

**Meeting of the Board of Governors and the Federal Advisory Council
September 14, 2012***

Board members: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, Stein, and Powell

Council members: Joseph L. Hooley, Vikram Pandit, Bharat B. Masrani, James E. Rohr, Richard D. Fairbank, Daryl G. Byrd, David W. Nelms, Bryan Jordan, Richard K. Davis, Stanley A. Lybarger, Richard W. Evans Jr., and J. Michael Shepherd

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 implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Council members expressed the following concern about regulatory uncertainty:

Continued uncertainty over the Dodd-Frank Act's risk-retention rules continues to plague the commercial real estate capital markets. Insurers and banks have finite capacity for term financing; therefore, the revival of the capital markets is vital to the overall availability of capital to commercial real estate investors.

The Council also presented its views on the proposed rulemakings for regulatory capital requirements (Docket R-1442) and on stress testing, including stress tests required by the Board's proposed rulemaking on enhanced prudential standards (Docket No. R-1438).

The information collected from the Council at the meeting is summarized in the attachment. The viewpoints expressed in the attachment are solely those of the Council.

*Updated to include appendix.

Attachment

Basel III NPRs

The Board recently released the following notices of proposed rulemaking (NPRs) related to Basel III: (1) the Basel III NPR (quality and quantity of capital), (2) the Standardized Approach NPR (calculation of risk-weighted assets), and (3) the Advanced Approaches and Market Risk NPR (revisions to the advanced approaches consistent with the Dodd-Frank Act). What are the Council's views on those NPRs and in particular, its views on the magnitude of the change in capital requirements, scope of their applications, implications for the availability and cost of credit, profitability of banking and mix of banking products, volatility of regulatory capital, and transition period for implementation?

Overview

The Council has serious reservations about the intended and unintended consequences from the proposed Basel III capital requirements. Members support the principle that all banks should have comparable standards, and the amount of capital required should be reflective of the institution's risk. However, making these specific rules applicable to community banks as well as the largest financial institutions, which are required to adopt the advanced approach, has the potential to cause significant disruption to the industry and the overall economy. These rules have the potential to place U.S. institutions at a meaningful disadvantage relative to foreign institutions. The cumulative effect of the significant changes in capital and risk weights should be weighed carefully.

Chief among our concerns are:

- We believe the cumulative impact of these NPRs will have highly negative results to consumers and the economy. We suggest that the regulatory authorities carefully consider whether the end result is an improvement.
- As proposed, certain residential mortgage products will no longer be profitable unless the interest rate charged to the customer increases dramatically to cover the higher capital cost and compliance costs. The expected end result is that many consumers will either have to pay more, do without, or go to the unregulated sector.
- When coupled with the other provisions affecting mortgages – including Qualified Residential Mortgages, restriction on capital treatment for mortgage servicing assets, increase in risk weighting for mortgage loans, implementation of complex rules resulting in an increase in capital required for securitizations – regulated lenders will likely focus only on loans they can sell or securitize with or to Fannie Mae or Freddie Mac. This will only accentuate the concentration of mortgage credit in these institutions and further hinder the resolution of their conservatorship status.
- Capital levels will become more volatile due to the impact of market-value changes in available-for-sale (AFS) investment securities. Most would expect that an increase in lending accompanies an economic recovery and an increase in market interest rates. However, under the proposed rules the effect of an increase in interest rates will be a reduction in capital, potentially restricting credit and hampering any economic recovery. We believe the existing rules for determining impairment are sufficient for determining whether an adjustment to income, and thus capital, is necessary.

- The cumulative effect of these proposed and other regulatory changes will result in traditional banking becoming even less profitable and investors eventually choosing to put their money elsewhere. Consequently, we expect to see additional consolidation into the largest institutions. Such consolidation is contrary to the goal of reducing concentration risk in financial services and moves the industry in the wrong direction. Consumers will have fewer choices for meeting their credit needs within the regulated sector.
- We believe that the changes to risk weights are not supported by sufficient empirical data or logic. For example, the proposed residential real estate risk weighting could create an incentive to release collateral, which would create an unsecured loan and reduce risk-weighted assets.
- A significant concern at this point is not the transition schedule but the timing of the implementation of the final rule. Many of the new proposed risk-weighted asset calculations, such as for residential mortgage, HVCRE, and bank-book-securitization calculations, require the incorporation of qualitative information at the individual exposure level that, while employed in many risk-management processes, is not readily available in the data-intensive processes required to support the newly proposed capital calculations. In many cases, this qualitative information requires periodic updates. Adapting data processes to incorporate these proposed changes will be an expensive and lengthy undertaking. Any of these changes require careful planning and long lead times to ensure the integrity of the calculations and management of the data.
- The calculation of risk-weighted assets for U.S. banks in the Standardized Approach NPR is not consistent with the risk weightings of these same assets measured by regulatory calculations in other countries. The differences are most pronounced when compared with the risk weightings applied to similar assets of European banks. This dichotomy renders capital and leverage comparisons between U.S. and European banks uneven and useless, placing U.S. banks at a huge disadvantage globally.
- Finally, banks have structured existing portfolios of assets and evolved capital structures that were consistent with existing U.S. application of the rules in Basel I and Basel II. Consideration needs to be given to grandfathering affected assets and liabilities under existing rules or for providing significant transition times in order to adjust these positions in an orderly and positive economic fashion.

Stress Tests

To best judge systemic risks, the Federal Reserve’s stress-testing process is based on industry data, industry-wide trends and averages, and macroeconomic scenarios. Although these elements are important to a macroprudential approach to capital, they play less of a role in the calculation of risks and capital at individual banks. What suggestions does the Council have for communicating and accommodating these differing perspectives in order to strengthen the CCAR and capital plan review process?

- The Council believes that the CCAR process has improved as it has evolved:
 - Enhancements to disclosures have been thoughtful and well received by banks and the market.
 - Greater granularity of data has helped to improve the accuracy of the tests.

- Banks are increasingly weaving stress testing into the ongoing fabric of their financial and capital planning efforts.
- There are two fundamental areas of CCAR that should be addressed to accommodate individual bank perspectives and strengthen the connection with bank capital planning:
 - 1) Enhancing Federal Reserve models with bank-specific adjustments where appropriate to ensure they are effective in evaluating individual bank resilience, and
 - 2) Providing banks with preliminary feedback on their stress test submission during the CCAR process.
- The Council recognizes the difficult task of developing a systemwide and comprehensive framework for assessing capital adequacy. We understand that any changes to CCAR must meet multiple objectives:
 - *Maintain objectivity* – by deploying a consistent methodology, approach, and approval criteria across all banks;
 - *Prevent undue influence* – by establishing an interaction model between the banks, Federal Reserve “central” teams, and local bank examiners that avoids preferential treatment;
 - *Preserve the credibility of the tests* – by avoiding the “teaching to the test” problem that can result from too much transparency into the Federal Reserve’s models; and
 - *Improve accuracy* – by leveraging the insights and best practices of all relevant industry parties to improve projections of performance under stress.
- We believe that our recommendations permit the Federal Reserve to meet these objectives.

Current State

- As the Board’s question itself contemplates, CCAR is geared primarily towards producing an accurate macroprudential evaluation of the resilience of the banking industry.
- The Federal Reserve’s CCAR modeling approach is less effective in assessing the resilience and planned capital actions of a specific bank because it uses an industry-average modeling approach without sufficient adjustments to reflect differences among banks.
 - There are many reasons that an individual bank’s performance may differ from an industry average in ways that are material. For example:
 - Although very different tax rates apply to different institutions in practice, the Federal Reserve applied an effective tax rate of 35% to all the participating banks.
 - Accounting policies can vary significantly. For example, some banks’ accounting practices capture recoveries expenses as an operating expense. The Federal Reserve’s model, however, captures expenses relating to recovering charged-off debt in its net charge-off estimates. Because the Federal Reserve’s model was not consistent with these banks’ own accounting practices, recoveries expenses were double counted.
 - Underlying performance can vary due to fundamental differences in business strategy that are both objectively observable in data and sustained over long periods. Loans from different banks that would be scored identically by an industry-level model have been observed to consistently experience varying actual loss performance. These outcomes may be due to important bank or portfolio-specific factors, such as customer selection, brand power, pricing, and risk-management strategies. (Please see attached Appendix.)

- Differences in underlying business mix between banks and the industry overall can produce materially different views of performance if not modeled at an appropriately granular level. For example, it is not clear that the Federal Reserve’s credit card modeling fully captures important performance differences between transacting and revolving customer segments.
- Both the Federal Reserve and the banks have an incentive to strive for the most accurate answer possible at the individual bank level.
 - By its very design, omitting differences between individual bank performance and performance of the industry on average rewards banks that fall below that average. Weaker institutions may be assigned lower capital requirements and permitted to pay out more capital than might be warranted if actual performance were considered. This result provides the Federal Reserve and other regulators with an inaccurate risk picture and puts both individual banks and the system overall at risk.
 - Differences between Federal Reserve and bank methodologies and projections will become apparent to the market once the company-run stress test disclosures required under the Dodd-Frank Act are introduced next year. This development could damage the credibility of the stress tests and create market confusion.

Recommendations

We believe the changes we propose will meaningfully improve the relevance of CCAR in evaluating individual banks without compromising the objectivity, credibility, and accuracy of the tests. Importantly, by ensuring that adjustments can work both to the benefit and detriment of a bank, as appropriate, we can avoid a dynamic where only advantageous adjustments are considered, thus placing every institution “above average.”

1) Permit bank-specific adjustments in certain cases:

- The Federal Reserve should make bank-specific model adjustments if all of the following conditions are met:
 - A material difference between bank and industry-average performance exists and can be objectively observed in the data provided to the Federal Reserve.
 - The reason for the difference is well understood by both the bank and Federal Reserve.
 - The difference is likely to persist over the stress period.
- Although the Federal Reserve is, of course, the final arbiter of what differences ultimately merit bank-specific adjustments, having both the Federal Reserve and individual banks identify potential differences would improve the accuracy and credibility of the CCAR process.
- The Federal Reserve can identify differences itself and validate bank perspectives by:
 - Examining relevant data in the Federal Reserve’s own rich data sets,
 - Comparing trends across the industry,
 - Validating purported differences using Federal Reserve models, and
 - Leveraging on-site exam teams together with the central horizontal teams to determine independently (i) whether these variances are driven by true differences in business model or strategy that are likely to persist and thus suitable for CCAR model adjustments or (ii) whether they are more tenuous and thus more appropriately ignored.

- The Federal Reserve’s proactive identification or validation of bank-specific differences will protect against “one-way bias” (i.e., if banks only self-identify differences that work in their favor). As such, bank-specific adjustments in some cases would result in increased capital requirements for certain institutions.
- These benefits could be achieved without compromising objectivity and efficiency:
 - Discussions would be grounded in specific variances and observable data.
 - The Federal Reserve would not need to discuss its models but rather only seek a better understanding of the bank’s specific trends and underlying drivers.

2) *Strengthening two-way communication:*

The Federal Reserve could also improve the effectiveness of the CCAR process as a micro-prudential tool by allowing capital plans to be directly informed by Federal Reserve feedback on the stress test.

- As we discussed at the FAC meeting in May 2012, banks plan capital actions today based on their own projections of performance under stress. This approval occurs without the Federal Reserve’s perspective on their performance.
- We propose that near the end of the stress test and capital plan process, the Federal Reserve provide banks with preliminary feedback on their stress test submission. This feedback would include data similar to what would be disclosed publicly and would describe generally the nature of any material stress test discrepancies. Banks would then have an opportunity to revise and resubmit their capital plans within a certain period of time (e.g., five days), prior to the Federal Reserve rendering a decision on the capital plan. This approach has the following advantages:
 - Enables bank capital plans to reflect both Federal Reserve and bank perspectives in determining discretionary capital actions,
 - Adds rigor to the planning process and creates greater market confidence by eliminating unnecessary guesswork, and
 - Ultimately, results in a capital plan that better reflects the true capital needs of the bank.

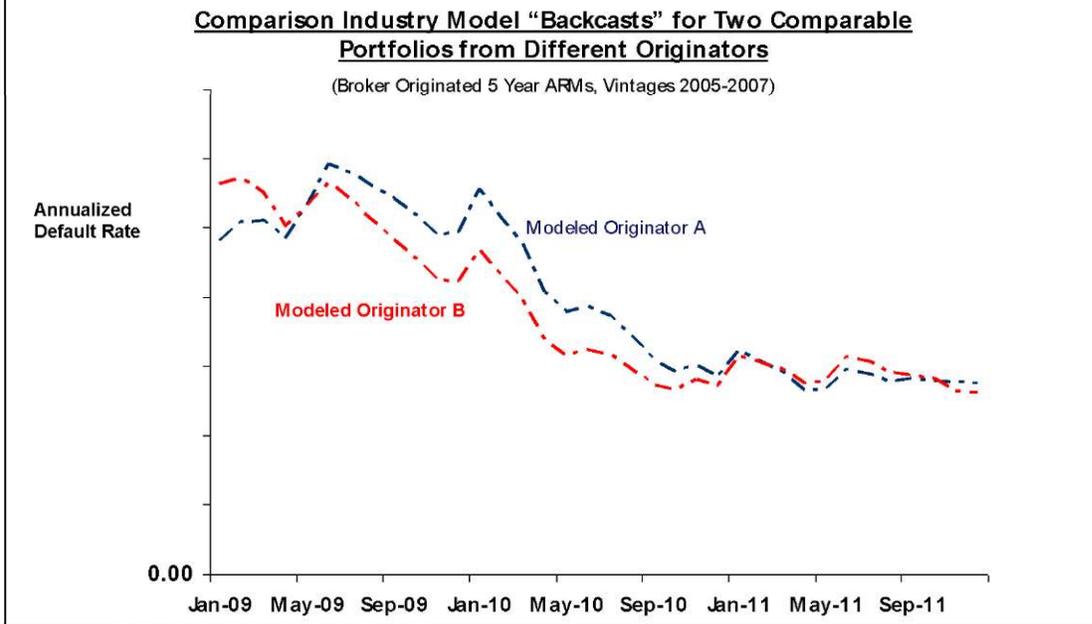
To be clear, we propose limiting communication to any discrepancies in the stress test submission rather than any details of the capital plan itself. This approach would avoid creating an incentive for banks to “game the system” by being aggressive in their initial capital plan submissions in the hopes of negotiating their way to a “passing grade.

Appendix

Sample driver of differences between Federal Reserve and Bank projections

In CCAR 2.0, the Federal Reserve made no distinction in its projections for observable, material differences in mortgage credit performance across banks.

Industry level models do not capture originator specific origination strategies (1 of 2)



Industry level models do not capture originator specific origination strategies (2 of 2)

