down 70% from peak levels and commercial construction is subdued. In many parts of the country, multifamily construction has improved, especially in the Boston area as they shift from condominiums to rental units. One member stated there was a slight uptick in builder showroom traffic.
- Some members foresee housing stabilization and the start of a period of modest appreciation, assuming low mortgage rates continue and the market is not flooded with distressed properties. According to the MBA, loan refinances increased to 82% of mortgage activity. Frustration exists over difficulty in getting financing, due to lower appraisals combined with higher qualifications. This has come from both high- and low-income purchasers.
- Foreigners are active buyers in South Florida. The foreclosure process in Florida now averages 749 days, or 2.1 years. At the beginning of 2007, it was only 169 days. Half of all residential loans in Florida are underwater. Other Real Estate Owned and short sales are 52% of total sales and cash sales account for 33% of total sales (October 2011). Anecdotal commentary has suggested that the shadow inventory (foreclosures) would increase housing inventory in Florida by 50% or more.
- The University of Alabama Real Estate Confidence Index in the first quarter of 2012 (a survey of 500 real estate professionals completed in December 2011) shows a significant improvement on all survey measures (sales, inventory, price, and credit). Both consumer and commercial markets improved, as did nearly all regions of Alabama.
- From a national perspective, housing may be nearing a bottom in late 2012 based on relative values and affordability. The price-to-rent ratio is approaching its historical average (it was 50% above the long-term norm in 2006). Housing affordability (as a percent of income spent on mortgage and principal and interest) is approaching its most favorable position in decades. A proprietary model suggests housing prices may decline 2.5% through mid-2012, followed by stabilization in the year thereafter. The model finds that a 1% increase in income is associated with a 0.6% increase in housing price. The model has varying regional results, with suggested price improvements in Detroit, Miami, and Cleveland, but sizable declines in Portland, New York, and Atlanta.

(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?**

- The overall labor market demonstrated some strengthening in early 2011, followed by a slowdown, and then a subsequent improvement late in the year. Employment metrics in recent months remain well below pre-recession levels. There is a strong consensus among members that employment growth has improved and unemployment rates have generally improved or remained stable in most regions. One member expected the rate of improvement to diminish over the next few months.
- New England is tracking similar to national trends, while the Boston area has been fairly strong. The Mid-Atlantic region is stable, while the South Atlantic has improved. Tennessee is also following the national pattern. State and local government layoffs weigh

heavy in the Mid-Atlantic region, as budget shortfalls loom large. In the Chicago area, education and health services experienced the largest job growth, while leisure and hospitality decreased. Nashville is doing well with, an influx of jobs, and Memphis remains challenged. Birmingham is generally resilient and stable. New Orleans is projected to recover 100% of its pre-recession jobs by the end of 2012.

- One member reported significant employment gains in areas that were previously hard hit, such as business and professional services, hospitality, manufacturing, and construction. Expectations for future manufacturing activity rose modestly according to one member. Areas that usually provide stability have weakened, such as government and health care. Another member observed some momentum in wholesale and retail trade subsectors. Service-producing sectors provided most of the job gains on the East Coast. Similarly, mining and durable manufacturing and professional services were reported to have seen the strongest employment growth, while retail, information services, transportation, and trade were weak.
- Hiring remained selective and many customers were postponing hiring until economic conditions improve. One member stated many contacts noted they will likely be increasing employment levels in 2012. Anecdotally, a staffing firm reported permanent placement activity increased for industrial positions. One member summed it up as "this economic recovery is fragile, but it feels like progress."
- Labor conditions appear bifurcated. Some members stated wages are still declining or flat, at best. Others said nominal wage gains are modest and real hourly wages remain stable. On the other hand, firms struggle to find qualified people for many available jobs, despite their willingness to pay above-market wages to new hires. Anecdotally in North Carolina, one contact stated little success in hiring 20 software engineers at significant salaries due to few qualified applicants. People who have been laid off are at least finding contract work now. Firms are slowly adding lower-cost staff to support their anticipated 2012 demand. Certain Texas labor markets are favorably impacted by Eagle Ford Shale drilling. Skilled labor in Houston is in tight supply, and companies are having trouble filling open spots with experienced workers. Several firms reported record backlogs.
- A recent Fortune survey of executives and entrepreneurs found that 78% of respondents believe their firms' revenues will grow this year. Forty-six percent of the firms plan to hire, while another 7% are contemplating lay-offs. In the Vistage CEO Confidence Index (a December 2011 survey of 1,641 CEOs of small and midsized U.S. companies), 73% expect their firms to grow revenues and 55% expect profits to rise. Half of the respondents expect to hire new employees and 42% expect to invest in new plants and equipment.

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

- Some members are seeing encouraging signs in consumer confidence. Increasing confidence is due to falling energy prices, improving global equity markets, favorable labor market conditions, and a lessening of negative political headlines surrounding the debt ceiling and deficit issues. As evidence of that trend, the University of Michigan consumer confidence index was up 20 points between August 2011 and January 2012. Consumer

confidence is expected to continue an upward trend over the next few quarters; however, a rapid deterioration in Europe could change that situation.

- Consumer spending improved materially in the third quarter but stalled in the fourth. Members saw improved consumer spending associated with auto sales (replacement demand due to record high age of vehicles) and holiday shopping. Shoppers spent more spending on luxury items but were also more aggressive in bargain hunting. Seasonally adjusted retail sales were up 6.5% on an annualized basis in the fourth quarter of 2011. One member stated retailers and manufacturers expect increased sales and production in the months ahead.
- Over time, consumer spending should advance more in line with personal income, because now consumer spending is dampened by subpar income growth. Personal income growth averaged 0.1% per month between May and November, even though spending increased throughout the period (this figure rose to 0.5% in December, which may or may not be an anomaly). Higher consumer spending and falling consumer savings (from 5.8% in June 2010 to 4.0% in December 2011) may be the catalyst behind the recent pickup in revolving credit. However, consumers are not necessarily better off compared to the prior year, just borrowing more, saving less, and reducing savings. This could create a higher risk exposure if the economy slides into a recession. As a side note, some rent-to-own businesses are having one of their best years.
- As an indication of local seasonal strength, a manager of a large upscale department store indicated that over the holidays the Houston store sales were up 40% in some departments over the prior year. One member stated higher retail sales in the holiday season likely took from future retail sales and/or added somewhat to consumer charge-offs, though no real trend has yet become apparent.
- Consumer credit statistics (delinquency flow rates, bankruptcies, and recoveries) have seasonably stabilized. Consumer loan demand showed signs of renewed demand in late 2011, and for the first time in several years, there was strong growth in total revolving debt. Auto losses have declined but are likely past their cyclical lows. Expect the losses to increase gradually as near-record-high used auto auction prices begin to moderate. Credit card receivables losses are likely to remain near the bottom or return to seasonal loss trends. One member expressed growing concern regarding student loans (mostly federal student loans) and mortgages. Mortgage-related products remain stressed and losses are expected to remain elevated due to the high level of foreclosures to work through. Consumer credit quality continues to improve, especially in the 2010 and 2011 vintages. Consumers remain pessimistic in their talk but continue to spend on more than just necessities.
- From a sector perspective, agriculture continued to boom, but future farm incomes may be tempered somewhat by higher inputs costs. Oil prices remain strong and natural gas prices will remain depressed until supply is reduced. State governments are starting to recover with higher expenditures expected in the current fiscal year. Motor vehicle sales rebounded in the second half of 2011.
- A quarterly survey of 2,000 consumers updated in the fourth quarter of 2011 showed consumer pessimism appears to have stabilized and moderated recently, reversing its trend in 2011. Low-end consumers are most pessimistic in absolute terms, but the largest increases in pessimism were for mid-high consumers. The survey found that despite the

recent overall improvement, consumers intend to spend less over the next six months. The primary reason was the perceived affordability across discretionary categories.

- Recent surveys regarding consumer and business confidence suggest a fairly positive economic mood improvement (e.g., Manufacturers Alliance for Productivity and Innovations, National Federation of Independent Business, NFIB Small Business Survey, National Association of Manufacturers, Institute of Supply Management, National Retail Federation).

Item 8: Monetary Policy

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

- Most Council members believe the Federal Reserve's current highly accommodative policy to be appropriate given the moderate forecast for inflation, economic outlook, persistent high unemployment, and continued pressure on housing.
- This, however, was not a universal view. Some questioned whether the Federal Reserve's accommodative stance is appropriate in light of signs of recovery and the risks of elevated inflation, while one member felt strongly that the Federal Reserve's current policy is having a significant negative impact on many areas of the economy.
- Some on the Council expressed the view that the Federal Reserve's current monetary policy has had, and will continue to have, a negative impact on retirees, pension funds, and endowments who rely on fixed-income investments to fund their retirements, obligations, and mandates. Further, it has had the perverse effect of encouraging commercial banks to make loans to less creditworthy borrowers in order to maintain bank profitability in light of the current interest rate environment.
- Questions were also raised over the reliance on the Federal Reserve's use of monetary policy to stimulate the economy and housing sector. Members suggested that there needed to be a more coordinated approach among policy makers, including more targeted fiscal, trade, tax, and regulatory policies to address these persistent problems.
- In support of the Federal Reserve's current stance on monetary policy, while economic indicators pointed to increased momentum as 2011 came to a close, headwinds to growth have also strengthened. Economic activity is projected to decelerate in the first half of 2012, suggesting that the Federal Reserve's decision to leave interest rates on hold and continue to reinvest proceeds of maturing asset sales into longer-term securities is prudent in the short run.
- In terms of the Federal Reserve's dual mandate of maximum employment and price stability, the core inflation rate appears likely to ease over the next year and stay within the Federal Reserve's comfort zone. At the same time, while the unemployment rate has declined in the last year from 9.4% to 8.5%, the economy is still well short of full employment.
- With respect to the Federal Reserve's recent moves to increase transparency and accountability, there is general, although not universal, support for this policy. Some members commented that the Federal Reserve's decision to publish its internal balance sheet and rate forecasts would provide useful information to the market about future monetary policy and help anchor long-term interest rates. On the other hand, others felt the

Federal Reserve was exposing itself to additional scrutiny without providing significant monetary policy enhancement or economic stimulus, thereby possibly limiting the effectiveness of the policy.