AGENDA

Meeting of the Federal Advisory Council
and the Board of Governors

Friday, September 14, 2012

<u>Item 1</u>: <u>Current Market Conditions</u>

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

- Demand for consumer credit is generally improving, but demand for business loans has softened over the last quarter. The credit capacity of banking institutions continues to grow, but concerns over the health of the economy and uncertainty over the country's fiscal situation are impacting demand.
- Large corporate clients remain opportunistic borrowers and pricing remains competitive. Competition in the middle market has increased, but utilization of lines of credit is flat and cash reserves are increasing. Cash flows have improved for many companies, driven primarily by cost reductions and modest revenue growth.

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

- Small business optimism and borrowing demand remain tempered by high U.S. unemployment and turmoil in Europe. While we see some industries and businesses utilizing credit, many are not only remaining on the sidelines in terms of hiring and borrowing but are also paying down debt and de-leveraging.
- Despite slow demand, new loan volume continues to show growth via industry segments that show strength – primarily healthcare, wholesale, manufacturing, and agriculture. Microbusinesses (sales of $1 million or less) continue to be the most cautious.
- Loan balances continue to shrink as small businesses de-leverage, especially as they consider interest rates will remain low until mid-2015 per the Federal Reserve's public statements.
- While loan spreads continue to be stronger than pre-recession, there is increasing pressure on yields and spreads due to competition. Rate competition increased in late 2011 and has continued in 2012, particularly for larger ($500,000 - $3 million) secured loans, with yields on new loans down ~50 basis points over the past 12 months. Some banks have become very aggressive in pricing, returning to pre-recession pricing levels on some transactions.
- Credit quality of small business portfolios continues to improve. Net loan losses dropped significantly in the first 6 months of 2012 compared with the same period in 2011. Lending standards have not changed in the last quarter. More banks are doing longer term loans with maturities as long as 15-20 years and amortizations as long as 25 years.

(B) Commercial Real Estate Lending:

Have there been any changes in the Council's view of the challenges in the commercial real estate market? How are commercial real estate loans performing compared to your expectations?

- In the current commercial real estate environment, credit performance continues to improve, with significant declines in both nonperforming loans and charge-offs over the past quarter. Loan activity for acquisition, refinancing, and construction remains soft due to the economic environment, although multifamily housing construction continues to fare well. The major challenge to the industry continues to be a lack of a viable capital markets solution for term financing.
- Conditions for the four major asset classes are as follows:
    - Apartment vacancy rates continued to improve, declining 60 basis points from a year ago to 4.8%. According to CBRE Group, markets with vacancy rates of 3.5% or lower included Newark, Pittsburgh, Minneapolis, San Jose, Hartford, Boston, Miami, Providence, Oakland, Ventura, San Francisco, and Salt Lake City. Vacancies are approaching the historically low levels last seen during the 2006-2007 period.
    - For office buildings, CBRE reports that vacancies dropped to their lowest level since 2009, falling 30 basis points during the 2nd quarter to 15.7%.
    - For industrial properties, national vacancies declined by 20 basis points to 13.2% in the 2nd quarter, making it the 8th consecutive quarterly decline.
    - Retail properties, which have generally lagged other property sectors during the recovery, saw a slight improvement in availability, with vacancies falling to 13.0% during the 2nd quarter. The rate represents a decline of 10 basis points compared with the previous quarter and 20 basis points compared with the rate one year ago. Absorption levels were well above the low square footage of new space completed in the 2nd quarter, enabling availability to improve.
- Continued uncertainty over the Dodd-Frank Act's risk-retention rules continues to plague the commercial real estate capital markets. Insurers and banks have finite capacity for term financing; therefore, the revival of the capital markets is vital to the overall availability of capital to commercial real estate investors.

(C) Construction Lending:

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

- From the 2nd quarter of 2011 to the 2nd quarter of 2012, the industry saw increased demand for apartment construction loans but limited demand for construction of other commercial property types. This dynamic was mostly driven by the undersupply of apartment properties and limited demand for office properties built specifically for a corporation and, therefore, pre-leased. Any new construction activity must be driven by the demand side, which comes from job growth.
- There is some increased regional demand for residential-for-sale development lending. However, demand has generally been isolated to markets that have recovered and that have developers in a strong financial condition.

- A potential future threat to the continued provision of capital to developers is the classification of construction loans as High Volatility Commercial Real Estate (HVCRE) under Basel III for purposes of capital treatment. In addition, the absence of improvement in economic conditions may further dampen construction lending.

***(D) Agricultural Lending**:*

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

- Farmland values continue to show strengths due to high forecast for 2012 farm income and low interest rates. The higher-than-expected income is a result of significant increases in grain prices combined with proceeds from crop insurance.
- Increased land prices are not an immediate concern but need to be watched closely as interest rates rise, commodity and input costs continue to be volatile, and outside investors park money in farmland. However, we do not expect to see significant risk of loss of income except for situations where the farmers did not carry crop insurance and their yields were adversely affected by the drought.
- Farmers are monitoring changes in world economics that impact world supply and demand for U.S. agricultural commodities. This watch list includes Europe, Brazil, Russia, India, China, and South Africa. Foreign policies on imports/exports, monetary policy, and political initiative are of most interest.
- The livestock sector has been adversely impacted by high feed prices, reduced demand precipitated by economic challenges, and price-increase resistance by consumers. These conditions have put significant pressure on profit margins for livestock and dairy producers, processors, wholesalers, and retailers. Continued liquidation of livestock is particularly apparent in the beef and poultry industries. The swine and dairy industries have seen less adverse impacts to date.

***(E) Update on Consumer Lending**:*

What changes have you seen in consumer lending?

- While consumer spending has increased slightly, payment rates for revolving lines of credit have also increased, showing a decline in the consumer’s willingness to borrow. Concerns about employment and the overall economy are major reasons for the de-leveraging.
- Demand for home equity loans and lines of credit increased through the 2nd quarter of 2012 based on a sustained low interest rate environment. However, demand is also a function of de-leveraging and pursuit of lower monthly payments. Real estate values for certain geographies remain challenged, with other geographies showing stable to improving signals.
- Student loans are demonstrating robust growth. College enrollment and tuition have increased while state education funding and scholarships have declined. Private student loan demand is expected to remain at current levels while continue growth is expected for federal loan demand. However, despite longer cure periods and greater payment flexibility, federal student loans have high and increasing default rates compared with private student loans due to minimal credit underwriting.

- Demand for auto loans has increased, and credit quality continues to improve. Decade-low delinquency rates are being reporting across the auto loan industry.

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

- Earnings were strong among most large lenders in spite of declining mortgage servicing rights (MSR) values. This result reflects significantly higher production volumes and higher margins due to capacity constraints driven by increasing refinance demand.
- Refinance demand continues to be fueled by historically low interest rates, the HARP2 program, and a new FHA streamlined refinance program that does not require a new appraisal and has reduced mortgage insurance premiums. The Mortgage Bankers Association (MBA) Refinance Application Index rose in all but 3 weeks of the 2nd quarter of 2012.
- The purchase market is experiencing several unique phenomena.
    - On the positive side:
        - Few sellers are offering properties in move-in condition, which has led to an increase in new home sales and price improvement in existing home sales as available inventory continues to decline.
        - Rising rents and low interest rates make home ownership very attractive.
        - Shadow inventory sales are going mainly to investors on a cash-sale basis, liquidating inventory, albeit at "distressed" prices.
    - On the negative side:
        - According to Fannie Mae's latest housing survey, the sentiment of 73% of respondents is that today is probably a good time to buy because of low rates and home prices, but only 17% of homeowners said it is a good time to sell.
        - The shadow inventory continues to depress prices in general and, more specifically, affects the appraisal process, having an adverse effect on home financing.
        - The MBA Purchase Application Index declined in all but 3 weeks of the 2nd quarter of 2012 (the last 2 weeks of April and the last week of June), however, was flat relative to the prior year levels.
- Credit quality continues to improve, with only 16% of applicants in June at a credit score of less than 660.[1] Credit constraints are widely believed to be the result of lenders imposing "overlays" to GSE and FHA guidelines in order to avoid future repurchase exposure.
- In July, notices of default were up 2% versus July 2011 but down 38% from the level in July 2010. Year-to-date, notices of default were down 3%, and REO filings were down 20% from last year.

[1] Zelman & Associates, Research Division.

***(G) Mortgage Foreclosures**:*

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

- The percentage of loans in foreclosure decreased for all loans types except FHA loans. This observation is consistent with a recent report from Realty Trac, which found that overall foreclosure activity decreased on a year-over-year basis in July and that the decline was driven primarily by a 21% year-over-year decrease in REOs.
- Overall, quarter-to-quarter, foreclosure starts were essentially flat. But according to Realty Trac, U.S. foreclosure starts in July increased 6% on a year-over-year basis. They report that foreclosure starts increased annually in 27 out of the 50 states (16 judicial states and 11 nonjudicial states). In addition, foreclosure sales were down 12% quarter-over-quarter and 22% year-over-year.
- The biggest factors reducing new 2012 cases are implementation of a foreclosure sale review checklist, reinstatements, and loss-mitigation options, rather than completion of foreclosures. However, bankruptcy filings are up compared with 2011 and that will lengthen the timeline for these loans.
- Regional disparities are evident between nonjudicial and judicial states, where more stringent processes result in slower inventory turnover. In addition, foreclosure timelines are being extended by legislative changes and aggressive courts, although some states like Florida are seeing improvement as a result of judicial reforms.

Item 2: Basel III NPRs

> **The Board recently released the following notices of proposed rulemaking (NPRs) related to Basel III: (1) the Basel III NPR (quality and quantity of capital), (2) the Standardized Approach NPR (calculation of risk-weighted assets), and (3) the Advanced Approaches and Market Risk NPR (revisions to the advanced approaches consistent with the Dodd-Frank Act). What are the Council's views on those NPRs and in particular, its views on the magnitude of the change in capital requirements, scope of their applications, implications for the availability and cost of credit, profitability of banking and mix of banking products, volatility of regulatory capital, and transition period for implementation?**

Overview

The Council has serious reservations about the intended and unintended consequences from the proposed Basel III capital requirements. Members support the principle that all banks should have comparable standards, and the amount of capital required should be reflective of the institution's risk. However, making these specific rules applicable to community banks as well as the largest financial institutions, which are required to adopt the advanced approach, has the potential to cause significant disruption to the industry and the overall economy. These rules have the potential to place U.S. institutions at a meaningful disadvantage relative to foreign institutions. The cumulative effect of the significant changes in capital and risk weights should be weighed carefully.

Chief among our concerns are:

- We believe the cumulative impact of these NPRs will have highly negative results to consumers and the economy. We suggest that the regulatory authorities carefully consider whether the end result is an improvement.
- As proposed, certain residential mortgage products will no longer be profitable unless the interest rate charged to the customer increases dramatically to cover the higher capital cost and compliance costs. The expected end result is that many consumers will either have to pay more, do without, or go to the unregulated sector.
- When coupled with the other provisions affecting mortgages – including Qualified Residential Mortgages, restriction on capital treatment for mortgage servicing assets, increase in risk weighting for mortgage loans, implementation of complex rules resulting in an increase in capital required for securitizations – regulated lenders will likely focus only on loans they can sell or securitize with or to Fannie Mae or Freddie Mac. This will only accentuate the concentration of mortgage credit in these institutions and further hinder the resolution of their conservatorship status.
- Capital levels will become more volatile due to the impact of market-value changes in available-for-sale (AFS) investment securities. Most would expect that an increase in lending accompanies an economic recovery and an increase in market interest rates. However, under the proposed rules the effect of an increase in interest rates will be a reduction in capital, potentially restricting credit and hampering any economic recovery. We believe the existing rules for determining impairment are sufficient for determining whether an adjustment to income, and thus capital, is necessary.
- The cumulative effect of these proposed and other regulatory changes will result in traditional banking becoming even less profitable and investors eventually choosing to put their money elsewhere. Consequently, we expect to see additional consolidation into the largest institutions. Such consolidation is contrary to the goal of reducing concentration risk in financial services and moves the industry in the wrong direction. Consumers will have fewer choices for meeting their credit needs within the regulated sector.
- We believe that the changes to risk weights are not supported by sufficient empirical data or logic. For example, the proposed residential real estate risk weighting could create an incentive to release collateral, which would create an unsecured loan and reduce risk-weighted assets.
- A significant concern at this point is not the transition schedule but the timing of the implementation of the final rule. Many of the new proposed risk-weighted asset calculations, such as for residential mortgage, HVCRE, and bank-book-securitization calculations, require the incorporation of qualitative information at the individual exposure level that, while employed in many risk-management processes, is not readily available in the data-intensive processes required to support the newly proposed capital calculations. In many cases, this qualitative information requires periodic updates. Adapting data processes to incorporate these proposed changes will be an expensive and lengthy undertaking. Any of these changes require careful planning and long lead times to ensure the integrity of the calculations and management of the data.
- The calculation of risk-weighted assets for U.S. banks in the Standardized Approach NPR is not consistent with the risk weightings of these same assets measured by regulatory calculations in other countries. The differences are most pronounced when compared with the risk weightings applied to similar assets of European banks. This dichotomy renders

capital and leverage comparisons between U.S. and European banks uneven and useless, placing U.S. banks at a huge disadvantage globally.

- Finally, banks have structured existing portfolios of assets and evolved capital structures that were consistent with existing U.S. application of the rules in Basel I and Basel II. Consideration needs to be given to grandfathering affected assets and liabilities under existing rules or for providing significant transition times in order to adjust these positions in an orderly and positive economic fashion.

Item 3: Stress Tests

To best judge systemic risks, the Federal Reserve's stress-testing process is based on industry data, industry-wide trends and averages, and macroeconomic scenarios. Although these elements are important to a macroprudential approach to capital, they play less of a role in the calculation of risks and capital at individual banks. What suggestions does the Council have for communicating and accommodating these differing perspectives in order to strengthen the CCAR and capital plan review process?

- The Council believes that the CCAR process has improved as it has evolved:
  - Enhancements to disclosures have been thoughtful and well received by banks and the market.
  - Greater granularity of data has helped to improve the accuracy of the tests.
  - Banks are increasingly weaving stress testing into the ongoing fabric of their financial and capital planning efforts.
- There are two fundamental areas of CCAR that should be addressed to accommodate individual bank perspectives and strengthen the connection with bank capital planning:
  1) Enhancing Federal Reserve models with bank-specific adjustments where appropriate to ensure they are effective in evaluating individual bank resilience, and
  2) Providing banks with preliminary feedback on their stress test submission during the CCAR process.
- The Council recognizes the difficult task of developing a systemwide and comprehensive framework for assessing capital adequacy. We understand that any changes to CCAR must meet multiple objectives:
  - *Maintain objectivity* – by deploying a consistent methodology, approach, and approval criteria across all banks;
  - *Prevent undue influence* – by establishing an interaction model between the banks, Federal Reserve "central" teams, and local bank examiners that avoids preferential treatment;
  - *Preserve the credibility of the tests* – by avoiding the "teaching to the test" problem that can result from too much transparency into the Federal Reserve's models; and
  - *Improve accuracy* – by leveraging the insights and best practices of all relevant industry parties to improve projections of performance under stress.
- We believe that our recommendations permit the Federal Reserve to meet these objectives.

Current State

- As the Board's question itself contemplates, CCAR is geared primarily towards producing an accurate macroprudential evaluation of the resilience of the banking industry.
- The Federal Reserve's CCAR modeling approach is less effective in assessing the resilience and planned capital actions of a specific bank because it uses an industry-average modeling approach without sufficient adjustments to reflect differences among banks.
  - There are many reasons that an individual bank's performance may differ from an industry average in ways that are material. For example:
    - Although very different tax rates apply to different institutions in practice, the Federal Reserve applied an effective tax rate of (b) (8) to all the participating banks.
    - Accounting policies can vary significantly. For example, some banks' accounting practices capture recoveries expenses as an operating expense. The Federal Reserve's model, however, captures expenses relating to recovering charged-off debt in its net charge-off estimates. Because the Federal Reserve's model was not consistent with these banks' own accounting practices, recoveries expenses were double counted.
    - Underlying performance can vary due to fundamental differences in business strategy that are both objectively observable in data and sustained over long periods. Loans from different banks that would be scored identically by an industry-level model have been observed to consistently experience varying actual loss performance. These outcomes may be due to important bank or portfolio-specific factors, such as customer selection, brand power, pricing, and risk-management strategies. (Please see attached Appendix.)
    - Differences in underlying business mix between banks and the industry overall can produce materially different views of performance if not modeled at an appropriately granular level. For example, it is not clear that the Federal Reserve's credit card modeling fully captures important performance differences between transacting and revolving customer segments.
- Both the Federal Reserve and the banks have an incentive to strive for the most accurate answer possible at the individual bank level.
  - By its very design, omitting differences between individual bank performance and performance of the industry on average rewards banks that fall below that average. Weaker institutions may be assigned lower capital requirements and permitted to pay out more capital than might be warranted if actual performance were considered. This result provides the Federal Reserve and other regulators with an inaccurate risk picture and puts both individual banks and the system overall at risk.
  - Differences between Federal Reserve and bank methodologies and projections will become apparent to the market once the company-run stress test disclosures required under the Dodd-Frank Act are introduced next year. This development could damage the credibility of the stress tests and create market confusion.

Recommendations

We believe the changes we propose will meaningfully improve the relevance of CCAR in evaluating individual banks without compromising the objectivity, credibility, and accuracy of the tests. Importantly, by ensuring that adjustments can work both to the benefit and detriment of a bank, as appropriate, we can avoid a dynamic where only advantageous adjustments are considered, thus placing every institution "above average."

1) Permit bank-specific adjustments in certain cases:

- The Federal Reserve should make bank-specific model adjustments if all of the following conditions are met:
  - A material difference between bank and industry-average performance exists and can be objectively observed in the data provided to the Federal Reserve.
  - The reason for the difference is well understood by both the bank and Federal Reserve.
  - The difference is likely to persist over the stress period.
- Although the Federal Reserve is, of course, the final arbiter of what differences ultimately merit bank-specific adjustments, having both the Federal Reserve and individual banks identify potential differences would improve the accuracy and credibility of the CCAR process.
- The Federal Reserve can identify differences itself and validate bank perspectives by:
  - Examining relevant data in the Federal Reserve's own rich data sets,
  - Comparing trends across the industry,
  - Validating purported differences using Federal Reserve models, and
  - Leveraging on-site exam teams together with the central horizontal teams to determine independently (i) whether these variances are driven by true differences in business model or strategy that are likely to persist and thus suitable for CCAR model adjustments or (ii) whether they are more tenuous and thus more appropriately ignored.
- The Federal Reserve's proactive identification or validation of bank-specific differences will protect against "one-way bias" (i.e., if banks only self-identify differences that work in their favor). As such, bank-specific adjustments in some cases would result in increased capital requirements for certain institutions.
- These benefits could be achieved without compromising objectivity and efficiency:
  - Discussions would be grounded in specific variances and observable data.
  - The Federal Reserve would not need to discuss its models but rather only seek a better understanding of the bank's specific trends and underlying drivers.

2) Strengthening two-way communication:

The Federal Reserve could also improve the effectiveness of the CCAR process as a micro-prudential tool by allowing capital plans to be directly informed by Federal Reserve feedback on the stress test.

- As we discussed at the FAC meeting in May 2012, banks plan capital actions today based on their own projections of performance under stress. This approval occurs without the Federal Reserve's perspective on their performance.
- We propose that near the end of the stress test and capital plan process, the Federal Reserve provide banks with preliminary feedback on their stress test submission. This feedback would include data similar to what would be disclosed publicly and would describe generally the nature of any material stress test discrepancies. Banks would then have an opportunity to revise and resubmit their capital plans within a certain period of time

(e.g., five days), prior to the Federal Reserve rendering a decision on the capital plan. This approach has the following advantages:
  - Enables bank capital plans to reflect both Federal Reserve and bank perspectives in determining discretionary capital actions,
  - Adds rigor to the planning process and creates greater market confidence by eliminating unnecessary guesswork, and
  - Ultimately, results in a capital plan that better reflects the true capital needs of the bank.
- To be clear, we propose limiting communication to any discrepancies in the stress test submission rather than any details of the capital plan itself. This approach would avoid creating an incentive for banks to "game the system" by being aggressive in their initial capital plan submissions in the hopes of negotiating their way to a "passing grade."

Item 4: REO Disposition

Council members recently indicated that they have been working on REO disposition programs that would expedite the return of foreclosed properties to the marketplace while minimizing the negative social effects on communities. Please describe these programs and your experience with their effectiveness.

- The majority of members observed that returning REO to occupant/investor ownership in a timely manner stabilizes neighborhoods and generally provides the best economic outcome for the seller and the community.
- Many members reported that REO disposition through traditional marketing and sales channels (realtors, bank asset managers) is producing good results.
- Some members reported stabilization of home values as being the catalyst allowing traditional marketing and sales channels to be effective.
- Other members identified loss-mitigation strategies as being effective in keeping distressed properties from becoming REO properties.
- Two nontraditional REO disposition programs were mentioned as being particularly effective:
  - Auction Sale Channel:
    - Utilizes online and on-site auctioneers to conduct scheduled auctions after a marketing period.
    - Customers provide proof of funds or documentation showing loan pre-approval and the property is sold to the highest bidder.
    - The seller reserves the right to decline the high bid if it is deemed too low.
    - This channel allows for a quicker disposition time frame relative to the traditional marketing and sales channels, while providing better price results relative to the Bulk Sale Channel.
  - Bulk Sale Channel:
    - Allows a number of properties to be sold to a given investor in one transaction.
    - Properties are "pooled" in a manner to represent a sample of the entire REO portfolio, preventing the appearance of targeting specific neighborhoods or income levels.

        - A property management firm is used for renovation, upkeep, and preservation regardless of the expected hold period and all the way through disposition, helping to minimize negative social effects.
        - Due diligence is conducted on investors to ensure they have the financial backing to keep the properties moving in the right direction, again helping to minimize negative social effects.
        - This channel allows a high volume of properties to be liquidated quickly, albeit at lower prices relative to the traditional marketing and sales channels and the Auction Sale Channel.
- One REO disposition program underway for which it is too early to determine success is the FHFA's pilot REO-to-Rental program.
    - The REO-to-Rental program was developed in conjunction with Treasury, HUD, FDIC, the Federal Reserve, Fannie Mae, and Freddie Mac.
    - The FHFA launched the pilot program in late-February 2012, and in the 2nd quarter of 2012, bids were solicited from qualified investors to purchase approximately 2,500 single-family Fannie Mae foreclosed properties geographically concentrated in Atlanta, Chicago, Las Vegas, Los Angeles, Phoenix, and Florida.
    - Investors were qualified to bid after a rigorous evaluation process and were evaluated on the basis of several factors, including financial strength, asset management experience, property management expertise, and experience in the geographic area.
    - The first completed transaction was announced on September 10, 2012, with 699 properties in Florida being sold at 95.8% of the current third-party appraisal valuation.
    - With the exception of the Atlanta properties, which received no acceptable bids, the remaining transactions are expected to be announced by the end of the month.
    - The FHFA noted that all properties were sold near or above appraised value.

Item 5: Europe and U.S. Banking (Update)

What is the Council's current assessment of the situation in Europe? What new prudential steps can U.S. regulators and banking institutions take to enhance the resiliency of the banking system to potential spillover effects from European financial difficulties?

- The Council recognizes the seriousness of the challenges confronting Europe, including recessionary conditions in many countries, high sovereign debt loads, and increasing borrowing costs. Ratios of sovereign debt to GDP are worsening as recessions outweigh the effects of austerity measures. Growth is restrained by fiscal tightening, deposit outflows, and the reduction of credit availability due to banks de-leveraging by shedding risk-weighted assets, building capital, and adjusting to stringent liquidity requirements. This contraction has greater impact on European economies as banks provide roughly 70% of credit intermediation in the Eurozone. The slow loan demand in the U.S. has allowed American firms to replace European banks in providing credit for American borrowers, with no apparent impact on pricing or credit availability, and banks have acquired attractive U.S. operations of European banks.

- The European Union, which has contributed greatly to geopolitical stability, makes for cumbersome decisionmaking and policy action. Regional differences in economic performance and some cultural differences in expectations of government have put additional strain on the structure at a time when markets are reluctant to continue to finance external debt, and the common currency has removed the traditional tool of currency devaluation.
- Government officials and business leaders generally have expressed confidence that Europe has the capacity, and will summon the unity of purpose and fortitude, to "muddle through" the current situation. The bond buying program of the European Central Bank has materially reduced financial risk, but the possibility of political and civil instability persists. Meanwhile, the United States has encouraged more decisive, coordinated action, and many observers are calling for a stronger European Banking Authority with more centralized prudential supervision, including a move toward a European deposit insurance system.
- Council members report that financial companies in their Districts do not have substantial exposure to Europe through European operations, through investments in European sovereign securities, or through significant lending to European obligors. Others note both direct and indirect exposure to financial counterparties with European exposure. Of course, European distress will be transmitted through the integrated world economy to dampen growth prospects at home, including through the results of multinational American companies and trade flows.
- Prudential supervisors have cautioned U.S. banks to lessen the impact of the European crisis on their capital and soundness.
- Strong capital positions, actions taken in response to stress tests, diversification, and restrictions on transactions with affiliates all bolster the soundness of U.S. banks.
- Council members encourage (i) continued liquidity support, (ii) coordination on capital and liquidity regulation, and (iii) transparency about European exposures of U.S. banking companies to reassure counterparties and investors.

Item 6: LIBOR

What is the best way to reform the LIBOR or to create credible alternative(s), and should the banking industry or government undertake such action?

Overview

LIBOR is the predominant interest rate benchmark globally and is estimated to be referenced in transactions with a notional outstanding of $300 trillion or more. As currently defined and constructed, LIBOR has a number of weaknesses that have eroded its credibility:

- LIBOR has been criticized as too reliant on expert/subjective judgment of contributing banks.
- The interbank term borrowing market, upon which LIBOR is based, has become significantly less liquid, making the submission to LIBOR reliant on expert or subjective judgment of the contributing banks.
- There is no regulatory oversight or third-party verification of LIBOR submissions.

- There is significant concern that contributing banks have submitted, or could submit, inaccurate rates to either influence perceptions of their creditworthiness or benefit their trading positions.
- Numerous legal actions are pending or expected related to possible LIBOR manipulation.

Various regulators are undertaking reviews of LIBOR

- U.K. Chancellor of the Exchequer – Chancellor George Osborne ordered the FSA to conduct an independent review of the LIBOR scandal. The initial discussion paper led by Martin Wheatley, who will head the U.K.'s new Financial Conduct Agency, was released on August 10, 2012 (comments are due September 7). The final report will be issued before the year's legislative session ends.
- E.U. – The European Parliament has solicited public input on whether the LIBOR and EURIBOR benchmarks need to be regulated and/or reformed. The European Commission released a "Consultative Document on Regulations of Indices" on September 5, 2012, seeking comment on necessary changes to the legal framework for benchmarks, and its antitrust arm is investigating the LIBOR and EURIBOR benchmarks.
- Financial Stability Board (FSB) – Mark Carney (BOC) and Mervyn King (BOE) announced that global central bankers will undertake a review of LIBOR during the September 2012 Basel negotiations, which is likely to lead to the issuance of a consultative paper in late September.
- U.S. Congress – in July 2012, Congress launched inquiries into LIBOR, widening the scope to include U.S. banks and U.S. regulators along with U.K. banks.

Regulators and market participants are discussing options to either reform or replace LIBOR ---

- LIBOR reforms under consideration include the following:
    - Increase governance, oversight, transparency, and robustness of the current process.
    - Apply a mathematical process to the rate submissions to reduce vulnerability to manipulation.
    - Reduce LIBOR coverage to only currencies/tenors with sufficient observable market data.
    - Change panel composition or impose government-mandated participation.
    - Base LIBOR on actual transaction data.
    - Introduce regulatory oversight of rate setting.
    - Introduce mechanism for independent verification of submissions.
- LIBOR replacements under consideration include:
    - Overnight index swaps (OIS) rates, T-bills, Repos, CD rates, Central Bank policy rates, and
    - Blends of rate and credit market data (e.g. CDS) to try to replicate LIBOR as banks' cost of funding.

FAC Recommendation

- LIBOR is too intertwined with the global financial system to be replaced in the near term, but it can be improved by strengthening governance and oversight and increasing transparency.
- Council members believe actual transaction data should be used where possible, but it is unlikely to fully replace survey responses because of limits to data availability. One FAC

member suggests lack of trade data could be addressed through broadening the definition of LIBOR to include money market funds, commercial paper, CDs and other funding sources.

- The governance of LIBOR should be strengthened by measures such as:
    - Broadening membership in the Foreign Exchange and Money Market (FX&MM) Committee, with a focus on recruiting "independent" (i.e., noncontributing member) banks,
    - Increasing transparency by releasing details on committee membership and conflicts of interest, as well as meeting minutes,
    - Shifting oversight of LIBOR entirely from the FX&MM Committee to a wholly independent entity, possibly even a commercial enterprise, and
    - Requiring more transparency from the individual participants. Several FAC members, however, noted sensitivity over public disclosure of individual institutions' submissions may contribute to the lack of accuracy of LIBOR and may not be needed.
- To varying degrees, most members support some level of government or regulatory involvement in the LIBOR rate-setting process. For example, one member strongly suggested that the LIBOR rates should be set by a government entity rather than an industry trade association, and that institutions' submissions should carry the weight of regulatory filings. Another member, however, suggested government should have no role in LIBOR reforms.
- Longer-term alternatives to LIBOR should continue to be considered. Suggestions made by Chairman Bernanke and others to use existing measures that are based on observable market data, including OIS and Repo rates, while all having both advantages and disadvantages, should be considered as possible longer-term alternatives to LIBOR.
- Widespread reliance on LIBOR throughout the financial markets, including for loans, swaps, and investment vehicles (investment funds included), raises the potential for numerous legal actions against parties using LIBOR in good faith, based on well-established market practices. Regulators should consider ways to limit the market disruption that such actions could cause.

<u>Item 7</u>: <u>Economic Discussion</u>

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

Growth remains restrained due to global uncertainty.

- Consumer and business confidence is waning, which in turn is suppressing investment and hiring activities.
    - Regulatory changes and uncertainty are having adverse consequences, suppressing growth.
    - There are increasing concerns about tax increases and federal spending cuts scheduled to take effect in 2013.
    - Unemployment and underemployment remain elevated nationally, but some regions are experiencing improvements due to continued strength in the oil and gas industry and a nascent recovery in residential real estate.

    - The Eurozone crisis is affecting the New England region in particular as it relies heavily on trade with Europe.
- Excluding the automobile sector, which continues to improve, manufacturing activity has moderated in some regions due to earlier inventory replenishment and lower export demand.
- Analysis of credit card sales data over the past 12 months indicates the following:
    - Retail sales growth (excluding auto) has decelerated, with home improvement and department store sales particularly demonstrating more weakness.
    - Discretionary spending growth continues to outpace nondiscretionary (excluding gasoline) spending growth.
    - The South Central region[2] realized the highest year-over-year sales volume growth, likely due to growth in the oil & gas and manufacturing industries.
    - The New England and Mid-Atlantic regions have decelerated from the highest sales volume growth to the lowest sales volume growth regions.

Credit is available but loan demand is low.

- Despite a willingness to lend on competitive terms, some banks are encountering lackluster loan demand as business operations and household finances continue to be conservatively managed.
- Consumers continue to de-leverage resulting in continued improvement in credit quality as evidenced by low personal bankruptcy filings and record low credit card and auto loan charge-off and delinquency levels.
- Student loans continue to grow rapidly due to expanded federal student loan availability and tuition/enrollment increases.
- There is increasing disparity between prime and subprime consumer credit availability, due to increased regulations and a decline in the number of subprime credit providers.
- Analysis of credit card charge-off and delinquency trends over the past 12 months indicates that the Mountain and Pacific regions continue to lag other regions in terms of credit quality and receivables growth.

Real estate prices and inventory levels continue to improve.

- Residential real estate prices and inventory levels across all regions are demonstrating modest improvement.
    - The National Association of Home Builders Housing Market Index improved for a fourth consecutive month in August.
    - Prices and housing starts in Florida are up year-over-year; however, foreclosure activity has increased as well and Florida's shadow inventory is almost 2.5 times the national average.
    - Rental residential real estate market is faring better than the owner-occupied market.
- Commercial real estate prices are showing some improvement, but demand for retail and office space continues to be weak.

[2] South Central region includes Alabama, Arkansas, Kentucky, Louisiana, Mississippi, Oklahoma, Tennessee, and Texas.

Inflation remains subdued but elevated petroleum prices are having mixed effects.

- High gasoline prices in the 12th and 7th Districts, especially in California and Illinois, are having a detrimental effect on disposable income and spending.
- The oil and gas industry continues to be a source of job growth in the 10th and 11th Districts, with some areas reporting inadequate labor supply and an increase in economic activity around remote oil and gas fields.

Item 8: **Monetary Policy**

How would the Council assess the current stance of monetary policy? What do Council members see as the ongoing impact of the Federal Reserve's portfolio?

Overview

Attempting to balance all the conflicting currents in the economy, most members reiterated their monetary-policy assessment provided at the May meeting: While the highly accommodative policy in place since May continues to be appropriate, further accommodation is not warranted.

- In considering the current stance of monetary policy, Council members cited continuing drags on economic recovery from housing, unemployment, and overall uncertainty. The unemployment rate is currently at 8.1%, and there are few signs that economic growth will accelerate materially over the next several quarters or that unemployment will fall meaningfully by the end of 2013.
- Inflation is slated to rise, but not meaningfully, and should stay contained in a low range of 1.3-1.7% range over the next 6-9 months due to base-year effects. Looking further out, headline and core inflation may rise to roughly 2% in 2014, but this is within the Fed's implicit comfort zone. With inflation pressures relatively benign, the Fed has scope to maintain a loose monetary stance to support job growth.
- However, members cited risks associated with the current policy, including:
  - Near zero interest rates adversely impact savers, retirees, pension funds, and the overall profitability of financial institutions, which in turn adversely impacts total spending;
  - The publishing of forward interest rate guidance can serve as an "anti-stimulus" for investment and business growth; and
  - Further, while monetary policy accommodation could have a marginal impact on economic growth and unemployment, the costs of the policy are potentially more significant.
- Members expressed the concern that a major issue is not the rate environment but a lack of consumer demand that is delaying business investment. In addition, many members identified the need for more coordinated and targeted fiscal, trade, tax, and regulatory policies, as well as more clarity around these policies as opposed to an over reliance on monetary policy.
- Other policy options available to the Fed include additional asset purchases, lowering the interest rate on excess reserves, and/or changes to the forward guidance on short-term interest rates. Member consensus is that the main effect of those policies would be to marginally decrease interest rates. However, while the lower rates could provide some support to risk appetite in financial markets and result in some improvement in business

and consumer confidence, long-term interest rates are close to historic lows and additional asset purchases are unlikely to exert sizeable downward pressure on rates.

- Members also stressed that negative real interest rates place a significant strain on financial institutions, and a further rise in the share of long-term government bonds held by the Federal Reserve threatens to reduce market liquidity and pricing information. Similarly, lowering the interest paid on excess reserves could threaten the functioning of repo and money market funds. There are other consequences to current monetary policy that may not be readily apparent, such as incenting financial institutions and investors to seek higher yields by increasing risk profiles in investment accounts in the areas of credit and duration.
- In addition, there is the risk that further balance-sheet expansion, including the purchase of agency mortgage-backed securities (MBS), is depriving investors of better potential yields and could weaken the public's confidence in the Fed's ability to exit smoothly and contain inflation. On this last point, concern has been raised that we are in unchartered waters, and when the time comes to unwind, there will be uncertain effects, including risks to price and financial stability.

Appendix to Item 3

Sample driver of differences between Federal Reserve and Bank projections

In CCAR 2.0, the Federal Reserve made no distinction in its projections for observable, material differences in mortgage credit performance across banks.

(b) (4)

[redacted]

(b) (4)

[redacted]