RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, December 5, 2014

<u>Item 1</u>: <u>Current Financial and Economic Conditions</u>

> **What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Are there any notable developments in loans for (1) small and medium-sized enterprises, (2) commercial real estate, (3) construction, (4) corporations, (5) agriculture, (6) consumers, or (7) homes? 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?**

Overview:

- Conditions remain stable with no notable developments in the loan markets.
- Members report no significant change in demand for loans during the 3rd quarter of 2014; however, consumers' confidence and willingness to borrow is improving. Overall, loan demand remains stable in most commercial categories and in non-real-estate related consumer categories such as auto and credit card.
- Overall credit structures continue to loosen and credit spreads continue to tighten, as competition for good loans intensifies.
- Banks are looking to loan growth and expense reductions to offset tight net interest margins. Pricing is firming.
- The decline in energy prices is expected to be stimulative across the board, although the full benefit has not yet materialized and some sectoral challenges exist.
- There continues to be demand for leveraged credit, although it is increasingly provided by the shadow banking system.

(1) Small and medium-sized enterprises

- The overall small business lending environment continues to improve. While demand for credit remains somewhat subdued, Council members report positive trends. There has been no significant change in the availability of credit over the previous quarter.
- Small business owners continue to be cautious about making significant investments due to uncertainty associated with the long-term economic and regulatory environment.
- The competition for very creditworthy borrowers remains very strong, which has led to continuing relaxation in pricing and structure. In addition, Council members noted competitive pressure from nonbank lenders entering the market.
- The outlook for small business lending remains positive.

(2) Commercial real estate

- Commercial real estate fundamental trends continue to be positive for most major property types and credit quality remains stable. Multiple sources of financing continue to be available to absorb demand, including domestic and foreign banks, commercial mortgage-backed securities, and specialty finance companies.

- The multifamily market has fully recovered from the recession and property performance metrics are at high levels. However, the rate of improvement has slowed as supply and demand have come closer into balance. The increased supply, which will be delivered over the next few years, should be monitored for its impact on vacancy and rental rates.
- Industrial assets have experienced a moderate recovery to this point, but Council members are increasingly optimistic about this sector. Port cities and intermodal hubs continue to lead the recovery, while secondary and support markets are continuing to build momentum.
- Health-care and senior housing projects continue to show strong demand for both new facilities and refinancing to capture the benefits of the low-interest-rate environment.
- Retail and office properties have experienced a slow recovery with marginally improving vacancy rates. Challenges continue to exist, particularly for properties lacking credit-worthy tenants or long-term leases.
- The hotel industry continues its recovery, led by full-service properties.

(3) Construction

- The supply and availability of credit for commercial real estate construction projects remains ample but varies by property type and location, especially for office, retail, and industrial loans. Demand has remained consistent over the last several quarters, with multifamily projects accounting for the majority of the demand.
- Loan terms continue to become more aggressive as some banks are loosening standards. The intensity of competition to finance high-quality projects has accelerated, as lender demand is exceeding market supply.
- District 11 reports that significant equity contributions are required (30%-40%), while District 9 notes that developers are seeking and obtaining loans with minimal capital structures.
- Members report modest growth in both demand and credit availability for single-family construction loans with mid-sized local and regional builders. However, this sector continues to be dominated by national builders.
- Retail development continues to be limited to urban in-fill sites and expansion of successful shopping centers. Limited new development is expected with the exception of pre-leased or substantially pre-leased projects.
- Members do not expect significant growth in office construction as many markets digest the current supply of surplus space.
- Investor interest in industrial construction and development is currently focused on coastal markets and centers of dense population with sufficient distribution infrastructure.
- Increases in construction costs are expected to slow the pipeline of projects as some projects become less viable for development.

(4) Corporations

- In general, Members reported that corporate lending continues to be strong and highly competitive, putting pressure on spreads and structure. Lower spreads and relaxed structure have not resulted in tightening the availability of credit.
- There are signs that after several years of downward pressure, lending rates for corporations have bottomed. Margin compression continues as nontraditional bank lenders

and nonfinancial lenders have entered the market, specifically for equipment and real estate.

- Companies are seeing improved balance sheets but have not shown much appetite to take on additional debt. While some economic reports are reflecting improved activity, it has not necessarily translated into improved corporate performance or driven business expansion.
- Optimism continues to increase on the part of business management, but Members reported that businesses remain conservative with hiring, replacing equipment, and investing aggressively in capital expansion.
- District 5 reports that volume in this segment continues to be driven by "shareholder-friendly" transactions, such as share repurchases or special dividends, with fewer opportunities around economically productive purposes, such as capacity expansion or facilities upgrades.
- The M&A market has been more active as opportunities arise.

(5) Agriculture

- The farm sector has experienced uneven performance in 2014. Districts 3 and 4 describe agriculture as fairly stable and positive, while District 9 reports some weakness is still evident in the agricultural economy. District 11 reports that agricultural lending increased in the 3rd quarter of 2014 despite weaknesses in certain subcategories of agricultural lending.
- After several years of record profits and high land values, agricultural grain prices declined rapidly in 2014 as a result of record acreage being planted and record crop harvests. Members report that lower commodity prices are resulting in lower revenues, down some 30%, which is stressing producer profitability. This pressure is likely to mean more reliance on federal crop insurance for revenue.
- The declines in grain prices and profits have reduced some land rents, tempering the rapid run-up in farmland values. Other agricultural commodity prices, including those for cotton, corn, and soybeans, are also falling.
- Implement dealers have shown stress as sales of new farm equipment have dropped significantly and used equipment prices have fallen as well.
- District 12 reports that drought is a continuing concern in California and the Southwest. Lenders are increasingly cautious with extra due diligence regarding water resources. Conversely, in District 11 an easing of Texas drought conditions is improving production expectations for cotton and corn. Texas's receipts for cotton and livestock are expected to increase this year, which could help the region avoid the nationally projected farm income decline.
- On the positive side, livestock producers are enjoying record prices and profits, benefiting from low feed costs and drought conditions in prior years, which had reduced herd sizes and limited supply. Dairy farmers' and ethanol producers' margins have also improved. Grain processors also benefit from greater demand for storage and transportation. Recent declines in oil prices will provide a small improvement as fuel is a material cost for most farms.

(6) Consumers

- Consumer borrowing increased at a faster rate in September as American households took out loans for cars and education. Auto sales and indirect lending continue to hit new highs.
- Student loans have been the fastest growing loan type over the past 5 years, and serious delinquencies (90+ days) remain near historical high levels at 11.5%. Private student loans make up approximately 5% of total student loan originations. In contrast to the federal program, private loan delinquency rates are low. Districts 5 and 12 report that the borrowing capacity for younger consumers is being limited by their student loans.
- Several Members report that home equity loans are on the rise, partially due to an increase in home values, coupled with low interest rates and growing confidence in the housing market.
- After four years of little to no growth, credit card loan growth has returned at modest levels.
- Rate competition is intense, as competitors are chasing similar high-quality, short-duration assets.
- Credit losses in the prime sector remain at or near record lows.
- With unemployment numbers trending downward and cheap borrowing costs, consumer loan activity is expected to pick up in 2015. Disposable incomes will likely increase through wages and a significant drop in oil prices.

(7) Homes

- Total origination volumes improved slightly for a second consecutive quarter in the 3rd quarter of 2014. Year over year, the origination volume is down 36%.
- The business mix continues to be mostly purchase applications, with a slight uptick in refinance applications. Conversely, District 2 reported the vast majority of originations have been refinancings.
- Members noted that applications and originations spiked higher as a result of lower interest rates. District 7 also attributed the increase to market volatility.
- On a year-over-year basis, home prices increased by 5.6% in September 2014.
- A number of factors in the housing market and broader economy are making it increasingly difficult for new buyers to enter the market. High student loan debt, rising rents, and a weak labor market have combined to make it more difficult for many borrowers to save the necessary down payment and to qualify for a mortgage. Tight mortgage standards are also a commonly cited barrier.
- Fannie Mae and Freddie Mac have signaled that they may soon loosen credit standards, which could result in an influx of homebuyers who have been unable to enter the markets.
- Further market consolidation of mortgage loan originators is expected, as many firms are unable to cover the large fixed overhead expense of regulatory compliance.

Item 2: CCAR

What are the Council's recommendations for ensuring that the 2015 capital planning process operates smoothly?

Overview:

- Stress testing, forecasting, and modeling improvements have been valuable for banks in enhancing business-planning and risk-management capabilities. CCAR has driven changes in the institutional composition and managerial focus of the country's largest financial institutions. Over the last five years, supervisory stress tests have prompted these institutions to increase or preserve common equity, reduce leverage through tier 1 capital raises or balance-sheet reductions, and materially invest in risk-management capabilities. However, stress testing and resolution planning programs should be commensurate with size, complexity, interconnectedness, substitutability problems, or cross-jurisdictional activity. The $50 billion threshold is unique to the U.S. and is not consistent with Basel standards. Some of the changes outlined below would allow the Fed to redirect resources towards larger risks to the financial system, as well as allow Boards of Directors and management teams to remain focused on and more efficiently manage the most important risks of the firm.
- The Council acknowledges the recent change announced in the October final rule that adjusts the capital plan submission date from January 5, 2016, to April 5, 2016, and commends the Federal Reserve for adjusting the date to separate stress testing from other year-end processes.
- Going forward, there are both near-term and long-term opportunities to improve the effectiveness and efficiency of the capital planning process.

Near-term improvements for consideration in the 2015 review cycle include:

1. Enhanced Coordination and Timing
    - Improve efficiency by enhancing coordination between the Federal Reserve, OCC, and FDIC on stress testing oversight, examination procedures, examination letters, and updates to rules and templates.
    - Enhance exam team structure and advance review:
        - Better leverage local FRB examination teams focused on institution-specific supervisory priorities to implement centrally set standards;
        - Name a CCAR coordinator from the horizontal team for each bank. Allow this individual to be a point of contact and provide answers to questions rather than relying solely on the FAQ process. This structure will provide banks with better access to important information and improve transparency and effectiveness throughout the process;
        - As much as possible, retain continuity of Fed staffing to reduce learning curve;
        - Enhance the planning process to provide for coordinated horizontal and local exam team engagement to avoid unnecessary duplicative meetings at financial institutions;
        - Maintain an open dialogue throughout the process (for example, provide additional Q&A guidance well in advance of the filing deadline to allow the additional information to be assimilated); and
        - Establish a threshold for materiality to ensure time spent to address a "risk" is warranted.
    - Limit changes late in cycle.

2. <u>Structure and Timing of Capital Deployment Authorizations</u>
   - Eliminate focus on the specific dollar value of capital deployment and replace it with either (1) a target payout ratio or (2) the opportunity for fourth-quarter revisions based on actual results versus capital plan submission.
   - Combine the announcement of qualitative and quantitative results or reverse the sequencing by providing the qualitative results before disclosing the quantitative results in order to avoid investor confusion and trading activity based on partial information.
   - Consider modifying the sequencing of capital action decisions. Create a two-step process for capital action approval. First, allow banks to make an initial submission excluding any capital deployment in order to allow the Fed to assess the quantitative and qualitative strength of each bank. Second, allow banks to submit their requested capital actions after the results of the review are shared by the Fed. This sequencing would enable banks to responsibly gauge the capital capacity available under the Federal Reserve Board's results.

Longer-term improvements for 2016 submissions and beyond include:

1. <u>Consideration of Banking Tiers/Tailoring</u>
   - Banks ranging from $50 billion to $250 billion in size ("midsized banks") are generally held to the same standards as very large banks, although the Council applauds the recent $250 billion LCR policy threshold.
   - It is a challenge for small and midsized banks to meet the same standards without the scale and infrastructure to support them. Significant investment in sophisticated technology and specialized employees is required to facilitate data compilation and reporting.
   - It is also worth noting that supervision and expectations can be inconsistent across lines of business, disadvantaging smaller institutions. A line of business that is relatively small within a large bank will oftentimes receive less scrutiny than the same line of business within a smaller bank.
   - Options to better align financial system risk and CCAR requirements include:
     - Apply DFAST instead of CCAR to midsized banks that are not subject to the Advanced Approaches; and/or
     - Create additional tiers within the group that will reduce complexity and cost for institutions that pose less risk to the financial system.
     - Also, consider tailoring of horizontal exams to smaller peer groups versus bundling all CCAR banks in the same framework and requirements.
   - Allow banks with up to $250 billion to utilize the FR Y-16 template, currently used by banks with assets between $10-50 billion (SR 14-3). The FR Y-16 requires banks to stress test against only supervisory scenarios and summary-level data segmentation (100 lines per scenario versus ~2,500 lines per scenario). These banks could continue to submit the Systemic Risk Report FR Y-15 to allow supervisory teams to monitor the size, complexity, and interconnectedness of midsized banks and determine the need for greater stress testing requirements.

2. Constraints
    - Consider modifying constraints on reducing buyback plans in adverse scenarios in order to better reflect actions that Boards/companies would actually take. Recent changes in CCAR instruction have increased the impact of these constraints.

3. Reporting and Documentation
    - Increase efficiency by scaling documentation requirements to be consistent with general risk-management documentation expectations. The process should be proportionate to the size, complexity, and interconnectedness of the filing bank.
    - Allow for open discussion of qualitative issues throughout the year to eliminate surprises when the CCAR results are announced.
    - Redefine model thresholds and tiering to ensure model risk-management requirements and documentation are based on materiality and the risk of the model itself. Banks should be allowed to use business rules rather than models when practical.
    - Refocus Board of Directors requirements to enable effective challenge at a strategic level rather than in the details of the model.
    - Provide more transparency regarding Federal Reserve modeling approaches and allow for discussion on gaps between bank and Federal Reserve PPNR, loss, and capital forecasts.
    - Provide banks with greater lead time for final instructions, rule changes, and FR Y-14 template modifications.
    - Reduce or eliminate individual public disclosure for banks that do not pose a significant risk to the financial system.

Item 3: Bank Resolution Plans

What lessons do Council members draw from the recent reviews of banks' resolution plans? During the 2008 financial crisis, would the bank resolution plans have been an effective tool for mitigating the crisis, especially with respect to the largest banks? What recommendations would the Council make for ensuring the ability to stabilize and resolve banks in a severe systemic crisis?

The pointed comments made by the Federal Reserve and FDIC in their joint statement of August 5, 2014, made it clear that the resolution plans submitted by the eleven "first-wave filers" in October 2013 did not meet regulators' expectations, and the agencies provided additional guidance about the areas where significant progress is necessary. The FDIC went further, separately opining that regulators have provided sufficient guidance to allow firms to prepare "credible" plans but that those submitted in 2013 were definitively "not credible."

Firms have a vested interest in understanding exactly what it takes to meet the regulators' test of "credibility," not only to avoid higher capital requirements and forced divestitures that could result from deficient plans, but also to ensure the effective and efficient use of resources. Resolution plans typically run thousands of pages in length and require year-round attention and global coordination. Hundreds of employees and advisors participate, senior management and

Boards are engaged, and major remediation projects have been launched to remove potential impediments to resolution. Having a clear and consistent target, common to both oversight regulators, is critical to achieving the regulators' aim, given the complexity and dynamism of the process.

What lessons do Council members draw from the recent reviews of banks' resolution plans?

One fundamental lesson is that the process is less about specific "**plans**" appropriate for narrowly defined circumstances and more about "**planning**," i.e., the process by which firms and regulators identify and remediate barriers to essential outcomes across a range of resolution scenarios. Several key areas were noted:

- Firms must simplify their legal-entity structures and ensure the capability to produce, in a timely manner, the information needed for resolution planning and plan execution;
- The legal-entity placement of shared resources, including personnel, facilities, and technology assets, should facilitate the continuity of support services in resolution; and
- An insolvency event at one entity should not automatically trigger termination rights by the critical counterparties and service providers to other still-solvent entities.

During the 2008 financial crisis, would the bank resolution plans have been an effective tool for mitigating the crisis, especially with respect to the largest banks?

Once a pervasive, severe, and systemic crisis like 2008 is in motion, there is likely little that a single firm in bankruptcy proceedings can do to stop it. That said, the resolution planning process generates several benefits to help navigate any such future crisis:

- First, the plans reveal connections within and between financial institutions that were unknown in 2008. This information can be used to better predict the potential impact of action or inaction, and includes:
    - Details about the systemically important products and services (if any) provided by the firm to other financial institutions or the real economy;
    - The organization's core legal-entity and jurisdictional hubs through which funds, securities, and risk flow;
    - Maps of internal and external support service providers to the business lines that rely on them for continuity of operations; and
    - Greater understanding of the impact of insolvency events on legal contracts.
- Second, regulators require anticipatory changes such as TLAC and the ISDA Resolution Protocol to facilitate a "single point of entry" resolution (i.e., the ability to ensure continuity of services to customers and counterparties of operating subsidiaries while still imposing losses on the failed firm's investors). This option was unavailable in 2008, when governments had to choose between allowing G-SIFIs to cease critical functions abruptly and bailing them out.
- Third, self-discovery within the resolution planning process has already caused firms to take significant preemptive action in reducing complexity and eliminating unnecessary interdependencies.

What recommendations would the Council make for ensuring the ability to stabilize and resolve banks in a severe systemic crisis?

Council members have several recommendations:

- First, clearly articulate among regulators and to firms the "essential outcomes" that individual firms must ensure are feasible in resolution. Ideally, these outcomes would be pre-agreed by all regulators that form that firm's Crisis Management Group.
- Second, streamline the resolution plans to increase digestibility and usability, with separate data repositories maintained to hold identified critical data. Plans could focus on how to achieve the identified essential outcomes and provide summaries of relevant changes to the firm's business and risk profile since the prior submission in order to ensure plans' continued relevance as organizations evolve.
- Third, define a strategy to provide liquidity to solvent bank and nonbank entities as needed to maintain financial stability in a systemic crisis. Members suggested that stabilization authorities clarify what flexibility they have to act in exigent circumstances. Members note recent actions taken by the Bank of England to expand its discount window program by expanding access to nonbank entities that play a central role in markets (e.g., broker-dealers, central clearing counterparties). Combined with firms' increased capital and liquidity requirements, enhanced supervision, and a prohibition on providing equity capital through these facilities, U.S. regulators could jointly protect essential outcomes across market environments and mitigate moral hazard.
- Fourth, increase coordination among the regulators.
- Fifth, provide faster and better feedback on resolution plans.
- Finally, the scenarios on which plans are based should be tailored to the actual business model and risk profile of each firm. For example, a blanket assumption of essentially overnight failure is less appropriate for firms that have invested meaningfully in building a durable financial profile with higher capital and liquidity buffers, longer-dated liabilities, and a more stable business mix. Avoiding contrived scenarios that may not be universally applicable will ensure that plans remain useful and actionable.

Item 4: Bank Liquidity Regulation

Implementation of the Liquidity Coverage Ratio (LCR) will begin next year, while the Net Stable Funding Ratio (NSFR) has been recently finalized by the Basel Committee. What is the Council's view of the potential impacts of the LCR and NSFR? Would higher liquidity buffers have been effective in preventing or significantly reducing the social costs of the 2008 financial crisis? Going forward, how will these measures affect (1) the resilience of banks to liquidity pressures; (2) banks' business models; (3) the liquidity and functioning of the market for U.S. Treasuries, including the availability of financing for such securities through repurchase agreements; and (4) other short-term funding markets? Will these measures have more general, longer-term effects on financial products, financial markets, or the macroeconomy?

What is the Council's view of the potential impacts of the LCR and NSFR?

- The introduction of the LCR and NSFR comes as a result of insufficient liquidity on bank and broker-dealer balance sheets during the 2008 financial crisis. While addressing the evident weakness in liquidity regulation is quite important, LCR and NSFR may result in many unintended consequences to the banking industry, the global economy, and various segments of the capital markets. Further, it is important to note that these consequences have the potential of compounding the impacts caused by other regulations being rolled out as a part of Basel III (B3) and the Dodd-Frank Act.
- The overall implementation of liquidity rules will make institutions better equipped to handle financial stress. However, the combination of LCR and NSFR with other rules, including the Supplementary Leverage Ratio and Volcker Rule, while increasing bank liquidity, may result in reduced liquidity in the capital markets. The decline in tri-party repos and stock lending and the recent Treasury market dislocation are all early signs of reduced capital market liquidity.
- Beyond the changes in liquidity rules and other regulatory initiatives since the financial crisis, the question remains whether, collectively, these initiatives would meet the challenge of the next financial crisis – especially given the restrictions imposed by Dodd-Frank on the Fed's ability to act as a lender of last resort.
- Certain types of assets and liabilities will be favored by the LCR and NSFR. The following table includes a list of the major winners and losers from each category. Demand (or lack of demand) for these products will have an impact on the pricing and value of these assets or liabilities in the B3 world. We would expect to see asset yields decrease for U.S. Treasuries, GNMA Securities, and other high quality liquid short-term securities. In contrast, we would expect to see asset yields increase for loans, lines of credit, and riskier securities.

Assets		**Liabilities**	
Winners	**Losers**	**Winners**	**Losers**
U.S Treasuries	Commercial Loans	Consumer Deposits	Large Corporate Deposits
GNMA Securities	Committed Lines of Credit	Small Business Deposits	Short-Term funding
Short-Duration Securities	Corporate Debt Securities	Long-Term funding	Municipal Deposits
	Municipal Securities*		

*Note: The regulators have hinted at a relaxation of the liquidity guidelines related to municipal bonds in the future.

Would higher liquidity buffers have been effective in preventing or significantly reducing the social costs of the 2008 financial crisis?

- The financial system during the 2008 financial crisis undoubtedly suffered due to a lack of liquidity and liquidity regulation. Had they been in place, the LCR and NSFR would have certainly provided for a higher percentage of quality liquid assets on balance sheet and would have limited the reliance on shorter-term funding. However, these ratios do not address the serious decline in asset prices (across liquid assets as well) that ultimately created a capital hole that could not be corrected at many institutions. Moreover, it does not seem likely that these ratios would have "unfrozen" the interbank lending market. There may have been less reliance on the interbank market (because of NSFR), but interbank lending would likely have still been a very important component of the banking system (and we expect that to continue).

- In our view, the ratios would not have saved the financial institutions that failed during the onset of the crisis. However, the increased liquidity may have provided for more time to diminish the risks associated with liquidating assets, resolving defaults, etc. This may have reduced some of the social costs associated with the crisis, but it would not have been significant.

Going forward, how will these measures affect the following?

(1) the resilience of banks to liquidity pressures;

- The LCR and NSFR should make banks more resilient to liquidity pressures going forward, but the regulations do not provide any certainty that banks will withstand a full liquidity crisis again. There is no way of definitively knowing that the high quality liquid assets (HQLAs) will maintain liquidity in future cycles. Furthermore, there is already some question as to whether the liquidity hierarchy within LCR reflects the true liquidity observed in today's marketplace (for example, GNMA securities qualify as level 1 while FNMA and FHLMC securities qualify as 2A, despite similar if not greater liquidity for FNMA and FHLMC).
- There is some concern that the LCR and NSFR ratios will create a self-fulfilling liquidity freeze in the interbank market when liquidity stress begins. The transparency of LCR and NSFR ratios, and the advertised stress on these ratios during a crisis, may act to create further reluctance to lend in the interbank market.

(2) banks' business models;

- The new liquidity regulations will require banks to hold more HQLAs and obtain longer-term, costlier forms of funding. As discussed previously, this requirement will work to decrease revenues and increase the cost of doing business. As a response, banks will inevitably react to mitigate the negative impacts associated with the ratios. We expect banks to implement balance-sheet strategies to offset lost earnings (replacing traditional lending with riskier assets in some cases) and to exit lines of business that may be less profitable. We expect banks to exit certain products, such as customer repo sweeps, and certain client types, such as municipalities and financial entities, due to the liquidity costs associated with the business.
- Larger banks will also start gearing more of their activities to fee-producing activities and businesses with continued emphasis on cost-cutting in nonessential areas.

(3) the liquidity and functioning of the market for U.S. Treasuries, including the availability of financing for such securities through repurchase agreements;

- The rulings will require that banks hold more level 1 assets, which include U.S. Treasury securities. This will result in banks holding a larger portion of the U.S. Treasury market, which we expect will ultimately ***decrease*** the level of liquidity for Treasuries. The greater demand for Treasuries will create an artificial downward pressure on Treasury yields, which could artificially impact the pricing of other asset classes. All the while, the U.S. government obtains lower financing costs, while banks suffer lower revenues.

- As banks will need to hold more Treasuries as unencumbered assets, fewer Treasury securities will be available for repo financing. In general, banks will be better served holding the securities for liquidity purposes versus as collateral for repurchase agreements. Additionally, the "unwind rule" in LCR is prohibitive to the use of repurchase agreements. In addition, we believe there will be fewer counterparties for institutions needing to monetize HQLA via repurchase agreements during a liquidity crisis.

(4) other short-term funding markets?

- Banks will rely less on short-term funding markets but will be more likely to lend to short-term borrowers. This should reduce short-term borrowing costs in the market. However, the repurchase agreement marketplace will certainly be disrupted as these transactions are now subject to the "unwind rule," which is detrimental to a bank's HQLA calculation.

Will these measures have more general, longer-term effects on financial products, financial markets, or the macroeconomy?

- Financial Products:
    - Banks will likely exit (or significantly reduce extension of) products that are punitive to the LCR or NSFR calculation. These products include customer repurchase agreements, lines of credit (unused), certain deposit product types (municipal deposits), and even lending in general (as more assets on the balance sheet need to be HQLA).
- Financial Markets:
    - Banks will be required to stockpile HQLAs (specifically level 1 assets) and obtain longer-duration funding sources. Furthermore, all of these banks will be seeking to accomplish this at the same time. We expect that this will drastically change asset and liability valuations as the key players flood the markets.
    - We also stress the potential impact that LCR and NSFR could have on the ability of marketmakers to maintain deep and effective secondary markets for securities that are not considered HQLA (corporate debt securities and equity securities).
- Macroeconomy:
    - The LCR and NSFR will without question reduce the velocity of credit in the global economy. This will have a disparate impact in markets that already experience lesser availability to credit. Additionally, the rules may result in a transfer of risk to the unregulated shadow banking market, which by definition is less regulated, less transparent, and less measurable (with its implications for reduced ability on the part of regulators to read and control the money supply) and could come around to cause significant financial issues in the future.

Item 5: Cybersecurity

Recent security breaches show an increase in the number of firms breached and in the importance of the information compromised. Are additional actions needed to protect financial information? What are the costs and benefits of additional actions, and what role should regulators play in requiring such actions?

Overview:

- Recent security breaches have been prolific, as professional criminals backed by organized crime and nation-states have obtained significant funding to continually explore ways to attack financial institutions and, in particular, the payment infrastructure. These groups have significant knowledge of the payment ecosystem and quickly discover the weak links in the payment chain that they can then attack to acquire important financial information. Attacks are broad-based, and in recent months have included card compromises, ATM fraud cash-out schemes, social engineering schemes, and malware, to name a few. While there have been some breaches at financial institutions, the majority of breaches have occurred at companies that are not bound by the FFIEC guidelines and are not adhering to policy and standards from the International Standards Organization and the National Institute of Standards and Technology.
- Council members agreed that while much has been done to address cybersecurity issues, there is a considerable amount of work left to do. Members did feel it important to acknowledge the following actions that financial institutions have taken or are taking to protect financial information against cybersecurity threats.
    - Providing funding for and rollout of automated information sharing through the Financial Services Information Sharing and Analysis Center's (FS-ISAC) Soltra Edge project.
    - Providing funding for and actively participating in establishing the strategic plan to roll out two new "community-owned" and controlled top-level domains, .bank and .insurance.
    - Working with The Clearing House to fund the development of an industry "tokenization" solution that will encrypt data and better protect card credentials.
    - Reissuing cards with chip-based technology (EMV) to reduce fraud associated with counterfeit cards.
    - Fortifying infrastructures with layered defenses and multi-authentication access requirements.
    - Improving detection and response capabilities.
    - Working collaboratively with government authorities, the regulatory communities, and others to share information in order to protect consumers' financial information.

Are additional actions needed to protect financial information?

- Council members do believe that the following additional actions are needed to protect financial information and to defend against growing cybersecurity attacks.
    - Require information sharing across industry sectors (supported by appropriate legislation) that focuses on disseminating "actionable intelligence" that could be used to ward off cybersecurity attacks.

- Improve the quality and speed of information sharing between government agencies and financial institutions.
- Ensure 100% participation by financial institutions in the FS-ISAC to ensure information is being shared and that there is access to information on current cybersecurity threats or events. (The FFIEC recommendation encouraging participation in FS-ISAC is a good first step.)
- Ensure all participants in the payment system adhere to appropriate levels of security to protect the integrity of the system.
- Require that other companies or industries responsible for breaches reimburse financial institutions for their expenditures in full. This measure would "incent" all participants to adhere to certain standards and would ensure that the company responsible for a breach is held accountable.
- Support innovation that enables the detection and monitoring of data breaches and a more secure payment system.
- Establish a cybersecurity framework and best practices for third-party vendors that will assist all financial institutions, particularly community banks, in protecting consumers' financial information.
- Recognize security cannot be dependent only on external firewalls and personal authentication, as perimeter breaches or internal compromises cannot be ruled out and must be contained and mitigated through layered security.
- Consider the heightened risks related to massive amounts of proprietary data being stored at the regulatory level.

What are the costs and benefits of additional actions?

- Council members believe that there are both financial and reputational benefits that would result in additional efforts to strengthen the cybersecurity framework and communication network.
  - The costs of data breaches are significant for all financial institutions. These data breaches are resulting in increasing fraud across the industry and they are requiring card reissuance where card information has been compromised. The American Bankers Association (ABA) reported that community banks experience disproportionately higher costs when reissuing cards. According to the ABA, banks with under $1 billion in assets spent just over $11 per debit card and $12.75 per credit card (including mailing, card production, and staff time) as compared to approximately $3 per card for large banks. The ABA also reported that only one-third of banks reported receiving any reimbursement for fraud losses and reissuance costs in the previous five years and that, of those that did receive reimbursement, 83% said they received less than 10 cents on the dollar. One large regional bank reported that the cost of reissuing EMV-enabled cards would be approximately $20 million.

What role should regulators play in requiring such actions?

- The FFIEC release on observations from the recent cybersecurity assessment by regulators at more than 500 community banks noted that there is wide variation in practices to protect financial information and to identify, respond to, and mitigate cybersecurity threats and incidents.

- Council members suggested that regulators could provide more guidance on strong practices around a cybersecurity framework for financial institutions and third-party vendors that process and/or access customer-related data.
- Most Council members support regulatory involvement in the establishment of cybersecurity standards for co-dependent industries, such as the telecommunications and power industries, and for nonbank providers of payment services.
- Council members felt strongly that regulators should support legislation that would facilitate more information sharing around cybersecurity threats and events and should consider requiring financial institutions and third-party vendors that process data and/or access customer data to participate in FS-ISAC.

Item 6: Banking Issues for 2015

After the midterm elections, what banking issues does the Council view as likely to be addressed and to remain unaddressed during the next two years?

- Consideration of banking issues in the next two years will be influenced by the substantial strengthening of the banking system, the Republican majorities in the Congress, and the passage of time since the crisis and the attendant emergency actions and legislation. The continued polarization of the political environment, exacerbated by current confrontations between the branches, reduces the chances of major banking legislation. Nevertheless, the changing composition of the oversight committees and the compelling arguments for regulatory standards appropriate to different kinds of institutions call for legislative action.

A. Regulatory Reform

- The Council strongly supports efforts to design supervisory standards appropriate to the size, complexity, and interconnected business models of regulated institutions. Experience since the enactment of the Dodd-Frank Act and its implementing regulations suggests that the selection of $50 billion as the threshold for systemically important institutions was too low. Many additional measures have been taken to strengthen and test the resilience of the largest institutions to reduce the risks they are believed to represent to the financial system. The application of these requirements to regional banks has imposed enormous expense that cannot withstand cost/benefit analysis.
- Asset size is only one rough measure of systemic importance, as Governor Tarullo noted in his May 2014 speech at the Chicago Bank Structure Conference. Even if such a measure were used as a proxy for systemic risk, most observers believe that the threshold should be much higher. Raising the limit would free resources for customer service, product innovation, and credit provision to support economic growth throughout the country. It would also allow rationalization, cost efficiencies, and asset diversification among the critical segment of the banking industry with assets between $40 billion and $200 billion. Moreover, refraining from applying to regional banks the standards that may be appropriate to very large, internationally active firms would reduce the likelihood of large bank standards being imposed on community banks as best practices. This appropriate

segmentation would also allow scarce regulatory resources to be focused on truly systemic issues.

- The Federal Reserve has recognized the wisdom of reducing unnecessarily burdensome requirements on smaller banks in areas such as liquidity regulation. We urge that similar steps be taken by administrative action where possible to reduce the scope and severity of requirements such as CCAR testing, and we support a more comprehensive approach through legislation. Leaders in both houses and both parties have expressed interest in this initiative, and both houses will be more likely to act with confidence that the other body will take up the bill in the new Congress.

B. Related Legislation

- Considerable support for amendments has built up in the five and one-half years since the Dodd-Frank Act was swiftly enacted in a time of national emergency. Other measures that are likely to be considered in the next two years include:
    - CFPB. Structural and funding changes to the CFPB to provide improved congressional oversight and accountability, as well as adjustments to the size of institutions subject to jurisdiction.
    - FSOC. Increased transparency to the deliberations and decisions of the FSOC.
    - Capital Regulation of Large Asset Managers and Insurers. Amendment to the Dodd-Frank Act to allow the Federal Reserve Board greater flexibility in designing capital requirements for large asset managers and insurance companies appropriate to their business models and risks underwritten.

C. Legislative and Regulatory Issues

- Information Security. As detailed in the Council's response to the previous item, the increasing attacks on information systems and concern about their vulnerability will give rise to consideration of standards for information sharing, protective practices, and, perhaps, the delineation of responsibility among parties in a data breach.
- GSE Reform. The Council continues to support reforms to reduce the extent of the federal role in housing finance, but it currently appears that a consensus on legislative action will remain elusive in the next two years.
- Economic Growth and Regulatory Paperwork Reduction Act. The Council supports careful attention to the results of the decennial review of the costs and benefits of regulations and urges the banking agencies to also consider the aggregate impact of those regulations.
- Accounting Rules. Among the important accounting rules likely to be adopted in the next two years is a new treatment of the allowance for loan and lease losses, with its potentially procyclical result.

Item 7: Monetary Policy

How would the Council assess the current stance of monetary policy?

- The Council sees the current stance of monetary policy as being appropriate to underlying conditions. However, if the economic data continues to track along current trend lines, the

Council would encourage the FOMC to begin an incremental increase in the federal funds rate in the coming quarters.

- The prolonged period of exceptionally accommodative monetary policy and expectations of a gradual path of the federal funds rate hikes beginning in mid- to late 2015 have led to heightened concerns over the potential for undue appreciation of asset prices and instability in the financial markets. It is possible that, going forward, the Fed may wish to use policy actions, as opposed to regulatory actions alone, to remedy or fend off such imbalances in the financial markets. If so, this could add an element of uncertainty into the stance and effects of the FOMC's monetary policy decisions.
- Despite improving economic conditions and the Fed gradually winding down then ending its monthly asset purchases, long-term interest rates have declined from year-end 2013 and remain low. This trend, along with the FOMC's guidance that the current 0 to 1/4 percent funds rate target will be appropriate for a "considerable time" after the end of the asset purchases, has generally been supportive of asset valuations. Heightened global risk aversion and expectations of additional policy accommodation by foreign central banks, particularly the ECB, have played a significant role in suppressing long-term U.S. interest rates. Financial conditions are expected to remain accommodative even as the U.S. economic outlook improves. Considerable uncertainty remains as to how changes in Fed policy after quantitative easing will impact markets as the economy moves forward. This uncertainty should be mitigated to some degree, however, as the FOMC continues to use policy guidance in an attempt to influence market expectations.
- Although monetary policy has been exceptionally accommodative, the U.S. dollar has appreciated significantly over recent months. Rather than reflecting expectations of aggressive unwinding of monetary stimulus on the part of the Fed, this appreciation is more a reflection of further monetary policy accommodation on the part of foreign central banks, such as the Bank of Japan, and expectations of further monetary policy accommodation from the ECB. The appreciating U.S. dollar has contributed to inflation in the U.S. remaining below the 2% target rate despite further improvement in U.S. economic fundamentals. The U.S. dollar will likely appreciate further over coming quarters, particularly if the FOMC begins raising the Fed funds rate as anticipated in 2015.
- The degree of remaining slack in the labor market remains an open question, which bears on how rapidly wage pressures will begin to build. Though some analysts argue there is significantly less slack than the FOMC believes (at least collectively), there is yet no evidence of broad-based and sustained wage pressure. Chair Yellen has made it clear that wage inflation in and of itself is not sufficient to trigger acceleration of the process of normalizing monetary policy, and it is widely believed that the Fed will be willing, at least in the shorter term, to tolerate inflation running slightly ahead of its target if the alternative is choking off a nascent recovery in earnings growth.

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