

## RECORD OF MEETING

### Federal Advisory Council and Board of Governors

Friday, February 6, 2015

#### **Item 1: Current Financial and Economic Conditions**

**What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Are there any notable developments in loans for (a) commercial real estate, (b) construction, (c) corporations, (d) agriculture, (e) consumers, or (f) homes? Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in aggregated data?**

#### *Overview:*

- On balance, members report a modest firming of confidence and optimism that the economy will continue to improve, although there is a widening gap between the rate of recovery between specific regions.
- Consumer confidence in particular has improved, with very strong spending in the fourth quarter of 2014. Consumer borrowing demand, with the exception of auto lending, has not fully reflected this increased confidence.
- Overall credit structures continue to loosen and credit spreads continue to tighten, as competition for good loans intensifies. Supply of credit continues to outpace demand.
- Banks are looking to loan growth and expense reductions to offset tight net interest margins. Banks reported stronger loan growth in 2014 than in any of the past 5 years and expect continued growth in 2015.
- The decline in energy prices is expected to be stimulative across the board, although the full benefit has not yet materialized and some sectoral challenges exist. Although not yet apparent in reported data, Districts with more oil and energy production have started to see significant decreases in the number of active rigs, leading to lower company capital expenditures. These decreased drilling levels are leading to lower employment in these sectors.
- The drop in interest rates in December and January has led to a spike in home mortgage refinancing activity. Most notable was an increase in the percentage of cash-out refinancings.
- Fiscal pressures in some local and state governments may have a negative impact in selected regions.

#### **(a) Commercial real estate**

- Commercial real estate fundamental trends continue to be positive for most major property types, and credit quality remains stable. Multiple sources of financing continue to be available to absorb demand, including domestic and foreign banks, commercial mortgage-backed securities, and specialty finance companies. During 2014, multifamily CRE loan

balances outstanding grew by 14.5% over 2013, while nonfarm nonresidential CRE loan balances grew by 3.7%.

- The CPPI's National All Property composite has increased by 68.6% since its January 2010 trough and now stands at 2.4% above its December 2007 peak, for a recovery of 106% of peak-trough losses. This exceeds the 54% rise in the Case-Shiller index for residential properties.
- However, the price recovery is uneven, as prices for multifamily housing and offices have recovered better than those for retail, hotel, and industrial space. Major markets have recovered 142% of peak-trough losses, while nonmajor markets have recovered only 79%. There is some indication that institutional investors have begun to look more at secondary and tertiary markets, as competition in the primary markets intensified.
- The MBA's CRE loan origination index is at 193, or 45% below its 2007 peak, suggesting that loan originations are still lagging the pre-crisis levels. CMBS issuance is expected to increase to \$125 billion in 2015, as the CMBS market share of large loans scheduled to mature in 2015 should grow to around 35%.
- The multifamily housing market continues to be strong, with some concern that the emphasis has been in higher-end developments. The increased supply of luxury units to be delivered over the next few years should be monitored for its impact on vacancy and rental rates. Some observers report a leveling off in lease-up activity, perhaps signaling a potential market equilibrium.
- Industrial assets have experienced a moderate recovery to this point, but Council members are increasingly optimistic about this sector.
- Retail and office properties have experienced a slow recovery with marginally improving vacancy rates. Challenges continue to exist, particularly for properties lacking credit-worthy tenants or long-term leases. Some increase in rehabilitation of existing properties was noted.

#### **(b) Construction**

- The supply and availability of credit for commercial real estate construction projects remains ample but varies by property type and location, especially for office, retail, and industrial loans. Demand has remained consistent over the last several quarters, with multifamily projects accounting for the largest portion of the demand. C&D loans outstanding at banks grew by 11.9% during 2014.
- Loan terms continue to become more aggressive as some banks are loosening standards. The intensity of competition to finance high-quality projects has accelerated, as lender demand is exceeding market supply.
- Members report modest growth in both demand and credit availability for single-family construction loans with mid-sized local and regional builders. However, this sector continues to be dominated by national builders. Inventory levels are low, but so is land availability.
- Members reported a modest amount of new construction of large bulk industrial facilities in port cities and major transportation hubs. Hospitality projects are also showing some improvement.
- Retail development continues to be limited to urban infill sites and expansion of successful shopping centers. Limited new development is expected with the exception of pre-leased or substantially pre-leased projects.

- Members do not expect significant growth in office construction as many markets digest the current surplus supply of space.

### **(c) Corporations**

- Overall, members report stable corporate loan demand, but much of it is for refinancing and M&A rather than new expansion. The Midwest reports some expansion in equipment and leasing activity. In general, members reported that large corporate lending continues to be strong and highly competitive, putting pressure on spreads and structure. Lower spreads and relaxed structure have not resulted in tightening the availability of credit.
- Investment-grade borrowers continue to have significant choices. Bond issuance in 2014 was at record levels due to the continued low level of interest rates and a flat weighted average cost of capital (WACC) curve. Bond issuance in 2015 is expected to decline only slightly.
- Much of the larger corporate borrowing in 2015, whether from banks or the markets, was for “shareholder friendly” purposes, including M&A, share buybacks, and opportunistic refinancing.
- Margin compression continues as nontraditional bank lenders and nonfinancial lenders have entered the market, specifically for equipment and real estate. “Covenant light” terms seem to have hardened as banks have drawn a firmer line. However, for smaller credits, some of the loosening of terms seen earlier in larger credits has moved downstream.
- Optimism continues to increase on the part of medium-sized business management, but members reported that businesses remain conservative with hiring, replacing equipment, and investing aggressively in capital expansion. Smaller companies continue to borrow for expansion, equipment renewal, and efficiency purposes, but not as aggressively as the larger corporations.
- The impact of lower oil prices has been noted in lower borrowing demand for capital expenditures by producers but has not yet manifested in other sectors.

### **(d) Agriculture**

- Land loans outstanding grew by 7.3% year over year through the third quarter of 2014. Farm production loans grew by the same 7.3%.
- After several years of record profits and high land values, agricultural grain prices declined rapidly in 2014 as a result of record acreage being planted and record crop harvests. Members report that lower commodity prices are resulting in lower revenues, down some 30%, which is stressing producer profitability. This pressure is likely to mean more reliance on federal crop insurance for revenue.
- On the positive side, livestock producers are enjoying record prices and profits, benefiting from low feed costs and drought conditions in prior years, which had reduced herd sizes and limited supply. Dairy farmers’ and ethanol producers’ margins have also improved. Grain processors also benefit from greater demand for storage and transportation.
- Recent declines in oil prices will provide a small improvement as fuel is a material cost for most farmers. Demand for gasoline should remain high, and with required ethanol minimums, ethanol producers could see an excellent year, especially as their raw material costs have dropped.

### **(e) Consumers**

- Consumer confidence increased strongly in December, buoyed by perhaps the best year in the labor market since 1999 and by dropping gasoline and oil prices. This environment led to the strongest quarter for consumer spending in the last nine years. Consumer loan demand has not fully reflected that spending pattern, as the savings rate has continued to drop, until December when it suddenly spiked.
- Through the third quarter of 2014, auto loans grew by 9.4% over 2013, while credit card loans grew by only 0.9%. However, the trend for credit card borrowings was on the upswing as the year progressed.
- Student loans also continued to increase to levels that have raised some alarms. Delinquencies in all loan categories except student loans have either improved or reached record low levels. Student-loan serious delinquencies (90+ days) remain near historical high levels at 11.5%.
- Several members report that home equity loans are on the rise, partially due to an increase in home values, coupled with low interest rates and growing confidence in the housing market. Overall, residential closed-end loans rose 1.6% in December, despite falling 1.9% for the fourth quarter in total. Again, confidence and borrowing increased in the last part of the quarter, and we may be seeing the beginning of another home equity borrowing cycle.
- The growing scrutiny on fair lending practices in indirect auto lending, especially the focus of the CFPB on disparate impact, led at least one major indirect lender to move to a “zero discretion” pricing policy. So far no other major lenders have followed.
- Credit losses in the prime sector remain at or near record lows, but there are reports of growing delinquencies among subprime auto borrowers.
- The growing popularity of peer-to-peer lending, as with the Lending Club, could change the consumer credit market and bears close watch.
- With unemployment numbers trending downward and cheap borrowing costs, consumer loan activity is expected to pick up in 2015. Disposable incomes will likely increase through wages and a significant drop in oil prices.

### **(f) Homes**

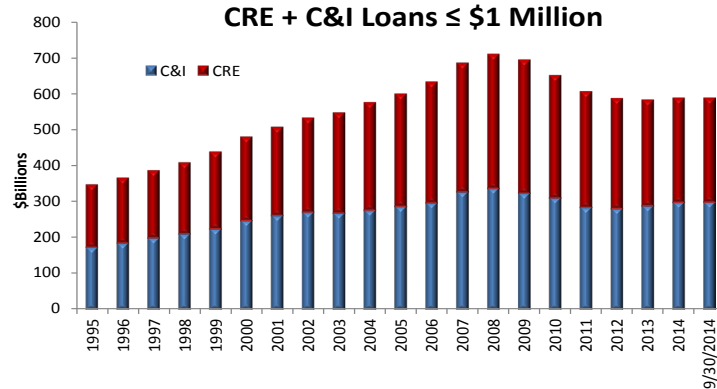
- From September 25 until December 31, the rate on a conforming 30-year mortgage fell from 4.20% to 3.87%, spurring an increase in refinancings and home mortgage borrowings in general. The numbers may not be apparent in total Q4 figures, but the month of January 2015 has shown a substantial increase, as the rate has further dropped to 3.63% by mid-January. 15-year rates, popular with refinancings, have fallen to under 3%.
- Another trend seen during the first part of 2015 has been an increase in cash-out refinancing. Cash-outs rose from 14% of refinancings in January 2014 to 28% in January 2015. Cash-outs were a hallmark of the pre-recession period and should be watched carefully.
- With the drop in rates, the business mix has begun to shift toward more refinancings and less purchase business.
- On a year-over-year basis, home prices increased by 5 to 7%, for most Districts. Higher-priced inventory may be offsetting the affordability of lower interest rates, as existing home sales have remained stagnant, and there have been only modest increases in new home sales until December, when sales increased 11.6% to an annualized rate of 481,000 units, the highest since June 2008. There was a 54% increase in the Northeast.

- Part of the reason for lower year-over-year home sales in the early part of 2014 may be due to a drop in first-time homebuyers. Historically, first-time buyers represented about 40% of the purchase volume, while in 2014 they were only about 33%.
- A number of factors in the housing market and broader economy are making it increasingly difficult for new buyers to enter the market. High student-loan debt, rising rents, and a weak labor market have combined to make it more difficult for many borrowers to save the necessary down payment and to qualify for a mortgage. Tighter mortgage standards and regulations are also a commonly cited barrier.
- The recent lowering of PMI payments for HUD loans by 50 basis points, which translates into a \$41-a-month lower payment on a \$100,000 mortgage, could have a positive impact. Other GSE initiatives in the works may also prove helpful in stimulating sales.

**Item 2: Small Businesses**

**What is the Council’s assessment of the current environment for the creation and growth of small businesses? What are the major impediments faced by small businesses? In the Council’s view, why has the market for small business loans been so lackluster the last few years?**

- The small business sector is an important contributor to the U.S. economy, accounting for approximately one-half of GDP and responsible for the creation of two out of three jobs. This sector was hit hard during the financial crisis and, although improving (as evidenced by the recent NFIB Optimism Index), this segment still faces many challenges.
- Major impediments impacting small businesses include higher income taxes and increased costs associated with regulations and healthcare reform. Regardless of the industry, the vast increase in regulations is a significant challenge for businesses with limited resources. Additionally, in order to avoid the costs of healthcare or the penalty of noncompliance, many small business owners are focused on keeping their number of employees below the thresholds in the Patient Protection and Affordable Care Act.
- Accessibility to credit is an important condition of the future growth of small businesses. Research is inconclusive on whether or not credit is accessible to small businesses, and there are divergent opinions even among the Council members. The Harvard Business School published a paper authored by Karen Gordon Mills and Brayden McCarthy on July 22, 2014, entitled “The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game.” In this paper, they state that “the data on the small business credit gap is limited and inconclusive, but raises troubling signs that access to bank credit for small businesses was in steady decline prior to the crisis, was hit hard by the crisis, and has continued to decline in the recovery as banks focus on more profitable market segments.” Industry data used in the Harvard study would support the conclusion that small business loans less than \$1 million have declined since the crisis; however, recent data show this trend has stabilized and there is greater accessibility to credit as can be seen from the chart below.



Note: All data is outstanding balances as of June for each year, except for last data point  
Source: FDIC's *Loans to Small Businesses and Farms* Report, 1995-2014

- The Council believes that the market for small business loans has been lackluster due to the following:
  - Many financial institutions backed away from score-only processes, which were prevalent prior to 2007, due to higher-than-expected losses and now require more information and a more traditional underwriting process. This has increased the underwriting costs for financial institutions and has lengthened the time it takes to respond to the credit request.
  - The CFPB has the authority to regulate small business lending practices and has indicated that it will be collecting certain data on small business credit requests. This has created some uncertainty around regulatory expectations for this segment.
  - Most small businesses are seeking credits for amounts less than \$250,000. The cost of sourcing and originating small-dollar loans makes it difficult to generate an appropriate return for many institutions using a traditional underwriting approach coupled with a traditional sales model.
  - Community banks have traditionally used a more qualitative (character-based and less rigid) underwriting process that benefits small business borrowers; however, the number of community banks has declined due to the consolidation of community banks through mergers and due to bank failures during the crisis.
  - The redesign of existing processes to source, underwrite, and service small business clients in a manner that (1) allows financial institutions to earn an acceptable return on their capital and (2) makes it easier for small businesses to access credit requires ongoing technology investment at a time when most technology resources are being used to meet new regulatory requirements.
  - Small business owners have historically obtained credit by using the equity in their primary residence as collateral. Real estate values have not yet fully recovered making it more difficult for these borrowers to obtain credit. In addition, the regulatory requirements on mortgage lending and the potential for a loan to a sole proprietor secured by a primary residence to carry with it requirements normally associated with consumer purpose lending could make this a less attractive credit product.
  - Start-ups remain the most challenged stage of a small business to obtain credit.

- Small business owners have become more financially conservative since the financial crisis, and their concerns over government regulation and taxes have steadily increased since 2009.
- Because of the difficulty of obtaining credit, many small business owners have opted for alternative lenders.
  - These new alternative lenders include players who use their own balance sheets by raising capital from institutional investors and private equity firms and peer-to-peer lenders who connect institutional and retail investors with borrowers.
  - Many of these lenders use models that are innovative but untested over an economic cycle. This also means that they are often lending to a client that would be “unbankable” by traditional standards or models.
  - These alternative lenders face significantly less regulation, and it is yet to be determined how they will be regulated in the future.
  - While the aggregate credit outstanding by these lenders is small at the present time relative to the total credit outstanding to small businesses, these lenders are growing rapidly.
  - Many of these lenders offer access to very short-term capital with significantly higher interest rates than banks and often with nontraditional repayment schedules.
- In order to increase the accessibility of credit supporting small business growth and to prevent the business from moving to alternative lenders in the shadow banking system that could ultimately cause systemic risk, banks may need some small-business-lending-specific relief from regulations to create a level playing field.
- This relief could come in the form of more willingness to accept lower documentation requirements for these borrowers if the originating bank demonstrates effective risk identification and monitoring programs (e.g., analytic scorecards and tools). Additionally, many of these borrowers are more frequently impacted by seasonal or unforeseen circumstances without the level of financial flexibility of larger companies (liquidity and capital). As a result, there needs to be more flexibility to offer prudent modifications and temporary workout arrangements without triggering adverse accounting or regulatory classification requirements (e.g., troubled debt restructuring, nonaccrual status, etc.).

### **Item 3: The Outlook for Banking in 2015**

#### **(a) What will be the drivers of bank profitability in 2015?**

- The primary drivers of bank profitability in 2015 will include the economic environment and its impact on net interest margins, likely escalating loan loss provisions, and the need for continued core expense control.

#### **Net Interest Margins:**

- Continuous management of loan growth and growth in net interest income will be critical to driving 2015 profitability. An increasing demand for commercial and industrial loans is expected; however, a highly competitive loan environment will likely continue impacting loan yields. Thus, loan growth should stay relatively healthy in 2015 as the economy gains traction, but pressure on net interest margins is unlikely to abate.

- Ongoing regulatory changes may further impact net interest margin growth in 2015, since, to address new liquidity requirements, larger banks may be required to hold a higher concentration of liquid but low-yielding assets, which will likely suppress net interest margins.
- Several Council members noted that banks have shortened maturities that will re-price within a year, leading to all-time high levels of asset sensitivity, so better positioning for a rise in rates could translate into greater net interest margin expansion in the longer term.

#### **Provision for Loan Losses:**

- Reserve releases – a strong tailwind for earnings during the recovery – may shift to headwinds in 2015 and suppress earnings growth. Industry-wide, the exceptionally low level of gross charge-offs is expected to revert closer to prior mid-cycle averages.

#### **Expenses:**

- Council members anticipate that banks will continue to focus on operational efficiency in 2015, but opportunities for further cost reductions may be limited, particularly given the increasing regulatory requirements and the investments necessary to position banks to compete in the long term. While incremental improvements are likely, substantial reductions will require business-process redesign and automation. Much of the “low-hanging fruit” on core operating expenses has already been realized, making further efficiency improvements very challenging.
- Information technology (IT) and infrastructure spending, particularly concerning information security, is expected to rise significantly in 2015, as increasing challenges from the combination of evolving cyber threats and newly identified IT vulnerabilities are confronted. Continued investment in regulatory processes and systems is also expected. Council members suggested that many banks’ IT departments are focused on new systems, system upgrades, and enhancements needed to meet the current regulatory requirements and therefore will be unable to support initiatives to redesign businesses in the near term.
- Council members pointed out that there are significant fixed infrastructure costs required to track, manage, and monitor the new liquidity standards, as well as significant structural balance-sheet costs to meet the required standards. These are long-lasting and semipermanent expenses that must be incurred and planned for, even in the midst of discussions about whether or not LCR standards are necessary, or will be maintained, for smaller, non-complex regional institutions.
- Several Council members noted that larger banks should see an improvement in the legal environment in 2015, since many of the biggest settlements have already been levied. Thus, lower charges in 2015 related to legacy legal issues should partially offset higher expenses and provide a boost to earnings at the largest banking institutions in 2015.

#### **(b) What are the greatest competitive challenges (domestic and international) facing the banking industry in the coming year?**

#### **Domestic:**

- Council members continued to express concerns about the effects that intensified competition are having on both margins and underwriting standards. There is intensifying competition for qualified borrowers, and banks’ appetite and expectations for growth are



outstripping demand, thereby forcing downward pressure on pricing and liberalized structures.

- On both the lending and the deposit fronts, members noted that banks will continue to face steep competition from nonbank financial institutions (credit unions, insurance companies, online lenders, REITS, insurance, private equity, business development companies, etc.). In this regard, additional prudential regulation may actually be increasing systemic risk, rather than reducing it, by pushing banking activity into the unregulated nonbank sector, where historically most crises have begun.
  - From a depository standpoint, credit unions will continue to be an attractive alternative for consumer borrowers, and their pull on banks' deposit bases may be felt more acutely in a rising rate environment. Due to the implications of the LCR, as loans grow, it is likely that more intense competition for consumer deposits will follow. On the credit side, nonbank lenders have successfully used electronic communication and delivery conduits to target smaller businesses that may be too new or too risky to be palatable to a traditional bank. These lenders may attract more and larger borrowers. Regarding other services offered by banks, nonbanks offering payment processing also pose a growing challenge. It was also noted that nonbanks may take market share as capital and consumer regulatory requirements (and the rapid pace of change) boost cost of service to banks.

#### **International:**

- Several Council members noted higher U.S. capital requirements, which create a competitive disadvantage to overseas peers with lower capital requirements.
- Members further discussed the weak global economy and the fear of deflation, which is driving down commodity prices (including oil and copper), causing a flight to quality that is driving longer-term interest rates lower in the United States and is disrupting what appeared to be positive momentum going into 2015. International "event" risks, such as the recent terror attacks in France and the revaluation of the Swiss currency, add more uncertainty that impacts both consumers and businesses.

#### **(c) What will be the most significant technological change in banking in the near future?**

- The most significant technological change in banking in the near future will be driven by the requirement to protect client information from cybersecurity threats. All Council members noted that cybersecurity will continue to be an overriding priority for banks in 2015. Rapid technological change should continue to pressure banks on both the revenue side, from increased competition, and on the cost side, due to the cost of bolstering cybersecurity. The rate, frequency, and complexity of attacks have forced banks to respond by strengthening network and perimeter defenses, further protecting client or sensitive information, engineering tighter controls, and investing in tools and analytics to study system patterns and spot anomalous activity. As key members of the payments system, banks are exposed and can suffer financial loss and reputational damage even when they are not the compromised link in the payments chain. EMV-chipped credit cards are becoming the industry norm and will be especially difficult for smaller banks to adopt.

Increasingly costly cybersecurity requirements and investment will be needed to protect client information, detect threats, prevent breaches, and meet client expectations.

- Cybersecurity is further impacting the industry in the following ways:
  - *Greater Use of Third-Party Tools*: Lacking a “silver bullet” that provides comprehensive cybersecurity protections, banks will need to invest in a broad range of tools from the marketplace to detect, respond to, and analyze cybersecurity threats.
  - *Change in Development Practices*: To develop mobile solutions for clients and financial advisors, use web and social media, and enhance communications infrastructure for trading activities, firms must incorporate security protocols into these internally developed products and services to manage cyber risk.
  - *Focus on Security Talent and Staff Education*: To address threats and attacks, the industry will focus more deliberately on grooming and attracting emerging talent in security engineering. It will also need to drive a deeper level of awareness of general staff to spot and handle incidents. One Council member pointed out that more technology will increase demand for IT talent, and banks are not traditionally the first choice of technology talent, limiting the labor supply and increasing compensation expense.
  - *Further Collaboration with Experts and Peers*: Banks will continue to work together to share best practices and get early insight into cybersecurity incidents. In addition, many will deepen relationships with independent advisors, law enforcement, and the broader intelligence community to help improve cybersecurity protocols.
- Also significant technological change noted by members was the growing volume, variety, and velocity of raw data and information. New sources of high-quality and specific data will enable businesses to improve the client experience across all channels while also improving the bank’s overall business intelligence capabilities. Emerging technologies and the dramatic growth in electronic payments are quickly transforming the payments system, changing the way financial institutions connect with their consumers. Banks are designing products/services with a “mobile first” strategy and expanding to other access channels to meet client demand for effortless multichannel delivery and interactions.

**(d) What is the most substantial regulatory concern for the industry in 2015?**

- 2015 will represent the first year in which all new regulatory standards will be implemented. A substantial regulatory concern will be the calibration of prudential regulatory standards, with a focus on how these standards will interact with each other. The Council urges regulators to consider empirical evidence and thoughtfully consider fine-tuning rules to the emerging regulatory paradigm. Otherwise, the cumulative effect of these new regulations could cause negative consequences for the availability of credit, job creation, and economic growth.
  - Many of the new regulatory tools, including the supplemental leverage ratio (SLR), net stable funding ratio (NSFR), liquidity coverage ratio (LCR), total loss-absorbing capacity (TLAC), and global systemically important bank (GSIB) capital surcharges, did not come into play until the last few years.
  - Some examples of areas that may require recalibration include:
    - SLR limits banks’ ability to hold cash and U.S. Treasury securities, while LCR encourages banks to hold surpluses of such instruments.

- SLR places an absolute limit on banks' balance-sheet sizes, but that may mean strong banks are forced to turn away client deposits in crises to avoid leverage gross-up.
    - Both the SLR and NSFR place practical limits on banks' ability to act as primary dealers in U.S. Treasury securities.
  - Given the primacy of CCAR for the ultimate determination of capital within large institutions, the Council encourages the Board to take the opportunity afforded by next year's CCAR timetable to enhance transparency around modeling and evaluation processes.
  - The new liquidity regulations (LCR and NSFR), combined with the Volcker Rule, will impact banks' ability to efficiently act as market makers in the fixed-income market, which will ultimately harm overall liquidity.
  - While smaller banks are not subject to the more advanced rulings, they are not entirely excluded from the new regulatory paradigm, as increasingly stringent examinations and regulatory "best practices" are painted across banks of all sizes.
  - The cumulative effect of the new framework could create a host of outcomes that may not be empirically evident: diluted access to capital due to inferior returns, diluted leadership as the brightest and best young people choose other careers, and a stagnant economy due to the de-risking of banks.
- Another significant regulatory concern is the question of how regulators intend to tackle the issue of culture. There is a concern that regulators will use a rules-based approach to regulate an issue that inherently requires a principles-based solution.

**(e) What is the outlook for mergers and acquisitions in the coming year?**

- With 302 deals announced in last year, 2014 showed continued momentum in the bank M&A arena. The 302 transactions represented approximately 4.5% consolidation (measured as the number of deals/number of banks), much higher than the long-term average of approximately 3.5%. While aggregate deal values are much smaller today (median of ~\$100 million), all of the relevant factors supporting greater consolidation remain in place. For example, overcapacity/fragmentation remains an issue with ~6,900 banks today, earnings pressures (margins, regulatory costs, and low branch profitability) continue to impact returns, and many banks are still unable to earn an acceptable rate of return for shareholders to justify long-term independence (particularly the smallest institutions). Management and Board fatigue will also be a persisting factor in the coming year(s). Management teams just came out of the Great Recession only to be met with additional earnings and operational headwinds.
- The current view on the outlook for mergers and acquisitions is dependent on the size of the acquiring institution.
  - Most Council members see little or no merger opportunities for the four largest institutions given the continuing "Too Big to Fail" discussion in Washington and the new capital requirements.
  - Views are mixed for regionals and super-regionals, with some regionals stating that they believe mergers create unknown legal and regulatory risks and others feeling that strategic mergers would create scale badly needed to realize efficiencies in a world of

- soaring regulatory costs. The enhanced prudential standards for larger banks serve as a deterrent to grow via acquisition unless substantial efficiencies can be gained.
- Of the 302 M&A deals announced in 2014, 299 were from buyers with assets less than \$25 billion. The consensus opinion is that this will continue in 2015. Many community bank CEOs are tired of trying to implement the host of new regulatory requirements. Private equity firms purchased failing institutions during the crisis. With the benefits of these prior deals waning, many are looking to deploy a “roll-up” strategy to continue to create value.
  - In normal times, M&A activity allows for the rightsizing of the economics and returns in a business. The evolving and complex regulatory landscape clouds the typical M&A decisionmaking process (for both sides of the equation) and thus is having a dampening effect on M&A activity. The M&T/Hudson City deal, now delayed for approximately 2½ years due to the lack of regulatory approval, serves as a warning to would-be buyers and sellers that the process can be cumbersome and time-consuming.
  - There has been a call for greater consolidation activity for several years and while directionally the number of deals has been on the rise, it has not yet hit full stride. “Deals beget deals,” and with cost savings from M&A still one of the lowest risk methods of growing earnings per share in today’s environment, banks will likely continue to deploy excess capital through consolidation. In addition, the degree to which rates stay lower for longer, all else equal, would support greater M&A activity. While M&A pricing is still low by historical standards (1.4x tangible book value and 5% core deposit premium in 2014), rising loan-to-deposit ratios are again in focus, particularly for banks with growth aspirations. As a result, banks are beginning to focus more on funding strategies today, and proper M&A is a logical and efficient solution.

**(f) Is the industry well positioned if interest rates rise?**

- The industry is generally thought to be asset sensitive, which, all else equal, will result in increased profitability in a rising rate environment.
  - While most banks expect that Fed rate increases will result in net interest margin expansion, their expectations are generally based on the assumption of a parallel shift in the yield curve, where the increase in longer-term lending rates exceeds the increase in short-term funding costs. Historically, Fed tightening cycles have resulted in a flattening of the yield curve, where short-term rates increase faster and to a greater extent than long-term rates. To the extent that intermediate and long-term lending rates do not increase by the same magnitude as short-term funding costs, the higher-rate environment may not result in significant net interest margin expansion for many institutions.
  - The U. S. Treasury curve has been steadily flattening for the past 13 months. Long-term rates have declined substantially due to deflationary pressures, plunging commodity prices, and global quantitative easing. Conversely, short-term rates have been stable to slightly higher given expectations that the Fed will start raising rates at some point in 2015. Once the tightening cycle gets underway, this flattening trend could gain further momentum and prevent a new set of challenges for bank margins.

- If higher long-term rates accompany a normalization of the short end of the yield curve, bank capital will depress due to fair-value adjustments on available-for-sale securities.
- Despite the focus on rising rates, banks cannot ignore the possibility of continued low rates or even negative rates, as we have seen in Germany, Switzerland, and Japan. The lack of inflation, the significant decline in the price of oil, the flight to quality where investors are seeking U.S. Treasury investments, and the Fed's dual mandate all have the potential to keep rates low for an extended period of time.
- As noted in the M&A portion of the 2015 outlook, the impending rising-rate environment draws heightened attention to banks' deposit franchises. Those with stronger franchises will be more asset sensitive and take advantage of rising rates, while those with weaker franchises will underperform the industry. This underperformance will likely be a key driver of consolidation in the coming years.
- In predicting the impact of rising rates on the industry, it is important to note key differences between the industry now vs. the industry during the last rising rate environment. In particular, technological advancements (mobile banking vs. branch banking, in particular) could have a profound impact on the speed at which deposits switch from bank to bank or to other types of financial institutions. Additionally, the larger banks will be concurrently dealing with increased funding regulations like LCR and NSFR. It remains to be seen how these larger institutions reevaluate the value of certain deposit products (let alone in a rising rate environment).

#### **Item 4: Capital Surcharge**

##### **What is the Council's view of the recently proposed capital surcharges for the largest, most systemically important U.S. bank holding companies?**

- Recent years have seen multiple regulatory efforts – along with proactive measures taken by financial institutions – to achieve systemic safety and soundness. These steps have included, among others: the introduction of Basel III and the Financial Stability Board's original buffer to Basel III for global systemically important banking organizations (G-SIBs); the recently recast supplemental leverage ratio (SLR) for U.S. regulated entities; total loss-absorbing capital (TLAC) requirements; the liquidity coverage ratio (LCR); the net stable funding ratio (NSFR); and the Comprehensive Capital Analysis and Review (CCAR) and Comprehensive Liquidity Analysis and Review (CLAR) processes (the last of which are now governing constraints for most institutions). For some time, the Federal Reserve has explicitly signaled the need to revisit the formula for calculating G-SIB capital surcharges. Following the recent publication of the proposed surcharge, or buffer, the Council is grateful for this opportunity to comment.
- The Council reiterates its support for prudent capital standards that target firm-specific risk, mitigate systemic contagion, and align the risk- and leverage-based capital requirements governing G-SIBs. In that regard, the proposed buffer is another important step toward protecting systemic integrity. Although the surcharge addresses these goals, certain components of it may yield results that are inconsistent with the spirit of the proposed regulation, thereby causing unintended consequences. G-SIB capital standards are one tool

among many to mitigate systemic risk; as such, calibrating G-SIB surcharges with various new prudential standards will be critical to their success. One area of particular concern is the proposal's addition of a liquidity component to determining capital charges (replacing Method 1's Substitutability with Method 2's Short-Term Wholesale Funding, or STWF) just as liquidity regulations undergo clarification themselves. Indeed, none of the cited liquidity rules existed in final form even a year ago.

- As a governing theme, the Council encourages consistency with existing standards prior to finalizing the proposed surcharge to ensure that the buffer achieves its objective. The Council also offers the following thoughts for consideration.

METHOD 1		METHOD 2	
Component	Ratio	Component	Ratio
<b>1. Size</b>		<b>1. Size</b>	
<b>2. Cross-Jurisdictional Activity</b>		<b>2. Cross-Jurisdictional Activity</b>	
- Cross-jurisdictional claims		- Cross-jurisdictional claims	
- Cross-jurisdictional liabilities		- Cross-jurisdictional liabilities	Bank
<b>3. Interconnectedness</b>		<b>3. Interconnectedness</b>	
- Intra-financial assets		- Intra-financial assets	
- Intra-financial liabilities		- Intra-financial liabilities	
- Total marketable securities		- Total marketable securities	
<b>4. Substitutability</b>		<b>4. Short-Term Wholesale Funding</b>	
- Assets under custody	Bank	- Maturity / duration	Bank
- Payments	Industry	- LCR liquidity characteristics	RWAs
- Underwritten transactions in debt equity			
<b>5. Complexity</b>		<b>5. Complexity</b>	
- OTC derivatives notional value		- OTC derivatives notional value	
- Level 3 assets		- Level 3 assets	Bank
- Held for trading and AFS assets minus HQLA		- Held for trading and AFS assets minus HQLA	Industry
<b>Average of 5 category averages</b>		<b>(Average of 4 category averages plus STWF)*2</b>	

- A central principle of prudential regulation is to incentivize behavior among boards and management that mitigates operational and financial risk. This principle is evident in almost all regulation: holding lower-risk assets reduces risk-weighted assets (RWAs); holding larger volumes of high-quality liquid assets (HQLAs) raises LCR; and shrinking one's balance sheet reduces SLR. In this regard, the proposal's approach to risk sensitivity is problematic. In current form, G-SIBs cannot manage their risk profiles to achieve lower capital requirements that in turn drive business performance. Some examples of risk insensitivity in the proposal include:
  - **Relative Calculation:** The G-SIB methodology relies on a bank's relative risk indicators within total industry risk indicators. This fails to account for the scenario in which a bank reduces its risk but does so proportionally to the rest of the industry: in that case, the stated goals of reducing idiosyncratic and systemic risk are achieved but a G-SIB's surcharge remains static. This could be addressed by permitting total industry risk indicators to decline in response to enhanced prudential risk management.
  - **Euro-Dollar Volatility:** Since G-SIB international risk indicators are euro-denominated, U.S. G-SIBs' relative risk indicators fluctuate with normal-course euro-dollar volatility. This yields potentially higher capital requirements with no commensurate increase in actual bank risk and is particularly problematic for large U.S. money-center banks. As an alternative, the standard could control for foreign exchange volatility by integrating five-year exchange averages rather than spot rates.

- **RWA Denominator:** Given that Method 2 substitutes a bank's RWAs as the ratio denominator for STWF, if a G-SIB simultaneously reduces STWF and RWAs, its surcharge remains static. If a G-SIB reduces RWAs and does not reduce STWF, its G-SIB surcharge could increase. By reconsidering the denominator to incentivize prudent use of STWF, the proposal would reflect both the industry's effort to reduce reliance on it and the enhanced regulatory standards governing liquidity.
- At a more granular level, the Council believes modifications to deposits, secured funding, and short sales as defined in the calculation of STWF in Method 2 will more appropriately align this proposal with other recently introduced rules to manage liquidity. These modifications include:
  - **Deposits:** The proposal penalizes G-SIBs that rely on wholesale and brokered deposits by taxing them at comparatively higher rates. In the case of fully insured affiliated brokered deposits, for example, this approach does not properly align with market behavior in stress scenarios or LCR assumptions.
    - The proposal imposes high capital charges on all brokered deposits, regardless of the source. Instead, the proposal should follow the LCR's calibration, which distinguishes between fully-insured affiliate brokered deposits (10% run-off assumption in the LCR) and less stable forms of brokered deposits.
    - The proposal taxes wholesale deposits at 50% (for nonfinancial counterparties) and 100% (for financial counterparties). These calibrations are punitive – particularly in the case of nonfinancial counterparty deposits, which support normal-course business activity necessary for economic growth – as well as unnecessary – since the LCR already requires banks to hold substantial liquidity pools against these deposits to guard against the risk of sudden deposit withdrawals in market stress conditions.
  - **Secured Funding Transactions:** Method 2 imposes significant charges on secured funding transactions that present two issues. First, they conflict with the calibrations of existing prudential regulations developed by international standard-setting bodies based on empirical reviews. Second, they fail to reflect the durability of transactions secured by high-quality collateral even in periods of market stress. Specifically, the proposal conflicts with basic assumptions of existing liquidity and funding regulation, namely the NSFR (which applies a 5% funding requirement on Level 1 assets) and the LCR (which considers Level 1 assets the highest-quality liquidity resource available). Reducing these charges better aligns the proposal with other regulatory standards and market realities.
  - **Short Sale Coverage:** Method 2 includes the value of securities borrowed by a G-SIB to facilitate short sales. Such securities borrowing activities should be excluded from the G-SIB methodology for several reasons:
    - When a G-SIB borrows securities externally to cover short sales, it provides cash to an agent securities lender; as such, the G-SIB is providing funding rather than receiving it.
    - A single securities-borrowing transaction between two G-SIBs will be double-counted as STWF: once by the agent securities lender receiving cash and a second time by the G-SIB providing cash.

- Short coverage is already extensively covered by SEC regulation (which requires a permitted purpose), as well as new prudential funding and liquidity regulations like the LCR and NSFR.
- An additional substantive issue with the surcharge proposal is its role within the CCAR process. The Federal Reserve has indicated that it is considering how to revise CCAR to incorporate the G-SIB buffer, which could result in a shift away from the generally applicable capital standards currently governing the process to firm-specific G-SIB requirements. It is a significant issue that the Council recommends be raised for consideration at a future meeting of the Board of Governors.
- As a final point, the Council is of the strong view that the desire for safety and soundness should be balanced against relative differences in capital and liquidity standards between the United States and the rest of the world. Those differences have become increasingly pronounced as the Federal Reserve has introduced higher supplementary leverage ratio requirements, standardized risk-based capital floors, imposed the most robust stress-loss testing through CCAR and CLAR, and now proposed higher G-SIB capital buffers. The obvious and very helpful benefit of these collective actions is the resultant relative strength of the U.S. financial system, which is consistent with and necessary for a strong and growing economy. However, there are two potentially constraining factors to be considered in understanding the cumulative impact of regulatory efforts:
  - The degree to which the best-in-class capital and liquidity standards governing U.S. G-SIBs inhibit lending, market-making, or the provision of liquidity by the financial sector, all of which are critical for sustained economic growth; and
  - The extent to which the standards limit the ability of large public banks to generate sufficient returns, rendering the sector unattractive to investors and in turn creating unusual opportunity for the unregulated shadow banking sector.

### **Item 5: Lender of Last Resort**

**What is the appropriate role for the Federal Reserve as lender of last resort through discount window lending? In the wake of the financial crisis, how does the Council view the discount window as a backup source of liquidity and its likely use by institutions in contingency situations? Given that the Federal Reserve encourages banks to include the discount window in their liquidity contingency plans only as a source of very short-term transitional liquidity, how should the discount window be factored into living wills?**

#### *Overview:*

- The Council believes that the Federal Reserve's role as lender of last resort (LOLR), and the powers that make this possible, is critical for the safety and soundness of the financial system and the health of the larger economy.
- A number of factors have reduced the likelihood of a market panic in the near future. These factors include: better internal and regulatory controls and reporting, rationalizing of corporate structures, broader and more durable funding sources, restructured bank balance sheets, and current market aversion to speculative risk-taking by financial intermediaries.



- However, no one expects that this environment will be permanent. While better management and prudential regulation has reduced the near-term probability of a financial emergency, there are also factors that may reestablish conditions that may require extraordinary market intervention. With the passage of time, the introduction of new people, and the probability of growing scale, complexity, innovation, technology dependence, and interconnectedness, the likelihood increases for a market emergency that could precipitate panics and runs on financial intermediaries. Additionally, as recent research into the LIBOR market revealed, the interbank funding market itself has been in transition. Perhaps most importantly, a large and increasing portion of the American and global financial system falls into the shadow banking category, which is outside the scope of the so-called prudential regulators covering depository institutions and SIFIs. Indeed, the history is clear that the origins of the 2008 subprime panic began in the shadow banking realm of insurance, merchant banks, and money market mutual funds.
- Many commentators have noted that to the extent the LOLR provides a “safety net,” it may create the moral hazard of actually promoting incremental risk-taking and speculative behavior. Also, the perception of actual use of the discount window has a stigma reflecting the weakness of the bank. Media reports often suggest that access to the discount window offers eligible banks preferred status and favorable terms, using a characterization of “bailout” of a distressed or overextended company.
- However, in some sense, the need for a lender of last resort has actually increased since the Great Recession. If, for whatever reason, a financial panic did arise again *despite* all of the protective barriers undertaken, it would be all the more critical for the Fed to have latitude to respond quickly as lender of last resort.

*The Discount Window vs. Other LOLR Activities:*

- Discount window activities, as distinguished from open market operations, generally refers to provision of Federal Reserve credit to individual member banks. To the extent that it is operating through individual depository institutions in normal markets, the role of the discount window consists of providing short-term liquidity to depository institutions through advances on terms as outlined in Section 10(B) of the Federal Reserve Act.
  - Council members expect that individual banks will have access to the discount window on this basis, especially in normal markets to accommodate interbank market imbalances, disruptions, or shutdowns; facilitation of orderly closure of a failed institution under the direction of the FDIC; the failure of a large counterparty to deliver funds as anticipated; or significant and unexpected client withdrawals, particularly those occurring late in the day.
- However, members repeatedly noted the need to distinguish between the needs of a single troubled institution and the effects of a general systemic emergency. Section 13(3) of the Act provides the Fed with additional, broad powers to be used in “unusual and exigent circumstances” with multiple layers of reporting, controls, and oversight. The Fed used Section 13(3) to create numerous programs to resolve the 2008 panic. Members expressed concern that Dodd-Frank substantially constrains the Fed’s use of 13(3) and has decreased or eliminated the Fed’s discretion to resolve a future crisis.

### *Contingency Planning and Living Wills:*

- Regarding contingency planning, the large majority of the Council believes banks should be permitted to include discount window advances for temporary/short-term funding in their formal plans and procedures. There may be inconsistency between individual Fed Districts in this regard: members commented that at least some regulators discouraged the use of the discount window in contingency planning and that alternatives, such as the FHLB, were preferred.
- For the sake of clarity and consistency across the Fed system, members suggested that the Fed should ensure that rules, regulations, acceptable collateral, and subsequent disclosures should be standardized across Districts. Additionally, the Fed should consider aggregating the disclosure of discount window usage to the System level (rather than the current District level) to ensure better anonymity of borrowers, especially given the stigma of the discount window.
- Regarding the inclusion of the discount window in living wills, the general sentiment was that while regulators preferred that resolution plans be kept on a “standalone” basis, the discount window might be a useful, if limited, component in an orderly resolution. One member felt that practical issues, such as the availability of suitable collateral, the “haircuts” used to determine the dollar advance rates, and the short-term maturities, would make practical use difficult.

### *Discussion:*

- New regulatory requirements for the maintenance of liquidity and resolution plans have implications for both the affected banks and for the Federal Reserve itself. Council members have noted that the current approach to impose higher liquidity standards on banking organizations may reduce the availability of credit to support future economic growth. There may be a tradeoff with the ability to attract capital, as highly liquid assets generally have low return and accordingly have real potential to reduce earnings.
- Many capital stress and liquidity models are by their nature theoretical and untested. When liquidity buffers inside an institution are exhausted, regulators must use judgment on the method and timing for restoration. One commentator pointed to an August 2014 Bank of England communique which encouraged UK banks to utilize discount window advances prior to exhausting liquidity buffers, noting that this communication gave clear direction and potentially reduced the stigma of discount window use.
- There has been a substantial amount of work given to understanding the causes and history of financial panics. Several Council members referred to the work of Walter Bagehot and Henry Thornton, which could be summarized as “in a panic, the central bank, acting as Lender of Last Resort, should lend freely to all solvent institutions at a penalty rate.”
- Bagehot quoted a passage from a Bank of England governor referring to the BOE’s actions in handling the Panic of 1825: “We lent it,” said Mr. Harman [a former governor], on behalf of the Bank of England, “by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank, and we were not on some occasions over-nice. Seeing the dreadful state in which the public were, we rendered every assistance in our

power. After a day or two of this treatment, the entire panic subsided, and the 'City' was quite calm.”

- However, this order of liberality is concerning both because the American banking system may be fundamentally different from the English system, which Bagehot observed, but also because of the understandable desire to better define in advance when these lender of last resort powers should be employed, how they should be directed, and the implications for consistent and transparent policy. These distinctions include:
  - Market environment: “emergency” versus “normal”
  - Institutional viability: “illiquid and insolvent”
  - Scope: “idiosyncratic” (specific to one institution) and “systemic”
  - Response: “rules-based” versus “discretionary”
  - Time (and predictability) perspective: “ex post” versus “ex ante” analysis

*Conclusion:*

- The Council returns to this principle: the essential function of the LOLR is to provide for the restoration of order in unexpected emergencies, and that agency must have the full power to complete the critical task of arresting panic and restoring confidence. One is reminded that “the plan is often the first casualty in battle”; because of this real complexity, it may be possible to over-think this problem, and unnecessarily restrict the lender of last resort’s necessary powers.
- The method and timing of withdrawal of LOLR interventions is also undoubtedly critical to the restoration of normal market functions and the mitigation, if not avoidance, of the moral hazard problem.

**Item 6: FASB and Loan-Loss Accounting**

**What will be the impact of recent decisions by the Financial Accounting Standards Board (FASB) on banks’ loan-loss accounting procedures and, specifically, how will they affect bank capital?**

*Background:*

- The proposed accounting standard changes the current “incurred loss” model to a “life of loan expected loss model.” The move to Current Expected Credit Loss (CECL) will increase credit-loss reserves due to consideration of “life of loan” credit losses, which would be recognized upfront when the loan, commitment, or other financial asset is made or acquired. Upon implementation, a one-time increase in allowance levels for existing financial assets would be recorded through an adjustment to retained earnings. Post implementation of the new standard, changes in estimated credit losses will run through earnings.

*Advantage:*

- The primary advantage is that the new methodology is forward-looking and has promise to reduce pro-cyclicality. More reserves likely would be carried into periods of economic weakness, which should reduce the depression of earnings from reserve-building as banks enter weaker parts of the credit cycle.

- However, FASB should model and communicate the likely impact of CECL going into the Great Recession. How would life of loan loss have been calculated during 2008 when economic forecasters were prognosticating complete economic disaster? Might this accounting change actually have been pro-cyclical in a meltdown environment?

*Impacts:*

- Regulatory Capital Impact
  - Initial estimates by the industry and the OCC indicated there would be an increase in allowance for loans of 25 to 50% upon implementation. The potentially significant increase in the provision for credit losses will reduce common equity tier 1 regulatory capital. Only limited, if any, tier 2 benefit will be allowed for the incremental allowance under current Basel III rules due to existing caps. There is no indication from the regulators that transition relief will be provided for the impact on capital, should the CECL model be implemented as proposed.
  - With bank equity capital roughly 15 times the level of loan-loss reserves, a 50% increase in reserves should have a manageable 3 to 4% negative impact on aggregate bank capital. However, there are \$118 billion of reserves in the banking system today. Is there truly a need for \$30 billion to \$60 billion of additional reserves?
- Change in Credit Availability and Tenor
  - By requiring posting of life of loan reserves upon origination, new loans are dilutive to net income in the short run. This effect could restrict credit across the cycle, particularly during economic stress when bank income statements are pressured. Credit-availability restriction during times of stress due to an accounting convention would be highly undesirable and seems possible (if not probable) under FASB's proposal.
  - Banks may be forced to change their lending business model to shorten loan terms in order to lower estimated life of loan losses and enable better estimates of expected losses.
  - Banks may also be encouraged to price loans higher to offset the risk and cost of holding larger reserves and more capital, which could increase operational and reporting costs.
- Cost Burden
  - The proposed model will also increase indirect financial and operational costs (modeling/data, documentation and disclosures, internal/external audit, and validation and risk management challenges). The cost burden will disproportionately impact smaller banks if the accountants and regulators require full GAAP compliance.
- Comparability/Small Bank
  - FASB's proposal likely will be difficult to implement, particularly for small banks, and creates comparability concerns for investors/regulators, given the greater variability of estimates as the timeline for consideration of losses increases.
    - The forward-looking nature of the proposed practice necessitates more-sophisticated models than likely exist for small banks.
    - Smaller banks tend to have a higher concentration of longer-tenor assets and hence may experience a greater impact from the change in methodology.

- Earnings Management
  - There is the potential for earnings management associated with the assumptions around the estimated expected loss characteristics.
- Lack of Convergence
  - Convergence would not be achieved between U.S. GAAP and international financial reporting standards (IFRS). The IFRS impairment model would likely result in much smaller impairment as compared to the lifetime full recognition proposal from FASB. In large transactions, this could place U.S. financial institutions at a competitive disadvantage.

*Recommendations:*

- Carefully study the impacts of the proposed change. One of the guiding principles of FASB is to issue standards only when the expected benefit justifies the perceived costs. This model is estimated by FASB staff to cause financial institutions to add between \$25 billion and \$50 billion in reserves. To date, this amount of additional reserves has not been justified by the ongoing studies.
- Determine the position of the regulators regarding replenishment of the capital depleted by the accounting change. Will reserves be given additional credit in capital calculations such that the industry does not have to increase capital after the accounting adjustment into reserves occurs?
- Should CECL be finalized as currently proposed, provide five years of transition toward implementation. This timeline can be generally broken out by:
  - Eighteen months for banking regulators, with input from the auditing and banking industry, to determine and communicate specific practice expectations.
  - Two years for banks to reconfigure systems, including gathering data not currently collected.
  - Eighteen months of parallel testing by banks, feedback by bank examiners, and education of investors and bank directors.

**Item 7: Monetary Policy**

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

- The Council sees the current stance of monetary policy in the U.S. as appropriate based on underlying conditions and as highly accommodative. A host of market-based indicators suggest U.S. financial conditions tightened over the second half of 2014 in parallel with the Federal Reserve's tapering of large-scale asset purchases.
- Members believe that the normalization of monetary policy does not need to wait for both sides of the Fed's dual mandate to be fully satisfied. As this year progresses, we expect the Fed to assess the appropriate degree of accommodation carefully. Asset prices are being heavily influenced by the low-interest-rate environment and might tend to stray from fundamental value if policy remains too easy for too long.
- The pace of normalization ought to be carefully calibrated to avoid creating any threats to financial stability that might originate in particular corners of the world economy. If economic activity evolves as the consensus foresees, we think it will be appropriate for

- the Federal Reserve to initiate increases in its benchmark interest rates in 2015.
- Lifting the funds rate target off the current 0.00 to 0.25% target range is warranted by the appreciable improvement in the labor market and the broader domestic economy; increasing the funds rate target at only a gradual and measured pace is warranted by global forces that have contributed to low inflation and low long-term U.S. interest rates.
    - Although monetary policy has been exceptionally accommodative, the U.S. dollar has appreciated significantly over recent months. Rather than reflecting expectations of aggressive unwinding of monetary stimulus on the part of the Fed, this appreciation is more a reflection of further monetary policy accommodation on the part of foreign central banks. The appreciating U.S. dollar has contributed to inflation in the U.S. remaining below the 2% target rate despite further improvement in U.S. economic fundamentals. The U.S. dollar will likely appreciate further over coming quarters, particularly should the FOMC begin raising the Fed funds rate in 2015.
    - Falling gasoline prices are helping to push headline inflation and inflation compensation markedly lower in recent months. Opinions vary on whether this drop has been due to expanded U.S. production, geopolitical intrigue, declining worldwide demand, unwinding of leveraged oil-market trades, or some combination of these issues, but the extreme price weakness suggests at least some disinflation from a tighter U.S. policy stance. The prices of other important commodities such as copper and iron ore tell a similar story. At the same time, a stronger dollar is also helping to put downward pressure on prices for some imported goods.
    - However, core inflation, as measured by the Fed's preferred core PCE price index, has been fairly steady at around +1.5% while the unemployment rate has been steadily declining. There still seems to be evidence of some slack in the labor market – indeed, underlying measures of wage inflation still appear to be drifting sideways – although recent headline readings for indicators such as average hourly earnings and the employment cost index have been mixed.
  - Against this backdrop, an important issue confronting Fed officials is the degree to which financial stability considerations should enter into the policy equation. Traditionally, the Fed has focused on inflation and employment objectives while paying less attention to signs of imbalances and overvaluations. In the aftermath of the dot-com boom of the late 1990s/early 2000s and the housing bubble of the mid-2000s, some are starting to ask whether the Fed should utilize the tools of monetary policy – as opposed to regulatory actions alone – to prevent the formation of such imbalances. While there are many different viewpoints on this issue and no easy answers, it seems that financial stability considerations could play an increasingly important role in the formulation of Fed policy going forward.

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