Meeting of the Board of Governors and the Federal Advisory Council December 6, 2013

Participants: Chairman Ben S. Bernanke, Vice Chair Janet L. Yellen, Governor Daniel K. Tarullo, Governor Sarah Bloom Raskin, Governor Jeremy C. Stein, and Governor Jerome H. Powell (Federal Reserve Board members); William Bassett, Allen Fishbein, Robert Frierson, Robin Prager, Gretchen Weinbach, Maria Ling, Margaret Miller, Wanda Quick, and Brian Tabit (Federal Reserve Board staff)

Joseph L. Hooley, James P. Gorman, Bharat B. Masrani, James E. Rohr, Kelly S. King, Daryl G. Byrd, David W. Nelms, D. Bryan Jordan, Patrick J. Donovan, Jonathan M. Kemper, Ralph W. Babb Jr., and J. Michael Shepherd (Council members); James Annable and Shani Schechter (Council staff)

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

The Council discussed the Dodd-Frank Wall Street Reform and Consumer Protection Act and expressed the following concern about the proposed interagency rule on credit risk retention (Docket No. R-1411):

> Commercial mortgage-backed securities issuance has revived to $60.5 billion year-to-date September 2013, but there is continued uncertainty of Dodd-Frank Act risk retention rules, especially in light of the recently revised risk retention mortgage proposal.

Council members also presented their views on other pending Dodd-Frank Act rulemakings. Commenting on the proposed interagency rule establishing a liquidity coverage ratio for systemically important financial institutions, some Council members noted that corporate deposits on institutions' balance sheets could be drawn down too far in order to satisfy new liquidity requirements and that riskier assets could replace those deposits (Docket No. R-1466). In addition, the Council discussed incentive compensation practices at banking organizations (Docket No. R-1410).

The information on regulatory reform related to the Dodd-Frank Act that was collected from the Council at the meeting is attached. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

Liquidity Coverage Ratio

> **The Board and other federal bank regulators recently proposed a standardized minimum liquidity requirement (liquidity coverage ratio) for large and internationally active banking organizations and systemically important nonbank financial companies designated by the Financial Stability Oversight Council. What are the Council members' views on this proposal, including its potential effects on competition, domestically and globally; on the operations of banking organizations; and on the availability of credit to businesses, households, and municipalities?**

- The Council supports the objectives of the liquidity coverage ratio (LCR) proposal, which is designed to help address the liquidity problems that became evident during the financial crisis. However, the Council has a number of significant concerns with the proposal, many of which flow from the significant divergences between the U.S. proposal and the Basel III LCR framework.
- Unlike the Basel III framework, the proposal would require LCR banks to compute their ratio on a daily basis using the estimated "worst-day" net outflow over a 30-day horizon.
    - Requiring daily calculation of the LCR is both operationally burdensome and has the potential to understate available liquidity because daily variations in working capital are a normal part of sound business management. The operational burden is substantially magnified for banking organizations that are not required to report liquidity information to the Federal Reserve on a daily basis, particularly in light of the proposed January 1, 2015, implementation date.
    - Council members generally viewed the "worst-day" calculation requirement as unrealistic and punitive, especially in light of the mandated outflow/inflow rates and timing assumptions included in the proposal for the uninsured portions of retail deposits, retail deposits with terms greater than 30 days, brokered deposits, and instruments with call or notice features.
- The proposal also fails to appropriately take into account unique aspects of the U.S. financial system. For example, the 15% haircut imposed on GSE obligations and the inclusion of these obligations in the 40% cap on all Level 2 assets fails to adequately reflect the proven liquidity value and observed price behaviors of GSE obligations, even in times of severe stress. This will reduce demand for GSE mortgage-backed securities and may negatively impact the availability and pricing of mortgages. The proposal also does not appropriately reflect the important liquidity role played by the Federal Home Loan Banks in the U.S. financial system.
- Council members were especially concerned about the potential impact of the proposal on state and local governments. The proposal would inappropriately treat state and local government collateralized deposits ("preferred deposits") like repurchase agreements, forcing banks to assume these deposits are "unwound" in calculating their LCR ratio. As a result, state and municipal government will find it more difficult and more costly to maintain their banking relationships. In addition, the proposal would restrict the market for municipal securities by completely excluding all such securities from the definition of high-quality liquid assets (HQLA), even though the Basel III framework would allow qualifying municipal securities to be treated as Level 2 HQLA.

- The proposal also would benefit from a more granular treatment of certain types of lines of credit.
  - For example, the agencies should revisit the 100% outflow assumption required for asset-based credit facilities extended to manufacturing and service companies through the use of special purpose entities. These facilities, like credit facilities extended directly to a manufacturing or service company (which receive a 10%-30% outflow assumption), support the general working capital needs of nonfinancial borrowers while allowing banks to reduce their risk through the use of a bankruptcy-remote entity.
  - In addition, the agencies should better calibrate the outflow assumption for committed lines to U.S. and foreign mutual funds to better match historical experience and the similarity of these lines to corporate funding lines.
- The proposal indicates that the "modified" LCR is intended to apply to bank holding companies that have more than $50 billion in assets, but that have simpler balance sheets, are less complex in structure, and are less reliant on riskier forms of market funding. The advanced approaches threshold used for application of the full LCR, however, captures certain regional banking organizations that would appear to meet each of these criteria, creating the potential for the differential treatment of banking organizations with similar business models and liquidity risk profiles. Council members also expressed concern that supervisory and market expectations likely would result in the LCR effectively being pushed down to institutions with less than $50 billion in assets.
- Guidance is also needed regarding the liquidity flows related to U.S. broker-dealer client money protection (*i.e.*, lock-up). Flows into and out of segregated accounts used to protect clients from broker-dealer credit risk can be a significant part of overall funding sources and uses, and their treatment under the LCR should be clarified in the final rule.
- In closing, the Council has several particular strategic questions about the LCR:
  - Why are asset levels used to determine the level of LCR compliance? There could be unintended consequences, such as implying that the larger financial institutions need more liquidity without a regard to their risk profile.
  - Could the LCR implementation water down monetary policy? Currently, much of the liquidity that has been pumped into the economy has been re-deposited at the Fed.
  - Under the LCR implementation, if corporate deposits are drawn down due to higher rates or capital expenditures, banks will have to borrow to replace Fed deposits or *cut back on lending*.
  - Why not include mortgage-backed securities? Not including those securities would reduce investment in mortgages and would not use what has been a very liquid asset.
  - Are we simply pre-funding the discount window, which was invented to take care of liquidity crises?
  - The LCR does not fund holding companies or investment companies that are wholesale funded.
  - The LCR could be our primary constraint when combined with Basel III and a potential leverage ratio requirement. This could depress our economy by restricting lending growth.

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Incentive Compensation

> **What are the views of Council members on incentive compensation practices at banking organizations in light of recent regulatory guidance?**

Background

- Recent regulatory guidance has been provided via the banking agencies and their Interagency Guidance on Sound Incentive Compensation Practices published in June 2010. This publication provides three guiding principles relating to compensation to protect the safety and soundness of banking organizations:
    1. Balanced Risk Taking Incentives: Incentive compensation should provide employees with incentives that balance risk and reward and do not motivate them to take imprudent risks.
    2. Effective Controls and Risk Management: Processes and controls should reinforce and support these balanced incentive compensation arrangements.
    3. Strong Corporate Governance: Corporate governance should be strong and oversight by the board should be effective and active to help ensure sound compensation practices.

Key achievements

- Boards, management, shareholders, and regulators of U.S. banks all understand the importance of providing incentives that appropriately reward employees for performance and, at the same time, balance the risks they take to achieve it. Since the financial crisis, boards and management have made significant efforts to better balance risks with rewards. These changes were driven by a combination of the Federal Reserve's guidance and a shared view among boards, management, and shareholders of the benefit of mitigating inappropriate risk-taking. These changes, while not universal to all U.S. banks and not applied consistently, include the following:
    - Improving Incentive Compensation Program Design
        - Balanced Fixed and Variable Pay: Pre-crisis, base salaries were small in proportion to bonuses, which comprised a majority of total pay in the financial services industry. Post-crisis, overall compensation levels declined and base salaries increased.
        - Increased Deferrals: Since 2008, management at almost all banks has deferred compensation, and a more significant portion of variable compensation has been deferred over a multiyear period. Deferrals at large banks now range from 25% to 100% of bonuses, and awards are typically deferred over a three-to-five year period.
        - Equity and Performance-Based Awards: Banks have increased the portion of bonuses granted as equity and other forward-looking performance-based awards.
        - Clawbacks: New provisions allow banks to claw back deferred compensation in adverse circumstances (*e.g.*, financial losses, inappropriate oversight of risk, violation of risk policies, and personal misconduct).

- Enhancing Processes and Controls
  - "Covered" Employees: Banks have established processes to identify individuals, including senior management and other "risk-taking" personnel across the organization, and to document decisions on their compensation.
  - Risk Adjustments: Banks have formalized processes to consider and document risk management and risk outcomes in incentive compensation decisions, including clawbacks of previously awarded compensation.
  - Cross-Functional Collaboration: Human resources, legal, finance, audit, and risk management personnel collaborate on the design, operation, and monitoring of incentive programs.
  - Control Function Independence: Compensation decisions for individual control functions are made independently of the businesses that they support.
- Strengthening Corporate Governance Frameworks
  - Increased Board Engagement: Board engagement on compensation, both as a whole and at the committee level, is more robust, specifically in reviewing senior management compensation and funding of compensation plans.
  - Expanded Role of Board Compensation Committee: Compensation committees' focus has expanded beyond executive compensation to also include a review of broader-based incentive compensation programs.
  - Regular Compensation Committee Updates: Compensation committees receive frequent updates on the regulatory environment, changes to compensation programs, and compensation clawbacks.

Key challenges

- Two key challenges arise from regulation of compensation practices.
  - Multiple Regulatory Frameworks: Complying with different jurisdictional standards is a challenge for global institutions.
    - For example, the U.S. Interagency Guidance adopts a principles-based approach and recognizes there are multiple levers to balance risk and rewards, while EU rules take a more prescriptive approach to regulation by specifying required deferrals and pay mix.
    - Different compensation structures among colleagues performing similar job functions in different jurisdictions can create friction.
    - Prescriptive rules limit flexibility to design incentive programs that support the organization's specific strategy and contribute to talent-management challenges such as retention and recruitment issues.
  - Inconsistent Application of Guidance: Within the U.S., some institutions are disadvantaged relative to others as a result of inconsistent application of standards.
    - For example, there are competitive pressures from organizations (*e.g.*, hedge funds, independent asset managers) that operate in the same market as banking organizations but are not subject to the same constraints. Typically, nonregulated institutions have extremely modest or no compensation deferrals and no clawback provisions.
    - Even among regulated institutions, regulators have focused on larger institutions, specifically G-SIFIs, which can create anomalies among competitors subject to the same regulatory regime. For example, informal

Federal Reserve feedback to larger banking organizations has in certain cases become prescriptive on the use of stock options, leverage, and ROE targets in performance-based incentives.

Conclusions and next steps

- Significant changes have been made to incentive programs and processes, and in many cases, the changes exceed what was anticipated or requested. These changes have led to drastically different compensation structures and levels for employees. More importantly, these compensation practices are contributing to a meaningful change in behavior, particularly among financial institutions.
- The Council strongly believes a principles-based approach is constructive, fair, and commercial and will lead to a greater balance between risk and rewards at banking organizations.
- Given the significant changes to compensation to address regulator input, the Council believes that time should be allowed for such changes to be fully implemented, digested, and understood by both regulators and banking organizations before any further guidance or changes are proposed.