AGENDA

Meeting of the Federal Advisory Council
and the Board of Governors

Friday, February 8, 2013

Item 1: Current Market Conditions

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

- Generally speaking, loan demand continues to show improvement in the South Central portion of the country and to be sluggish in the remaining regions. In Texas, the state's business-friendly political environment has resulted in numerous corporate relocations, with the result being more demand for credit. Elsewhere, members cited intense competition among lenders for what deals are available, with continued compromising on credit terms and structure. Several members reported uncertainty over healthcare costs, tax policy, and the mounting U.S. debt as reasons why potential borrowers are refraining from business expansion. These factors appear to be particularly constraining business investment, reflected by tepid C&I lending and chronically undrawn lines of credit. Little change in this outlook is expected by the Council.

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

- In Texas, application flow continues to show improvement. However, building and maintaining liquidity and controlling costs seem to take precedence over expansion for many small businesses across the country, resulting in an overall credit demand from small businesses that could best be described as "tepid." Credit is readily available and loan standards have remained sound; however, borrowers are remaining cautious. Some members reported a bump in loan demand in the fourth quarter, reflecting an effort to beat the forthcoming tax law changes. The National Federation of Independent Businesses reports that business-owner confidence, while having risen slightly, is still near its lowest level in survey history. Growth in lending in this category seems to be offset by other businesses using excess cash to pay down existing loans. Uncertainty over the impact of Washington policies is keeping small businesses cautious.
- A particular concern of the Council regarding small business lending is the regulatory insistence that real estate collateral taken through an abundance of caution be treated and reported (on FR Y-9s) as a stand-alone real estate loan. This requirement subjects the loan to normal real estate appraisal and debt-service coverage tests. In practice, these loans are underwritten based on the creditworthiness of the small business, not the real estate value. Insisting that they be reported as real estate loans generates regulatory compliance difficulties.

***(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 with your expectations?

- Multifamily projects continue to be the one CRE sector that is past recovery and into expansion. Vacancy rates in office building projects continue to decline; however, retail space continues to languish. As weaker projects have been flushed out of the system, delinquencies and charge-offs have continued to decline. Pockets of strong positive performance are emerging across the country in retail, industrial, and lodging projects; however, these are generally the exception as opposed to the norm. Overall improvement in CRE markets has been slow but positive.

***(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?

- For projects with solid equity and good sponsorship, credit remains readily available. The excess inventory from underperforming properties is keeping a lid on growth in new projects, with renovation of good existing projects being preferable to launching new ones. There appears to be little speculative activity across the country, a fact that is probably due to apprehension on the part of both lenders and borrowers. Multifamily projects continue to be the superstar in the construction arena, with vacancies in such projects presently at a 12-year low, despite the increase in construction activity. Otherwise, growth in construction lending largely remains unchanged from the previous quarters.

***(D) Agricultural Lending*:**
Have there been any recent changes in agricultural lending? What is happening to the valuations for farm land?

- Agricultural land prices are veering further from what makes sense from a production standpoint as investors have continued to purchase farmland. Most areas report sizable gains in agricultural land prices to the point where some express reservations about lending on such values to farm producers. Members believe the run-up in agriculture land prices is a bubble resulting from persistently low interest rates. Investors who are seeking a positive return on their funds have shied away from bond markets and have purchased rural real estate as both a hedge against inflation and a means of achieving better than the negative real return associated with fixed-income securities.

***(E) Consumer Lending*:**
What changes has the Council seen in consumer lending?

- No significant changes are being observed. What increased demand there is seems to be centered in home improvement and automobile loan requests. Several members report an uptick in unsecured installment loan requests, as the lack of available equity in consumers' homes is precluding that as a source of collateral. Lenders are awaiting the impact of the

Consumer Financial Protection Bureau's final ruling on revisions to the Ability-to-Repay and Qualified Mortgage rules and are apprehensive that they will be caught between the seemingly conflicting requirements of the CRA and the new CFPB rules.

(F) Home Mortgage Lending:
What changes has the Council seen in the home mortgage market in the past three months?

- Mortgage volumes continue to grow as consumers respond to extremely low mortgage rates. One member reports having trouble hiring enough qualified mortgage loan processing personnel to keep up with the loan demand. Much of the activity has been centered on refinancing, particularly after the government's HARP program was enacted. Nationally, four-fifths of mortgage activity is in the refinance arena. Apprehension over tax hikes, expiration of the payroll tax reduction, and fiscal uncertainty in general has consumers still reluctant to undertake a move.

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

- In parts of the country where home values did not rise unrealistically and then crash, the housing market seems to be in a recovery mode. With the exception of judicial states, foreclosures seem to have leveled off and existing home prices seem to have found a bottom. New home construction is still very tepid, however, especially in parts of the country still suffering from high unemployment. In some areas, sales are centered in lower-priced housing, with sales not going to homeowners but to investors turning these properties into rental units. Financing remains an issue for potential buyers. Top-notch buyers have numerous financing alternatives to choose from, while the marginal credit-risk buyers have few, if any, lenders to whom they may turn. The sooner the decks are cleared of foreclosed properties, the sooner prices will stabilize; therefore, investor purchases of residential properties should be encouraged.

(H) Mortgage Foreclosures:
What changes has the Council seen in the pace of mortgage foreclosures during the past three months?

- Foreclosure activity has either remained steady or begun to slowly decline in various parts of the country. Members cite trouble in getting foreclosures through clogged court systems, especially in judicial states, and in the government's efforts to forestall foreclosure as the major impediments to "clearing the decks" and allowing the market to work once again.

Item 2: Recent Events Affecting Mortgage Markets:

During the past month, there have been several settlements of legal claims and rulemaking on ability to pay and qualified mortgage standards that could affect the availability of mortgage credit in the future. Although these events are

relatively recent, what effects does the Council expect on mortgage markets? Which institutions will continue to make mortgages and how will they derive profits? What type of mortgage contract is likely to evolve? For consumers, how will the cost and availability of mortgages be affected?

Overview

- While the recent legal settlements and the completed rulemakings will have definite impact on mortgage credit, there are numerous other interrelated mortgage issues not directly questioned in this agenda item that complicate an informed, comprehensive response and a forecast for the future availability and bank profitability of mortgage products. The yet-to-be finalized QRM rules impacting securitizations, the recent CFPB rules on servicing standards, the future structure and role of GSEs, and pending Basel III capital requirements for mortgage assets will all contribute to the shape of the future environment and drive the business model for mortgage banking. In addition, there are secondary implications that are not fully appreciated or understood at this time. For example, how does the availability of credit to low-income groups work when there are apparent conflicting motivations between QM standards and CRA goals?
- Reasonably, it does appear that the nexus of completed settlements and regulations along with the issues still being addressed can only lead to higher compliance costs; greater operating complexity for originating banks; fewer product alternatives for consumers; a reduced credit-risk appetite and, hence, less credit supply to consumers; and the consolidation or elimination of smaller banks and nonbank originators who cannot achieve economy in dealing with the higher costs.

The comments of the Council members were mostly uniform and are summarized as follows:

- The majority of Council members believe that recently finalized regulations from the CFPB around QM, servicing, and loan officer compensation are likely to further constrain mortgage lending and make credit more expensive to the consumer. The cost to consumers for QM and non-QM products will rise and the choice of mortgage products will be limited.
- Costs for prime borrowers in qualifying products may increase modestly due to increased costs of origination compliance and potentially increasing capital requirements. These increases may be partially offset by decreasing costs of legal uncertainty and the establishment of a safe harbor that minimizes open-ended "buyback" risks.
- Most members further believe that the new regulations will serve to eliminate or significantly limit origination of nonstandard mortgage products that lie outside of the QM boundaries of regulatory and legal safe harbor to all but the best customers with significant, existing financial relationships with the originating institution.
- Subprime and marginal creditor originations will be nonexistent. The cost of foreclosure compliance is simply too high. Further, mortgage loans to self-employed borrowers with uneven cash flows of limited predictability or who have contingent liabilities will be exceedingly difficult for banks to make and even more difficult for otherwise creditworthy borrowers to obtain.
- Smaller banks and monoline, nonbank mortgage companies, which do not achieve an equivalent scale economy to larger banking institutions in terms of leveraging the increased

operating costs and complexity of regulatory compliance, will be competitively priced out of the mortgage market.

- Caps on aggregate fees and costs (many of which are fixed) could adversely limit the availability of smaller mortgages.

Item 3: Domestic Regulation of Foreign Banking Organizations

The Federal Reserve has recently proposed significant changes to the regulation of foreign banking organizations in the United States. What are the Council members' views and concerns regarding this proposal? How would the proposal affect banking competition in the United States and the competitiveness of U.S. banks abroad?

- As noted, the Federal Reserve's recent proposal regarding the regulation of foreign banking organizations (FBOs) in the United States marks a significant change in the approach taken by the Federal Reserve since the adoption of the International Banking Act of 1978. Many members of the Council believe that the proposal establishes a balance between the regulation of foreign and domestic financial institutions in the U.S. while acknowledging concerns that foreign regulators may impose similar restrictions on U.S. operations in host countries.
- The proposal also raises a number of issues that merit attention. For example, the "one size fits all" mandate requiring FBOs to operate through an intermediate-level holding company (IHC) may work well for some, but it does not take into account the various forms of doing business in the United States that the Federal Reserve has long permitted FBOs to adopt. As a result, IHC capital will be effectively trapped in this country, making consolidated capital management more challenging and making global resolution of internationally active firms more difficult.
- The proposal also opens the door for the Balkanization of capital regimes globally as other prudential regulators may feel obligated to respond in a similar fashion. Existing frameworks for global coordination could be replaced by individual sovereign regulation, making global risk management challenging and systemic risk more difficult to control. While most would agree that the depth and severity of the recent financial crisis calls for effective responses to guard against the recurrence of such an event, even in the context of the orderly liquidation authority granted to the FDIC under Title II of the Dodd-Frank Act, there is a recognition that there is more than one path to the successful resolution of large, complex financial entities. The "single point of entry" model proposed by the FDIC is but one of a number of approaches that may be taken in the resolution process. Alternative business models for FBOs operating in the United States should continue to be considered as well.
- Similarly, forcing all U.S. branch and agency operations of FBOs to maintain a portion of their liquidity buffer in the United States takes into account neither the capital and liquidity structure of the foreign parent nor the comparability of that parent's home country regulatory regime. In adopting a uniform approach to all FBO branch and agency operations in the United States, the Federal Reserve effectively does away with the source

of strength assessments that have long been applied for these and other purposes and that have long served as the basis of international cooperation.

- Finally, in some cases, the proposal to require IHCs to hold minority interests in U.S. companies that are deemed to be controlling interests as defined in the Bank Holding Company Act could result in adverse tax consequences as well as punitive treatment under the Basel III capital guidelines. There should be some flexibility in the final rule that emanates from the proposal regarding the legal entity holding such investments so that the Federal Reserve is able to obtain a "line of sight" over the investments while at the same time having such investments housed in the legal entity that is already managing these tax and capital issues.

Item 4: Loan Loss Reserves

What is the Council's view of FASB's proposed change to loan loss reserving from the existing incurred loss model to a Current Expected Credit Loss (CECL) model? If the accounting change should be approved, how should it be phased in and how should the impact on capital be treated?

Key elements of the FASB's proposed model:

- The CECL model replaces the "incurred loss" concept and
  - Bases reserves on the estimate of all contractual cash flows not expected to be collected
  - Mandates nonaccrual treatment when it is not probable that the lender will receive "substantially all" principal or interest on a loan
  - Requires reserves on loan commitments if they represent noncancellable legal obligations
  - Applies to all originated and acquired loans, other receivables and debt securities.
- Implementation date not yet defined, but earliest expected to be 1/1/2015.
- A cumulative-effect adjustment to reserves (through equity) recorded upon adoption.

The Council supports the intended objective of the CECL model and believes that there are several positive aspects:

- The model covers a longer timeframe and theoretically enables more judgment, resulting in higher reserves. By some estimates, reserve levels are expected to increase 25% to 50%, with the largest impact on consumer loan reserves.
- Difficulty in identifying the loss-triggering event makes the incurred-loss concept challenging and has led to diversity in practice; moving off that model is a positive step.
- Moving to a more consistent approach on impairment of financial assets, including the elimination of a separate purchased-credit-impaired model, is a positive change toward simplifying the various impairment standards.
- The CECL model provides better alignment with credit grading and economic capital models.

However, the FASB proposal also poses some significant concerns for the industry, especially if it is ultimately implemented as "life of loan" reserving:

- The model results in a timing mismatch of earnings and credit losses, ignoring the association of credit risk and pricing (including loan origination income, which must be amortized).
- Forecasts of expected losses become less reliable as they look farther into the future, and this may call into question the validity of short-term reported results as well as reduce comparability among similar portfolios.
- Pro-cyclicality of reserve changes may not be resolved (and could possibly be accentuated) as it may be difficult to support reserve reductions during a period of economic weakness based on forecasted improvement or vice versa.
- The model could be conducive to pro-cyclical lending since a reduction in new loans (especially longer-term and higher-than-expected loss loans) during economic downturns could immediately boost profits and capital. Markets such as private mortgage and student lending could suffer a disproportionate impact.
- Requiring Day 1 recognition of lifetime-expected losses will make growing a lending business more challenging, and that could result in less availability of credit and less competition.
- Independent auditors will require much more evidence to support forward-looking assumptions and the burden will be on the banks to provide it; that burden will likely be compounded by expected PCAOB scrutiny on audit firms' evaluation of these estimates.
- For entities with dual reporting (U.S. GAAP and IFRS), there is significant incremental operational burden given the lack of convergence between FASB and IASB models.

Since banks are already adopting enhanced capital standards, the impact from the CECL proposal might be overlapping in objective and would result in the following unfavorable impacts on regulatory capital:

- If higher reserves are required without proportionately reducing capital requirements, total coverage may be excessive.
- In addition to the one-time reduction of retained earnings, an increase in reserves would cause an increase in deferred tax assets ("DTAs"), which could increase disallowed DTAs and further reduce regulatory capital (especially in periods of economic stress).
- During periods of excessive credit growth, the adverse impact on regulatory capital would be compounded through common equity and DTAs because of the combination of the countercyclical buffer requirement (for the largest banks) and increasing reserve levels related to new originations.
- The adverse impact on regulatory capital will be higher in the U.S. than in other countries (due to FASB/IASB inconsistencies), which could lead to unintended consequences such as geographical arbitrage.

Recommendations:

- Recognizing that this will have far-reaching impacts on banks and the economy, significant modeling across asset classes and economic cycles should be done to identify unintended consequences.
- Sufficient implementation time should be allowed as many institutions will lack the required historical data on lifetime losses necessary to implement the proposal and will

likely need a significant amount of time and resources to build, test, and validate new models utilizing forecasted economic data.

- Regarding regulatory capital, a multiyear phase-in period should be provided where the incremental reserve impacts on capital are included on a pro rata basis in order to mitigate the impacts on the banking industry and on broader credit availability.
- Since the CECL proposal permanently increases the dollar level of reserves held by the banking industry, recognition for reserves within tier 2 capital should to be increased commensurately.
- Efforts to prioritize the alignment between U.S. and international accounting standards should be encouraged.

Item 5: Cyber Attacks and Banking

Given the recent substantial increase in cyber attacks, particularly distributed denial-of-service attacks on financial institutions, has the Council seen the banking industry undertaking new programs or initiatives to better prevent, detect, and respond to such attacks?

- Given the unprecedented size and duration of recent distributed denial-of-service ("DDoS") attacks, institutions are now reviewing, assessing, and improving their plans for cyber-attack response and mitigation. Some of the affected institutions have requested and received, through the Department of the Treasury,[1] technical assistance from the National Security Agency, which has been helpful in mitigating the attacks. Some institutions are investigating new technologies for defense of DDoS and other cyber attacks through their Internet service providers or security vendors. Vendor activity in this area has increased and is extending to small and midsize institutions that historically have not been primary consumers of these high-end security services. Internally, some institutions are reviewing their incident response processes to better manage recovery time and communications between IT, employees, vendors, media, and customers.
- Over the past decade, the Financial Services Information Sharing and Analysis Center ("FS-ISAC") and the Financial Services Sector Coordinating Council ("FSSCC") have grown substantially to serve as the basis by which the financial services sector develops critical infrastructure protection policies. Following the DDoS attacks, the FS-ISAC was the primary mechanism by which the affected institutions and law enforcement agencies shared threat information and mitigation techniques. The network of bank information security and threat intelligence personnel within the FS-ISAC has in many instances leveraged each others' resources to counteract the attacks. Other industry organizations – such as BITS, the technology policy division of the Financial Services Roundtable – focus on cyber security policies affecting the industry. There is no doubt that cyber security is a critical issue for the industry and the financial system as a whole.

[1] The Department of the Treasury serves as the Sector Specific Agency for the banking and finance sector, as designated by the Homeland Security Presidential Directive-7 and the National Infrastructure Protection Plan (NIPP).

To what extent do cyber attacks pose risk to the financial health of individual firms or to the financial system more broadly?

- Cyber attacks can create significant financial, legal, and reputational risk to banks and the financial industry, including smaller institutions that often have less sophisticated security systems. Although there were no major breaches from the recent DDoS attacks, they still created customer dissatisfaction and loss of confidence. However, in the case of an actual intrusion or a well-planned coordinated attack to core payment and settlement systems (e.g., Fedwire, clearing house interbank payment system (CHIPS), SWIFT, central securities depositories (CSDs), and international central securities depositories (ICSDs)), the potential to erode confidence in our nation's critical infrastructure and disrupt our nation's ability to conduct financial transactions is a significant systemic risk. The high frequency of sophisticated attacks, such as DDoS, System Breaches, or Advanced Persistent Threats focused on large amounts of private customer data or intellectual property, is unfortunately becoming "business as usual." Risks that a loss of a critical infrastructure asset could pose to the U.S. economy include:
    - Disruption to the provision of credit, including the creation of new credit or the servicing of existing lines of credit
    - The loss of liquidity in the marketplace, including the non-availability of funds or assets through inability to move funds or buy/sell securities to individuals, investors, government, and businesses
    - The loss of confidence in the financial system would have a knock-on effect to the economy.

What additional steps should the private sector, the Federal Reserve, or the public sector more broadly take to manage these risks?

- **Information sharing among financial institutions** is critical to understanding the risks, trends, and best practices for mitigation against cyber attacks. Industry associations, such as FS-ISAC, FSSCC, and BITS, foster this kind of collaboration between member institutions and government agencies.
- **Enhancing cross-sector cooperation**, particularly with the energy and telecommunications sectors, can also play an important role. In particular, Internet Service Providers ("ISPs") should be encouraged to play a more significant role in the identification and mitigation of cyber attacks and be included in the effective sharing of information. An example of a successful collaborative, cross-sector group is the Advanced Cyber Security Center ("ACSC") in Massachusetts. The ACSC brings together expert practitioners from health care, energy, defense, financial services, technology, and higher education sectors to share best practices, conduct real-time threat analysis, and develop next-generation secure computing architecture. The ACSC aims to develop a national model to promote collective defenses against the advanced threats between the Center's 22 cross-sector and private-public members.
- **Improving real-time response to cyber attacks** by working to more rapidly distill and disseminate best practices after unique attacks and to automate the analysis of threat data.
- **Appropriate identification of critical systems** is the key to their protection. The FSSCC, in concert with the Department of the Treasury and Department of Homeland Security, is

currently developing a process by which critical infrastructure in the financial services sector is determined. The process is designed to identify the systemic functions supporting the operations of the financial sector, such as clearing, settlement, payment, and trading, and to evaluate those systems based on functionality of critical processes. It is essential, however, that the designation of critical infrastructure be carefully limited to systems posing systemic risks, and that those nonsystemically important enterprise-wide functions (e.g., payroll, human resources, etc.) not be inappropriately designated as critical infrastructure.

- **Other steps** that can be taken by industry include enhanced cyber security education to employees and consumers and ensuring that response programs are properly implemented and tested.
- **The role of The Federal Reserve and other regulators:**
    - The Fed plays an important role as an operator of critical infrastructure while several Federal Reserve Banks are already active members of the FS-ISAC. In addition, the Financial and Banking Information Infrastructure Committee ("FBIIC"), comprised of financial regulatory officials, is charged with enhancing the resiliency of the financial sector and promoting public/private partnerships. The FBIIC regularly meets with members of the FI-ISAC, FSSCC, and other industry associations to improve coordination and communication among financial regulators. We would propose that the Fed take a more active coordination role between member institutions, financial regulatory agencies, and intelligence agencies to expand efforts identifying and protecting critical infrastructure and establish a centralized source for communications about cyber attacks. As the coordinator between these groups, the Fed can provide expertise on financial services to the Department of Homeland Security and the FBI, while also helping ensure other government agencies do not create potentially duplicative new regulatory requirements. While the industry understands the need for government to preserve the confidentiality of some information, we would like to see greater reciprocity; government agencies should provide more information to industry in a timely manner to better secure critical infrastructure.
    - The Fed is already well equipped to play a role in sharing sensitive information among banks without disclosing commercially sensitive data (e.g., Quantitative Impact and Horizontal Studies) that it conducts as part of its normal supervisory process. The Fed could expand its role by providing cyber security advisory services as a trusted interlocutor between banks and other government agencies in relaying selected threat information to the banking community, as well as relaying appropriate information from the banking sector to other parts of government. Such a program should also include market infrastructure, such as clearing houses and exchanges.

- **Other government actions:**
    - Increasing international cooperation will be a challenging goal, recognizing the various political factors involved when dealing with some countries. Other actions the public sector could take to improve the cyber security environment for banks could include more broadly distributing security clearances and increasing declassification of threat information.

- **The role of the financial industry:**
  - The financial industry is also responding to the cyber security threat, perhaps most notably in a major coordinated effort led by BITS.

<u>Item 6</u>: <u>Measurement of Systemic Risks</u>

Complexity and interconnectedness have been widely discussed as a source of systemic risk to the financial system. However, applying those concepts in order to measure the risk posed by systemically important financial institutions is challenging. How does the council perceive that complexity and interconnectedness contribute to systemic risk?

- Throughout history, idiosyncratic risk and ultimately failure has, on occasion, led to systemic risk across the industry. After all, the bank funding model depends on confidence, which if depleted can lead to deposit withdrawal and the drying up of funding sources extending far beyond the original problematic institution. This "indirect" path to systemic risk can best be mitigated by tough regulation forcing higher capital levels, stronger liquidity, reduced leverage, improved deposit insurance, and significantly reduced principal risk taking. The Basel III capital and liquidity rules, stress tests, and Dodd-Frank legislation together with more prudent compensation structures have led to a safer financial system and have materially changed, but not eliminated, the potential for systemic failure by reducing systemic risk.
- Beyond these factors, the Council is unanimous in the view that complexity embedded in the modern financial system and the interconnectedness of institutions contributes to ongoing systemic risk. Market participants and regulators tend to agree, and much has been done. Examples of the steps taken include the establishment of the Legal Entity Identifier to standardize coding and therefore sourcing of transactions; punitive RWA treatment of more complex financial instruments; Volcker Rule capital limits on proprietary investing and trading what often are the most complex products; exchange trading and central clearing for certain OTC derivative contracts; new counterparty limits on credit, Prime Brokerage balances, and trading put in place by large financial institutions with respect to their interactions with each other; and the establishment of board risk committees as well as more rigorous franchise and new product approval committees. These steps amount to a launching pad for a more holistic view of risk.

Are there measures or methods that can be used to assess financial complexity, interconnectedness, and systemic risk to the financial system?

- The Council believes that such measures exist and offers the following as suggested areas for the Board of Governors to focus on. This is an initial list of thought starters, which is incomplete given the magnitude of the question asked.
  - *Transparency:*
    - Implement consistent and expansive disclosure rules across regions, working with the SEC and other global regulators, on counterparty credit and balances; geographic exposure (developed, emerging, peripheral, etc.) for each

institution’s trading/credit partners; and by sector and subsector. Currently, disclosures are incomplete and inconsistent, and therefore risk across the sector is not fully understood.

    - Central clearing for certain OTC derivatives is an example of a measure taken to increase transparency and reduce systemic risk:
        - Central clearing substantially reduces the bilateral exposures among financial institutions and interconnectedness between financial institutions and could benefit the financial system as a whole. However, the mutualization of the derivatives risk within central clearing entities requires standards and procedures to ensure these entities do not become “too big to fail” risks.
- *Enforcement:*
    - Oversee concentration limits and credit limits for each institution, sector, and region.
    - Engage in a regular dialogue with boards and management on how each institution is measuring and monitoring exposures.
    - Develop robust analytic tools for the Office of Financial Research or other designated body to interpret and apply across comprehensive data sets.
    - Adopt best-practice models as used by institutions today.
- *Harmonization:*
    - Develop standard terminology for use across institutions and regulatory regimes (e.g., RWA model inputs/methodology).
    - Develop standard product nomenclature (AAA tranche of a BBB-rated basket of securities).
- *Product complexity:*
    - Monitor sustained pricing premiums as a leading indicator of product complexity.
    - Monitor excessive legal documentation required to support products.
    - Monitor consumer, board, and senior management understanding of complex products (e.g., pick-a-payment mortgages, CDO/CLO securities, DVA/CVA, etc.).
- *Research:*
    - Too little appears to be known about the potential algorithmic trading models have to move and distort markets.
    - Careful analysis should be undertaken of institutions sharing common utility grids.
    - When businesses share a common operating platform, a failure of the data inputs or the platform itself can damage both institutions so careful cost/ benefit analysis of shared infrastructure is important.
    - Little effort appears to have been made to carefully understand the impact of the shadow banking sector on the regulated banking sector and the risks that sector imposes. For instance, Waddell & Reed and Long-Term Capital Management were relatively obscure institutions that featured prominently in times of global stress. Many asset managers, hedge funds, trading firms, and

    payments providers operate outside the regulated structures in place but interact with size with the regulated sector.
  - *Knowledge sharing (regulator/participant feedback loop):*
    - The policy implication is that it is important to create a feedback loop between regulators and financial institutions. Regulators are in the position to gather system-wide information of interconnectedness. If the information is provided to key market players with the assessment of their individual interconnectedness and the potential impact to the systemic risk, it would become a powerful tool to prevent/mitigate "excessive" interconnectedness.
- Simplification of business models:
  - A view on the Council suggested that a separation of commercial and investment banking had merit to reduce complexity and interconnectedness. Similar proposals have been raised in Europe, the UK, and even within a region of the Federal Reserve System. Obviously this is a very important discussion that should not be considered in the context of the question before this Council alone. However, it should be noted that large, global institutions carry many benefits of scale, strength, earnings diversification, and global capability; furthermore, of the four major institutions to fail or be forced to merge in the 2008 financial crisis – Lehman Brothers, Wachovia Bank, Merrill Lynch and Bear Stearns – not one of them had significant overlapping investment banking and commercial banking activities. Similarly, the recipients of TARP funds did not need those funds because of issues relating to the fact that they operated investment banking and commercial banking businesses. Nonetheless, the "separation" argument has been raised in many quarters and needs to be answered thoughtfully.

Summary

- Complexity has its limits, but also its purpose. Any derivative position is by definition more complex than a cash position; any packaged product is more complex than a single product; and any mortgage with variable terms is more complex than a fixed mortgage. Yet these financial instruments meet a market need, diffuse risk, and help provide liquidity. The Council strongly believes that rules to reduce complexity should be considered alongside the benefits that are provided.
- Interconnectedness has its limits, but it too has clear purpose. Financial institutions need counterparties to make markets, provide liquidity to each other, sell down risk through each other, and otherwise help capital flow through each other from and to the most efficient end source. To remove the benefits of interconnectedness would in itself have the unintended consequence of adding risk to individual institutions as it would to the system. Great care must be taken to think through these consequences.
- In addition, the Council strongly believes that complexity and interconnectedness may be independent of, and are better indicators of systemic risk than, absolute asset size.
- The Council, and the industry it represents, would be willing partners in helping the Board evaluate the many issues raised in this complicated area.

Item 7: Economic Discussion

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

- Reported aggregate data appear to be capturing actual and observed economic conditions relatively well. Members have not needed to make material revisions to their 2013 baseline economic forecasts of moderate GDP growth, gradually declining unemployment, low inflation, continued historically low interest rates, rising stock prices, and a strengthening housing market.
- While housing sales and prices continued to strengthen nationally, members report that the pace of growth was higher than average in the West and Southwest, and slower in the New England region.
- Industrial sectors and geographic regions that are experiencing above-average economic activity and growth include auto manufacturing in the Midwest, business and professional services (including technology-based services) in the Southeast, petrochemical and refinery businesses fueled by low natural gas prices in the Gulf region, oil and gas exploration and production in the Midwest, housing construction in the Southwest, and increased tourism in Florida.
- Industrial sectors and geographic regions that are experiencing below-average economic activity and growth include the New England and Mid-Atlantic as a result of Hurricane Sandy, faltering durable goods production, and fiscal austerity at the state and local government level. In addition, some members report a post-holiday consumer spending pullback reflecting reduced take-home pay resulting from higher payroll taxes, while others report concerns about declining consumer confidence and manufacturing sentiment as a result of continued gridlock over fiscal policy in Washington.

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?

- Believing the economy to be improving but still vulnerable, and recognizing the high quality of the Federal Reserve's information-gathering and analytical resources, the Council continues to support the FOMC's current accommodative monetary policy.
- Job increases have brought the unemployment rate down by over 200 basis points from its peak, and returnees are also being absorbed into the workforce, but unemployment remains well above the level expected if the economy were operating at its potential.
- The recovery in the critical, rate-sensitive areas of auto sales and housing is especially encouraging. Auto sales have risen above 15 million units, foreclosure rates have subsided, and home prices and home construction activity have rebounded. The exceptional strength of the balance sheets of both borrowers and financial institutions also demonstrates considerable potential for credit expansion as headwinds subside. Moreover, the reduction of spreads in some consumer finance categories and in sales of mortgages to GSEs suggest that monetary actions are being transmitted more directly to the economy.

- Measures of inflation continue to be in check, with additional capacity and global competition cited as restraining wages. The Council also noted increases in the valuation of financial assets, real estate, and commodities.
- With concern continuing about the impact of fiscal drags on the economy and uncertainty about government action, the Council believes that it is not yet time to withdraw monetary accommodation. Moreover, political leaders might conclude that expectations of monetary accommodation would allow more significant budget discipline without endangering the economy. Fiscal tightening at the federal level will create additional economic drag in 2013. Passage of the American Tax Relief Act of 2012 eliminated the near-term uncertainty around tax policy, but it is expected to subtract around 1.0 percentage points from GDP in 2013. The expiration of the payroll tax reduction and the increase in the personal tax rates for higher income households will reduce disposable personal income growth and slow consumer spending in the first half of 2013. Additional downside risks to the economy are looming from uncertainty about the debt-ceiling raise and imposition of sequester spending cuts. Uncertainty about government action continues to deter investors and businesses from making significant commitments that would spur growth.
- The Council welcomes the announcement following the December 2012 FOMC meeting of thresholds of unemployment and inflation rates that will guide future policy. Clarity about the use of widely available indicators allows markets to adjust as conditions evolve, making direct action less necessary to accomplish policy objectives. The expectation that low rates will persist continues to give businesses reasons to postpone long-term investments.
- The Council continues to note the collateral consequences of current policy. Corporations and state and local governments have difficulty funding their defined benefit pension obligations. The margin pressures that the low-rate environment has put on financial institutions, coupled with dramatically increased compliance and other infrastructure costs, have caused many to seek higher returns by accepting greater interest rate or credit risk. As the period of low rates is extended, these pressures have increased.