

**Meeting of the Board of Governors and
the Federal Advisory Council
September 2, 2011**

Board members: Chairman Bernanke, Vice Chair Yellen, Governor Duke, and Governor Raskin

Council members: Joseph L. Hooley, 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 Russell Goldsmith

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 and presented its views on standards for qualified residential mortgages (QRMs) under the proposed interagency rule on risk retention (Docket No. R-1411), proposed capital surcharges for systemically important banks under Basel III, and the shadow banking system. During the discussion, Council members expressed concern about the potential effect the QRM standards might have on loan underwriting more broadly.

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.

Attachment

(Comments related to Board rulemakings under the Dodd-Frank Act are provided below.)

Mortgage Foreclosures and Debt Overhang in the Housing Markets

Are there any actions that can be taken by government to expedite the recovery of the housing markets?

- Amend the proposed QRM (Qualified Residential Mortgage) rules, which have the potential to restrict availability and increase the cost of home mortgages.

Basel III

The Basel Committee has released its consultative document, "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement" (<http://www.bis.org/publ/bcbs201.htm>). What are the FAC's views on the policy measures set out in this document? In particular, what are the Council's views on the measurement of concepts like size, interconnectivity, substitutability, complexity, and cross-jurisdictional activity? Do the proposed indicators measure these concepts well or is there a better set of indicators? How well do these indicators capture the systemic risks associated with large financial institutions? What type of adjustments to portfolios and business strategies would large financial institutions make if these indicators become the basis for a systemic risk capital surcharge?

Overview

Robust capital requirements, including reforms intended to improve regulatory capital requirements both quantitatively and qualitatively, are a fundamental element of bank safety and soundness and a systemic risk mitigant. However, it would be premature to adopt the global systemically important bank ("G-SIB") surcharge proposal at this time or, for that matter, a capital surcharge for those banking organizations that are subject to a heightened regulatory and supervisory regime under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Furthermore, we have several concerns with the structure and components of the G-SIB surcharge proposal. In summary, we believe that any capital surcharge proposal should be postponed until a more

considered evaluation of its relative benefits, disadvantages and necessity in light of other evolving regulatory and supervisory policies is feasible.

- At the present time, U.S. banking organizations are confronting an extraordinary, and globally unique, array of new regulatory requirements. It is premature to consider additional capital surcharges until there is sufficient time to assess the aggregate impact of Basel III and other regulatory and supervisory requirements.
 - o Basel III sharply increases the amount of required capital, as a result of both major quantitative and qualitative changes, and introduces, for the first time, new short-term and longer-term liquidity standards.
 - o Large U.S. banking organizations also will be subject to a wide array of special regulatory requirements under the Dodd-Frank Act including the Volcker Rule, fundamental changes to the regulatory regime for derivatives, “living will” requirements and, importantly, the comprehensive and effective resolution program that is intended to end “too big to fail.”
 - o The combination of Basel III’s new liquidity requirements (which will require banks to increase their holdings of liquid debt instruments) and the loss of the so-called accumulated other comprehensive income (AOCI) filter is likely to introduce substantial volatility in the capital ratios of both large and small banks. As a result, banks will be forced to maintain substantial “uncertainty buffers” over stated regulatory requirements to avoid adverse consequences.
 - o The imposition of a capital surcharge in addition to the new Dodd-Frank resolution regime also may effectively “double-up” regulatory costs for U.S. banks even though both policies are designed to address the same problem.
 - o An extended development period would give policymakers time to develop reliable, standardized datasets and a transparent calculation methodology, both of which are necessary to properly assess the impact and effectiveness of a potential surcharge and to allow banks to properly engage in long range capital planning.
- Regarding the specifics of the G-SIB proposal, no system for measuring systemic importance will be perfect. The proposal, including its five broad categories of indicators (size, interconnectedness, substitutability,

complexity and cross-jurisdictional activity), represents a thoughtful effort towards assessing an institution's global systemic footprint. However, there are weaknesses with the structure of and the individual systemic indicators included in the proposal. These weaknesses make it unlikely that the proposal will appropriately reflect the true risk of firms and could, in some instances, create incentives to increase firm-specific or systemic risk.

- o For example, because the calculation methodology is based on the relative score of a G-SIB within the universe of G-SIBs (rather than an absolute score that takes into account other banking or financial organizations), it is possible that actions by G-SIBs as a group to substantially reduce their level of risk as measured by the indicators would not equate to any reduction in the capital surcharge for these firms.
- o In addition, the proposed size, cross-jurisdictional activity, interconnectedness and complexity categories use indicators that are based on a gross, rather than a risk-adjusted, measure of assets, derivatives or other exposures. This risk insensitive approach will misstate the risk posed by individual firms and, all else being equal, encourage firms subject to the G-SIB surcharge to hold higher-risk assets and exposures.
- o Other significant concerns include the following:
 - Size, the most important category (in terms of both weighting and incorporation into other indicators), is not necessarily directly correlated to risk or the consequences of failure, particularly for firms that are subject to an orderly resolution regime like those embodied in Title II of the Dodd-Frank Act or in the Federal Deposit Insurance Act.
 - The cross-jurisdictional activity category may penalize reasonable geographic diversification and does not take into account whether cross-jurisdictional assets and liabilities are funded in local currencies (which would reduce cross-jurisdictional risks and complexity). In fact, the proposal could encourage G-SIBs to fund assets in foreign jurisdictions with home country liabilities even though match funding foreign assets with local jurisdiction liabilities is less risky and more readily resolvable.
 - The substitutability category includes two indicators that may not effectively measure systemic importance. The assets under custody indicator fails to recognize that, in the United States at least, the assets under custody of a failed bank are segregated from the bank's own

assets and remain fully available to the bank's customers. Similarly, experience indicates that the underwriting functions of particular firms are readily substitutable.

- In the complexity category, the OTC derivatives indicator does not take account of legally enforceable netting agreements, and the AFS indicator may penalize a bank for increasing its holdings of liquid debt securities to satisfy Basel III's new liquidity rules, resulting in a designation criterion that does not accurately capture firm-specific or systemic risk.
- At a time when the economy is still troubled, the Federal Reserve should be cautious about undermining its monetary policy with regulatory policies that curtail bank lending.
 - o Banks today hold large liquidity reserves, and the lending issue currently is more one of demand rather than supply. Nonetheless, the potential of even more sharply increased capital requirements inserts an inherent conservatism into lending decisions.
 - o Moreover, a capital surcharge on G-SIBs or large banking organizations more broadly will likely act as a disincentive to any bank otherwise interested in acquiring a large troubled bank. The surcharge could have other structural impacts on the financial system. For example, it is not clear that small banks will be able to enter some of the business lines targeted by the proposal (such as clearing, underwriting and derivatives) and, thus, any surcharge may encourage the shift of important businesses to the shadow banking system or less regulated segments of the financial sector.
- Capital policies should be applied in a way that maintains the competitiveness of U.S. banks and recognizes the differences among banking organizations.
 - o In order to ensure that U.S. financial institutions remain competitive in global financial markets, any surcharge that ultimately is agreed to on the international level for G-SIBs should serve as the cap for any surcharge established by U.S. regulators for G-SIBs.
 - o The floor of any globally agreed-upon G-SIB surcharge should serve as the *maximum* of any potential surcharge for banking organizations that have \$50 billion or more in total assets but are not themselves G SIBs. However, even if a surcharge framework were to be established for this

latter group, a number of organizations within this group should warrant a zero or, at most, a de minimis surcharge since they present little, if any, risk to financial stability.

The Shadow Banking System

Concerns have been raised that new regulations might drive banking activity into the shadow banking system.

- The current regulatory environment does not address the shadow banking system in a material way, and most of the work currently being implemented is within the regulated banking system. One area of concern is that Basel III requirements may shift activities into the shadow banking sector, while higher capital charges may encourage banks to engage in riskier activities to justify the higher levels of capital.