Transcript of Open Board Meeting
September 3, 2014

CHAIR YELLEN. Good morning, everybody. I'd like to welcome our guests to the Federal Reserve today as we take another important step to enhance the safety and soundness of our large financial institutions and the stability of the U.S. financial system. The final rule before the Board would implement the liquidity coverage ratio in the United States, a regulatory requirement that will help strengthen the liquidity positions of large financial institutions. As the financial crisis demonstrated, most of our largest and most systemically important financial institutions used excessive amounts of short-term wholesale funds and did not hold a sufficient amount of high-quality liquid assets to independently withstand the stressed market environment. In the wake of the crisis, regulatory bodies from around the globe convened to develop the first internationally consistent quantitative liquidity standard for banking firms. The final rule under consideration today will complement the Federal Reserve's enhanced supervision and regulation of these firms' liquidity positions, and thus further bolster financial stability. We will also be discussing the re-proposal of the swap margin rule. Global policymakers and the Dodd-Frank Act have sought to reduce systemic risk in derivatives markets by moving standardized derivatives into central clearing and subjecting the remaining over-the-counter derivatives to bilateral margin requirements. The banking agencies issued an initial swap margin proposal in 2011, and today we consider a revised proposal that reflects comments on the 2011 proposal and internationally agreed swap margin standards finalized in 2013. I look forward to today's discussion of these important initiatives. Let me now turn the meeting over to Governor Tarullo.

GOVERNOR TARULLO. Thank you, Madam Chair. Adoption by the bank regulatory agencies of the Liquidity Coverage Ratio will establish, for the first time, a liquidity rule applicable to the entire balance sheet of large banking organizations. This rule implements the international LCR standard developed by the Basel Committee on Banking Supervision, which was a response to the fact that liquidity squeezes were the agents of contagion in the financial crisis. The LCR makes such squeezes less likely by limiting large banks from taking on excessive liquidity risk in advance of a period of financial stress, during which the distinction between illiquidity and insolvency can be increasingly blurred, as asset values tumble and uncertainty heightens. Precisely because of its novelty, this first liquidity regulation has taken longer to complete than the parts of Basel III that strengthened capital requirements for internationally active banks. It was important to consider carefully the potential impact of the LCR on financial markets. In the interim, of course, our supervisors have been conducting horizontal exams of liquidity risk management by the largest banking organizations. The LCR will provide a regulatory baseline for that work as it pertains to the 30-day stress period covered in this regulation. When work is completed on the Net Stable Funding Ratio, which will require firms to have a stable funding structure over a one-year horizon, it will constitute the third element of a comprehensive approach to liquidity regulation. This approach is intended to limit destabilizing funding runs and credit contraction, while not creating incentives for firms to hoard liquidity in periods of stress. And I have a few additional points. First, consistent with our overall regulatory approach and with the requirements of Section 165 of Dodd-Frank, the rule applies differently to bank holding companies of differing systemic importance. The rule does not apply at all to bank holding companies with less than $50 billion in assets. Bank holding companies with between $50 billion and $250 billion in assets will be subject to a less stringent version of the LCR. Only bank holding companies with $250 billion or more in assets or with substantial international operations will be subject to the full panoply of requirements in the rule. Second, this rule will apply only to domestic bank holding companies. We anticipate a future rulemaking exercise extending an LCR to the U.S. intermediate holding companies and branches of large foreign banking organizations. Additionally, the rule would not apply to non-bank systemically important financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve. Liquidity standards would be applied to those institutions through rule or order, based among other things on an evaluation of the business model of each designated firm. Third, the LCR does not address all risks associated with short-term wholesale funding. For example, it does not address liquidity needs beyond the 30-day horizon or the risks associated with even the largest matched repo books. There is thus still work to do in this area. When completed, the Net Stable Funding Ratio should address some of these risks. Additionally, we intend to incorporate reliance on short-term wholesale funding as a factor in setting the amounts of capital surcharges applicable to the most systemic banking organizations. Finally, we are working internationally to develop proposals for minimum collateral haircuts in securities financing transactions. Fourth, I want to take note of one issue that was not resolved in this final rule. The proposed rulemaking excluded state and municipal bonds from the various categories of high-quality liquid assets that make up the numerator of a bank's liquidity coverage ratio. While it is true that most state and municipal bonds are not sufficiently liquid to serve the purposes of HQLA in stressed periods, public comments and staff analysis over the past several months suggest that the liquidity of some state and municipal bonds is comparable to that of the very liquid corporate bonds that can qualify as HQLA. Staff has been working on ideas to develop some criteria for determining when such bonds fall into this category and thus might be considered for inclusion as HQLA. That work has not yet been completed, and it is important to get this final rule adopted now, so that the largest banks can begin to prepare for its implementation on January 1. However, I anticipate that staff will be coming back to us with a report on efforts to develop a proposal along these lines. So now, Madam Chair, let me turn to Mike Gibson for the staff presentation on the LCR.

MICHAEL GIBSON. The rule the Board is considering today is a significant step in our efforts to strengthen our regulatory and supervisory framework for the large financial firms. The Liquidity Coverage Ratio will become part of the Federal Reserve's comprehensive Liquidity Risk Oversight program for large banking firms, which includes both regulatory and supervisory pieces. This past February, the Board issued a final rule under Section 165 of the Dodd-Frank Act that requires enhanced liquidity risk management for bank holding companies with at least $50 billion in assets. In addition to setting out enhanced liquidity risk management standards, that rule also requires firms to maintain a 30-day liquidity buffer based on a firm's internally modeled stress test. With today's final rule, the standardized LCR stress test will now augment the internally modeled stress test. While firms set the runoff rates and other parameters of their internal stress tests, regulators set these parameters in the LCR.

Together, these stress tests should provide for both a tailored assessment of each firm's liquidity risk and a common assessment based on the LCR that allows for comparisons across the industry. Alongside these new regulatory requirements on liquidity risk, the Federal Reserve is also enhancing its supervision of liquidity risk at the largest firms. We now conduct regular horizontal examinations of both qualitative and quantitative aspects of liquidity risk management at large firms. These horizontal examinations allow our supervisors to benchmark across firms, identify outliers, and send more consistent messages. Our supervisory process compliments the regulatory requirements and allows for further tailoring of our oversight of the unique liquidity risks at each firm. I will now ask David Emmel to describe the draft final rule.

DAVID EMMEL. Thank you, Mike. The final rule before the Board today is the result of an extraordinary team effort across divisions here at the Board and across the federal banking agencies, and represents a major step forward in addressing weaknesses in the regulatory liquidity framework highlighted by the financial crisis. The final rule would implement for the first time a minimum quantitative liquidity requirement that would be applied to U.S. banking institutions with at least $50 billion in assets. It would establish a baseline assessment of an individual firm's resiliency that will allow regulators and market participants to make comparisons across the industry. This morning, I will provide an overview of the motivation behind the final rule, describe its primary elements, and highlight key concerns raised by commenters and revisions that have been made to the proposal to address some of those concerns. My colleagues, including Bill Nelson, Ray Diggs, and Dafina Stewart will help answer questions about the details of the rule following my remarks. The recent financial crisis demonstrated significant weaknesses in the liquidity position and risk management practices of banking organizations, many of which experience difficulty meeting their obligations due to a breakdown of funding markets. As individual institutions face difficulties meeting their own liquidity needs, they withdrew lending from other market participants, resulting in a downward spiral that reduced overall market liquidity, which had severe implications for the broader economy. Consequently, many governments and central banks across the world provided unprecedented levels of liquidity support to the financial sector in an effort to sustain the global economy. The final rule is a critical part of the enhanced liquidity standards intended to strengthen bank's overall liquidity positions and liquidity risk management. The final rule would apply to banking organizations with $250 billion or more in total assets or $10 billion or more on balance sheet foreign exposure, and also to subsidiary depository institutions of these banking organizations with $10 billion or more in total assets. Additionally, like the proposal, the final rule includes a less stringent modified LCR that would only be applied to bank holding companies or savings and loan holding companies with at least $50 billion in total assets that are not subject to the full LCR. The final rule establishes a standardized liquidity stress scenario, where the definition of liquidity resources and projected inflows and outflows are fixed in the rule. The standardized stress requires a covered company to maintain an amount of high quality liquid assets for HQLA to cover its total net cash outflows over a perspective 30-day period. Outflow rates are reflective of a severe stress event, including a partial loss of secured and unsecured wholesale funding in unscheduled draws uncommitted but unused credit and liquidity facilities and other shocks which affect outflows linked to other types of transaction, such as derivatives and mortgage lending. The final rule 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. The agencies received 119 comment letters on the proposed rule. While most commenters supported the agencies efforts to strengthen the regulatory liquidity framework, many expressed concern about the operational challenges in meeting the LCR and about key differences between the U.S. proposal and the Basel III liquidity standard. The most notable concerns raised by commenters were related to the transition period for implementation, the operational challenges of computing the LCR on a daily basis, the mechanics for capturing a firm's maturity mismatch within the 30-calendar day stress period, the treatment of municipal deposits and municipal securities, and the operational challenges of using a 21-day stress period for firms subject to the modified LCR. The transition periods in the U.S. proposal are accelerated compared to the phase-in requirements of the Basel standard. For example, under the Basel standard, global banks are required to have an LCR greater than 60 percent by January 1, 2015, but US firms would have been required to have an LCR greater than 80 percent starting January 1, 2015. The phase-in requirement introduced in the January 2013 Basel version of the LCR reflected the fact that some jurisdictions had significant short falls and required more time to comply with the standard, while the accelerated phase-in within the U.S. proposal reflected the improved liquidity positions many U.S. banking organizations had achieved since the financial crisis. Staff still believes these transition periods are appropriate and have maintained them in the final rule for firms subject to the full LCR. For firms subject to the modified LCR, the rule will not be effective until January 1, 2016, providing smaller firms more time to build up system capacity to calculate the LCR. Many commenters expressed concern about the operational challenges of calculating the LCR on a daily basis as proposed. Further, smaller or less complex firms stated that computing an LCR on a daily basis was not necessary, because their balance sheets typically did not fluctuate substantially. Liquidity positions at the largest, most systemically important institutions can change quickly, and therefore the final rule requires that firms subject to the full LCR compute the LCR daily. However, in recognition of the operational demands to implement the systems for daily calculation, the requirement will be delayed for all firms with a faster phase-in for firms with the largest systemic footprint. Finally, firms subjects to the modified LCR are typically smaller with less complex balance sheets, and therefore the final rule exempts modified BHCs from the daily calculation requirement. Several commenters were concerned that the mechanism propose to capture maturity mismatch within the 30-calendar day stress period was overly conservative because it assumed that all non-maturity outflows occurred on day 1. The final rule eliminates this conservative day 1, assumption but still addresses the liquidity risk of maturity mismatches inside the 30-day window by focusing more explicitly on outflows and inflows that have contraction maturity days of less than or equal to 30 days. The most frequently criticized aspect to the proposal was the treatment of deposits received from municipalities and the exclusion of municipal securities from HQLA. The proposal treated secured municipal deposits as secured funding. This, in many cases, resulted in a lower outflow rate then if the deposit were unsecured. However, in some cases this treatment had an adverse impact on the firm's LCR. Staff has modified the final rule so that municipal security deposits receive the same or better treatment as unsecured municipal deposits. With respects to including municipals securities in HQLA, the municipal market is diverse and the liquidity characteristics of municipal security varies significantly. Many municipal securities do not exhibit the necessary liquidity characteristics for inclusion of HQLA. However, after reviewing commenters' concerns and based upon our analysis, there are a limited amount of municipal securities that may exhibit characteristics similar to assets that are currently eligible as HQLA. Therefore, and in response to commenters' concerns, staff recommends further analysis to develop a standard for potentially including some municipal securities as HQLA, and that we develop a new proposal for public comment to include the most highly liquid municipal securities. Finally, many commenters appreciated the proposal's tailored approach and less stringent requirements for firms subject to the modified LCR, which would have applied a 21-day stress period instead of a 30-day stress period and a 30 percent lower outflow factor on non-maturity liabilities. However, commenters also describe the burden of setting up the technological infrastructure associated with the 21-day metric as opposed to the 30-day metric. Accordingly, the final rule applies a 30-day metric to firms subject to the modified LCR and a 30 percent lower outflow factor applied to all liabilities and off balance sheet commitments. Staff believes the final rule will produce a modified LCR that is similarly stringent to the original proposal but with reduced operational burden. Under the final rule, companies generally will be required to maintain 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 to their 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. The final rule before the Board today better positions banks to withstand future market shocks, which should result in a banking system that is less reliant on government liquidity support. As discussed earlier, the majority of covered banking organizations had made significant improvements to their liquidity positions, including significantly increasing amounts of HQLA as well as reducing reliance on less stable forms of funding. These improvements result in a majority of holding companies already complying with the rule. Based on the quantitative impact study and supervisory information, we believe that of the roughly $2.5 trillion system-wide HQLA requirement, the remaining shortfall performs that are not compliant is $100 billion for all holding companies subject to the full and modified LCR. Finalization of this rule will help ensure firms preserve the liquidity gains made since the financial crisis. This concludes my prepared remarks. My colleagues and I would be pleased to answer to your questions.

CHAIR YELLEN. Thank you very much. Let me start with just a couple questions and then I'll turn to our colleagues. Let me start by asking you a little bit more about municipalities. You mentioned that you're doing some follow-up work and considering the possibility that there are some highly liquid municipal securities that you might consider later on to be eligible to count as high quality liquid assets. States and municipalities seem quite worried about this proposal, they seemed to be concerned about the potential impact on their access to that market. So I wonder if you could comment on what you see is the likely effects on states and municipalities.

DAVID EMMEL. OK, thanks. The final rule as, the implication for states and municipalities, we don't think will be significant based on the final rule. Banks currently--estimates of banks' participation on municipal market is relatively limited currently at 10 to 15 percent. And we also saw that banks as part of their--banks had held municipal securities previously and did not include them in their liquidity buffer, so they held them for other reasons, not just for HQLA, and we expect that to continue regardless of the final rule's implementation. But, that said, and reflection of commenters' concerns, we are looking at certain municipals securities that may qualify as eligible securities. But overall, we don't believe the impact would be very significant, be impactful to the municipal market.

CHAIR YELLEN. OK. Thank you. And let me just sort of follow up on that by asking a broader question about economic impacts. So you've discussed what you think the economic impact will be on one segment of borrowers. Do you think that there will be a significant economic impact of this rule on the broader economy? And do you see any potential for banks to reduce lending because of the requirement?

BILL NELSON. Madam Chair, I'll address that question. So, most banks, as David mentioned, most banks are around, near compliance with the LCR or do comply with the LCR. So we don't anticipate any immediate impact of the regulation being passed on lending. Of course, banks are near compliance or in compliance because they've anticipated that this regulation will be put in place. And banks are in the business of engaging in liquidity transformation as they take, for example, deposits that are very liquid and make loans which are less liquid. And this regulation by design will make that business a bit more costly as banks are forced to internalize the external costs that are associated with shortfalls and liquidity. As we saw in the crisis, those external social costs can be quite profound. And that will, to some extent, make credit a bit more costly but weighed against that is that these regulations will cause financial crisis to be less likely and less frequent and less severe, because they will make financial institutions more resilient to the kind of liquidity pressure that were the immediate causes of the most recent financial crisis. And as we all saw, the impact on credit and credit availability in the economy can be catastrophic, crises of that sort. And indeed, in the August 2010 study by the Basel committee weighing the cost of the capital and liquidity regulations, including the LCR, against the benefit of the reduced incidence of the financial crisis found that the benefit significantly outweigh the cost.

CHAIR YELLEN. Thank you very much. Vice Chair Fischer is participating in the meeting over the telephone. And let me turn to him and ask, Vice Chair, if you have any questions.

VICE CHAIRMAN FISCHER. Hello. Thank you, Madam Chair. I'm sorry, I entered the conversation a bit late because of some confusion over the code number. Let me ask a question which may be difficult to answer. I'm thinking about what happens during the crisis. This make a crisis less likely, but suppose there is a liquidity run despite everything and we're getting to a crisis. And assets which we had thought were liquid become less liquid. Are there assumptions made? Have you done any stress test on what would happen? This is a follow-up one, obviously, on the Chair's question. What would happen in a crisis if, for some reason or whatever, there was a shortage of liquidity? Is there an assumption in the stress test if the Fed would be able to inject liquidity in a way which would keep the institutions at their ratios? Would there be special provisions for running with our liquidity during the crisis? And my question isn't incredibly precise, but could you give us some idea of how you envisage this working, not in preventing crisis, as far as one can see, but how it would work during a crisis?

DAVID EMMEL. I think I can that with that answer and then perhaps Bill can talk about the Fed's ability to interject as well. The standard was set up, first of all, to make sure that firms are recognized, that they can use the buffer. So we would expect firms to be liquidating some assets if they're having outflows. And also as we thought about--how we thought about the assets that qualify as high-quality liquid assets and the haircuts we assigned to those, we tried to only incorporate assets that are of the highest quality, and assign haircuts accordingly. So level one assets are just U.S. Treasury securities, which we saw during the last crisis performed really quite well. And so the expectation would be that they would, again, and there aren't haircuts assigned with that, whereas more volatile assets have higher haircuts. So I think, generally, firms would be able to address their liquidity needs using HQLA. And like I said, we would have a very flexible response in how firms were meeting the requirement and if they were having to go actually below their LCR requirements. And I think I'll turn it over to Bill, as far as—

BILL NELSON. Well, I had a couple of thoughts to what David said.

VICE CHAIRMAN STANLEY FISCHER. This is Bill--sorry, is this Bill Nelson?

BILL NELSON. It is, Mr. Vice-Chair.

VICE CHAIRMAN STANLEY FISCHER. Yeah. OK.

BILL NELSON. So, you know, as the crisis develops, one of the benefits of this regulation, and the immediate initial causes of financial crisis that--you know, demonstrates in financial crisis was several financial instruments that had been expected to repay. We're not repaid. And financial institutions became much less confident of their own financial situation and the ability of their counterparties to repay them. And, moreover, the cost of coming up short became very high. So, institutions pulled back from one another starting the kind of downward spiral that David mentioned earlier. So this regulation should help short-circuit that initial stage of a crisis and make--as you've mentioned, make the crisis less likely. Now, in a systemic financial crisis there's still going to be a very important role for the Federal Reserve as the lender of last resort to the economy, to act as the lenders of last resort, and provide liquidity aggressively to the market, and broadly as the lender of last resort. Those actions themselves would help the institutions maintain their LCRs at current levels if necessary, whereas David said, they can use their LCRs to get through difficult patches.

Moreover, the LCR will complement the actions of the Federal Reserve in a crisis, because as Governor Tarullo mentioned in his remarks, during a crisis it's difficult at times to tell what the difference between a liquidity problem and insolvency problem is. And LCR, what the LCR will do, give us time--as the supervisor's--time to deal with that situation without lending if necessary and resolve an institution that's come into difficulty, because of solvency problems not liquidity problems. So that we won’t, again, be at times forced to act quicker than we would normally have wanted to. That said, as I mentioned, it will still be an important role for the Federal Reserve, I think, to be a lender of last resort in a financial crisis.

VICE CHAIRMAN STANLEY FISCHER. OK. Thanks. Well, I do apologize that I couldn't get in at the beginning so I didn't hear Governor Tarullo, but I didn't want to continue on this line. But there's something that slightly bothers me in this example. And I'll continue thinking about it while the discussion goes on. And, if I may, Madam Chair, if I have another question I'll come back at some point.

CHAIR JANET L. YELLEN. OK. Very good. Let me turn to Governor Tarullo.

GOVERNOR DANIEL K. TARULLO. Thank you Madame Chair. Maybe following up a bit on the Vice-Chair's question, David, and the rest of you. There's been a lot of comment as to how the analogy between capital requirements and liquidity requirements is important but not perfect and not precise. And I think this is probably one of the principal areas in which people see differences. You know, we establish in Basel III minimum capital requirements below which we really never want anybody to fall. But then we've also got a series of buffers which when violated result in certain restrictions on capital distributions and the likes. So this is kind of an intermediate set of measures that are applicable well short of minimum requirements. With the LCR, we don't have a system like that and I think what may lie in part behind the Vice-Chair's question certainly lies behind a lot of people questions, is how do you--how can supervisors ensure that we don't end up in a circumstance in which maintaining that ratio becomes sort of a prime focus of CFOs and others during a crisis? Just about everybody who writes in this area, alludes to the old story about the town with the ordinance that there always has to be one taxi at the train station as a result of which the taxi can never be used and people stuck at the train station. That's presumably not the way we want people thinking about liquidity but how we're going to be able to communicate at when that ratio actually should be breached in a sense and liquidity should be used precisely because we're in a stress period.

DAVID EMMEL. Yeah. So, I think part of our jobs as supervisor is when working with firms to clearly communicate to them that in times of crisis, this is designed to be used. And I think as--that should be clearly communicated both currently and prior to the crisis but also I think could be very critical that once we are getting into a crisis or firms actually experience in an idiosyncratic stress that we're very closely communicating with them that we are--we do expect them to be able to use the buffer and then it's there designed to be used. So I think it'll be really a communication strategy that we will have as supervisors and potentially publicly as well if we get--to a supervisory--or a systemic stress that we can indicate publicly that, you know, firms falling below 100 percent may be appropriate but I think it'll more of the day-to-day basis in working with the firms. And we will be seeing firms' ratios on a regular basis so

I think as we're seeing that we should be in communication with them not falling below 100 percent is OK and it's actually what the metric is designed to do.

MICHAEL GIBSON. And I would just add that there's an important difference as you alluded to between the capital regulation and liquidity regulation in terms of the consequences of a breach. For capital, there starts to be restrictions on dividends, restrictions on compensation, and with the liquidity regulation, the only consequence is you have to have a conversation with your supervisor about how you're going to deal with the liquidity stress that's pushed your LCR below 100 percent, and that's it. So, that's a recognition that once a firm is under liquidity stress, it's really becomes a supervisory matter rather than something of regulation is intended to deal with, the regulation as really intended to deal with *ex ante* make sure firms have strong liquidity buffers before the crisis.

GOVERNOR DANIEL K. TARULLO. OK. Thank you, Madam Chair.

CHAIR JANET L. YELLEN. Thank you. Governor Powell.

GOVERNOR JEROME H. POWELL. Thank you Madame Chair. So, I have a question about the scope of application particularly to the banks between $250 billion and $700 billion in total assets. Those institutions as, you know, tend to be more like traditional commercial banks in a sense of their activities are commercial lending, and residential lending. On the funding side they tend to be more deposit funded at the margin and less short-term wholesale funding, unless we're applying the full strength, full strength of LCR to them. So, could you talk about that decision a little bit and also specifically how does the LCR, you know, take into account the differences in their business models?

DAVID EMMEL. Sure. So, in establishing the threshold of over $250 billion, we'd looked at the different business models and the different markets at the banks are participating in and we felt like 250 billion was the appropriate line. And it also a line we’ve drawn in other regulations, including the capital standards for applying that full Basel requirement, too.

The LCR itself, though, actually does adjust to different business models. So as firms are less relying on short-term wholesale funding or don’t have a substantial amount of off-balance-sheet commitments, their LCR requirement will be substantially smaller than a firm that is overly reliant on short-term wholesale funding. So, as an example of firm that's really retail-deposit based and heavily oriented with retail deposits, would just have a 3 or 10 percent outflow rate associate with those retail deposits. Conversely, a firm that's reliant on wholesale markets potentially have 100 percent outflows and have to hold substantially more HQLA relative to total assets than a firm that is not relying to those markets.

GOVERNOR JEROME H. POWELL. Thank you.

CHAIR JANET L. YELLEN. Governor Brainard.

GOVERNOR LAEL BRAINARD. OK. So first, let me just say that this rule really represents a huge amount of work on the part of the staff, and I have to say you taken on board a very complicated and important comments and have struck an important balance, I think, on many of the issues that the commenters raised. One question I had is just looking at the way liquidity management has proceeded over the last few cycles tends to be other procyclical and unlike your stress test kind of approach. On the capital side, this is a standardized liquidity stress test. How do you anticipate the LCR along with the other tools that you have as supervisors can be adapted through the cycle.

DAVID EMMEL. So, I think, one of the big benefits of the LCR is that it's going to--as you talk about the dynamics of liquidity risk management seem to ebb and flow with different cycles. And one of the benefits of the LCR is going to establish a baseline of, this is the expectations for firms to hold standard amount of HQLA. And I think, as the--as folks’ memory of the crisis kind of fades away, there'll still be these lessons that we learn during the crisis. So I think that's a really important benefit. But in response to yours of how do we actually evolve and I think with capital stress testing, we certainly learned a lot over the past several years, and capital stress testing I think made enhancements and how's the response can be with that. We do have, as we mentioned earlier, the Reg YY, which requires firms to do internal stress testing. And as a part of our supervisory approach, we are doing horizontal reviews that are assessing those internal stress testing, and I think even in the first few years that we've had, since that we've seen substantial gains both in the firms' stress testing and our supervision stress testing as we're learning different dynamics that exist in different practices. So I think the two will complement each other really well where that will have a standardized floor but we'll also be doing these horizontal assessments of firms internal stress testing in running our own--as part of that we also are running our own stress test assessments which I think we'll also benefit from knowledge that were gained over the years. So, I think, the firms' internal stress testing are stress test will continue to evolve into a better place and we'll still have this baseline of a standardized LCR metric.

GOVERNOR LAEL BRAINARD. May I ask a second question? Obviously, there's a lot of concern, I think, legitimate concern about risk associated with the short-term wholesale funding. The LCR goes some distance in addressing this but it's probably not wholly adequate. Can you talk a little bit about where it might still fall short and what additional belts and suspenders might be needed on that front?

MARK VAN DER WEIDE. Sure, I'll take that one.

So the LCR is a pretty important step forward in mitigating some of the financial stability risks in short-term wholesale funding. It's particularly good on treating mismatches that across the 30-day window. And it's pretty good on very short-term wholesale funding of illiquid assets. But it's not, in of itself, a sufficient solution to the financial stability risk in short-term wholesale funding. As Governor Tarullo and others have highlighted, it misses maturity mismatch inside the 30-day window. It doesn't cover maturity mismatch outside the 30--it's entirely outside the 30-day window, and this is matched book repo funding. It also only applies to banks, and financial stability risk in short-term wholesale funding are in banks and outside of banks in the shadow banking system. So more work needs to be done. That work is being done. The NSFR is going to be coming soon and that will address the maturity mismatch that occurs outside the 30-day window. The US version of the LCR, unlike the Basel version will address maturity mismatch inside the 30-day window, so it's resolved that problem already for ourselves. On the matched books, the NSFR firms that Basel is working on right now do include in the proposal from last January, a charge, an asymmetry of treatment between the repo and the reverse repo. So, Basel is working on a charge for the matched books through the NSFR process. We continue as well to work on potential capital surcharges for our largest banks that would be in part a function of short-term wholesale funding. And we also through our financial stability work as Governor Tarullo mentioned, are working on potential minimum margin requirements on securities financing transactions, so working through multiple channels globally and domestically to kind of fill in the gaps. Clearly supervision is going to be a big part of it, too. And David talked a little bit about that. But I think it's really important that we have a pretty robust supervision of liquidity risk management of these firms, as well as a good standardized set of liquidity rules both to prevent arbitrage of simple rules and also to get some of the idiosyncratic risks that standardized measures don't get.

CHAIR JANET L. YELLEN. OK. Are there any further questions? Vice Chair, do you have some further question?

VICE CHAIRMAN STANLEY FISCHER. No, Madam Chair. Thanks. This discussion has clarified the—some—most of the issues that I had.

CHAIR JANET L. YELLEN. OK. Great. Then, what I'd like to do is have a go-around. I'd like to ask each one of you to state your position on the rule and I'll start and I just want to say that I consider this very important regulation that will serve to strengthen the resilience of internationally active banking firms. I want to thank the staff for all of your excellent work in bringing this to formation and say that I support the staff proposal to finalize Liquidity Coverage Ratio rule. Vice Chair, can I ask you to state your position?

VICE CHAIRMAN STANLEY FISCHER. I agree with every word you said Madam Chair and support the suggested regulation.

CHAIR JANET L. YELLEN. Governor Tarullo?

GOVERNOR DANIEL K. TARULLO. Thank you Madam Chair. I'd subscribe to what you said as well. And just add, as Mark was suggesting in answer to Governor Brainard's question, we've got a continuing agenda here on liquidity generally short-term wholesale funding. And I think as everybody can tell from the staff responses and from the questions of the Board is going to continue to be a balance between wanting to make sure that there is liquidity in the system that does allow for productive lending and economic activity. On the one hand, while avoiding the kind of build ups of risk that Bill Nelson was describing that lead to be stress periods. And I think the time we took to work on LCR, the extra couple of years was worth it and so I very much support the final rule. Thank you.

CHAIR JANET L. YELLEN. Thank you, Governor Powell?

GOVERNOR JEROME H. POWELL. Thank you Madam Chair. So, I see the LCR is tied directly to some of the events of the crisis of the distresses around liquidity and therefore, it's a really important post-crisis regulatory innovation which is designed as the strength in our system and our large financial institutions. And since liquidity regulation is in its early stages, it is important to consider very carefully any side effects such as effects on credit. And I want to say, I think, we've really gone out of our way to do that. With the extra time we've taken, I think we've done--I think you've done a great job in balancing both comments from the public and our own considerations and those of our fellow regulators in coming up with the balanced approach here and so I'm very pleased to support the proposed final rule. I'm also pleased to support the development of a new proposal for public comment that would allow certain highly liquid securities to count as HQLA. Thank you Madam Chair.

CHAIR JANET L. YELLEN. Thank you, Governor Brainard?

GOVERNOR LAEL BRAINARD. Thank you Madam Chair. Liquidity risk was a critical amplifier of financial stress during the last crisis. That is abundantly clear. And so, I think, today's rule is a very important one that I'm very pleased to support. The final rule together with the horizontal Comprehensive Liquidity Analysis and Review Program that the Federal Reserve Board has instituted for the largest and most systemic institutions should help you ensure that the largest institutions manage their liquidity risks in a transparent, rigorous, and standardized way. And that should help to protect consumers and small businesses from the kinds of ravages that they have experience from the financial crisis over the last few years.

Today's rule is based on a thorough and serious analysis of the many comments that were provided and response to the proposed rule and I think it strikes the right balance. It provides for a simpler and less stringent liquidity requirement with a later phase-in date for large financial institutions that are not systemic and it allows for a longer time for financial institutions to meet daily reporting requirements which is appropriate. There's still some work to be done as several governors have said in assessing the relative liquidity in the trading and sub-segments of the municipal securities market and I trust there will be an opportunity to come back to the important question. Thank you Madam Chair.

CHAIR JANET L. YELLEN. Thank you. I'd like to now move Approval of the staff's proposal for the final rule on the Liquidity Coverage Ratio in the United States and note that we will await those steps of further proposals relating to the treatment of municipal securities as high quality liquid assets at a later day. Do I have a second?

GOVEROR DANIEL K. TARULLO. Second.

VICE CHAIRMAN STANLEY FISCHER. So moved, Madam Chair.

CHAIR JANET L. YELLEN. Thank you. All in favor?

PARTICIPANTS. Aye.

CHAIR JANET L. YELLEN. Any opposed?

OK. So, the rule is adopted. Thank you all and we're now ready to move along towards second topic today which is the proposed rule on margin requirements on non-cleared swaps. Let me turn the floor to Michael Gibson.

MICHAEL GIBSON. Thank you Madam Chair. In addition to the Liquidity Coverage Ratio, the Board is also considering today a rule to establish margin requirements on non-cleared swaps. Reducing systemic risks from derivatives is one of the key pieces of the global reform program put in place after the financial crisis and one of the key goals of the Dodd-Frank Act. Under the global financial reform program, all standardized OTC derivatives should be cleared through a central counterparty and all other derivatives, those that are not cleared should be subject to margin requirements. Margin requirements for non-cleared swaps will have two main benefits. First, many OTC derivatives are not standardized and will never be able to be cleared. These non-cleared swaps will pose the same type of systemic contagion and spill over risks that materialized in the recent financial crisis. Margin requirements will reduce these risks by ensuring that collateral is available to offset losses caused by the default of a derivatives counterparty.

A second benefit is to provide an incentive for central clearing. Clearing houses require margin to be posted against cleared swaps. Without margin requirements on non-cleared swaps, market participants would have an incentive to try to avoid clearing. With the margin requirements on non-cleared swaps being proposed today, the incentives will go in the right direction, and firms will have an incentive to clear their standardized derivatives.

Today's proposal is joined with the other prudential regulators and is a re-proposal of a rule that was first proposed in April 2011. This re-proposal reflects comments received on the 2011 proposal as well as international standards for margin requirements on non-cleared swaps that were completed by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions in September 2013. In light of the significant changes that have been made relative to the 2011 proposal, staff is recommending that the Board seek public comment on this revised proposal.

Sean Campbell and Anna Harrington will now provide an overview of the proposed rules margin requirements and highlights some of its main provisions.

SEAN CAMPBELL. Thank you. The agencies have proposed a risk-based approach to establishing margin requirements consistent with the statutory requirement that these rules help ensure the safety and soundness of the swap entity and be appropriate for the risk to the financial system associated with non-cleared swaps held by swap entities. In implementing a risk-based approach, the proposed rule will distinguish among different types of counterparties for purposes of establishing margin requirements. In particular, the proposal makes a distinction between swaps with other swap entities, such as swap dealers, financial end-users, such as insurance companies, and nonfinancial end-users, such as commercial end-users who use swaps to hedge commercial risks. Staff believes that the relative risk of each of these counterparties is officially different to warrant differential treatment in the proposed rule. Accordingly, the specific margin requirements that would apply to a swap transaction depend on which of these counterparties the swap entity faces.

I now turn to a brief discussion of the proposal-specific margin requirements. The proposed rule establishes initial margin requirements on all of a swap entity's non-cleared swaps. Initial margin can be thought of as a performance bond that guarantees the performance of a swap entity's counterparty and can be used to replace the swap in the event that the counterparty defaults. Moreover, initial margin is a key risk management tool that is employed by central counterparties and cleared swap markets. These initial margin requirements on non-cleared swaps should be considered a significant change to market practice going forward. While the collection of initial margin on non-cleared swaps has been a common market practice among some segments of the market, these requirements will significantly broaden the extent to which initial margin is applied to non-cleared swaps. A swap entity that transacts with another swap entity or a large financial end-user would be required to collect and post certain amounts of initial margin from and to its counterparty. Staff believes that requiring both the collection and posting of initial margin on swaps with these large and significant counterparties will result in a meaningful reduction and systemic risk by reducing the probability of failure of swap entities and the potential damage to the financial system in the event of a default of a swap entity. The specific amount of initial margin that must be collected and posted in a swap transaction would depend on the risk of the swap. Swap entities would be allowed to use an approved internal model or a standardized initial margin schedule. In both cases, the initial margin amount would be calibrated to an extreme, plausible loss that would be expected to occur over a 10-day horizon during a period of financial stress. These requirements are intended to ensure that margins will be robust to a period of market turmoil, will be more conservative than those required on more liquid cleared swaps, and will provide appropriate incentives for central clearing.

In addition, swap entities will be allowed to extend a limited amount of credit to their counterparties in the form of an initial margin threshold. Allowing swap entities to extend the limited amount of credit to their swap counterparties will incentivize strong counterparty credit risk management. The use of thresholds will also reduce the liquidity cost of the requirements by reducing the total amount of initial margin collected while focusing the requirements on the largest swap counterparties that are the most likely to pose systemic risks.

In addition to initial margin, swap entities would also be required to exchange variation margin. Variation margin reflects the change in the mark to market evaluation of a swap between two counterparties. Regular and timely exchange of variation margin ensures that current credit exposures do not build to unsustainable levels that can pose systemic risks to the economy. Unlike the initial margin requirements, which represent a significant change in market practice, the exchange of variation margin on a regular basis is a current risk management best practice that is widely adopted by many swap market participants. Moreover, the regular exchange of variation margin is also required on cleared swap transactions. A swap entity will be required to collect and pay variation margin on a daily basis with all of its swap entity and financial end-user counterparties. Unlike the case of initial margin, swap entities will not be permitted to extend any credit to their counterparties in the context of variation margin. Any variation margin that is owed must be paid. The margin requirements that have been described above apply to swaps with swap entities and financial end-users.

In the case of nonfinancial end-users, the proposal would not impose specific, numerical, initial, or variation margin requirements on swaps with these counterparties. Rather, a swap entity would merely have to collect margin if the swap entity determined that doing so is necessary to appropriately address the risk posed by the counterparty and the swap. A swap entity that currently engages in swaps with nonfinancial counterparties and does not collect margin because it has determined that margin is not necessary to address the risk of the counterparty and the swap would not be required to collect margin under the proposal. Given the limited amount of systemic risk in a swap transaction between swap entities and commercial end-users, staff believes that this treatment of nonfinancial end-users is appropriate and consistent with the statutory requirement that all non-cleared swaps of a swap entity be subject to margin requirements, but that the margins be risk-based.

ANNA HARRINGTON. In addition to the amounts of initial and variation margin required, this proposal also establishes the types of collateral assets that may be used to satisfy these requirements. In the case of variation margin, the proposal would require cash to be used to make variation margin payments. Staff believes that limiting variation margin collateral to cash is appropriate and consistent with current market practice. In the context of initial margin, the range of eligible collateral is significantly broader and would include a variety of high-quality and liquid assets, including certain corporate bonds, sovereign bonds, and equities. The value of these assets, however, would be adjusted by risk-based haircut to ensure that the amount of initial margin collected could withstand fluctuations in asset market values. Staff believes that broadening the scope of eligible initial margin will alleviate the liquidity costs of the requirements and will minimize any distortions in the underlying asset markets without reducing the efficacy of the requirements.

When initial margin is provided to a counterparty, there is a risk that the counterparty defaults, and the provided collateral cannot be recovered. To address this risk and to protect the safety and soundness of the swap entity, a swap entity would be required to insist upon the segregation of any initial margin it pose to its counterparty at one or more third-party custodians. A swap entity would also be required to place initial margin collected in accordance with the proposed rule at a third-party custodian. In addition, the custodian agreement must prohibit the custodian from rehypothecating the collateral held by the custodian. Staff believes that these collateral safekeeping provisions are important to ensure that initial margin collected will be available when it is most needed and thereby result to significant reduction in systemic risk.

Given the global nature of swaps markets, the proposed margin requirements would be applied to swap transactions across different jurisdictions. In particular, some swap entities will be foreign entities, such as foreign banks swap dealers, and will engage in swaps with both foreign and U.S. counterparties. Swaps of foreign swap entities with foreign counterparties would not be subject to the margin requirement. In addition, certain foreign swap entities would be permitted to comply with the foreign margin rule on their swaps with U.S. counterparties, if the agencies determine that the foreign rule is comparable to the proposed rule. This approach is intended to limit the extraterritorial application of the margin requirements while preserving to the extent possible competitive equality among U.S. and foreign firms.

As discussed, the requirements of this proposal represent a significant change to market practice. A number of operational and legal changes by swap entities and other market participants will be required to comply with the new requirements. Staff believes that it is important to provide firms with sufficient time to conform to the new requirements. Accordingly, the requirements would be phased in over time between December 2015 and December 2019. This concludes staff prepared remarks. My colleagues and I would be pleased to answer your questions.

CHAIR YELLEN. Thank you very much. Let me kick off with one question. I think one of the goals of derivative reforms that were incorporated in Dodd-Frank was to promote central clearing of swaps to the maximum extent feasible, and as I understand it part of the rationale of these requirements is to provide appropriate incentives to centrally clear swaps as opposed to design them in such a way that they're non-cleared. And I guess a question I have for you is whether or not you think the regulations that you are proposing here do create the appropriate incentives for swap dealers and swap participants to centrally clear when that's really feasible.

SEAN CAMPBELL. Sure. So the proposal takes an approach to the marginal requirements that I think staff believes appropriately incentivizes central clearing, so let me--let me elaborate on that just a little bit. So initial margin requirements in particular under the proposal would be calibrated to a 10-day period of risk. In the context of cleared swap markets, most cleared swap contracts are going to be margined with respect to a five-day period of risk, and that differential translates into something like a 40-45 percent difference in the margin requirements. So an entity doing an uncleared swap is going to face a margin requirement that would generally speaking be say 40 or 45 percent higher than if they would undertake a cleared swap. So sort of right at the get-go, there's going to be a sort of clear, a clear economic incentive to engage in central clearing. Another point to keep in mind is that in the context of central clearing, if I'm a swap dealer and I'm engaging in cleared swaps with a variety of counterparties, all of those swaps will be novated to the central clearing house, and I'll be able to benefit from essentially netting across those counterparties, which is by most accounts extremely valuable. In the context of bilateral margin requirements, the same dealer would initiate five swaps with five different counterparties that are not cleared, they would effectively have five different margin requirements, which could add it up together, making the margin requirement significantly more on risk for unclear bilateral transactions. So both of those things working together, I think, suggest to staff that the way this proposal has been designed and consistent with the international standard provides appropriated incentives for essential clearing.

CHAIR YELLEN. Thank you very much, Vice Chair Fischer.

VICE CHAIR FISCHER. Thank you, Madam Chair. Can you give us some idea of--would you have any instruments of where we're going to be end up with the new regulations in something like current volume, or I don't know which date-to-volume of total derivative transactions that would be covered by regulations like, “This is X. We expect X over Y to be dealt with through exchanges, and the remainder to be dealt with through margin requirements.”? And question, will there be any impact—do you expect to have any impact on the overall volume of derivative transactions in the economy? Are we doing something that's going to have a big effect on the amount of derivative transactions people--companies enter into? Or is this going to be not match change?

SEAN CAMPBELL. O.K., so let me try to address the each part that question separately. So I think your first question was around sort, you know, what's the fraction of total derivatives activity that might ultimately be centrally cleared versus bilaterally conducted? And it's not an obvious or simple matter to put a precise estimate on that, but actually we've done some work in the context of the international work that was discussed earlier in terms of the BCDS and IOSCO standards to try and get an assessment for what that--what that breakdown might likely be. And, you know, according to some estimates, it might be the case that going forward we might expect to say you know 60 percent of the market to migrate to clearing ultimately. I think, you know, consistent with the remarks that Director Gibson made earlier, there's going to be some fraction of the market highly tailored to bespoke swaps that are important for a particular, you know, say, you know, nonfinancial end-users, commercial firms, hedging risks, that just are never going to be amenable to clearing, but we think that a significant fraction, say, upwards of 60 percent, might ultimately end up being cleared through a CCP, and that number is itself a little bit too broad in the sense that it varies a little bit asset class by asset class. So relatively more interest rates swaps than say potentially credit derivatives are going to be cleared through central clearing.

In terms of the impact of this particular proposal that it might have on the market, in terms of the total aggregate amount of swaps that ultimately get conducted, you know, I think as was discussed in the context of the prepared remarks, these regulations--or this proposed regulation should not be interpreted as being sort of a minor modification to current market practice. It is a pretty significant new requirement and regulation in the context of uncleared swaps, especially in the context of collecting and posting initial margin. So I think it's fair to say that this is going to be a significant issue that swap end-users are considering as they're deciding whether and how to use a swaps.

You know, having said that though, you know, whether or not it's going to, you know, have a large sort of systematic across-the-board effect on the total amount of the derivative usage in the economy, I think that's quite frankly very hard to say, and I think that staff, the agencies in particular, in the context of the international agreement have tried to sort of take the potential costs of these requirements into account when making some choices about how these requirements are parameterized to ensure that costs being borne upon financial end users and nonfinancial end-users are not unduly burdensome.

VICE CHAIR FISCHER. Yeah, well, I mean that--that's a nice statement, particularly the last part about not unduly burdensome. Did we get feedback on that? Have there been comments on this? I assume that whatever we do with these statements will be unduly burdensome, even if that's an unreasonable position to take. Did we get any feedback on this rule? Or we relying on the fact that it's internationally agreed and--

SEAN CAMPBELL. So going back to the--

VICE FISCHER. –roughly speaking?

SEAN CAMPBELL. Sorry to interrupt. Going back to the original proposal that was released in April 2011, we certainly received a significant amount of comment sort of related to the potential and significant liquidity burdens of this proposal. Those comments tended to be rather high-level, if you will, without a lot of detail and specificity. In the current proposal, you know, we've asked for very detailed and specific comments on what the potential sort of burdens might be to different kinds of end-users, and we hope to receive, you know, additional feedback on some of those specific costs and what those estimates might be.

In the context of working on an international basis to put the--sort of--these rules together, we've done some work ourselves to come up with some estimates of what the overall liquidity burden of the requirements might be. The estimates that we’ve put together suggest in the context of the U.S., so for the U.S. requirements, you know, the total amount of initial margin that might be required under this proposal once the requirements are fully phased in might be something on the order of $300 billion U.S. And so that sort of the overall stock of initial margin that would be required, of course, the cost associated with carrying around that stock of initial margin is--depends on essentially the rate of return on the underlying initial margin assets that have been posted and the cost of funding those assets: What’s that return differential, or what’s that funding differential? And quite frankly, that varies across a number of dimensions. That varies over time as economic conditions change, and that also varies across different counterparties. A highly regulated financial institution might have one--might face one funding cost differential, and a large asset manager that is going to be owning large stock of eligible margin--eligible initial margin collateral anyway might face a different sort of cost to carrying that collateral on its balance sheet. So, we've--I think, we've done some work to try and size the liquidity cost. That work has been put out in the public square, has received public comment, and I think we look forward to receiving more public comments on this proposal with respect to that, that aspect of the requirements.

MICHAEL GIBSON. And I would just add one other thing, which is on the 2011 proposal that the U.S. agencies put forth, the set of eligible collateral for initial margin was very narrow. It was basically cash and U.S. treasuries. And one of the comments we got on that proposal from financial end-users was that they may not hold a lot of treasuries in their portfolio, but they have other assets, such as equities or corporate bonds, that with an appropriate haircut could in their view be used as initial margin. And one of the changes in the current proposal compared with the 2011 proposal is that the set of eligible collateral is much broader, and it does include things like equities and corporate bonds with what we consider appropriate haircuts. So we have addressed one of the comments that we received on the 2011 proposal in terms of lessening the impact on the financial end users.

VICE CHAIR FISCHER. O.K. Thank you, Madam Chair.

CHAIR YELLEN. Thank you. Governor Tarullo.

GOVENOR TARULLO. Thank you, Madam Chair. I just want to start with a brief observation as a prelude to the question. The observation is that after Dodd-Frank was passed and after the initial proposal that Mike and Sean had been talking about, there was a lot of commentary, I think, among regulatory agencies, by members of Congress, by academics, and others that this was an area where the absence of some international convergence and consistency could really lead to some big shifts in where swaps and derivatives activity was conducted. And I think we shouldn't understate the accomplishment in getting an international agreement on this and particularly the role that the Fed and Mike played in pushing us to that agreement.

So my question actually is: Where is the rest of world, particularly the other large financial centers in their implementation of the international framework?

SEAN CAMPBELL. Sure. So the international framework was established and published by Basel committee, and I also go back in September of 2013. Since that time, two large and significant jurisdictions have proposed their own set of rules to sort of put into sort of jurisdictional practice the sort of international agreed upon standard. So Europe came out with its proposal in April of this year, and Japan came out with its proposal in July of this year. Both of those proposals are still outstanding. The comment period on both of those proposals has since expired in both cases, and both of those jurisdictions are currently involved in the process of moving those rules to a final rule stage.

GOVERNOR TARULLO. They're slightly ahead of us?

SEAN CAMPBELL. They're slightly ahead of us.

GOVERNOR TARULLO. OK. Thank you.

CHAIR YELLEN. Governor Powell.

GOVERNOR POWELL. Thank you, Madam Chair. I want to make sure that I understand correctly the commercial end-user approach here. So the statute is very clear that we're required to impose margin requirements--initial margin requirements on commercial end-users, but it's silent as to the level. So as I understand what you said, if a commercial end-user were to look--if one were to look at a commercial--commercial end-users were to look at a counterparty and see that no margin was required to deal with either the risk of the swap or with the credit risk of the counterparty, that that would be O.K.? Is that right?

SEAN CAMPBELL. That's correct. The approach that we've taken in the proposal, staff believes, is consistent with current industry practice in the context of swaps with nonfinancial end-users and commercial end-users in particular. So in the specific example that you've provided, if a swap entity was conducting, say, an interest rate swap transaction with a commercial end-user, and according to its own internal credit assessment determined that no margin was needed to address the risk of the counterparty or the interest rate swap and wasn't--didn't feel as though it was necessary to collect any margin, then this proposal wouldn't require then to collect any additional margin either. That being said, as you also earlier pointed out, the statute requires that all swaps of a swap dealer be covered by the requirements. And so, in this case, to the extent that there is a requirement, the requirement is that the swap dealer engage in a credit assessment and act accordingly.

GOVERNOR POWELL. Great. Thank you. So, we have defined the level of material swaps exposure at $3 billion for financial end-users, and I think that's a very sensible distinction in regulation, but I'd like to ask a couple of questions about the level of it. First, what is the effect that we can--have we been able to calculate what the effect would be on the total amount of margin required by exempting swaps below that level, or counterparties who have below that level of swaps?

SEAN CAMPBELL. Sure. So in thinking about the total amount of margin that's going to be required by this regulation, there are sort of two key features, which are important. The first key feature is the size, the initial margin threshold, which we talked about earlier, and the second is, I hasten to use this term, but for the purpose of this discussion, let's say the de minimis amount of $3 billion. And both of those things taken together when they're enacted according to the staff analysis that we've done, essentially have the total amount of initial margin that would be required on the regulation.

The more precise question that you are asking is: Well, what about the effect of using this $3 billion sort of cutoff to exempt the smaller financial end-users? So, off the top of my head, I don't have a specific estimate of what part of the halving that that relates to. If I, you know, if I had to hazard an estimate, I would say that that probably accounts for a relatively smaller portion of the halving because those folks that have under a $3-billion notional exposure would be expected to have relatively small initial margin requirements to begin with. You know, say $25 million rather than $50 (million), $60 (million), or $80 million. And so, removing them from their sort of requirement towards sort of treating them differently, it does reduce the total amount of initial margin requirement, but probably has a somewhat lesser effect than the initial margin threshold of $65 million.

GOVERNOR POWELL. Great. Thank you. It appears that Japan and Europe have chosen a substantially higher level than $3 billion. How do we think about that, and do we think there's any possibility that we'd be taxing our swap providers in a way that would be a competitive disadvantage?

SEAN CAMPBELL. Right. So the point you're raising is that the internationally agreed upon standards that we've discussed sets as a level for these sort of smaller financial end-users, financial end-users that have a notional derivative or swap exposure of roughly $11 billion. I say “roughly”, because the standards are denominated in terms of euros, so $11 billion is roughly the U.S.-dollar equivalent of the U.S.--of the euro amount, which was 8 billion euros.

In the context of the rule-making process, staff did some additional analysis, and it was informed by some data that was provided by some of the other rule-making agencies on data on initial margin amounts that were collected by clearing houses that execute interest rate swaps for their clients. And analysis of that sort of data suggested that we could--if we went with the $11 billion threshold for defining the smaller financial end-users, we could have situations where there's a financial end-user that has, say, a $10-billion notional exposure, but would have an initial margin requirement on a cleared swap of something well in excess of $65 million. And that situation seems not to be compatible with the underlying notion for this de minimis level, which is essentially to carve out folks that would be nowhere near the initial margin threshold of $65 million. So, in light of that--in light of that data that was provided and sort of some additional sort of consideration amongst the agencies, we determine for the purpose of the proposal to go with a number that's significantly smaller: $3 billion. And we're hopeful that during the comment process, and as the other jurisdictions across the globe finalize their rules, that we'll be able to take the comment process into account to ultimately come to some sort of final determination as to whether right level or line is.

GOVERNOR POWELL. Great. Thank you.

CHAIR YELLEN. Sure. Thank you. Governor Brainard?

CHAIR YELLEN. O.K., if there are no further questions, then I would like to have a go-around for stating positions, and I'll start off by saying that I support staff's proposal to issue this revised proposal on margin requirements on non-cleared swaps. I think these swaps certainly contributed importantly to systemic risk and played a key role in the financial crisis, and I see this rule as a significant step forward in addressing these risks. So I want to thank you all for your hard work over many years and getting to this point in the international agreement that you have negotiated as well. Vice Chair Fischer?

VICE CHAIR FISCHER. I agree with position you expressed, Madam Chair, and the importance of this issue, particularly in light of the staff's estimate that we're dealing with possibly approximately 40 percent of the current volume of derivative [inaudible]--of the future volume derivative transactions. And it turns out that the sort of generalized hope that you'd get everything with very large--large majority of transactions and to organize the exchanges is not fully recognizable, and thus this is extremely important--that's an the extremely important part of the international attempt--of international work to prevent derivative transactions becoming as critical a feature--as important a danger in potential future crisis.

CHAIR YELLEN. Thank you. Governor Tarullo.

GOVERNOR TARULLO. Thank you, Madam Chair. I support proposed rule, and I look forward to the comments we're going to get during the comment period. I think it's actually particularly useful that our period is overlapping with that of Japan and the European Union, because we may all be able to profit by comments that each gets in its own jurisdiction and I assume we'll have our opportunity if needed to discuss with those other jurisdictions any modifications that might be warranted. With that, I’m supportive.

CHAIR YELLEN. Thank you. Governor Powell.

GOVERNOR POWELL. Thank you, Madam Chair. So I think this is important both in making the non-cleared swaps market more robust and also in assuring that the incentives are still to clear where that is appropriate. I think this is in very good shape, and I look forward to seeing the comments on it. Obviously we have to re-propose it given all the nature of the changes, but I'm happy to support you.

CHAIR YELLEN. Thank you. Governor Brainard.

GOVERNOR BRAINARD. Thank you, Madam Chair. The crisis illustrated starkly the dangers posed to financial stability from improper risk management of large non-cleared derivatives exposures at major financial institutions. In the world of swaps, which is highly globalized, it's critical to achieve international consistency in order for us to satisfactorily address the systemic risk here at home. That's why I was pleased in my former life, Pittsburg in 2009, to be part of the effort that secured for the first time international commitment to ensure standardized derivatives contracts would be centrally cleared and to also ensure that non-cleared swaps should be subject to margin requirements to provide incentives to clear and also to ensure strong risk management for swaps that are not cleared.

I'm very supportive of today's re-proposal for the same reason. It builds on the very important proposal that was made in 2011 under the Dodd-Frank Act, but it also achieves international consistency with the 2013 Basel committee IOSCO framework that I think the Federal Reserve really deserves credit for spearheading, in particular, Mike Gibson. The re-proposal strengthens the swap margin rule in important respects from requiring two-way posting of initial and variation margin to proposing stronger segregation requirements and prohibitions against the rehypothecation of initial margin. I will be interested to hear from the comment period comments on the $65 million consolidated minimum thresholds. I think that is a very important issue to ensure that we focus these requirements on the greatest sources of systemic risk while also reducing the overall collateral burden together of course with certain exceptions for nonfinancial end-users. So I support the re-proposal and look forward to the comments on it. Thank you.

CHAIR YELLEN. Well, thank you very much. I'd like to then move approval of the staff's proposal to public--to publish for public comment, a rule to establish margin in capital requirements on all non-cleared swaps by swap entities for which the Board is the prudential regulator. Do I have a second on that motion?

VICE CHAIR FISCHER. So moved, Madam Chair.

CHAIR YELLEN. Thank you. All in favor?

ALL. Aye.

CHAIR YELLEN. Any opposed?

[Silence]

CHAIR YELLEN. O.K. The proposal passes, and thank you all very much for all your hard work and contributions to moving the regulatory structure in a very positive direction.