Record of
Meeting of the Federal Advisory Council
and the Board of Governors

Friday, May 17, 2013

Item 1: Current Market Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally?

- Overall loan demand continues to be suppressed by borrowers' uncertainty, especially about the fiscal outlook.
- Lender competition for the relatively weak loan demand has resulted in lower spreads and riskier balance sheets.

(A) Small Business Lending:
Has credit availability for, and demand for credit from, small businesses changed significantly recently? Have there been changes in lending standards for these borrowers?

- Small business owners are generally apprehensive to grow and increase spending. They continue to look for more positive signs in the economy, and they lack confidence in Washington's ability to resolve federal budget problems or formulate and follow a sustainable fiscal policy. Small businesses remain conservative in their borrowings. Due to low borrowing and investment rates, cash is often used for capital spending when it does occur.
- With weak demand, competition for lending to small businesses is intense, particularly for credits with lower risk profiles. Several members report that lending standards at smaller banks appear to be loosening, while larger banks have not changed. Smaller banks are offering very competitive pricing and/or looser structural elements. Personal guaranties are commonly being sacrificed in competitive situations.

(B) Commercial Real Estate Lending:
Have there been any changes in the Council's view of the challenges in the commercial real estate market? How are commercial real estate loans performing compared to your expectations?

- Leasing activity in office, industrial, and retail real estate has been improving, but vacancies remain relatively high. These property types are reliant on true economic growth to generate demand and have therefore lagged the recovering performance of some other property types.
- Demand for rental housing, both multifamily and senior housing, is strong. This phenomenon is driven by former homeowners becoming renters, more stringent residential mortgage underwriting standards, and more cautious attitudes about the risk/reward tradeoffs of homeownership.

- There is increased competition among banks for quality commercial real estate credits. Both pricing and structural underwriting elements are under pressure. In particular, banks are increasingly accepting lower cash equity levels as the low-interest-rate environment enables projects to cash flow with reduced borrower equity. Owner guarantees have also been increasingly eliminated due to competition.
- Most members report that their commercial real estate portfolios have been performing well, with increased occupancy rates and low interest rates on long-term debt supporting good cash flow. Others see continued challenges for banks' commercial real estate portfolios until employment and general business activity rebound further.

(C) Construction Lending:

What is the Council's view of the availability of credit for construction and development projects? Has the Council seen any changes in the demand for construction loans recently?

- Credit is readily available for properly positioned and well-sponsored projects. Construction loan activity is currently dominated by multifamily residential projects, including senior care facilities. There are reports that single-family construction and development loans are also rising, but at a slower pace than multifamily construction, due to reduced inventories, low interest rates, and increased rental costs.
- There is more-limited construction activity in the general office, industrial, and retail sectors. These markets suffered larger losses in the recession than the multifamily residential market and are still absorbing square footage that already exists.

(D) Agricultural Lending:

Have there been any recent changes in agricultural lending? What is happening to the valuations for farm land?

- 2012 was a banner year for agricultural producers, creating strong levels of liquidity for farmers and driving significant capital spending for equipment and land acquisition. Although farm land values are at historical highs, members report that values have either stabilized or are increasing at a slower pace than in recent prior years. Land values are directly tied to commodity prices, and one member reports that cotton-producing land in the Southeast has declined in value based on decreased cotton prices.
- Respondents are cautious about 2013 due to the possibility of generally lower commodity prices, particularly for grain, and unfavorable spring weather conditions in parts of the country. Nevertheless, loan demand is average to strong, and credit is readily available.

(E) Consumer Lending:

What changes have you seen in consumer lending?

- Reports of consumer lending activity are very mixed, ranging from "10-15% below the same period last year" to "demand continues to show growth compared to prior periods." Home equity lending activity is generally reported to be modest, with consumers still engaged in taking advantage of low interest rates. There is also some reported demand in the other consumer lending products such as vehicles and recreational items, although the dollar increases are small.

- Most members do not report changes in underwriting standards or the levels of competition for consumer credit.
- Credit card volume and loan growth and debit card volume growth all appear to have been slowing down modestly during the past three months. Meanwhile, credit card delinquency rates have reached yet another all-time low.
- Federal student loan balances and delinquencies continue to rise at concerning rates. Some proposals in Congress to dramatically reduce interest rates could further encourage student debt and increase the ultimate cost to taxpayers.

(F) Update on Home Mortgage Lending:
What changes have you seen in the home mortgage market in the past three months?

- Members generally report that refinancing activity has slowed from the fourth quarter of 2012 but continues to be much stronger than new purchase loans, possibly at the rate of 3 to 1.
- The following occurrences are taking place in the industry:
    - Credit tightening by the major aggregators with an increase in credit score minimums and file documentation requirements.
    - Increased investor requirements for FHA, VA, FNMA, and Freddie Mac loans, resulting in increased volumes being held in the banks' in-house portfolios.
    - Significantly increasing regulatory requirements due to Dodd-Frank. Increased operational costs associated with the implementation of these regulations will negatively impact profit margins and credit availability. For example, the Council members strongly believe that the QM standards will drive many potential homebuyers out of the banking system, including low-income, some moderate-income, uneven-income, and other nonstandard-income clients.

(G) Housing Markets:
Has the national housing market finally turned a corner?

- The national housing market appears to be slowly recovering from the depths of the recession. There has been a rebound in prices largely related to low inventories. Continued low interest rates and high rental costs make homeownership more attractive to some. While prices and activity are generally improving, there are regions where this is not the case, such as New England.
- One member reports that entry-level and high-end homes are seeing the largest activity increase. Another member reports that home prices and activity in prime areas have significantly rebounded but that purchases in outlying areas and for second homes are lagging significantly.
- Interest rate increases could damage the current momentum. As previously mentioned, multifamily housing construction has been robust, and one respondent expressed concern over a potential glut in the rental sector of that market, especially if the conditions for homeownership continue to improve.

***(H) Mortgage Foreclosures*:**

What changes has the Council seen in the pace of mortgage foreclosures during the past three months?

- The national rate of residential mortgage foreclosures is decreasing, aided by rising home prices that have helped the sales of distressed properties. There are geographical pockets where foreclosure rates have not improved, generally in the same areas where the housing market remains weak.
- Members report improved delinquency rates, which indicates that foreclosure rates may continue to fall. One member expresses concern that Fannie Mae, Freddie Mac, and others continue to hold a significant number of underperforming loans and are not taking foreclosure actions. This is skewing the positive market-condition data and creating a potential future challenge.

<u>Item 2</u>: <u>GSE Reform</u>

What are the Council's views on the best way to reform Fannie Mae/Freddie Mac or to create viable alternatives, and how should such transition take place?

- Years of analysis, Administration reports, and Congressional hearings have framed the discussion of the appropriate role of government in housing finance. The size of the mortgage market, the importance of housing as an engine of economic growth, and the shifting profitability and political standing of government-sponsored entities ("GSEs") have led to caution and difficulty in maintaining a policy consensus to support action.
- The current debate is centered on the treatment of GSEs, although questions about other subsidies affecting housing and broader initiatives to advance social policy objectives are relevant.
- Like most participants in the debate, all Council members recommend that the extent of GSE activities be curtailed over time, recognizing the large role of the GSEs in current mortgage finance, and Council members offer the following suggestions:
    - Continue the gradual increase in guarantee fees, creating room for private-sector participants.
    - Reduce GSE conforming loan limits.
    - Consolidate the GSEs at least by standardizing their operations on a common platform.
    - Wind down GSE investment portfolios.
- Many Council members favor maintaining a government backstop offering a guaranteed secondary market to ensure adequate liquidity. As set forth in a recent report by the Bipartisan Policy Center, this proposal calls for a "Public Guarantor" to provide a "government guarantee for catastrophic credit risk," covering the timely payment of principal and interest of mortgage-backed securities in the event that a private-sector credit enhancer is unable to meet its obligations. The Public Guarantor in this plan would be roughly analogous to Ginnie Mae. The Public Guarantor would have a minor presence in the market in normal times but maintain the ability to increase its participation dramatically if private capital were inaccessible.

- Although the Public Guarantor would be subject to oversight by the FHFA, some Council members expressed concern that it would be subject to mission creep and may not be able to price its guarantees accurately or to build sufficient reserves in good times. The mortgage market is the largest and most important, but some commenters also noted that other securitization markets are functioning better, without government involvement.
- Notwithstanding the apparent agreement on broad policy, including the February 2011 Administration report to Congress, "Reforming America's Housing Finance Market," proponents have found the road to reform to be steep and muddy. The government is reluctant to consolidate GSE debt on its books and is happy to receive dividends; improvements in the housing market and GSE profitability reduce the sense of urgency in the reform effort; and other market participants continue to benefit from existing subsidies. Moreover, policymakers seeking substantial restructuring may be reluctant to accept relatively minor enhancements that reduce the likelihood of more effective action.

Item 3: FHA

The mission of the Federal Housing Administration (FHA) is to provide stability and liquidity in the housing market, broaden homeownership, protect lending institutions, and stimulate the building industry through federal mortgage insurance. Recently, the FHA's costs from expected defaults are estimated to exceed its loss reserves. Should the FHA be reformed and, if so, how?

- The FHA served a valuable countercyclical role in the latest recession, providing stability and liquidity when private lenders pulled out of the mortgage market. Without the FHA's support, the housing crisis could have been much worse. Continued government involvement is essential to ensure mortgages remain available and affordable to qualified homebuyers while protecting taxpayers. However, any changes to the FHA should be part of the broader reform of government participation in housing finance, including the future of the GSEs.
- The most recent audit for FHA showed the Mutual Mortgage Insurance Fund's ("the Fund") capital reserve ratio of *negative* 1.44% to be well below the statutorily mandated ratio of 2% and, for the first time in history, the FHA is projecting a loss in the current fiscal year. These losses can be primarily attributed to the reverse mortgage program (which is driving the agency's projected loss this year) and to losses incurred on FHA mortgages insured between fiscal years 2007 and 2009, the height of the mortgage crisis. However, FHA loans originated after 2009 are of the highest credit quality in the history of the FHA. The performance of these loans along with improving home prices will positively affect capital reserves and the Fund may not need to draw upon the Department of the Treasury.
- Several Council members have suggested lowering loan limits to pre-crisis levels and tightening underwriting guidelines, while one member suggested either eliminating the FHA and GSEs or combining them into one entity.
- Most Council members believe the current challenge of the FHA is to return to its original mission of providing mortgage credit access to first-time and low- to moderate-income

homebuyers while encouraging private capital to return to the market, thereby reducing the pressure on the FHA as the lender of first resort.

- Overall, Council members believe that the FHA has already taken steps to remediate the Fund's shortfall by increasing mortgage insurance premiums, increasing down-payment requirements for certain borrowers, and reexamining its reverse mortgage policies, among other reforms. While it will take some time for these recent changes to have their intended impact, the Council recommends the following additional actions:
  - Provide clarity and stability in advance of the impending HUD December 31, 2013, expiration of historically high FHA loan limits. Gradually lower the current FHA loan limits in specific regions to align with established conforming loan limits to allow for private-sector capital competition in the single-family housing market.
  - Provide more specificity on indemnification for FHA loans so that younger, lower-income, and minority borrowers are not excluded due to uncertainties of possible legal actions against lenders.
  - Enhance the FHA's TOTAL Scorecard underwriting engine to provide lenders with greater confidence that their FHA status will not be negatively impacted if loans granted based on approvals from the FHA tool subsequently have unsatisfactory defaults and claims ratios.
  - Revise the FHA's compare ratio to provide greater clarity and certainty for lenders while enabling the FHA to more effectively minimize poor lender performance and resulting losses.
  - Provide the FHA Commissioner with the authority to temporarily suspend problem lenders without the necessity of federal legislation. The FHA should also have the ability to transfer servicing for poor servicing practices.
  - In order to support appropriate underwriting practices by direct endorsement lenders, Congress should grant the FHA additional indemnification authority, but not without a formal appeals process with a neutral arbiter.
  - Monitor the impact of recent changes in FHA's reverse mortgage program to ensure it is actuarially sound and meets the needs of the country's increasing retirement-age population.

Item 4: 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:

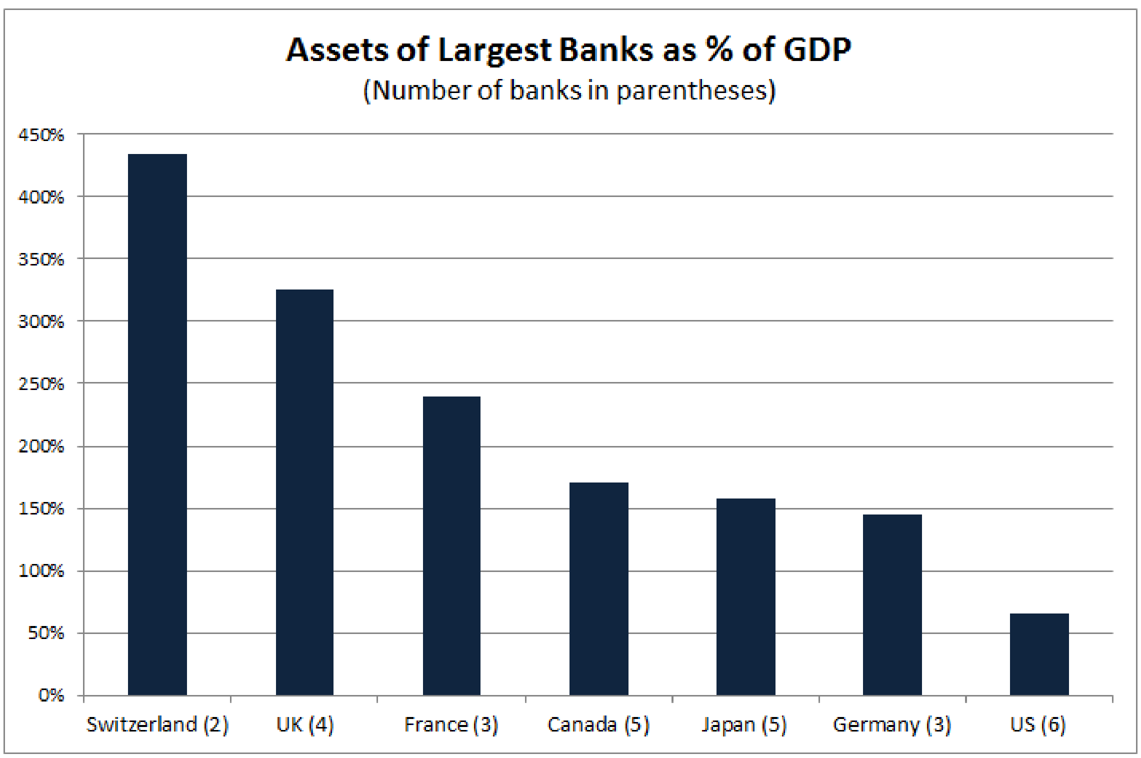
- Banks have played a critical role in society's economic foundation for hundreds of years. The challenge today is that there exists a perception, largely rooted in the events of 2008, that some banks are so large, complex, and interconnected, that governments will have no choice but to "bail them out" 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.

Item 5: 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:

Action	2012-13 Date	Revised Date
Scenarios released	Nov. 15, 2012	Jul. 15, 2012
Submission of Capital Plan	Jan. 7, 2013	Sept. 5, 2012
FRB discloses final CCAR results to banks and the public	Mar. 14, 2013	Nov. 14, 2012

- 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.

Item 6: 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.

Item 7: Economic Discussion

Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in aggregated data?

- Council members' responses reflected a broad geographical dispersion in economic outlook. There appears to be extreme unevenness in the ongoing recovery with regard to employment and confidence (certainly by geographic region, less so by industry).
- Texas reports its entire recessionary job losses were recouped by the end of 2011, that broad-based employment growth across all major industry groups continued over the last year, and that skilled labor shortages were pronounced across the state. Positive employment reports also came from the west coast and Louisiana, with the latter citing gains stemming from energy and tourism.
- Contrast that with reports that Alabama's Business Confidence Index remains in negative territory, with the Huntsville metro area survey falling to the lowest level ever. Arkansas's labor market remains considerably weaker than the country as a whole, and Mississippi continues to report falling home prices and little to no pickup in housing construction. Illinois's labor markets were highlighted as weaker than average, with home prices still falling.
- The Northeast also reports a bumpy recovery, highlighting business surveys that have been up and down for more than two years. This may be a measurement issue: the Massachusetts Labor surveys employers reported 40,300 jobs gained March to March, while the household survey reported only 600 additional jobs. A strong demographic component, particularly with regard to education attainment, has also likely contributed to the uneven recovery.
- Even within metropolitan regions there is dramatic variability: falling home prices in the Illinois side of the St. Louis region contrast sharply with improving home prices just across the river in the St. Louis, Missouri, market.

Positive Signals Outside the Norm

- One member notes that sharp improvement in natural gas prices are spurring plans for additional drilling. The 12th District, like the 11^{th} District, reports job growth running well ahead of the national average. If Massachusetts employer surveys are correct, the state would also have recouped all of its recessionary job losses, which would fall under the headline of "important if true." Finally, while nearly every region except Illinois, Mississippi, and Alabama report materially stronger housing markets with improving prices, in Missouri, year-over-year declines in building permits bottomed in the first quarter of 2012. In the two largest metro markets (Kansas City and St. Louis), permits have accelerated materially each quarter since the first quarter of 2012, especially those for single-family homes, with 50% year-over-year growth.

Negative Signals Outside the Norm

- In aggregate, and largely in line with national surveys, most reports were cautionary with regard to both consumer and business confidence.
- One member reported problems that housing appraisals in rapidly improving markets are slowing access to home lending.
- Another noted additional consideration of the likely impact future interest rate hikes might have in terms of cash flow compression on typical commercial real estate balloon mortgage finance.
- Almost every member bank still highlighted significant concern over the implementation of the impending health care legislation and its potential material impact on business confidence.

What effects on the economy have members seen, if any, from the budget sequester or other fiscal policy actions?

- There was nearly unanimous consensus that the sequestration has had little direct business impact so far. With the specific exception of the Washington, D.C., metro area, no member indicated material measurable impact from the sequester.
- Two members noted specific impact on major defense contractors' activities in their regions. One suggested the impact of sequestration would be difficult to assess, with only 3% of business respondents reporting a direct effect.

<u>Item 8</u>: <u>Monetary Policy</u>

How would the Council assess the current stance of monetary policy? What do Council members see as the ongoing impact of the Federal Reserve's portfolio? How are the Federal Reserve's securities purchases influencing financial markets?

- Based on economic forecasts, and in light of ongoing economic weakness, continuing fiscal policy restraint, and the recent downturn in inflation, it is likely that current policy accommodation will continue for one to three years. When policy accommodation ends, the Fed's actions are likely to be linked to improved economic activity, which will serve to cushion fallout. The Fed is expected to communicate its intentions to the markets to help avoid sudden shocks.
- The Fed's policies have had positive direct and indirect effects on the housing market, consumer sentiment, and the overall U.S. economy. The aggressive rate of asset purchases

has helped maintain low short-term and mortgage interest rates and liquidity in the markets. This in turn has increased prices of debt and equity securities, consumer confidence and spending, and confidence in the financial markets. The Fed's stance on monetary policy has provided support for a slow but measurable economic recovery in critical areas such as the financial and housing markets and consumer finance.

- However, the effectiveness of the policies in producing healthy economic and employment growth is not clear. Uncertainty about fiscal and monetary policy is deterring business investment that would spur growth, and despite policy accommodation, economic growth has remained sluggish and uneven. While some believe monetary policy may not be accommodative enough in light of current government fiscal policy, others believe that constant injections of new reserves have not returned the economy to the vibrant upbeat model it used to be and that current monetary policy is ineffective.
- There are potential risks associated with current policy. The Fed's securities purchases have reduced mortgage yields and, to a lesser extent, Treasury yields. Current low bond yields are disruptive to management of fixed-income portfolios, retirement funds, consumer savings, and retirement planning. They may encourage unsophisticated investors to take on undue risk to achieve better returns. MBS purchases account for over 70% of gross issuance, causing price distortion and volatility in the MBS market. Fixed-income investors worry that attractive mortgage-backed securities are in very tight supply. Higher premium coupons carry too much exposure to prepayments, potentially led by new government support programs for housing. Many are concerned about the Fed's significant presence in the market. They have underweighted MBS in favor of corporate, municipal, and emerging-market bonds. There is also concern about the possibility of a breakout of inflation, although current inflation risk is not considered unmanageable, and of an unsustainable bubble in equity and fixed-income markets given current prices.
- Further, current policy has created systemic financial risks and potential structural problems for banks. Net interest margins are very compressed, making favorable earnings trends difficult and encouraging banks to take on more risk. The Fed's aggressive purchases of 15-year and 30-year MBS have depressed yields for the "bread and butter" investment in most bank portfolios; banks seeking additional yield have had to turn to investment options with longer durations, lower liquidity, and/or higher credit risk. Finally, the regressive nature of the artificially compressed savings yields creates pent-up demand within bank deposit portfolios; these deposits may be at risk once yields begin to rise and competitive pressures increase.
- Uncertainty exists about how markets will reestablish normal valuations when the Fed withdraws from the market. It will likely be difficult to unwind policy accommodation, and the end of monetary easing may be painful for consumers and businesses. Given the Fed's balance sheet increase of approximately $2.5 trillion since 2008, the Fed may now be perceived as integral to the housing finance system.

12:00 Luncheon for Council and Board Members in the Board Room