Meeting between the Board of Governors and the Federal Advisory Council

May 17, 2013

Participants: Chairman Ben S. Bernanke, Vice Chair Janet L. Yellen, Governor Elizabeth A. Duke, Governor Daniel K. Tarullo, Governor Sarah Bloom Raskin, Governor Jeremy C. Stein, and Governor Jerome H. Powell (Federal Reserve Board members); Michelle Smith, Linda Robertson, Robert Frieron, Katie Ross, Margaret Miller, Gretchen Weinbach, Robert Petrine, Pamela Martin, Traci Mach, Sabrina Rahman, Wayne Passmore, William Treacy, William Bassett, Burcu Duygan-Bump, Shahera Williams, Becky Hasberry, and Maria Martin (Federal Reserve 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 presented its views on so-called too-big-to-fail financial institutions and related policy concerns, stress tests, and the reliance on economic models in the Comprehensive Capital Analysis and Reviews and other supervisory processes. In particular, Council members discussed the effect of various measures to address the risks posed by too-big-to-fail institutions, including increased capital reserves and enhanced supervision by regulators. Some Council members also noted that the development of “living wills” for too-big-to-fail institutions could be useful in helping to reduce organizational complexity.

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

Attachment
Too Big To Fail

What is the Council’s perspective on the so-called “too big to fail” status of some financial institutions? Should too big to fail continue to be a policy concern after the Dodd-Frank Act and, if so, based on what considerations?

Overview:
- Banks have played a critical role in society’s economic foundation for hundreds of years. The challenge today is that there exists a perception, largely rooted in the events of 2008, that some banks are so large, complex, and interconnected, that governments will have no choice but to “bail them out” to avoid substantial economic harm to society as a whole.
- This “too big to fail” (“TBTF”) concern has led to significant advances in bank regulation, predominantly through the Dodd-Frank Act and Basel III, and milestone steps towards increased capital and liquidity, reduced leverage, and fully empowered regulators.

What has been achieved?
- The aftermath of the financial crisis and concept of TBTF have crystallized the drivers of default in the minds of boards of directors, management, and regulators.
  - Capital, liquidity and leverage have been addressed from both a standalone (Basel III) perspective and a ‘post-crisis’ (CCAR) perspective.
    - CCAR requires banks to maintain capital levels that are high enough to withstand extraordinary losses and still remain viable going concerns to their clients and investors.
    - Boards of directors, management, and regulators have made very meaningful changes in risk-management oversight, limits, staffing, and processes.
- Real actions have been taken.
  - Tier 1 common equity of the 19 largest BHCs has nearly doubled since 2009; holdings of cash and liquid securities have doubled; and leverage has been reduced, in some cases by half.
  - The largest U.S. financial institutions have undergone significant changes in both focus and composition, pivoting from a less-focused, pre-crisis collection of principal-and-agency businesses to the streamlined, client-centric model prompted by Dodd-Frank and Basel III.
  - Four cycles of CCAR/SCAP have occurred, with at least 15 banks receiving objections or conditional non-objections and being forced to resubmit remedial capital plans.
  - The “enhanced prudential supervision” provisions of Dodd-Frank – together with the major improvements made by the industry since 2009 – have significantly reduced the likelihood of large institution failures.
  - The orderly liquidation provisions of Dodd-Frank have created a credible and workable framework for the controlled wind-down of a major institution in the unlikely event of a failure, dramatically reducing risk to the financial system and the U.S. taxpayer.
- Global oversight and coordination have been established.
Key differences between regulatory regimes have been exposed, for example by the January 2013 BIS study on the consistency of market risk RWAs, and those differences are being addressed today in a coordinated cross-border manner.

- To protect themselves and the financial system against the “weekend events” of 2008, banks have built durable runways by extending the term of their funding; increasing their stocks of liquidity; and implementing the monitoring, governance, and playbooks required to support their recovery plans.
  - Banks have reduced, and in some cases eliminated, reliance on “runnable” forms of wholesale funding such as commercial paper and overnight or ultra short-term repo with money market accounts.
    - Progress is being made on Fed-mandated tri-party reform to reduce counterparty credit risk.
  - The Liquidity Coverage Ratio and Net Stable Funding Ratio will impose a binding minimum on this durability.

*With that in mind, what are the next steps?*

- The range of choices presented by regulators, academics, media, and industry participants include everything from completely watering down current legislation; completing current legislation and letting it settle; taking more aggressive steps with capital, liquidity, and leverage levels; or fundamentally restricting industry participants even more.
- The Council believes that a lot has been done, rules still need to be written, and while we should remain open to additional “dial turning” of key ratios, the evidence does not yet support further incremental action.
  - CCAR has, in effect, raised capital levels; its punitive nature means banks must keep higher levels than they otherwise would.
  - Funding-wise, credit markets turned up the dial regarding liquidity, necessitating increased prudence.
- If regulators do choose to act, acting too soon could risk unintended consequences:
  - Impacting the global competitiveness of the U.S. financial system
    - By global standards, U.S. banks are not especially large, nor is the U.S. banking system particularly concentrated:
As of September 2012, there were more than 7,180 individual banks operating in the United States – the largest and most diverse banking system in the world.  
- Taking away a key ingredient or piece of economic growth while the country is in recovery mode.  
- Making the sector uninvestable as a result of overly punitive capital, liquidity, and leverage requirements that create unacceptable returns for equity investors.  
- In addition, there is significant evidence that markets find the Dodd-Frank resolution framework credible:
  - Studies point to a significant decrease in any funding advantage that large U.S. financial institutions may have had in the past relative to smaller financial institutions and also relative to nonfinancial institutions at comparable ratings levels. Increased capital and liquidity, in addition to meeting the demands of many regulatory bodies, has largely, if not entirely, eroded any cost-of-funding advantage that large banks may have had.  
- The net impact of all of these changes is that banks are already operating with a more conservative capital, liquidity, leverage ratio, and business mix than is currently required under Basel III or Dodd-Frank.

**Stress Tests**

What lessons do Council members draw from the results of the recent Comprehensive Capital Analysis and Review (CCAR) stress tests of large U.S.
bank holding companies? What suggestions does the Council have to improve the CCAR and capital plan review process going forward?

Summary:
- Council members support the stress tests and capital planning process and consider them important elements in restoring investor and public confidence in the banking system. However, further consultation between regulators and institutions related to disclosures and transparency could provide more meaningful information to the public, particularly investors. In addition, the CCAR remains a highly labor-intensive effort and could benefit from coordination with bank budgeting and capital management processes and other regulatory requirements. Changes in timing could help address these concerns.

Lessons:
- Post-crisis Federal Reserve stress testing has achieved the goal of increasing capital levels of large U.S. banks, more than doubling the weighted average tier 1 common equity ratio of the 18 CCAR banks from 2008 to 2012. With 14 banks receiving non-objection to their capital plans and two banks receiving conditional non-objections, it appears that banks are receiving somewhat greater flexibility in pursuing desired capital actions.
- The qualitative aspects of bank capital plans appear to be as important in the Federal Reserve’s decisionmaking process as the quantitative aspects. Given the higher overall levels of capital in the system, banks’ capital planning, risk management, and overall governance processes are receiving as much critical scrutiny from the Federal Reserve as their capital levels.
- Since the original “SCAP” stress test in 2009, the Federal Reserve’s capital stress testing process has continued to build investor confidence in large U.S. banks’ ability to withstand a significant and sudden economic downturn. The amount of attention and analysis provided by industry analysts, rating agencies, and the financial media demonstrates the interest in and relevancy of the CCAR results. Notably, the focus of dialogue has materially shifted from one of viability to a discussion of capital optimization and shareholder returns, further supporting the view that large U.S. banks have built robust capital bases and stronger, more liquid balance sheets.
- The release of the stress test results continued to show a divergence between the company-run stress tests and the FRB-run stress tests. Little information has been provided by the FRB about its models or why such divergence exists.

Suggestions:

Transparency and consultation:
- The most significant improvement the FRB could make to the CCAR would be greater transparency into its own loss-estimation models and procedures. Such transparency would provide banks a better understanding of the FRB’s view of their risks and sensitivities, increasing banks’ ability to deploy capital in a way that reduces these risks, and would support the goal of promoting a healthier and more resilient banking system.
- Uncertainty around the FRB’s methodology encourages banks to hold an excessive capital position to accommodate for regulatory uncertainty. Greater transparency into the FRB’s
process and views would reduce this uncertainty and allow banks to use this excess capital to support economic growth.

- Bank investors would also benefit from greater transparency into the FRB’s methodologies. Enhanced disclosure could be provided at different levels of detail depending on whether it is intended for public or private consumption.

**Timing:**

- CCAR requirements for stress scenarios, data templates, methodologies, documentation, and governance have evolved over the past few years. The rate of change has made it difficult to execute stress tests while making process improvements. The FRB should minimize changes going forward and communicate those changes earlier or allow for longer implementation times.

- Council members view the current timeline for CCAR as less than optimal:
  
  - The current CCAR and DFAST timetables create significant resource pressure on banks at year-end, in competition with numerous other year-end requirements.
  
  - The CCAR process is misaligned with corporate annual budgeting and capital planning processes by one to two quarters.

- A revised CCAR schedule could improve the efficiency of the exercise. Looking back to the recently completed CCAR, the following illustrative revised schedule could improve the process:

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- The FRB should consider closer coordination of the DFAST and CCAR results, ideally releasing data very close together, perhaps on the same day. Differences between DFAST (which assume historical dividend payouts) and CCAR (which reflects proposed capital plans) are not well understood, and staggered release can create confusion for investors. It is important to maintain the ability for banks to make adjustments to their capital actions after receiving the FRB preliminary CCAR results but without creating confusion with respect to SEC disclosure requirements.

- Acceleration of the publication of the macroeconomic scenarios, global market shocks, and related instructions could increase the efficiency of the execution of both pre- and post-submission processes for both the FRB and banks.

**Other comments:**

- Several Council members, representing banks between $10-50 billion in assets, will initiate company-run stress tests and DFAST reporting this year. Such banks remain concerned by the significant resources that will need to be devoted to meeting the requirements and by the potential lack of distinction between risk profiles of large and smaller banks. In addition, smaller institutions would particularly benefit from clear and uniform guidance from regulators, particularly with respect to operational risk stress testing, where smaller banks typically have less access to robust loss-event data.
• With many banks in Basel II ‘parallel run’ and with final Basel III rules on the horizon, the Federal Reserve should clearly communicate how the transition from Basel I to Basel II and Basel III will affect the CCAR process. In particular, when will the definition of capital and risk-weighted assets transition from Basel I, and will the current post-stress minimum capital ratios change?
• Regulators should re-assess whether prescribed macro shocks (i.e., Trading Book shocks) appropriately and adequately differentiate between the price dynamics of financial instruments originated pre- and post-2009. The underlying collateral of post-2009 issues is generally of considerably higher credit quality and tends to exhibit significant secondary-market depth relative to pre-2009 issues.

Reliance on Models in Regulation

In connection with CCAR, some observers have argued that there is an overreliance on models and too little reliance on bankers’ judgment. How does the Council view this issue? Are there other areas of regulation or supervision where an overreliance on models is a concern? To the degree that the Council believes more bank judgment should be incorporated into CCAR and similar horizontal supervisory processes, how could this be accomplished in a manner consistent with the aims of comparability, consistency, and transparency?

Overreliance on Models in CCAR

• CCAR puts a great deal of reliance on modeling, a discipline that adds rigor and structure to the evaluation of capital adequacy. Of the various approaches utilized for capital adequacy, stress testing is by far the best approach.
• However, a risk associated with models is that those who use them may overlook the important step of determining the level of uncertainty associated with any particular model. Placing undue reliance on a model’s accuracy, particularly when it is utilized for the evaluation of extreme or rare events, can be particularly problematic. We should always have a sense of humility about the reliability of models.
• Quantitative models are critically important tools for assessing financial risks but by definition are incomplete and simplified representations of economic reality. As a result, the development and application of such models intrinsically requires sound judgment at each stage of the model development process, including data selection and model design. Such judgment is critical to determine that all relevant aspects of the targeted context have been properly captured.
• Models are by their nature backward looking. Though history can be highly predictive of the future over time in a macro sense, the drivers on a micro level may and most likely will be different. In a time of extraordinary monetary policy, dysfunctional fiscal policy-making, massive change in regulatory policy, and generational change in the psyche of consumers, it is not possible for the model drivers of the past to fully predict the future.
• Consequently, models must be supplemented by judgment. Judgment should be embraced as an appropriate and valuable part of the planning process.
Overreliance on Models in Other Areas

- The capital rules have developed into very complicated modeling processes. Basel II and CCAR are both very intensive exercises that require large investments to support. The modeling of liquidity risk is now moving down a similar path as capital. We need to consider whether the increased investment in models will pay dividends commensurate with the investment.
- Operational loss modeling is a clear example of large investments with limited returns. The determination of Basel II capital requirements for operational risk is heavily reliant on modeling, with limited influence from banker judgment. At this point, enough time and effort has been expended on operational risk modeling to clearly show that a simpler approach is warranted. As an example, in the case of Distributed Denial of Service (DDoS), it would be far more productive to make investments toward controls that prevent or mitigate risks than continuing to try to develop a loss model that predicts such attacks.
- In addition to investing in models, we should be investing in other risk-management activities, including data collection, analysis, and monitoring. With limited investment resources, it is important to find the appropriate balance between models and use of banker judgment to manage risk.

Comparability, Consistency, and Transparency

- We believe more banker judgment should be incorporated into CCAR, but we also appreciate that horizontal supervisory processes must be accomplished consistent with comparability, consistency, and transparency. The key to achieving both of these aims is to recast CCAR as a confidential supervisory process.
- The public benefits from the objective, quantified results from stress tests. However, due to the inherent and necessary judgment in the CCAR process, publishing these results by objecting or not objecting to the capital request makes a huge statement about the company, declaring, even if unintentionally, that the bank “passed” or “failed.” The consequences of the public’s reactions to this overall declaration far negatively outweigh any benefit. The FRB can make its decision on the capital request, and based on the company’s actions, certain conclusions will be drawn. But these conclusions will be focused on the capital action or inaction, not on speculation over why the company “failed.”
- For example, examiners have long evaluated banks’ credit underwriting capabilities, systems, etc., closely. When weaknesses have been found, examiners decisively “require” changes. Yet, we have never found it necessary to “pass” or “fail” a bank on typically the most important aspect of bank management. In fact, it has been very helpful in avoiding public overreaction to credit weaknesses that supervisory ratings are not disclosed. Why then should we effectively disclose the evaluation of models and capital considerations?
- Finally, while we have clear concerns about the path we are on regarding models, we absolutely agree with the use of modeling to support good bank management and supervision. We simply ask that we keep a healthy balance between theory and practice.