Transcript of the Open Board Meeting
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CHAIRMAN BEN S. BERNANKE. Good morning. I'd like to welcome our guests to the Federal Reserve Board as we discuss our proposal that represents the key component of our efforts to promote financial stability. The proposal, which today the board will consider publishing for public comment, would implement the Basel III Liquidity Coverage Ratio that the Federal Reserve and regulators from around the world--around the globe have crafted for large and internationally active banking organizations and financial companies. It would also establish enhanced credential liquidity standard consistent with section 165 of the Dodd-Frank Wall Street Reform Consumer Protection Act.

Adequate liquidity is essential for healthy and stable banking and central to the smooth functioning of the financial system. The proposed rule would for the first time in the United States put in place quantitative liquidity requirement aimed at fostering a more resilient and safer financial system.

I look forward to today's discussion of this important initiative. Let me turn now to the head of our supervision committee, Governor Daniel Tarullo.

GOVERNOR DANIEL K. TARULLO. Thank you, Mr. Chairman.

The proposal before us today marks an important advance in prudential regulation because as you just noted, large banking organizations would for the first time be subject to a quantitative liquidity rule. Since financial crises usually begin with a liquidity squeeze that further weakens the capital position of vulnerable firms, it is essential that we adopt liquidity regulations to complement the stronger capital requirement, stress testing, and other enhancements to the regulatory system we've been putting in place over the past several years. I like to draw attention to several features of today's proposal.

First, the LCR will become a part of the Federal Reserve's comprehensive liquidity risk oversight program for large banking firms. In addition to the coming quantitative liquidity regulations, the board has sought public comment on enhanced liquidity risk management standards for large banking firms as part of our Dodd-Frank section 165 proposal. Under our section 165 proposal, large banking firms would among other things be required to conduct internal liquidity stress tests and to maintain liquid assets sufficient to meet expected net cash outflows under the stress tests. And we have already begun conducting in-depth horizontal reviews of the liquidity risk management and liquidity positions at the most systemically important banking firms.

Second, the proposed LCR would sustain the progress that has been made by banks and regulators over the past four years in improving the liquidity positions of large banking organizations. The rule would help ensure that the liquidity positions of our banking firms do not weaken as memories of the Crisis fade.

Third, the proposed LCR we review today is super-equivalent to the Basel Committee's LCR standard. That is, the proposal is more stringent in a few areas, such as the transition timeline, the definition of high quality liquid assets, and the treatment of maturity mismatch within the LCR's 30-day window.

Fourth, the proposed LCR is tailored to the systemic footprint of different US banking firms. Bank holding companies with less than 50 billion dollars of assets, that is below the Dodd-Frank enhanced credential standards line, will not be covered by the proposal at all. Bank holding companies with 250 billion or more of assets, or which have substantial international operations, will be subject to the full LCR proposal. Firms in the middle range between 50 billion and 250 billion in assets will be subject to a less stringent version of the LCR. This tailored approach is consistent both with good public policy and with gradation requirements in sections 165.

While the LCR is an important step forward in prudential regulation, it is not sufficient to address potential liquidity problems at large banking firms. That is one of the reasons for the set of 165 measures I described a moment ago. We must also continue work on the net stable funding ratio. Because the LCR creates only a 30-day liquidity requirement and because liquidity strains can last considerably longer, the NSFR's one year structural funding requirement will be an essential complementary measure. The Basel Committee approved an initial version of the NSFR in December of 2010 and is now well along in completing a final version. We anticipate proposing a US-rule consistent with the end product of that work.

Finally, it is important to recognize that the risks associated with short term wholesale funding are as much or more a macroprudential as they are firm specific, whereas the LCR has a principally macroprudential focus, focused as it is on liquidity of each firm individually. For example, with this emphasis on matching inflows and outflows at individual firms, the LCR does not address the fire-sale externalities and other financial stability risks created by the large matched books of securities financing transactions at large banks. I believe that among our highest remaining priorities should be more macroprudentially informed regulatory measures to address the tail risk event of a generalized liquidity stress by forcing some internalization of the systemic tasks of these form of financial intermediation.

Let me turn now for the staff presentation to David Emmel, who along with Mary Aiken has carried the burden of the LCR work over the past couple of years, both internationally and domestically. David.

DAVID EMMEL. Thank you, Governor Tarullo.

The proposal the Board is considering today is the result of a team effort across divisions here at the Board and across the US banking agencies. The proposal would implement for the first time a minimum quantitative liquidity requirement that would be applied to US banking institutions with more than 50 billion dollars in assets. The proposed liquidity coverage ratio, or LCR, is consistent with the Basel III LCR release in January 2013, with some modifications to reflect unique characteristics and risks of the US market and US regulatory framework. I will provide an overview of the motivation behind the proposal, describe basic elements of the proposal, and outline key differences between the Basel III LCR standard and the US proposed LCR. My colleagues, including Mary Aiken, April Snyder, and Bill Nelson, will help answer your questions about details in the proposal following my remarks.

The recent financial crisis demonstrated significant weaknesses in the liquidity positions of banking organizations, many of which experience difficulty meeting their obligations due to a breakdown in funding markets. As a result, many governments and central banks across the world provided unprecedented levels of liquidity support to companies in the financial sector in an effort to sustain the global financial system. Despite the substantial amount of liquidity support, the stress in the financial system contribute to a significant global recession that resulted in a prolonged period of high-end employment.

These events came in the wake of a period characterized by ample liquidity in the financial system. The rapid reversal in market conditions and the declining availability of liquidity during the financial crisis illustrated both the speed with which liquidity can evaporate and the potential for protracted illiquidity during and following these types of market events.

In response to these events, the Federal Reserve, along with the FDAC and OCC worked with our international colleagues on the Basel Committee to develop liquidity principles and quantitative liquidity standards that included the Basel III LCR and net stable funding ratio or NSFR. Domestically, the Federal Reserve has taken several steps to improve liquidity risk management and increase expectations regarding the amount of liquid assets the institutions held.

First, in March of 2010, the US banking agencies issued an inter-agency policy statement on funding and liquidity risk management, followed by a January 2012 Board proposed rule that required enhanced liquidity-risk management for bank holding companies above 50 billion dollars in assets. Lastly, the Federal Reserve has increased supervisory oversight of liquidity risk management particularly at the largest firms through increased data collection and horizontal assessments of both qualitative and quantitative aspects of liquidity risk management. The proposal under consideration today which would implement the Basel III LCR in the United States would complement these efforts by providing a standardized minimum liquidity requirement.

The proposal would apply to all internationally active banking organizations, that is banking organizations with 250 billion dollars or more in total assets or 10 billion dollars or more in on-balance-sheet foreign exposure and to consolidate subsidiary depository institutions of internationally active banking organizations with 10 billion dollars or more in total assets. The proposal would also apply to companies designated by the Financial Stability Oversight Council under section 113 of the Dodd-Frank Act. However, it would not apply to any firm with significant insurance or commercial operations. Additionally, the proposal includes a modified LCR that would only be applied to bank holding companies that are above 50 billion dollars in total assets but are not internationally active.

The modified LCR would not apply to depository institution subsidiaries of any covered bank holding company or savings and loan holding company. The proposed rule establishes a standardized liquidity stress test with the definition of liquidity resources and projected inflows and outflows are fixed in the rule. This standardized metric will provide a valuable tool for supervisors and the industry to compare the relative liquidity of firms. The standardized liquidity stress test would require a covered company to maintain an amount of high-quality liquid assets, or HQLA, to cover its net cash outflows over a perspective 30-day or 21-day stress period. Outflow rates are reflective of a severe stress event including a partial loss of secured and unsecured wholesale funding, unscheduled draws on committed but unused credit, and liquidity facilities, and other shocks which affect the outflows linked to derivative transactions, mortgage pipeline, central bank borrowings, customer deposits, and customer short positions.

The proposal recognizes contractual inflows that should materialize during a stress period but does not include inflows that are less likely to materialize under a stress scenario. Assets may qualify as HQLA if they are unencumbered by leans and other restrictions on transfer so that they can be converted quickly in the cash with little to no loss in value. Consistent with the Basel III LCR, HQLA would be divided into three separate categories, Level 1, Level 2A and Level 2B assets. Level 1 assets, which are the most liquid assets include central bank reserves and securities issued or guaranteed by the US government and other highly rated sovereigns. Level 2A assets include securities issued and guaranteed by GSEs as well as sovereign debt instruments subject to a 20-percent risk rate under the standardized capital rule. Finally, Level 2B assets include investment grade publicly traded corporate debt and equities that are traded on the S&P 500 or an equivalent index. Because Level 2A and Level 2B assets are less liquid and they're more volatile than Level 1 assets, they would be subject to haircuts and a diversification requirement.

Generally, the proposed rule is consistent with the Basel III LCR. However, there are instances where the proposal is stricter than the Basel III LCR. Three important examples where the proposal differs from the Basel standard are: First, the proposal includes transition periods that are shorter than those set forth in the Basel III LCR, which is in recognition of the improved liquidity position many US banking organizations have achieved since the financial crisis. Second, some asset classes such as private label, mortgage-backed securities, covered bonds, and certain municipal securities that could have qualified for HQLA under the Basel standard, are excluded in the proposal due to the relative lack of liquidity and other factors. Third, the proposal requires internationally active firms to hold HQLA to meet their greatest liquidity need within the 30-day period rather than simply at the end of the 30-day period. This strengthens the LCR by requiring firms to hold additional HQLA against maturity mismatches within the 30-day period.

Staff believes--it is important for all bank holding companies subject to 165 of the Dodd-Frank Act and similarly situated savings and loan holding companies, to be subject to quantitative liquidity requirement as an enhanced prudential standard. However, staff also recognizes that these companies have a smaller systemic footprint than larger ones, than larger more complex companies. Therefore, the proposal would establish a modified version of the liquidity covered ratio for bank holding companies and saving and loans holding companies that are 50 billion dollars or more in total consolidated assets, but are not internationally active organizations. A modified liquidity covered ratio will have outflow rates based on a 21-day rather than a 30-day stress scenario. The requirements of the modified liquidity coverage ratio would be otherwise the same as the LCR that would be applied to internationally active banking organizations.

Under the proposal, companies generally would be required to maintain liquidity--a liquidity coverage ratio equal to or greater than 100 percent. However, one goal of the metric is to have HQLA available for stress periods and staff recognizes that under certain circumstances, it may be necessary for a firm's liquidity coverage ratio to fall below 100 percent for a period of time in order for the company to use its resources of HQLA to meet unanticipated liquidity needs. Such circumstances include situations where normal liquidity sources come under strain during either a systemic or idiosyncratic liquidity stress. Therefore, the proposal would establish a framework for flexible supervisory responses when a firm's liquidity coverage ratio falls below 100 percent, including notification of its primary supervisor of a shortfall but no automatic triggers.

These procedures are intended to enable supervisors to monitor and respond appropriately to the unique circumstances that are causing a company's liquidity coverage ratio shortfall. This concludes my prepared remarks. My colleagues and I would be pleased to answer your questions.

CHAIRMAN BEN S. BERNANKE. Thank you very much. We're now going to have an opportunity for the Governors to ask questions. Vice Chair Yellen is joining us by phone. Janet, are you there?

VICE CHAIR JANET L. YELLEN. Yes, I am.

CHAIRMAN BEN S. BERNANKE. Let me first commend the staff for several years of very hard work. Liquidity standards are not as familiar a tool as capital standards which have been around much longer. And I think the view of those of us involved in this was that the early versions of the liquidity standards that the Basel Committee was proposing had some significant defects. We worked with them to strengthen those standards. And I think we made a lot of progress in making them both strong and usable.

My first question is about the relationship between this proposal and our other tools for addressing liquidity, including our existing 165 qualitative proposals, our stress testing, our horizontal reviews, et cetera. How does the--how would this quantitative set of rules relate or be complemented by a broader supervisory framework for liquidity?

MARY AIKEN. I can take that one.

The standards--I think the LCR basically is a standardized supervisory-prescribed test that we think provides us with a quantitative metric that we can use to look across firms and allow supervisors to look on a consistent basis. It definitely complements what we've done in 165, which is more qualitative requirements. 165 also requires internal stress testing. That will remain. We will still expect firms to do internal stress testing because the LCR again is a standardized test so it doesn't get at all the unique risks that all the individual different firms have. So, I think it complements that well.

From a supervisory process, we do have specific supervisory program for firms 50 billion and larger that we run. That is our--the Federal Reserve's consolidated supervision program. And we will certainly--one of the kind of key things that we do there is we also tailor and graduate the different ways that we do our supervisory approach that's consistent with I think what David described that the LCR also has a tailored approach.

So, I think these things all worked very well together and allow us to have some quantitative standards to use, allows us to still look at qualitative risk management things which are just as critical as any kind of quantitative thing. And then also, I think it's important on the quantitative front that the LCR is just another tool. We also still do a lot of other types of robust quantitative analysis to look at liquidity position. So, I think it all fits very nicely together, all of the elements, the LCR 165, and then it fits well into our supervisory process.

CHAIRMAN BEN S. BERNANKE. Thank you.

My next question is about where banks are--US banks are today. I mean it's not--but they're--beginning today to worry about liquidity. They've been building liquidity to strengthen their balance sheets. What's your assessment of how much more liquidity banks will need, how close they are at this point meeting these standards?

DAVID EMMEL. So, our assessment based on quantitative impact study, you know, their supervisory data, that firms are--a substantial number of firms are relatively close to the 100-percent requirement and several are over the actual requirement.

The shortfall for firms that--or the amount of HQLA that firms are short is roughly 200 billion based on our quantitative estimates. And that is to the 100-percent standard not the phased in requirement that we're proposing.

CHAIRMAN BEN S. BERNANKE. And that's percentage wise, the magnitude is 200 billion?

DAVID EMMEL. Yeah. So, that's total HQLA that would be required under the standards would be roughly 2 trillion, so it's, you know, roughly 10 percent of that. And I would also state that through the observation period, we have observed firms make substantially larger gains than the 200 billion that remains to become in full compliance. They've been able to make a lot of adjustments. And it's not necessarily always requiring them to add HQLA which potentially could be one of the more costly ways. They can also turn out the structure of liabilities, change the structure of their funding structure of their liabilities as well.

And we've also seen firms take actions that are just improving the--or reducing the amount of collateral they have pledged unnecessarily to other institutions and freeing of assets that improve their LCRs as well, and we expect that those actions will continue.

CHAIRMAN BEN S. BERNANKE. This is a comment not a question.

Your last point was about the importance of firms being able to use liquidity. I mean, it's not of any use if it can't be used in a stress situation. So, I just want to emphasize the importance of our flexibility in allowing firms to use liquidity at those times when they need to meet their obligations, so that's obviously important part of the plan that they--there's no implicit sense in which this is not usable--these are not usable resources. Vice Chair, do you have some questions?

VICE CHAIR JANET L. YELLEN. Yes I do. Thank you.

Really just--my first one follows up on the comment that you just made, Mr. Chairman, about usability of these resources. If these are minima, and even if we have supervisory flexibility, isn't it conceivable that if we ended up in a crisis situation that banks would begin to hoard liquid assets and that could exacerbate a crisis, is that something you've thought about or you feel that the supervisory flexibility is sufficient?

APRIL SNYDER. So the supervisory framework designed in the rule was intended to allow supervisors in fact to evaluate the circumstances under which a bank, LCR does fall below 100 percent. So, both the Basel standard and this rule would really set up to contemplate that banks would need to be able to use their HQLA under times of systemic or idiosyncratic severe stress. So, the supervisory framework was intended to in fact allow supervisors to look at the circumstances, and if there is an appropriate circumstances for them to be able to use their HQLA to meet their liquidity resources, because their normal funding or even their contingency funding isn't available, supervisors would be able to evaluate the circumstance and respond appropriately and the firm should be able to rely on that supervisory framework.

BILL NELSON. So, Vice Chair Yellen, I would at that, you know, as you noted, in a circumstance where there's widespread liquidity concerns it's undeniably going to be the instinct of financial institutions in an environment when they're less certain of their inflows and their cost of appearing illiquid is higher the instinct to hoard liquidity will still be there. This regulation should help because institutions should be both more confident in their own liquidity situation going forward and more confident in the liquidity situation of their counterparties. So, even though that it would be--it might be very difficult to completely overcome the instinct to hoard liquidity, the regulation should make the financial more resilient for the kind of widespread liquidity concerns that we saw in 2007 and 2008.

VICE CHAIR JANET L. YELLEN. Thank you.

I had just one other question and it's probably one for Bill as well. And it has to do with the Fed’s discount window and whether or not any form of access to the discount window counts or could count as high-quality liquid assets.

My understanding from reading the proposal is that access to the discount window does not count at all in terms of high-quality liquid assets and I think I understand the reason for that. But, I also understand that countries like Australia that have a shortage arguably of high-quality liquid assets with very low government debt offer the Central Bank, if I understand this properly offer lines of credit that are priced to banks and that the Basel proposal did let those to count as liquid assets, high-quality liquid assets. And I'm wondering how you approached this decision. At the moment, we have over two-trillion dollars in reserves so we'd seem like there's no shortage of high-quality liquid assets for our banks. But conceivably one day in the distant future if we were to shrink our reserves back to pre-crisis levels, would you be potentially worrying about inadequate supply of high quality liquid assets?

BILL NELSON. So, let me take the last part of that question, first.

In an environment when the Federal Reserve was lowering the amount of reserve balances, that would also of course, as you know, would a time when the amount of Treasury and agency securities is being held by the Federal Reserve would be going down, basically dollar for dollar. So, I'm not concerned that that eventuality would result in the shortage of high-quality liquid assets.

That said, you completely accurately characterized the treatment of discount window lending within the regulation and in also how it's treated in Australia. The regulation is designed to be a uniform metric of the liquidity situation of the banks based on the specific standard of how the bank’s own internal--the bank's ability to meet the liquidity needs using its own internal resources. That of course is an exact measure of all of its liquidity and the resources that it could bring to bear, but it's one that can be applied uniformly. It can be challenging to adopt an international standard to reflect the liquidity that would be available from a central bank, the liquidity that central bank has offered changes overtime that's different from jurisdiction, to jurisdictions. So, using this one metric that measures their own internal resources was judged to be appropriate by the Basel organization and I think we feel the same way here internally.

That said, Australia was in a unique situation because they did not have sufficient HQLA within their jurisdiction to satisfy the LCR. So the regulation was adjusted, the standard was adjusted to allow them to offer guaranteed lines or credit from their central bank which count as a source of liquidity. So, I hope that you--that was fairly complex question, I hope the answer covered it but I'll be glad to follow up if there's more than you wanted.

MARK VAN DER WEIDE. Can I add one piece on the collateral-shortfall question?

The Basel Committee and we have recognized the potential issue of insufficient supply of high-quality collateral to meet the multiple demands for that collateral, they're going to be put on firms because of the Regulatory Reform Agenda that comes from the LCR, it comes from Central Clearings and Derivatives. It comes from marginal requirements for non-cleared derivatives, multiple sources of additional demand for high-quality collateral. One of the many ways and perhaps the primary way that regulators tried to address that is to expand the definition of what counts as high-quality liquid assets. In the early version of the LCR for example, it was pretty much central bank's reserves and the highest quality of government securities.

The version that we're proposing today, the version of the Basel Committee finalized earlier this year and the version that we're proposing today expands considerably the definition of HQLA to include high quality corporate bonds. Very-liquid equities and that's part of our mechanism for providing a little bit in situations where the supply of high-quality collateral is lower. We broaden out the definition. We've done that with haircuts and sub-limits on the various kinds of collaterals that wasn't a complete opening at the door and a treatment of the highest most liquid assets equal to some assets weren’t quite as liquid, but nevertheless, that's a mechanism, more the mechanism we used to address this on collateral shortfall issues.

VICE CHAIR JANET L. YELLEN. OK. Thank you very much and thanks for the great work by the staff.

CHAIRMAN BEN S. BERNANKE. I just want to quickly--Bill, it is the case, is it not, that the Basel Committee’s continuing to look at the role of central bank facilities?

BILL NELSON. That's exactly right. So the Basel Committee is continuing to work. That's been an issue. That's been pretty challenging to continuing to look at it, than looking at precisely this issue of how to treat the capacity of the borrower from the Central Bank.

CHAIRMAN BEN S. BERNANKE. Governor Tarullo?

GOVERNOR DANIEL K. TARULLO. I don't have any questions.

CHAIRMAN BEN S. BERNANKE. Governor Raskin?

GOVERNOR SARAH BLOOM RASKIN. Thank you, Mr. Chairman, and I too would like to commend the staff for its work in preparing this notice of proposed rulemaking.

I think the proposal reflects a proposed regulatory response to one particular signal emerging at the onset of the financial crisis, and that signal was the simultaneous failures in funding markets triggered in part by weaknesses in liquidity risk management by the world's largest banks and other financial institutions. As we know, as a result of these liquidity risk management weaknesses, many governments and central banks around the world were forced to provide unprecedented liquidity support to financial companies in an effort to unblock this severe stress that the financial system had been put under. This proposal, if finalized and implemented, is an attempt to reduce the possibility that such liquidity support on a massive scale would be necessary again.

There's no question that the proposal is complicated. To be clear, this proposal does not apply to banks with assets under 50 billion dollars unless they're internationally active in which case the proposal would not apply to such banks with assets under 10 billion. But even so, the decisions and calculations regarding what constitute high-quality liquid assets with a numerator and how to calculate the total net cash outflow for the denominator are multifaceted. There's a high degree of judgment and many calculating steps are necessary when computing the ratio.

But my sense is that we've attempted to construct a measure of liquidity coverage that's a reasonable proxy for an institution experiencing stress. For example, it makes perfect sense that the less liquid the asset, the greater the percentage haircut that the asset would be entitled to in the numerator. Similarly, the less liquid the asset, the smaller the overall composition of total liquid assets that that asset should comprise. The liquid coverage--the liquidity coverage ratios denominator is also the result of a complex calculation. But, again, I think it's a reasonable proxy for stress to calibrate net cash flows based on the most severe day within the 30-day liquidity stress period. I also think that the liquidity coverage ratios proposed outflow categories and corresponding outflow rates have been set appropriately in terms of our understanding of the stickiness, the different forms of funding we'd provide in the event of liquidity stress.

Given the decisions and calculations that are embedded in the ratios computation, my initial review is that this proposal represents some necessary and well-advised complexity. That said, anytime there is complexity in regulation, we increase the risk that it creates operational or execution or compliance challenges that permit manipulation or poor enforcement. So my first question goes to the potential for such manipulation, and my second question is going to go to the potential for good--of a poor enforcement.

So first, in terms of the potential for manipulation, I'm wondering whether you contemplate the issuance of some form of worksheet or template that will standardize the LCR calculation across large banks. Why would we--I'm wondering--why we would not want to issue such a worksheet or template now at the same time that we're issuing this notice of proposed rulemaking?

DAVID EMMEL. We currently have--for the largest firms at least, they're currently participating in a quantitative impact study, which does have exactly what you're talking about.

It's based on the Basel requirements, so it doesn't necessarily reflect all of our unique--the unique characteristics that we're proposing in this rule. But it is--it does serve as a good proxy, and we have been able to do adjustments off of that template. And I think--so to the first part, I think we do get some reasonably good information out of these templates already, and it has, to your point, it has helped firms considerably as they calculate the LCR.

Longer term, we definitely--we do anticipate having to issue reporting requirements that would come with the final rule. Assuming this is proposed and goes to final rule, we would issue reporting requirements with it then, and I think it would be along the lines of exactly what you're talking, a template where firms would be able to fill out, just basically put their categories in and we would apply the--some of the calculations that you're referring to. I think within that, we do recognize that there always still will be a lot of need for supervisory work to ensure firms are actually properly slotting different types of liabilities and correctly reporting--correctly and consistently reporting across firms the various aspects of the rule.

GOVERNOR SARAH BLOOM RASKIN. Thank you. As to my second question, I wanted to explore this question of enforcement. In particular, what immediately would happen from a supervisory perspective when there are shortfalls in the ratio? So currently, as I read the proposal, it would require a covered company to submit a plan to its primary federal regulator on how it would achieve compliance with the proposed requirements if its liquidity coverage ratio remains below 100 percent for three consecutive business days.

Now, I'd ventured to guess that if a bank's liquidity coverage ratio were below 100 percent with three consecutive days that there's a possibility that the institution is experiencing some kind of liquidity stress. So in such a situation, supervisors would want to act promptly to determine the cause of this shortfall. While, however, the supervisors are attempting to determine the cause of the shortfall, the liquidity buffer itself would need to be replenished.

In this scenario, I'm wondering why you would think it advisable to wait for the shortfall to accumulate before understanding from the bank what it would generally do in situations of a shortfall. In other words, if time is of the essence in such situations, I can imagine there being enhanced value to such a compliance plan if such a plan were prepared in advance of the actual shortfall situation. So I'm curious as to what your thoughts were in terms of deciding to wait for after the shortfall for the bank to be asked for a compliance plan.

DAVID EMMEL. Sure. The proposal waits until after the shortfall, I think, largely to reflect that potentially, the shortfall could be caused by a multiple, different varieties of stresses, and the bank would then be required to provide a very firm plan of what they're actually going to do to remedy the situation. I think to your point, there will be an expectation--we already have interagency guidance out that suggests that firms need to do contingency funding planning of a variety of liquidity stress events, and I think planning for a potential shortfall would be one of those, and our enhanced credential standards further that contingency funding planning requirement.

So while the proposal didn't actually hardwire a requirement ahead of time that they have a plan in place for potential shortfalls, we do have, and I--the guidance that we have out there would provide for an expectation that firms would actually have a plan ahead of time. And then the plan that we will be referring to in the rule would be a more specific plan of here's what we actually are. Here's where we see how we're going to get back above 100 percent. And ideally if they have the plan that you're talking about in place ahead of time, they should be able to just use that and go from there. It should be kind of a game plan ahead of the situation and potential options that they would have.

GOVERNOR SARAH BLOOM RASKIN And there's already such contingency planning already happening at these institutions that would encompass also liquidity shortfalls is what you're saying?

DAVID EMMEL. Yeah. Exactly.

MARY AIKEN. I would also add on the supervisory side we monitor liquidity at our firms on a daily basis, so we have a lot of information and look at outflows and can sort of do estimates of LCRs on a daily basis with the largest firms. So I think if we see firms trending, you know, we discuss with them on a, you know, multiple-times-per-week basis, trends in their liquidity. So I would hope that as we're having those discussions, if their liquidity starts to trend down and things like that, we'd be catching that as it was happening so it would be a bit more proactive versus, you know, waiting to it to actually occur.

GOVERNOR SARAH BLOOM RASKIN. Good, good. Thank you.

GOVERNOR JEREMY C. STEIN. Thank you, Mr. Chairman.

Let me just begin by adding my thanks to the team for all the hard work and patience that you guys have put into our crafting this rule. We've heard a little bit about why this stuff is so important and why it's complementary to many of our other efforts. I just wanted to underscore how challenging it is to design liquidity regulation. Some in part because it's new and you're starting from scratch and not building on an existing platform. But as Mark was alluding to, there's this fundamental difference, as opposed to say capital regulation, right? With capital regulation, you can essentially tell a firm or require a firm to issue more equity and they can always create more shares. Here, you're in the position of requiring a firm to hold liquid assets, and there is a fixed stock of liquid assets, and so one has to be attentive to the fact that if you require firms to hold more, exactly as Mark said, at the same time that we're requiring the swap margin and other thing, that this all has to add up in some sense and be borne in mind. So while one wants a robust framework, one doesn't want to be kind of unconditionally rigid without being attentive to this effect. So I think it's just been enormously important throughout this process to be data-driven in terms of the calibration and all that, and I'm sort of aware of the amount of work and effort that's gone into this and just wanted to say thanks again.

In terms of questions, let's see. So one question I had was about prime brokerage. So prime brokerage was, for a couple of firms during the crisis, a real source of pressure, a real source of vulnerability as clients were removing essentially their prime brokerage accounts from a few of the major broker dealers. Can you just say a little bit about the extent to which the LCR attempts to comprehensively address the issues associated with prime brokerage, or whether they're better left for some of the supervisory mechanisms that Mary was alluding to?

DAVID EMMEL. O.K., thanks. Prime brokerage is addressed by the proposal. It was one of the things that Chairman Bernanke had alluded to earlier that was not fully addressed in the December 2010 version of the LCR that was proposed by Basel, and that was one of the key things that we had worked with our international colleagues to ensure was better captured in the January 2013 version of Basel III LCR.

So generally the proposal assumes that prime brokerage customers are like other financial customers, and they are going to leave the banks. So there's going to be some--a reduction of actual free credits that the firms are depositing, and then, the short positions that they have that may be creating liquidity for the firm also go away. So I think the short answer is that on prime brokerage, we are--it is addressed. It is like the entire metric is, so it's a blunt tool, and we're doing the--you know, we're making assumptions on what outflow rates are going to look like, and so it gives us a good estimate and a baseline for what we think prime brokerage outflows would be. But I do think it's going to be one of these areas where for supervisory perspectives, and I think it has been one of the focuses of supervisory efforts that we've made in our horizontal assessments is to look at prime brokerage and how different firms are doing stress outflows and the different assumptions that are being made and the different--there's, you know, even different business models within the prime brokerage business lines.

So I guess overall, we do have a charge that's kind of--there's not a specific one charge for prime brokerage business. But built in through the various assumptions that LCR does capture, but I do think that it will be one of these areas that we have to develop a substantial amount of supervisory resources to.

GOVENOR JEREMY C. STEIN. So one other--just one other question, Mark had kind of touched on this, which is in the design here, there's this tension in terms of the breadth of assets that one wants to count as HQLA. So on the one hand, you want to have more, because that kind of makes the constraint bind less tightly. But of course, you want to have assets that are sufficiently liquid. And presumably, sufficiently liquid not just in a micro sense of being liquid today for an individual trying liquidate, but liquid in--under some notion of stress. Could you just say a little bit about how you guys have thought about kind of striking the balance there, and what the--you know, what the considerations were?

DAVID EMMEL. Yes, we did a considerable amount of work with global colleagues and here in the U.S. to look at the liquidity values of assets and, you know, some of the things that we looked at were what the markets actually look like in not only the most recent stress, but other stresses and how different types of assets classes reacted. We also considered the liquidity-

-not only that they have today, but once this stress occurs what we anticipate they would have and how correlated that would be to actual banking sector assets. So for one example would covered bonds, which are, you know, are liquid now. But I think we were a little bit concerned about the interconnectedness since those are generally issued by financial companies. And so not only did we look at the--how the assets performed in the stress, but we did look at correlations with what the assets would look like in a specific banking sectors stress, and we tried to assign outflow rates--or, I'm sorry, haircuts that are commensurate with that. And in addition to the actual markets, we did look at, you know, what type of haircuts were available on the repo markets during the crisis as well for this crisis and previous crises.

GOVERNOR JEROME H. POWELL. Thank you, Mr. Chairman, and let me also thank staff for what I find to be a very thoughtful piece of work developed over a period of years, so I commend you for that. I find that many of my questions about the LCR specifically have been asked and well answered. But let me ask this: We've been at pains to say that the LCR--we look at the LCR as just one tool to address liquidity, and I think that's been well covered, but that it doesn't really address broader problems associated with fire sale risk, and I'd like to give you an opportunity to talk about that and address areas where we're going to be working moving forward beyond the LCR.

MARK VAN DER WEIDE. Oh sure, I'll take that one. The LCR is a pretty important part of the regulatory program to address the risks in short-term wholesale funding markets. It does a pretty good job of addressing some of those risks. In particular, the use of short-term wholesale funding to fund illiquid risky assets, the kinds of things that were significant part of the reason why Bear Stearns and Lehman Brothers and other similar firms came under severe pressure back in 2008, and we think that's a pretty good job overall of dealing with kind of the microprudential risks and big banks maturity transformation activities. But it's not a perfect regulatory regime.

At a minimum we think the 30-day window of the LCR is obviously too short. I think, you know, some of our greatest concerns are under 30 days. But we don't stop worrying about liquidity risk inventory transformation in 30 days. So, obviously we need a liquidity regulation that's a little bit longer-term in nature, and the NSFR is going to be our way of drawing out that window to a longer time horizon. But the NSFR, too, as it's currently constructed is a fairly microprudential regime. We're still working on that in Basel. And, you know, the outcome of that finally is uncertain, but both regimes are fairly microprudential in nature.

So some of the concerns that we see that are financial stability in nature that hadn't been addressed by these two particular regulations, I'll just give a few examples. One is matched-book repo. Under both the LCR that we're proposing today and the NSFR as it is exist in Basel today, we don't see any liquidity risk in a matched-book repo book, no matter how large it is and no matter what the collateral is for that matched-book. So again that sort of makes sense microprudentially if you're borrowing overnight and lending overnight, they match. And if it all unwound appropriately, it would be fine. But I think we feel like there are some potential financial stability downsides of an unwind--of a very large matched repo book that the LCR and the NSFR don't address.

So there are few of those kinds of issues that where we think the rules don't quite get at the macroprudential risks in short-term wholesale funding. These are also big bank liquidity regulations. So they will constrain maturity mismatch, liquidity transformation at big banks. They won't do anything for money market mutual funds, for smaller banks, for finance companies, for the shadow banking system. And a lot of short-term wholesale funding, you know, occurred in 2008 and it still occurs now in the shadow banking system. And we need to do a little more additional work to see how to address those risks. So we're thinking through at the staff level the different kinds of tools that will be most effective to get at some of these residual financial stability risks. We're looking at potential additional ways to strengthen the bank liquidity regime to get at these risks. We're looking at capital surcharges for large banks to potentially address these risks, and we're also looking at potential margin requirements for securities financing transactions among other tools, but those are the three that we've been focused on.

GOVERNOR JEROME H. POWELL. Thank you, Mr. Chairman.

CHAIRMAN BEN S. BERNANKE. O.K. Thank you.

All right, are there any other questions from Board members? If not, we have before us a proposed rulemaking on liquidity coverage ratio. Let me ask members of the Board first to state positions, and then we can formally take a vote. Vice Chair?

VICE CHAIR JANET L. YELLEN. Thank you, Mr. Chairman.

I strongly support staff proposal to put that for comment this notice of proposed rulemaking. This is a key Basel III reform and an important part of our collective effort to strengthen the resilience of internationally active firms. I'm impressed by the amount of intensive study and assessment that's gone into formulating this proposal. I'm also pleased that internationally active banking organizations that will be affected by this rule are already well on the way to meeting its requirements, so I do consider it appropriate to have faster phase-in than what’s called for in the Basel proposal.

I do want to emphasize, however, my agreement with the comments that Governor Tarullo made in his opening statement that while this is an important step forward, there’s still more work to do. I look forward to completion of work on the net stable funding ratio. And as Governor Tarullo pointed out and Mark just discussed in some detail, there certainly remains a need to address the financial stability risks associated with short-term wholesale funding transactions. These transactions may not pose liquidity risks within the 30-day window, but the rapid sale of underlying assets that would be occasioned by an unwound for example, matched-books creates severe asset fire sale and financial stability risks.

CHAIRMAN BEN S. BERNANKE. Thank you. Governor Tarullo.

GOVERNOR DANIEL K. TARULLO. Thank you, Mr. Chairman. I obviously also am going to support the proposal. Just to say a couple of things to pull together some of the questions and comments: First, as you pointed out at the outset, this is the first quantitative liquidity regulation, and in that sense is a breakthrough in prudential regulation. But as Jeremy was noting, it's conceptually not just like doing capital but just--but in a different area. It requires a different set of calculations, which have taken a lot of work, and it's one of the reasons, I think, it took several years even after the original proposal to get it done.

The second point picks up on things that a number of you most recently, Janet, have said, which is that this is--the liquidity coverage ratio while being an important step, which it surely is, is not an end in itself. The end is the durability of funding in our financial system more generally, both in the large institutions that we prudentially supervise in a daily basis. And as Mark was saying, throughout the financial system, including the shadow banking system, that achieving that end of durability of funding, so you don't get in positions where people are in liquidity squeezes, is something that's going to take considerably more work, and just kind of compound the kind of conceptual challenges that Jeremy was pointing out earlier, but nonetheless is really important to achieve.

So this--we shouldn't understate the significance of the accomplishment that puzzle accord our agreement on LCR represents and what we're doing today, but also be fully aware that in some sense it's just a big but only first step down the road to achieving that durability of funding. Thank you.

CHAIRMAN BEN S. BERNANKE. Thank you. Governor Raskin.

GOVERNOR SARAH BLOOM RASKIN. Thank you, Mr. Chairman. And I, too, support the issuance of the proposed rulemaking and look forward to comments that are submitted in the public comment period.

CHAIRMAN BEN S. BERNANKE. Governor Stein.

GOVERNOR JEREMY C. STEIN. I also strongly support it, and I think it's very, very important--I would echo almost verbatim what both Janet and Dan said. It's very important. It's largely microprudentially-focused. There still remain sort of broader systemic fire-sale issues, which are going to be one of the important challenges for us to deal with over the coming months.

CHAIRMAN BEN S. BERNANKE. Governor Powell.

GOVERNOR JEROME H. POWERLL. Mr. Chairman, I also am delighted to support this proposed rule. Just to amplify a little bit, central banks have provided lender of last resort liquidity for a long, long time. But that lending exposes us, the taxpayer and also creates potential moral hazard problems associated with the knowledge of banks that there will be government liquidity in a crisis. And what this does is it puts private sector liquidity in front of the lender of last resort and in front of the taxpayer, and it does so by requiring a large pool of liquidity to be there in the event of a stress event. And I think that's a very smart way to go about it. And I'll just echo what others have said: There is so much more to be done. This is a good tool. It's a well-designed tool. I think very thoughtfully developed, but there are many other tools to be used here and much work to be done on the macroprudential front as others have said around the table. So I'm happy to support the proposal. Thanks.

CHAIRMAN BEN S. BERNANKE. Thank you. I also support issuing the proposal. Again, a great of the work has gone into this. I think the proposal has improved considerably over the last few years, and there's a lot of work that's not evident in the proposal, studying how this would affect market structure, how it relates to other parts of the regulatory regime pulling the shadow banking oversight and so on. So, it's been a part of a much bigger project that several people have already noted.

O.K, I need a motion then to approve the issuance of the NPR. Vice Chair?

VICE CHAIR JANET L. YELLEN. So moved. So moved.

CHAIRMAN BEN S. BERNANKE. Second?

GOVERNOR DANIEL K. TARULLO. Second.

CHAIRMAN BEN S. BERNANKE. I'll take a voice vote. All in favor?

VARIOUS. Aye.

CHAIRMAN BEN S. BERNANKE. Any opposed?

[Pause]

CHAIRMAN BEN S. BERNANKE. Seeing none the motion is carried. Thank you all very much. Thank you again to the staff for a lot of hard work and for your presentations today. And, of course, we have more to do but it's an important first [inaudible]. Thank you.