Transcript of Open Board Meeting
July 20, 2015

CHAIR YELLEN. Good afternoon. I'd like to welcome our guests to the Federal Reserve today as we take another important step to enhance the resiliency and stability of our financial system.

The final rule before the Board today imposes a risk-based capital surcharge on the most systemically important U.S. bank holding companies. A key purpose of the capital surcharge is to require the firms themselves to bear the costs that their failure would impose on others. In practice, this final rule will confront these firms with a choice: they must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system. Either outcome would enhance financial stability. The final rule complements other aspects of the Board's enhanced prudential standards for the largest and most systemic U.S. banking firms.

I look forward to today's discussion of these important issues. Let me now turn to Governor Tarullo.

GOVERNOR TARULLO. Thank you, Madam Chair.

A set of graduated capital surcharges for the nation's most systemically important financial institutions will be an especially important part of the strengthened regulatory framework we have constructed since the financial crisis. Like the higher leverage ratio requirements we will apply to these firms, they reflect the relatively new, but very significant, principle that the stringency of prudential standards should vary with the systemic importance of regulated firms. They will be added onto the increased capital requirements of Basel III, and they will take their place alongside another post-crisis regulatory innovation--the supervisory stress tests, to which I will return at the end of my remarks.

The final rule incorporates the framework for capital surcharges agreed upon in the Basel Committee on Banking Supervision for application to banks of global systemic importance, but adds an alternative method for calculating the surcharges. The higher of the surcharges determined by these two methods will be applied to each firm. Let me briefly mention the differences between the two methods.

One difference is that the second method calibrates surcharge levels so that they will generally be higher than those required by the Basel method, and meaningfully higher for some of the firms. As we noted in considering the proposed rulemaking last year, the calibration adopted in the Basel Committee was toward the low end of the reasonable range suggested by economic analysis. And, as explained at some length in the paper developed by Board staff that accompanies the final rule, the calibration levels in the rule's second method are somewhat higher and should provide substantial net economic benefits by reducing the risks of destabilizing failures of very large banking organizations.

The other significant difference is that the rule's second method departs from the Basel formula for determining systemic importance by substituting a measure of each firm's reliance on short-term wholesale funding for one of the factors in the Basel method. This substitution reflects the fact that reliance on short-term wholesale funding is among the most important determinants of a firm's systemic importance. It can leave a firm vulnerable to creditor runs that force the firm to rapidly liquidate its own positions or call in short-term loans to clients. Both of these responses can lead to fire sales that can reverberate through the financial system by creating a vicious cycle of mark-to-market losses, margin calls, forced deleveraging, and further losses. Still, important as it is to include this factor as a determinant of the potential impact of a firm's distress or failure on the financial system, it is not a substitute for measures that directly address the structure of bank funding, such as the Liquidity Coverage Ratio that we recently adopted, or the Net Stable Funding Ratio that we will be considering later this year.

While the final rule retains the basic approach of the proposed rule, the staff has suggested some changes based on comments received in the rulemaking process and additional internal analysis. Perhaps the most significant change is that the systemic score determined under the second method will be based on a fixed measure of each firm's systemic importance, rather than--as in the Basel method--on a measure relative to that of other firms of global systemic importance. As commenters pointed out, the Basel approach makes each firm's surcharge a somewhat unpredictable function of changes that a group of large firms have, or have not, made in their own systemic profile.

Finally, I would note that we will need to consider whether and, if so, how to incorporate the surcharges into the post-stress minimum capital levels required in our annual Comprehensive Capital Analysis and Review (CCAR). As members of the Board know, Board staff have been assessing a wide range of possible changes--substantive and procedural--to the CCAR, and related supervisory stress testing, exercises. We anticipate that later this year staff will develop a series of recommendations for consideration by the Board, including changes that would make the supervisory stress test and CCAR better address systemic risks arising from correlations in the exposures and activities of large financial institutions. While incorporation of some or all of the capital surcharges would be one way to account for those risks, it is only one among a number of possibilities, all of which we will want to evaluate.

And with that Madam Chair, let me turn to Mike Gibson and staff for a full exposition of the rule that we have before us.

MICHAEL GIBSON: Thank you, Governor Tarullo.

The draft final rule before the Board today is a complement to other measures the Federal Reserve has completed that aimed to strengthen the resiliency of the largest bank holding bank companies including the U.S. GSIBs thereby lessening the risks that these firms can pose to U.S. financial stability. Section 165 of the Dodd-Frank Act directs the Board to establish enhanced prudential standards for bank holding companies with a total of consolidated assets of $50 billion or more. Among other things, these standards must include risk-based capital requirements and must increase in stringency based on several factors including the size and risk characteristics of the firm. And as Governor Tarullo mentioned, this increased stringency is an important and new feature of the post-crisis regulatory reform program.

The GSIB surcharge adopted in the draft final rule is one of several enhanced prudential standards that the Board has implemented for large banking organizations. Other enhanced standards already in place include the resolution plan rule, the capital plan rule, the stress test rules, and other enhanced prudential standard rules. These were applicable only to companies covered by Section 165 of the Dodd-Frank Act and do not apply at all to smaller firms and do not apply for example, to community banks. The integrated set of enhanced prudential standards will results in a more stringent regulatory regime that will mitigate risks to U.S. financial stability and include measures that increase the resiliency of these companies and reduce the impact on U.S. financial stability were these firms to fail. With that, I'll now turn to Holly Taylor and Jordan Bleicher who will provide a more detailed explanation of the final rule before us today.

HOLLY TAYLOR. Thank you Mike. I will describe the main provisions for the draft final rule including changes made to address some of the concerns raised by the commenters. My colleague, Jordan Bleicher will discuss the short-term wholesale funding and calibration aspects of the rule. Then we, as will as my colleagues, Mark Savignac and Eric Kennedy will answer any questions you may have.

The draft final rule is based on an assessment methodology and surcharge framework developed by the Based Committee on Banking Supervision that is modified to address systemic risk concerns specific to large U.S. bank holding companies. To identify a firm as GSIB, the rule requires certain large bank holding companies to calculate annually in numerical score using five broad categories correlated with systemic importance. A bank holding company with a numerical score above a certain level would be identified as GSIB and would be subject to a GSIB surcharge. The threshold is intended to capture bank holding companies whose failure or material financial distress would post the greatest threat to U.S. financial stability.

The proposal would have required each U.S. top tier bank holding company of total assets of 50 billion or more to perform the annual calculation. To reduce regulatory burden, the final rule raises the applicability threshold such that bank holding companies with less than 250 billion in assets generally would not be subject to the requirement as these firms pose less risk to U.S. financial stability.

Using the most recent available data, eight U.S. bank holding companies would currently quality as GSIBs and be subject to a capital surcharge as a result. The capital surcharge would operate through an expansion of the capital conversation buffer under the regulatory capital rule. In that rule, all banking organizations must hold a minimum ratio of 4.5 percent of common equity tier 1 capital to risk-weighted assets and must hold an additional 2.5 percent capital conservation buffer in order to avoid limitations on capital distributions and certain discretionary bonus payments. This draft final rule requires that a GSIB increase its capital conservation buffer by the amount of its GSIB surcharge to avoid such limitations. The capital conservation buffer and GSIB surcharge will be faced in from January 2016 to year-end 2018.

Turning to how to calculate a GSIB surcharge amount, a bank holding company that is identified as a GSIB would determine its surcharge under two methods, methods one and two. The firm would subject to the higher of the resulting surcharges. Method 1 is aligned with the international standards and uses five categories correlated with systemic importance, size, interconnectedness, cross-border activity, substitutability, and complexity. Method 2 would use four of those categories but would replace substitutability with the use of short-term wholesale funding. Method 2 also is calibrated in a manner that generally will result in higher surcharges and those under Method 1. My colleague, Jordan, will discuss calibration in more detail in a moment.

Turning to comments received on the proposal. Commenters raised a number of concerns about the relative nature of the proposed framework. Under the proposal, a firm systematic importance would have been measured as the firm's amount as a percent of the global total for each systemic indicator which is updated annually and denominated in euros. Commenters expressed concern that if a firm takes steps to lower its score and larger group scores decrease proportionally, then the firm score will not change under this relative approach. Thus, the firm would not receive any benefit to its score from its risk-reducing actions.

In addition, under the proposal to calculate their score relative to global peers, U.S. banking organizations would need to convert the global totals used in the score calculations from euros to dollars using a spot rate as at the last day of the year. Commenters argue that changes in foreign exchange rates should not materially affect scores. The draft final rule would maintain the relative approach for calculating GSIB's Method 1 score as proposed. Thus, a firm will be identified as a GSIB and it will be subject to a floor on its GSIB surcharge using the relative approach. To address some of the concerns raised by commenters, however, the draft final rule includes several changes to the Method 2 calculation.

First, instead of using relative approach based on global totals that change every year, under Method 2, the global totals are fixed at certain levels. Use of a fixed approach under Method 2 which will generally be the applicable surcharge for firms is appropriate in order to provide a firm with greater predictability of its surcharge and to address some of the incentive concerns raised by commenters. Using a fix approach also resolves the concern over converting global totals from euros to U.S. dollars. With the fixed approach, the final rule incorporates a one-time conversion using an average of foreign exchange rates. Using a multiyear average of spot rates, smooths over short-term foreign exchange fluctuations relative to using a daily spot rate, but will still reflect sustain changes in the exchange rate. On average with the changes I just discussed, surcharges under Method 2 are approximately 1.8 times larger than those under Method 1. I will now turn to Jordan who will describe in more detail how a GSIB's measure of short-term wholesale funding is incorporated into Method 2. Then, Jordan will conclude by explaining how the GSIB surcharge calibrations would differ under the two methods.

JORDAN BLEICHER. Final rule would incorporate the measure of the firm's reliance and short-term wholesale funding in the Method 2 score. In recognition of the risk that use of such funding poses the financial stability. As Holly mentioned of short-term wholesale funding measure would replace the substitutability category used in Method 1. As in the proposed rule, the final rule would define short-term wholesale funding as total liabilities other than regulatory capital, debt with a remaining maturity of one year or more, traditional retail of deposits and operational deposits. Short-term wholesale funding liabilities would then be weighted based on two factors. First, the residual maturity of the liability, and second, in the case of secured short-term wholesale funding, the asset class of the collateral backing liability. The category is used for the weighting are generally similar to those used in the Board's liquidity coverage ratio rule or LCR.

Some commenters objected to the inclusion of short-term wholesale funding in the GSIB surcharge pointing to the LCR and other regulatory initiatives that are intended to address liquidity concerns. However, the final rule would include a short-term wholesale funding component because the GSIB's capital surcharge should increase based on the impact that the firm's failure would have on financial stability. And use of short-term wholesale funding is a key determinant of the systemic impact of the firm's failure. The LCR and other tools are designed to help ensure that large banking firms are in stable funding position and so less likely to fail, they cannot eliminate the financial stability risks posed by GSIB's use of very large amounts of short-term wholesale funding.

Commenters also provided views on the weights of short-term wholesale funding sources included in the proposal. A number of commenters noted that the weighting system for short-term wholesale funding focused on the liability side of the balance sheet and argued that this approach overstated the risk associated with wholesale deposits compared to secured funding. In response to these comments, the final rule would reduce the weight assigned to certain unsecured short-term wholesale funding sources as compared to the proposal. The maximum weight for wholesale deposits from non-financial clients would be reduced from 50 percent to 25 percent, while the maximum weight for wholesale deposits from financial clients would be reduced from 100 percent to 75 percent.

Turning to calibration, under the final rule, a GSIB would be subject to the greater GSIB surcharge resulting from the two methods described by Holly. In most instances, a GSIB would be subject to the surcharge resulting from Method 2. Several commenters express concern regarding the calibration of the GSIB surcharges and requested that the Board provide additional analysis to justify the proposed surcharge levels. Therefore, in connection with the final rule, staff has prepared a white paper that supplements the calibration discussion in the proposed rule. Although the white paper discusses several methods for calibrating GSIB surcharges, the white paper focuses on the expected impact framework.

Under this framework, GSIB should be required to hold enough capital so that the expected impact on financial stability from the failure of a GSIB is approximately equal to the expected impact on financial stability from the failure of a large non-GSIB referenced bank holding company. In other words, if a failure of a GSIB would have five times the impact on financial stability as the failure of a non-GSIB, the GSIB should be required to hold sufficient amount of capital that the probability of its failure is one-fifth of the non-GSIB.

Applying the expected impact framework require several elements. First, requires a method for measuring a relative harm that a gives firm's failure would do to the financial system, that is its systemic footprint. The white paper uses two methods described in the GSIB surcharge rule to quantify the harm that each firm's failure would do. Second, the expected impacts framework requires means of estimating, the probability of that firm with a given capital level will fail. The white paper estimates this relationship using 30 years of historical data and the probability that a large U.S. banking firm will experience losses of various sizes. Third, the expected impacts framework requires a choice of reference bank holding company, a large non-GSIB banking firm whose failure would not pose an outsized risk to financial stability. The white paper discusses several possible choices of reference bank. The white paper concludes that the surcharges produced by the final rule are consistent with the expected impact theory.

In large part because of CCAR, another supervisory and regulatory work we've done since the crisis, the U.S. GSIBs are now substantially better capitalized than they were before the crisis.

Staff estimates the seven of the eight firms that would be identified as GSIBs under the final rule already meet their GSIB surcharge requirements, and that all firms are underway to meeting their surcharges over the three-year facing period. The GSIB surcharge rule would require their GSIBs to maintain these capital buffers in the future, in order to avoid restrictions in capital distributions and discretionary bonus payments. As a result of this extra capital, the U.S. GSIBs will be considerably less likely to fail which will protect the stability of the financial system as a whole. That concludes our formal remarks. With that, my colleagues and I are happy to address your questions.

CHAIR YELLEN. Thanks very much. Let me just kick things off just with one question. Jordan, you described the framework, the expected impact framework that you used to calibrate the size of these surcharges. And I wonder if you could just give me a little bit more intuition than I have about how you calculate loss given default which is an element of the framework. You have the scores that you compute into these two methods is your assumption that loss given default is proportional to those scores or measured by those scores or if you just go into a bit more detail on how you get to loss given default.

MARK SAVIGNAC. Chair Yellen, the white paper describes the treatment of loss given defaults and it states that the analysis assumes that loss given default that the scores produced under the two methods are proportional to loss given default. At the same it acknowledges that there are probably reasons to believe that at least with respect to some of the components, there is not a proportional or linear relationship and rather the loss given default associated with a certain component increases at an increasing rate as the component increases. And that issue is taken into account in a qualitative and not in quantitative sense and is discussed further in the white paper that was probably reconsidered in establishing the ultimate surcharge levels.

CHAIR YELLEN. Thanks very much. Vice Chair.

VICE CHAIRMAN FISCHER. Thanks very much, Madam Chair.

In the Method 2, where everything--well, everything is non-relative, anyway, this case is within this statement that if you improve your performance and everybody else does, you don't gain any benefit. But you do gain a benefit because if you didn't, you'd have a higher requirement than all the others. So you better at least stay and stand still with the other guys if you don't want to have higher capital.

On the short-term wholesale funding, we have a lot of evidence either that was a critical factor in the right--for addressing the questions in this direction. So that was a critical factor in the difficulties that several firms faced. So, there seem to be much question that that should be taken into account and you figured out a clever way of taking it at least in logical way of taking it into account. Did we get a lot of pushback on this one? Who said we did?

MICHAEL GIBSON. There were some commentators who suggested that that was unnecessary but I think we felt--and like you said, that the lessons of the crisis seem clear that excessive reliance on short-term wholesale funding was a risk factor that cause some firms to get into trouble and that taken into account as part of the systemic footprint score made sense and it's a good thing to have in the methodology.

VICE CHAIRMAN FISCHER. Can you explain--help us we've got to also defend what's being done here. I don't have trouble most of the time, but big question, why are we more dangerous financial system than the others? Why should we have higher requirements? And people say we make it more difficult for American firms to compete in the international economy and all that? What is the underlying--it's just that we are more risk averse or what?

MARK VAN DER WEIDE. So I think fundamentally, we try to calibrate this review to make sure that we had addressed of cost the firms to internalize the externalities that their failure would cause on the U.S. financial system and in our view that was the right way to look at the problem and to not worry quite so much about comparisons that other countries are doing, their GSIBs in their jurisdictions. I will say that there are number of countries that have already decided to gold-plate the Basel standard in addition to us but it's not only in Sweden and Switzerland that also decided to go beyond the Basel surcharges and to go beyond them considerably roughly in the range of how far we're going beyond the Basel surcharges.

The U.K. is also working towards leverage ratio surcharges for their GSIB, so a very large number of the other countries that host GSIBs are moving down this path as well. Others may follow in the future. The other thing I'd say on a competitive equity point is that U.S. banking firms for several decades now, I'd say, have been subject to stricter regulatory regime than their foreign peers including on the capital side. And I think they've competed pretty successfully against their foreign peers including in the last two years. But fundamentally, I think we saw these surcharges as our white paper describes to offset the externalities that our firms have in the U.S. financial system and we think that's the right way to sort of attack the calibration of the problem.

VICE CHAIRMAN FISCHER. There's a lot of concern about the use of the exchange rate or at least the need to compare and we get told, well, that shouldn't affect things but at some--for some date, you have to make these calculation. So at least once it's going to affect things and then it's not clear to me why it shouldn't affect things. And if we become bigger as a result of the dollar appreciating, our banks become more--larger in the financial system. What is the objection into taking the exchange rate into account?

ERIC KENNEDY. So that's actually something that's been considered quite a bit at Basel. And I think there is some sympathy to the FX fluctuations actually changing your systemic footprint to the extent that they're sustainable. So if you see a very short spike in an FX rate at the end of the year, it may not actually reflect true changes in systemic importance, however, if that spike does persist over a longer period of time, then that perhaps is an indication that your systemic footprint has in fact changed along with that fluctuation.

So one of the things that we did with our Method 2, instead of using a fixed FX rate to create those U.S. proxies that we used to calculate the score we took a three-year horizon of FX rates to sort of decrease the volatility in the number that's used.

VICE CHAIRMAN FISCHER. And if you go back let's say 20 years, what is the maximum change year to year that you get out of using the three-year moving average?

ERIC KENNEDY. Well, the problem is the euro hasn't been around that long, but we saw--we have seen some—

VICE CHAIRMAN FISCHER. There are those who think that Deutsche mark has been around quite long time.

ERIC KENNEDY. We have seen some large fluctuations in a very short period of time. A good example is the Swiss franc against the euro. So you can imagine the two Swiss GSIBs being quite affected just by unpegging the euro to the Swiss franc, which should have happened overnight.

So while there have been some large fluctuations, we also note that it works in both directions. So, as the fluctuation could increase the value of your currency against the euro in one cycle, perhaps down the road it ends up working in the other direction and you actually shrink your systemic footprint. And we've seen that with a number of other currencies.

MICHAEL GIBSON. But you're right that over long period of time, if there is a changing exchange rates that sustain then that will feed through a relative size and systemic importance of firms and are ruled--you know, we'll take account of that but what's changed from the proposal is that there is no one day that this global adjustment is being made that could cause more volatility in the score from one year to the next. With Method 2, we've removed that.

VICE CHAIRMAN GIBSON. Yeah, I mean, that seems entirely logical, so I don't see a problem. Thank you, Madam Chair. Thank you for that.

CHAIR YELLN. Thank you. Governor Tarullo?

GOVERNOR TARULLO. Thank you, Madam Chair. I just have one very brief question which relates to the exchange rate and also to the fixed versus relative approach to determining systemic importance.

You've explained that what made changes in Method 2 as a result to the comments, but we haven't made changes in Method 1, one might--public might think if it makes sense to make them in one place, why not make them in both places? What's the answer to that?

HOLLY TAYLOR. Well, the general response is that Method 1 serves as a floor. In most cases, the Method 2 surcharge will be the higher surcharge than under Method 1. And Method 1 is also used to identify firms as GSIBs. So in that case we kept it as a relative approach.

MICHAEL GIBSON. That also keeps it more consistent with Basel.

GOVERNOR TARULLO. Thank you.

VICE CHAIRMAN FISCHER. It means something we don't use, keeps us consistent with Basel.

MICHAEL GIBSON. Well, it's used as a floor and it's used for identification but the Method 2 surcharge will generally be the binding one.

GOVERNOR TARULLO. I mean, it's theoretically possible that Method 1 could be binding under some circumstances. It's just not as likely.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. Thank you, Madam Chair. So one of the principal purposes here is create incentives for these firms to reduce our systemic footprint, and to do so they need to understand how changes in their business model activities would affect the calculation of their surcharge. So my question is do we feel they're in a position to do that? Is there enough transparency in the way these surcharges are calculated to enable the firms to make intelligent decisions about their business model and be able to anticipate the right ways and the fastest ways to reduce their systemic footprint?

MARK VAN DER WEIDE. Yes, it's a very transparent framework. It will be quite transparent to the firms and also quite transparent to the public as to what generates the scores and the algorithm, and what generates their surcharge levels. And as the Chair indicated, the way we structured our safety regulatory framework more broadly, we are designing it to force the firms to internalize the cost that their failure would impose in the system, but then to give them that choice as to whether they comply with our tougher regulation.

If they've decided that their economies of scale and scope in their business are such that they outweigh the regulatory burdens from our safety regulatory program, then they can keep their systemic footprints where they are and just bear the higher capital costs, and increase their resiliency to the levels that we are providing our regulations. But if they decide the other way, they have--they can shrink their systemic footprint to lower the regulatory burden.

And the way our formulas work, they are pretty algorithmic, so the factors are quite objective. Each firm can calculate for itself what its footprint is in the formula and exactly what transactions it engages in that produce those scores. The denominators are now fixed, so they can get a very accurate assessment of what actions they can do to reduce their systemic footprint and reduce their surcharges.

As to what individual firms will do, which ones will choose to retain their systemic footprint and hold more capital and which ones we will choose to reduce their systemic footprints to reduce their capital requirements, I think time will still tell. It will depend on the business model of the individual firm, and the surcharge that applies to them.

GOVERNOR POWELL. Great. Thank you.

CHAIR YELLEN. Thank you.

GOVERNOR POWELL. Good.

CHAIR YELLEN. O.K. If there are no more questions, then—

VICE CHAIRMAN FISCHER. Can I ask a question?

CHAIR YELLEN. Yes, sure.

VICE CHAIRMAN FISCHER. This is probably covered somewhere else, but I'm just trying to think of the international side of all this, and the--what we do know is that if you got a big international bank, a bank that operates in a lot of countries, they'll have thousands of subsidiaries in many cases, and winding them up is even more complicated than it is winding up an American--a purely American bank, not that there are any that are purely American. But there’s that. Wherein in the system--you know, we've got these living wills which require them to explain how they wind themselves up, and so those take care of the international aspect to some extent. But is that also reflected in the capital requirements at all? Should it be? Shouldn't it be?

So one of the indicators of systemic importance that goes into the score calculation that we're using is cross-border activity. So a firm that has more cross-border assets and liabilities would have a higher systemic footprint score, and therefore that would lead to a higher surcharge. So it is one of the five factors that's in--that's part of the score because of the links that you mentioned between cross-border activity and the systemic cost. It's the firm.

VICE CHAIRMAN FISCHER. That's it.

CHAIR YELLEN. O.K. If there are no more questions, I'm--let's have go-around in which we give our positions, and I'll just start off saying that I support finalizing the risk-based capital surcharge rule. I think this rule is a very important step in addressing the very serious concern that the failure of a systemically important firm would impose great harm on the financial system and the economy. Imposing higher capital standards on such firms first of all serves to reduce their risk of failure. And in addition, as you've noted, it incents actions that will help to incent firms to reduce their systemic footprint. So, I think you've done a good job of addressing the comments on the proposed rule, and I support moving ahead now. Vice Chair.

VICE CHAIRMAN FISCHER. I also support moving ahead right.

CHAIR YELLEN. Governor Tarullo.

GOVERNOR TARULLO. I'll just echo what Stan has just said. I'm fully supportive of the proposal.

CHAIR YELLEN. Governor Powell.

GOVERNOR POWELL. I, too, am supportive with moving ahead with the proposal.

CHAIR YELLEN. Governor Brainard.

GOVENOR BRAINARD. Today's rule represents important progress in strengthening the capital positions of the largest, most systemic U.S. bank holding companies, and for that reason, I support it.

The crisis taught us that the distress of large complex banking institutions can pose risks to financial stability. Whereas our pre-crisis regulatory framework focused on the safety and soundness of individual institutions, the regulatory framework that we are putting in place importantly also addresses the risk to the system posed by individual institutions. Within this framework, the first line of defense is to require a very substantial stack of common equity to provide loss absorbency and also to compel them to internalize the risk to their system--to the system posed by their activities.

Today's rule would impose capital surcharges proportional to the systemic riskiness of the eight U.S. systemic banking institutions. Importantly it is calibrated in proportion to how an institution scores on specific metrics that capture the risks it poses to the system, risks associated with size, interconnectedness, complexity, cross-border activities, and substitutability. It also reflects, as we discussed, the risks associated with greater reliance on short-term wholesale funding, which we saw in the crisis can spark creditor runs, asset fire sales, and contagion. By calibrating the surcharge in direct proportion to clearly specified measures of each institution's systemic impact, this approach provides clear, quantifiable incentives to the systemic banking institutions to reduce their systemic footprints.

The crisis also provided a stark reminder that what may seem like thick capital cushions in good times may prove uncomfortably thin at moments of stress. For that reason, I look forward to future discussions about the appropriate role, if any, of the capital surcharge in the supervisory stress tests. Thank you, Madam Chair.

CHAIR YELLEN. Thank you. And now we will have two separate motions to approve this rule. First, I need a motion to approve the draft final rule to establish risk-based capital surcharges for global systemically important bank holding companies.

VICE CHAIRMAN FISCHER. So moved.

CHAIR YELLEN. Thank you. Is there second?

GOVERNOR TARULLO. I second.

CHAIR YELLEN. All in favor?

ALL. Aye.

CHAIR YELLEN. And second, I need a motion to approve amending the proposed revisions to the FR Y-15 reporting form to conform the collection of information to the draft final rule and an extension of the comment period for the proposed revisions to the FR Y-15.

VICE CHAIRMAN FISCHER. So moved.

GOVENOR TARULLO. Second

CHAIR YELLEN. All in favor?

ALL. Aye.

CHAIR YELLEN. O.K. So these motions are approved.

And now I'd like to turn our attention to our second item today, which is to consider a final order that the regulation and supervision of General Electric Capital Corporation, or GECC.

GECC was designated as a systemically important nonbank financial company by the Financial Stability Oversight Council and as such, is subject to Board supervision.

Whether a firm we regulate is a bank or a nonbank, our goal is to tailor our regulation and supervision to the systemic footprint of the individual firm in a way that safeguards the stability of our financial system and our economy.

Because GECC's activities, risks, and operations are similar to a large bank holding company, the order we are considering today would require GECC to comply with many of the same standards that the Board has applied to large bank holding companies. However, in light of the substantial divestitures announced by GECC, which may shrink its systemic footprint, the order is tailored to introduce those requirements in two separate phases.

I look forward to this discussion and will now turn to Governor Tarullo.

GOVERNOR TARULLO. Thank you, Madam Chair. As you just noted, the proposed final order for the prudential standards applicable to GECC comes against the backdrop of GE's announced plan to cut substantially the size and scope of GECC's balance sheet and activities. Before explaining how the proposed final order takes account of that plan, let me note why it's appropriate for us to proceed with adoption of the order today.

We have a statutory obligation to apply enhanced prudential standards to GECC following its designation by the Financial Stability Oversight Council as a systemically important nonbank. It has been two years since that designation, during which time the Board has carefully evaluated how the enhanced prudential requirements should be tailored to the characteristics of this particular institution, including consideration of comments received through the public notice and comment process we have followed. While GE has put forward a plan for substantial divestitures by GECC and has already begun to execute that plan, no one can know with complete assurance if or when it will be fully executed or how GE's stated intention to seek de-designation of GECC will proceed. Thus it is possible that GECC will remain a designated institution for some time to come, and we should have a regulatory framework in place to take account of that possibility.

Having said that, it would not be sensible for us to disregard GE's announced plan to reduce GECC's size by about 70 percent, particularly in light of the fact that it is demonstrably executing that plan. The proposed order fulfills our statutory and administrative obligations in a way that reflects the practical situation before us by separating required implementation of the enhanced prudential standards into two phases. GECC will be subject to fundamental capital and liquidity requirements beginning January 1, 2016, but will not be subject to the full panoply of the order's enhanced standards until January 1, 2018. This approach will assure that GECC maintains important loss buffers for its continuing operations while it executes its divestiture strategy. If GECC is de-designated during the next two and a half years, the full set of enhanced prudential standards will never take effect.

And with that, let me again turn to Mike and staff for a description of the proposed final order.

MICHAEL GIBSON. Thank you, Governor Tarullo.

The order the Board is considering today is a significant step in our efforts to implement our regulatory and supervisory program for nonbank financial companies that had been designated for Board supervision. Many of the activities GECC currently undertakes are quite similar to those of banking organizations that are subject to regulation on a micro- and increasingly macroprudential basis.

By applying the same regulatory principles to GECC, the final order reflects the principle that the regulation and supervision of larger financial institutions must be guided by a broad system-wide perspective. The final orders subjects GECC to an integrated set of standards that would both reduce the probability of its failure and help insulate the financial system in the broader economy if it were to fail while building on the progress that the Federal Reserve has already made with the company through our supervisory program. At the same time, and in light of GECC's new strategy, the phased requirements in the final order help to ensure not only the GECC maintains capital and liquidity with respect to its current operation, but also that if GECC remains designated, it will have time to prepare for compliance with enhanced standards that are appropriate for an institution of its size and exposures.

With that, I'll turn to Elizabeth MacDonald, who will provide a more detailed explanation of the order before us today.

ELIZABETH MACDONALD. Thank you, Mike. The final order the Board is considering today would implement enhanced credential standards for General Electric capital Corporation, a nonbank financial company that the Financial Stability Oversight Council has designated for supervision by the Board. The order was produced by a multi-disciplinary team across the divisions of the Board. In my remarks today, I will provide an overview of the basic elements of the order the Board is considering. I and my colleagues will then answer your questions about the order.

GECC was designated for Board supervision in July 2013. In considering the application of enhanced prudential standards to GECC, we thoroughly assess GECC's business model, capital structure, risk profile, and systemic footprint to determine how the enhanced prudential standard should apply. In light of the substantial similarity of GECC's activities and risk profile to that of a similarly size bank holding company, the final order applies enhanced credential standards to GECC that are similar to those that apply to large bank holding companies.

Effective January 1, 2016, GECC will be subject to the Board's basic kit of standardized risk-based capital requirements. The first set of standards also includes a minimum leverage ratio of tier 1 capital to unbalance asset to 4 percent and the liquidity coverage ratio rule. Finally, the draft order--final order includes certain reporting requirements necessary to support compliance with the first set of standards.

Next, effective January 1, 2018, the final order requires GECC to comply with regulatory capital framework applicable to an internationally active banking organization, although GECC will continue to calculate its risk-weighted assets using only the standardized methodology. Consistent with that Dodd-Frank Act's requirement to apply and enhance leverage requirements to nonbank financial companies supervised by the Board, the final order requires GECC to comply with an enhanced supplementary leverage ratio standard while tailoring the standard to the GECC's risk profile, complexity, activities, and size. Specifically, effective January 1, 2018, the final order requires GECC to meet a 4 percent enhanced supplementary leverage ratio in order to avoid restrictions on capital distributions and certain discretionary bonus payments.

In addition to additional risk-based and leverage capital requirements, the final order requires GECC to comply by January 1, 2018 with the capital plan rule, the stress test rule, enhanced liquidity risk management and liquidity stress testing requirements, enhanced general risk management requirements, and additional reporting requirements.

In addition, the order would help to ensure that the perspectives of qualified individuals independent of the management of GE and GECC will have a strong voice in a governance of GECC. Accordingly, effective January 1, 2018, the final order requires a majority of the GECC board of directors to be independent directors unaffiliated with GE management or GECC management with an independent director as chair. In addition, the final order requires the entire GECC risk committee to be comprised of independent directors unaffiliated with GE management or GECC management.

Finally, also as of January 1, 2018, the final order applies certain restrictions to GECC's transactions with affiliated entities in order to address the potential for conflicts of interest between GECC and GECC that could have an adverse effect on the financial condition of GECC.

We are happy to answer any questions about the final order. Thank you.

CHAIR YELLEN. Questions. Vice Chair?

VICE CHAIRMAN FISCHER. Yeah. The documentation we have says that when it's completed, the divestitures, that it expects to make--the size of balance sheet will decline from $480 billion to about $140 billion within three years. We've sort of monitored that, and we know they're making progress. Obviously you don't do this all on the first day. So how do we know that it's going on? And how much should we take comfort from everything we've heard so far?

JYOTI KOHLI. The Federal Reserve has an on-site supervisory team that is--that continuously--that engages in a broad range of continuous monitoring activities, meets periodically with the management of GECC and GE, and views management information system reports on a regular basis. One of the mandates of the team going forward will be to assess compliance with the provisions of this order as it becomes effective while staying on top of the divestiture plan and the risk that ensue.

VICE CHAIRMAN FISCHER. And in terms of what we—have got the system set up yet? The monitoring system?

JYOTI KOHLI. We do have monitoring systems. We have a broad team that's actually looking at different phases of the divestiture plan. There's a team that's looking at the plans itself, the businesses, the lines of control, the actual asset sales, the divestitures, the legal aspects, the tax aspects. All facets of the business and divestitures are being monitored on 24-hour basis.

VICE CHAIRMAN FISCHER. And, you know, when we talk about how we expect the system--the new system of supervision and regulation to work, this is one of the--this is the prime example of how we're tightening the regulations. And if they're not willing to do them, they're going to have to slim down. Are there any hints anywhere else in the regulatory--in the banks we are supervising--you don't have to specify them--but similar considerations are being considered at other banks?

MICHAEL GIBSON. I think as we've--so just to link the last discussion with this discussion, after we proposed the GSIB capital surcharge last year, we observed a lot of discussion among banks and analysts around how different strategies, different banks might pursue, the large banks, might pursue to reduce their systemic scores and reduce their capital surcharge.

So, you know, with respect to nonbanks, they are designated by the Financial Stability Oversight Council for supervision by the Federal Reserve, so it’s really up to the Financial Stability Oversight Council to say if the efforts to shrink are sufficient to merit de-designation, that wouldn't be a decision for the Federal Reserve by ourselves to make. So we've set up the incentive framework for the GSIBs, which are the bank holding companies that we regulate. But for the nonbanks, it's really up to the FSOC.

VICE CHAIRMAN FISCHER. Well, I don't have further questions, but let me just say that I thought this two-stage, two-phase process is really very--a very good idea. It gives the right incentives. It tells other institutions that if this is the way you want to go ahead, and they may just shrink, we'll find ways of making sure that you don't pay a price in the meantime for being where you are rather than what you're likely to be. But putting in place a framework, which if they don't do it, we'll treat them as--we'll treat them appropriately to their size, and l think you've done this very well, so congratulations.

GOVERNOR TARULLO. No questions.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. No questions.

CHAIR YELLEN. Governor Brainard?

O.K, then let's go to positions, and I'll just start of saying I support the proposal. And as the Vice Chair just indicated, I think you've done a very good job of tailoring here showing that we do take account of the special circumstances and business models of firms as we try to craft appropriate supervision and regulation, and in this case, GECC's announced plan to really restructure its activities. I agree with Vice Chair. I think you have addressed this in a very appropriate and thoughtful way, so I support.

Vice Chair?

VICE CHAIRMAN FISCHER. You don’t need a motion?

CHAIR YELLEN. No, we need positions.

VICE CHAIRMAN FISCHER. Oh, positions. Sorry.

CHAIR YELLEN. We’re just asking for positions at this point.

[Laughter.]

CHAIR YELLEN. I will then ask--

GOVERNOR TARULLO. You're jumping the gun.

CHAIR YELLEN. --for a motion in a just a second.

VICE CHAIRMAN FISCHER. O.K. I agree with what you just said.

GOVERNOR TARULLO. Thank you, Madam Chair. I, too, support the order, and I just add that I think this--the notice and comment process that we went through here to tailor, as you and Stan have noted, the nature of the standards which would be applicable to GECC is one that I think we're going pursue in the future for the other nonbank SIFIs as well. Obviously, the set of considerations, they will be different, because they're different institutions. But the notice and comment, opportunity for the public to comment, is something that we will--that we will adhere to in the future as well.

CHAIR YELLEN. Thank you. Governor Powell?

GOVERNOR POWELL. Thank you, Madam Chair. So the standard kit, as I think Elizabeth put it, of capital standards and liquidity standards will apply to this company starting on--at beginning of next year. But assuming that the divestiture plans are effectuated, assuming then that the FSOC chooses to de-designate the company then, the far more extensive enhanced prudential standards that would be scheduled to come in place on--in the beginning of 2018, may never come into effect. So I think like--as others do, I think this is a very reasonable place for us to have landed these facts, and I compliment you on it.

CHAIR YELLEN. Thank you. Governor Brainard?

GOVERNOR BRAINARD. I think it's, you know, I really like the approach that you are putting forward here. This is an institution that has put forward a very ambitious plan of substantial 70 percent shrinkage and is proposing to undergo a de-designation process, and I think the framework that we put in place is carefully calibrated both to its plans and to its timelines to make clear that if it succeeds in its plans that it will be in a very different supervisory framework than if it doesn't, and I think that's forward looking, and that's exactly the kind of framework that we should have. So for all those reasons, I support it.

CHAIR YELLEN. O.K. Then I need a motion to approve the draft order applying enhanced prudential standards to General Electric Capital Corporation and the accompanying federal register notice.

VICE CHAIRMAN FISCHER. So moved, Madam.

CHAIR YELLEN. Thank you. Second?

GOVERNOR TARULLO. Second.

CHAIR YELLEN. All in favor?

ALL. Aye.

CHAIR YELLEN. Approved. And I think seeing no further business before us, this concludes the meeting. Thanks to all the staff for your hard work on both of these proposals.