RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, May 8, 2015

<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 (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, or (g) 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?

General Outlook:

- District members report that since our February 2015 meeting, loans to small and medium-size enterprises and to the agricultural sector were flat to down; construction and home lending were flat; lending to corporations was flat to moderately up; and commercial real estate lending and consumer lending were strong.
- U.S. economic activity was stable in the first quarter of 2015 with some seasonal/weather-related conditions adversely affecting activity, particularly in the Northeast and Midwest. Also, the port shutdown on the West Coast slowed activity there.
- District members continue to expect the economy to gain momentum throughout 2015.
- This gain in momentum has increased consumer and business confidence levels and members in all Districts are reporting increases in demand for loans, with loan pipelines at reported higher levels in most categories than at year-end 2014, as well as first quarter 2015. Loan growth is expected to continue in 2015. Credit availability to all borrower types remains high, with losses and loan loss provisions remaining very low.
- Competition also remains intense for producing this loan growth, with loan pricing continuing to be under pressure and overall credit structures loosening, as District members have stated in previous quarterly reports.
- Improving domestic conditions, combined with mixed international conditions and a stronger dollar, may represent a mixed outlook for loan demand later in 2015/2016.

(a) Small and Medium-Size Enterprises

- There are pockets of growth in certain markets, but we have yet to see a broad-based return of small business customers looking for new credit.
- Small business owners are more optimistic but remain reluctant to invest and are holding onto their cash. If they are investing, it is with their cash, not credit.
- Top concerns remain government regulation, taxes, and healthcare costs.
- Credit availability to small and medium-size businesses remains high.
- Competitors are indicating they are seeing increases in lines of credit but that is not necessarily translating into borrowing.

- Core lending that supports working-asset growth or non-real-estate transactions for medium-size businesses has continued to improve modestly.
- Medium-size businesses are seeing increased competition from nonbank lenders.
- Competition from lenders for both segments continues to be fierce, with aggressive terms, structure, and pricing. Clients are continuing to receive multiple offers to meet their financing needs, resulting in significant negotiations.
- Economic statistics and information from peer banks across all Districts show that we are starting to see the recent declines in loan balances begin to flatten out in the small and medium-size business portfolios. Further, business confidence is moving in the right direction. Credit quality remains stellar across the board.

(b) Commercial Real Estate

- Commercial real estate fundamentals continue to improve for most major property types, with liquidity for investment of equity and debt financing at unprecedented levels.
- Domestic and international investors continue to choose yield and seek safe, tangible assets due to the ongoing “zero” interest rate environment.
- Investor demand is pushing down capitalization rates to historical lows and pushing corresponding asset prices to historic highs.
- Commercial real estate values have generally risen, and for select products in some markets, values have returned to or exceeded pre-recession levels. Values of apartments and Class A office properties have fared the best. Industrial properties are getting stronger, particularly in areas where there are transportation hubs. Retail has been slower to recover and has been relatively uneven.
- The CPPI’s National All Property composite has increased by 80% since its January 2010 trough and currently stands 7% above its December 2007 peak, which represents a recovery of 117% of peak-to-trough losses, substantially higher than the 54% increase in the Case Shiller Index for residential property prices.
- The demand in applications for CRE loans varies across markets, consistent with the uneven recovery; demand is more uneven in submarkets.
- The MBA’s CRE loan origin index is currently at 246, which is 30% below its peak in 2007, suggesting that loan originations are still lagging the pre-crisis levels. CMBS are poised to increase to $125 billion in 2015 as the CMBS market share of loans scheduled to mature in 2015 grows to around 35%.
- The multifamily loan market remains robust. Near-term outlook is strong, however, as property supply and demand come closer into balance. Potential over-development poses the greatest threat over the longer term.
- The retail loan market has modest demand, with the office-loan market experiencing a slightly better recovery. Industrial loan markets have investors and lenders optimistic about this sector, with some markets experiencing or expecting a building of momentum in 2015/2016.
- Many banks and nonbanks continue to pursue CRE loan growth, and competition remains high as lenders look for new opportunities. Nonrecourse longer-term financing for high-quality borrowers with stabilized projects has become more common. Nonbank competition also continues to provide low interest long-term loans.

(c) Construction

- There remains ample credit available for construction and development projects, but this availability varies by both property type and location. Significant equity contributions have become the rule, as lenders are mostly underwriting to cash flow coverage guidelines that demand equity in the 30% to 40% range.
- Post-recession construction activity has been largely centered on multifamily expansion, senior housing, and medical office facilities. Other activity has been more specific single-tenant use.
- Construction activity in the multifamily (apartment sector) remains elevated. While vacancy remains near historical lows, it is anticipated that the wave of new construction will create an increase in vacancies and a slowing of effective rent growth. This moderation of apartment fundamentals should take the form of a reversion to historical averages, rather than a rapid deterioration in rents and occupancy rates.
- District members reported that single-family housing starts increased in 2014 but remain highly variable based upon individual markets/submarkets. Some markets still have a depressed level of lots and unsold finished new homes, as developers/builders remain cautious.
- Conversely, shortages of available single-family homes are reported in the larger urban markets such as Dallas and Denver.
- There is also a growing amount of new construction activity and loan demand for large bulk industrial/warehouse facilities in port cities and major transportation hubs as the outlook for this sector continues to improve.
- Loan terms available for CRE construction project opportunities continue to become more aggressive. Lending demand is exceeding market supply. Some speculative construction lending in these CRE categories is increasing.

(d) Corporations

- Corporate lending in general, including the shared credit market, is expected to continue to grow moderately. Loan spreads and fees are expected to continue to decline, along with compromises in loan structures (as evidenced in the report from the OCC, which summarized the Shared National Credit exam for 2014).
- A material percentage of loans in the leveraged lending space are being originated by nonbank competitors. The structures of these credits are evolving and reshaping the market. Those accepting the highest risk continue to be outside of the traditional bank market, with these firms (private equity, hedge funds, business development companies, finance companies, and others) extending credit at a faster pace than the previous quarter.
- Credit activity continues to be largely related to refinancing, M&A, or shareholder-friendly purposes rather than for new expansion.
- Capital markets remain open and supportive for larger companies.
- Investment-grade companies in the first quarter of 2015 have continued the trends from 2014, which was a record-breaking year for bond issuance.
- High-yield companies are expected to have a slight reduction in issuance of $339 billion of bonds versus $347 billion in 2014 and $380 billion of institutional leveraged loans versus $415 billion in 2014.
- From a borrower's perspective, structures continue to provide large corporations with more flexibility when they need to refinance.

- District members reported some anecdotal evidence recently that may suggest pricing is "bottoming" and covenant-lite deals are becoming less common.
- Management teams for corporations with mostly domestic revenues, outside of the energy sector, are generally optimistic about 2015.

(e) Agriculture

- Crop producers are showing weakness, with a second year of operating losses in a number of areas. The sharp decline in many agriculture commodity prices continues to present a material challenge.
- With crop prices generally down, more favorable margins have been created for protein producers, who use these grains as raw materials.
- Chicken producers remain extremely profitable right now; cattle and pork prices are near all-time highs.
- U.S. milk prices declined substantially in the first quarter of 2015, and although profits are expected to be lower, they will remain above breakeven.
- Recent declines in oil prices will provide a small improvement in farmer economics, as fuel is a material cost for most farmers.
- Avian flu was found initially in the Northwest in early 2015, has been spreading east and south, and has now been found in commercial turkey and chicken farms. In reaction, numerous countries placed import restrictions on U.S. poultry.
- The trend of increasing agriculture land prices appears to be at or nearing an end, with prices leveling off.
- Loan demand is steady, as many producers need to adjust their balance sheets and restructure term loans to provide more cash flow for working capital.

(f) Consumers

- District members report that consumers appear to be generally more optimistic about the U.S. economy.
- U.S. bank call reports for year-end 2014 show total consumer loans outstanding of $1.4 trillion, up 5% for the year. Growth was driven by auto lending, which was up 9%, and credit cards, which increased 4%.
- The Federal Reserve's most recent G.19 release shows total consumer credit continuing to increase through February at a seasonally adjusted slower rate of 5.6%.
- Home equity lines of credit (HELOC) are surging according to the Consumer Bankers Association. HELOC applications grew 25% in 2014. Attractive interest rates have contributed to the growth in demand. Weighted average credit scores are 777, and more than 85% of these borrowers have combined LTVs of 80% or less.
- While originations of HELOCs and HELs are increasing, the traditional second-lien position has transitioned such that 45% of these loan types are now in first-lien positions (Source: National Mortgage News).
- Dealership traffic began to pick up in March, and District members project the second quarter of 2015 to be favorable for auto lending due to pent-up demand after the harsh winter.
- Marketplace lenders, such as Lending Club, are impacting the unsecured borrower landscape by providing broad-based online borrowing offers. As marketplace peer-to-peer

lending evolves, retail banks will be required to enhance their online lending platforms to remain competitive.

- At the market's higher end, "luxury goods" asset loan structures (i.e., aircraft, yachts) have experienced loosening credit standards.
- While consumer attitudes and willingness to spend/borrow are improving, they are still not at pre-recession levels. Credit quality is very good, with consumer delinquencies consistently low.

(g) Homes

- District members believe that 2015 will be a much better year for the U.S. housing market than 2014 and that the risk to projections is to the upside.
- Despite some seasonality and the harsh winter, first quarter 2015 mortgage demand exceeded expectations. If we compare the different housing-activity metrics YTD versus the same period a year ago: existing home sales – up 6.6%; new home sales – up 21%; and housing starts – up 4%. Positive momentum is building across the board.
- The Mortgage Bankers Association's latest forecast for 2015 shows purchase volume at 59% of total origination volume industry-wide. This is despite the "mini" refinance spike experienced during the first quarter, based on the reduction of longer-term interest rates.
- New buyers may be poised to enter the market: (1) Rent prices have risen materially, thereby making a home more attractive, especially given the rate environment. (2) Negative credit events such as foreclosures remain on a credit report for up to 7 years, so those individuals who lost their homes at the start of the crisis (2007) may now have the ability to borrow again.
- The Core Logic HPI forecast over the next 12 months indicates that home-price appreciation will increase nationally to 5.3%. Many mortgage lenders have continued to aggressively price jumbo (nonconforming) products at or below conforming agency (Fannie Mae, Freddie Mac) products.
- Mortgage-credit availability remains somewhat constrained, preventing a sizable amount of potential customers from accessing the housing market as owners. 2014 gave us the qualified mortgage (QM) definitions, but the foreboding specter of mortgage litigation still looms large over lenders and poses a continuing challenge, consistent with the expansionary side of a lending cycle.
- Policy efforts to facilitate an expansion of the mortgage lending opportunities, while steps in the right direction, have not had a material impact on mortgage lending thus far.

Special Topics

(a) How are domestic energy producers responding to changing conditions in the global energy marketplace and how have these changes affected businesses that are heavily dependent on energy or that produce energy-intensive products?

How are domestic energy producers responding to changing conditions in the global energy marketplace?

- In the energy-rich 11th District, oil and gas extraction firms directly employ only about 2.5% of the Texas workforce, and the energy sector's contribution to the Texas GDP is less than 15%. However, companies in the region have sharply curtailed drilling activity in response to lower oil and gas prices. The number of rigs drilling for oil and gas in Texas has fallen from over 900 to 393, a decline of over 50 percent. In absolute terms, Texas has lost the most rigs of any state. New Mexico, the southern part of which is in the 11th District, has also seen a roughly 50 percent decline in the rig count. Oil and gas companies have begun reducing workers, and employment in the Texas mining sector has already fallen by more than 4,000 jobs since the start of the year.

- On a national basis, the U.S. drilling rig count is already down over 50% from a year ago, with the vast majority of the reduction taking place over the last three months. Further, domestic producers have dramatically cut drilling capital expenditure budgets for 2015, with average reductions of 40%. There can be a three- to six-month delay in the time from when capital expenditure is cut to seeing it flow through the system. Drilling in core areas will offset the decline somewhat, but actual production declines are expected in the second half of 2015.
- Companies are focusing on preservation of liquidity as borrowing bases are shrinking, leading to reduced capacity to borrow:
  - Those with access to capital markets are issuing equity and/or long-term debt and using these proceeds to reduce outstanding bank debt and/or bolster liquidity. More activity is expected, with tremendous amounts of equity available to facilitate taking advantage of opportunities once the financial cycle hits bottom.
  - Existing credit agreements are being amended and/or renegotiated. Many companies have requested covenant relief, generally around debt/EBITDA ratios for the next 12-18 months, and there is an abundance of ongoing merger talks and "strategic alternative" discussions.
  - Dividends and distributions are being reduced or suspended.
  - Equity commitments from private equity sponsors are being called.
  - Some producers are selling noncore assets to increase liquidity.
- Some companies are currently benefiting from hedges that mitigate lower oil prices; however, as these roll off, companies will be more susceptible. Companies are also evaluating the value of hedges in the current environment to protect against further price declines.
- Domestic energy producers are capping completed shale wells without "fracking" them, allowing new wells to be brought online very quickly in the event of a price increase, thereby potentially modulating the amplitude of a price increase, as supply growth rapidly surpasses demand growth.
- Refiners generally do not believe storage-capacity constraints will curtail domestic production in the near term, as tanker storage is still available. Additionally, refiners do not appear to be reducing planned capital expenditure budgets in 2015.

How have these changes affected businesses that are heavily dependent on energy or that produce energy-intensive products?

- The effects of these changes on businesses that are heavily dependent on energy or that produce energy-intensive products vary. Energy servicers/drillers should be hit the hardest, as they bear the immediate brunt of producers' capital expenditure cuts. The outlook for energy-services firms is much the same as it is for the exploration segment — in that if prices stay low for a long period of time, credit issues are to be expected. The services sector is under severe financial strain as it deals with leverage incurred for growth capital to keep up with the hyperactive drilling activity of the last five years. EBITDA for these companies will drop substantially as exploration and production firms (E&Ps) cut costs, and many of the high-yield servicers/drillers will likely default if oil prices remain low. Layoffs have been most notable in the energy-services sector, and it is anticipated that the massive reduction in producer capital expenditure will result in significant additional job loss in the U.S.

- Other businesses that are heavily dependent on energy or produce energy-intensive products are making several changes:
  - Workforce reductions: These workforce reductions could create manpower shortages when the industry returns to a more normal level of operation.
  - Consolidation opportunities: A number of private equity sponsors have announced their financial backing for management teams to purchase assets at distressed prices.
  - Transformational strategies: Surviving companies will have undertaken plans to operate at a high-level efficiency at lowest costs.
- Agricultural producers are presenting cash flow projections with significantly reduced petroleum expense, which has helped to ease the low commodity price effects.
- Major distributors of fuel oil and gasoline have seen falling prices severely impact their revenue streams as well as their costs. Discussions with most distributors would indicate the net impact has been fairly negative on their profit margins, leading to decreased appetite for investment in capital equipment or expansion.
- The industrial/commodity sectors are experiencing the downstream effects:
  - U.S. rails seeing declines in carloads related to energy.
  - Impact on commodity companies is mixed:
    - They are experiencing lower input costs, which reduces the cost curve on energy-dependent commodity production, such as aluminum.
    - The energy sector has been a major consumer of commodities such as steel, reducing demand.
- Inexpensive natural gas is replacing coal for the generation of electric power. Utilities often comment that the shale boom has made natural gas more attractive, not just from a peak-power perspective but for the base-load requirement, which is the minimum level of demand on an electrical supply system over 24 hours.
- Tourism will likely see an uptick due to lower gas prices, and automakers are selling more trucks/SUVs versus hybrids. Prolonged lower energy prices could influence car-buying choices and product designs.
- Certain airlines have suggested that they will continue to hedge fuel costs as they have in the past, which has been in a wide range depending on the duration of the hedge.

(b) How has the recent appreciation of the dollar affected business decisions and over what time horizon might a sustained increase in the value of the dollar change those decisions?

- With regard to specific business decisions, firms do not typically make long-term business decisions solely based on exchange rate movements, as exchange rates are volatile and highly unpredictable. Bankers anecdotally report they are not seeing material changes to client behavior at this time, but they expect changes if the dollar’s strength persists for the next 12 months.

- However, in the short term, the dollar appreciation is having an impact on corporate revenues and, in many cases, earnings as well, and it may be one of the key reasons that earnings growth expectations are lower today. Some companies highlighted currency impacts in their fourth quarter 2014 earnings releases, and many others (nearly 20% of the S&P 500) have warnings on earnings for the first quarter of 2015. Currency hedging strategies have become more of a discussion topic compared to last year, especially for companies that have not historically hedged. This has translated into additional hedging activity during the end of 2014 and the beginning of 2015. Other than adjustments in currency hedging, significant corporate action based on short-term moves in the dollar is not expected.
- On a long-term basis, there are no hedges that can make up for the changing economics of global labor and manufacturing costs. As such, if dollar strength moves from being transient to being more permanent, it can have a significant impact on corporate behavior. Corporations will need to adjust their business models to move costs closer to regions where revenues are generated, perhaps reversing a cross-border trend that has been moving in the opposite direction for years. The process of moving labor and manufacturing abroad can have long-term implications for U.S. growth and might also trigger a political response. In the long run, it might be expected that a sustained increase in the exchange rate of the dollar would force productivity increases among domestic producers, as well as other cost-saving practices, such as outsourcing and offshoring. Further increases would likely accelerate the trends toward defensive strategies. Major volatility in the dollar is a larger concern, as it would create a much higher level of uncertainty for U.S.-based international firms.
- Companies with significant imports are seeing an immediate benefit to their input costs. Some of these companies are choosing to enter longer-term currency hedges, some stretching into 2016. Exporters have taken a more cautionary and costly approach. Many have decided to wait it out and remain unhedged, waiting on a more significant rebound in foreign currencies.
- Beige Book respondents also indicated that some of the weakening in the international demand for personal computing devices was associated with the strengthening of the dollar.
- The most at-risk sectors are consumer staples, machinery, chemicals, and some parts of the technology and healthcare industries.

Item 2: Corporate Culture in Banking:

How can regulatory agencies best monitor and address weaknesses in the corporate culture at a large banking organization?

Regulators and the banking industry have worked extensively to restore financial stability through a series of mechanisms and rules that establish appropriate levels of capital, liquidity, and leverage. The Council believes that these actions have been overwhelmingly successful in improving the safety, soundness, and resiliency of firms and in improving structural integrity. As often as not, however, the challenges faced in recent years have been behavioral and cultural;

post-crisis episodes such as LIBOR and foreign exchange manipulation provide hard evidence that there remains work to be done.

Regulatory agencies can play an important role in monitoring and addressing weaknesses in corporate culture by providing clear expectations and guidance to banks. The active and transparent dialogue established through regulatory assessment processes should include culture as a key component; for example, meeting periodically with regulators to specifically address firm culture would provide an opportunity for banks to explain how culture supports the overall business strategy and to demonstrate that cultural and financial strength receive equal focus. Moreover, candid communication between regulators and senior leadership can highlight areas of concern before they become franchise, reputational, or operational risks to a firm and can ensure that banks are equipped to identify and remediate problems as early as possible.

Notwithstanding the above, it is important to state that day-to-day responsibility lies in the hands of management and that there are best practices that can be instituted to influence employee behavior and strengthen culture. Soft measures include clear articulation of a bank's values by its board of directors and senior management and reinforcement of those values at all levels of the firm. Tone from the top is a necessary but insufficient element in establishing strong culture and governance. Culture must be embedded in corporate strategy, integrated into business practices, and centered on doing the right thing for clients, colleagues, and communities. This may include:

- Establishing a risk-management-level function devoted to culture that aligns ethical expectations and incentives, measures and monitors progress, and holds senior and middle management accountable for building and maintaining the appropriate culture within their teams;
- Implementing processes that emphasize ethical decisionmaking through regular training and having well-resourced control functions; and
- Expressing cultural values through firms' (i) annual shareholder letter; (ii) recruitment, hiring, and promotion practices; and (iii) engagement with the communities in which they operate through giving back.

Stronger measures to address misconduct are essential tools in maintaining a sound business culture as well. To that end, banks have a number of mechanisms at their disposal:

- Addressing with conviction the "broken window" issues (i.e., pattern of minor offenses) that often precede more significant cultural breaches;
- Evaluating an employee's commitment to culture in performance reviews, rewarding that commitment through compensation, and attaching severe personal consequences to bad behavior through clawback or termination, both of which are real and tangible deterrents; and
- Reinforcing these tools with a safe environment and means for employees to report misconduct (e.g., nonretaliation procedures and anonymous reporting hotlines) and with ongoing anonymous assessment of employee perspectives on culture, for example, through surveys.

The existing power that regulators have to take action to address bad behavior also serves as a strong incentive for management to ensure corporate culture is a top priority. Furthermore, if misconduct does occur, regulators can assess how a firm responds to the incident and the steps taken to prevent recurrence, intervening where necessary. Both perspective and proportionality are vital in enabling the industry and its regulators to distinguish individual bad actors from pervasive systemic problems.

At the industry level, one significant and immediate step would be a coordinated effort to establish a comprehensive employee database across banks that could prevent bad actors from moving from one firm to another and allow for consistent regulatory supervision. For example, the Financial Industry Regulatory Authority's (FINRA) Central Registration Depository contains information about all licensed employees of registered broker-dealers, including employment history, involuntary terminations, as well as customer complaints and disciplinary actions. A regulator-sanctioned or -sponsored mechanism like FINRA's, with consistent and transparent standards covering various industry sectors, could assist both regulators and the industry in monitoring and preempting recidivist behavior.

Item 3: Regulations Tailored to Different-Size Institutions

> **In the Council's view, which regulations should be tailored first and how? In addition to size, what other factors should be considered when tailoring regulations?**

The Council is encouraged by recent proposals that would differentiate regulations based on the size and complexity of institutions and by the reduction of some unnecessarily burdensome tests. Tiered regulation has become a reality, particularly since the financial crisis. However, significant focus has been put on an institution's asset size, without much consideration of the institution's business model or risk. Council members believe that regulations could be more effective at achieving banking soundness, financial stability, and economic growth if they were effectively tailored to a bank's size, complexity, business model, diversity of business lines, sources of capital and funding, relationships with other institutions, ownership structure, and organizational structure, to name a few. The following are suggested regulatory changes, with those highest on the list having the greatest priority.

- **CCAR/DFAST/Stress Testing**
  Adopt a risk-based focus where requirements (e.g., the frequency and number of stress scenarios and included portfolios) vary based on risk. Consideration should be given to revising threshold tiers based on size and complexity/systemic linkages. Various midsize banks are somewhat concerned that the current discussions to remove the $50 billion threshold for CCAR could open banks below this threshold to become subject to additional tests/regulations, which would have no practical application given the bank's business model and risk.

  The DFAST tests, while providing some insights for management, are extremely costly to run, are costly to monitor, and produce relatively limited value for the bank or the regulator. Raising the limit to $50 billion would be appropriate; however, primary regulators could request an exception for an individual bank in that $10-$50 billion range, based upon certain predetermined criteria regarding the complexity of the business model being followed by that bank. The regulators have the authority to set the DFAST requirements at a much simpler, less costly' and complex level, without legislative action.

- **Resolution Planning**
  Regulators should focus on making sure that functions necessary for the smooth operation of the financial system are able to continue, or be easily substituted, upon a bank's failure. Banks that do not have any "critical business operations" should not be required to construct a living will. In this way, resolution planning would be more appropriately directed at SIFIs. Streamlining of resolution planning to focus on those larger entities, both bank and nonbank, that demonstrate a systemic risk profile would be a more efficient use of bank and agency resources.

  Consideration should also be given to requiring resolution-plan updates or having banks file a "lite" version (summarizing changes in the RP rather than recreating it) only when there are material changes at the bank, as opposed to recurring annual updates. Likewise, differentiated formal requirements could be based on a bank's wave (i.e., first wave) and filing status (tailored plan or not) and making the requirement to produce an updated plan (both 165 and IDI plans) less frequent for Wave 3 Tailored Plan filers, given their simple and stable legal structures. The regulations could provide materiality thresholds for key areas of the plan content. Having one plan satisfy both the Federal Reserve and FDIC should also be considered.

- **Liquidity Coverage Ratio (LCR)**
  There has already been recognition that LCR rules should be tailored for smaller, domestically oriented institutions. However, even these LCR constraints will force smaller, noncomplex banks to change, or at least reassess, their current business model, as bank balance sheets will now be limited by the ability to attract funding and not the ability to find assets.

- **Consumer Financial Protection Bureau (CFPB)**
  Revisit the requirement that banks over $10 billion be subject to the direct examination and supervision of the CFPB and consider changing the threshold to $50 billion. The CFPB sets the consumer compliance regulations that are applied to every bank. This agency is examining on a focused, subject-matter basis. It can continue to examine banks in the $10 to $50 billion range for specific matters in which individual banks are very concentrated or represent a potentially large risk, but the vast majority of issues could be covered by the current prudential regulatory compliance examiners.

- **Derivative Regulations**
  With interest rate risk management a well-developed discipline, and interest rate swaps a very safe product that introduces little counterparty risk into the system, the appropriateness of applying the burden of regulatory cost to this segment of the derivatives market should be reevaluated. At the same time, credit default swaps, the product that caused many of the challenges in the financial crisis, need to be subject to enhanced regulation and capital requirements.

- **Board Governance**
  Concern exists that directors increasingly are expected to assume responsibilities that management historically has handled. It would be more productive and more consistent with

their oversight role for directors to allocate their time to matters of strategy and to the most significant risks to the organization. Enhanced guidance from the Federal Reserve would be helpful in defining the role of directors and ensuring effective corporate governance.

- **Regulatory Reporting Requirements**
  A review of all reporting requirements to determine if some of the regulatory burden could be reduced for those financial institutions that perform traditional banking activities is needed.

- **Frequency of Regulatory Examinations**
  For well-managed institutions with less complex business models, the exam cycle should be lengthened from the currently required 12-month to a 24-month exam cycle.

Smart regulation balances banking soundness, financial stability, and economic growth. However, the focus on asset size, with hard $10 billion and $50 billion thresholds, weighs down lenders and leads to unintended consequences, impairing the ability of banks to serve their communities. In addition to tailoring regulations, tailoring supervision should also be considered. Supervisors could eliminate some of the more detailed reviews and concentrate on a fewer number of activities that are correlated with negative outcomes, including rapid loan growth, high lending concentrations, specific high-risk types of lending, and wholesale funding strategies. Given the coming wave of over $10 billion entrants, how will this further impact regulatory resources and uniformity? Across all the above-mentioned regulations, what is the regulatory benefit through these exercises of inclusion of the lower-rung tiers versus the burden of cost both at the institutional and regulatory level?

Council members recognize that regulators attempt to tailor their expectations for size and complexity. Nevertheless, because this tailoring may not be transparent as to expectations, it is necessary for banks to make every effort to meet the guidance as written, in what has evolved in an increasingly resource-intensive direction. The burden is especially cumbersome on small banks, which despite their traditional business models, have seen a significant increase in regulatory scrutiny since the financial crisis. Small banks have also experienced substantial increases in compliance costs in the wake of new regulations. Most have hired additional compliance personnel and have allocated scarce resources to outside compliance advice to meet compliance expectations. Many banks are reevaluating product offerings and exiting business lines, such as residential mortgages, and are considering selling or merging with a larger bank. Overall, the new regulatory environment has created significant obstacles to small banks' profitability and their ability to remain independent and continue to serve their communities.

Item 4: Asset Management Industry

What are the systemic risks posed by asset management and how should these risks be addressed by the financial supervisory agencies?

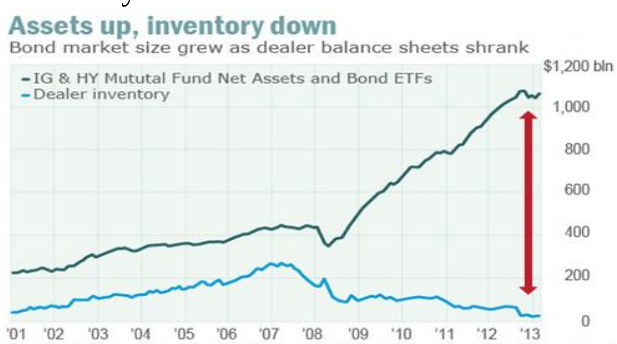
The asset management industry is large, with total global assets under management (AUM) reaching a record $68.7 trillion in 2013. This has grown substantially from 2007, the year before the financial crisis began, when global AUM stood at roughly $54.7 trillion. The sheer size and growth of the asset management industry has caused market participants and regulators to question whether the asset management industry or individual companies pose systemic risk.

In May 2014, the Financial Stability Oversight Counsel (FSOC) concluded that, with respect to asset managers, a focus on risk products rather than actual firms was a more practical approach given the nature and diversity of the industry. Asset managers are not highly leveraged, nor do they have access to taxpayer-provided central bank funding in times of distress. Many are already highly regulated by the SEC, and products geared toward retail investors (mutual funds) already have regulatory limits relating to leverage and liquidity, among other items. Further, the SEC is considering liquidity and risk/stress testing of certain regulated products. In addition, from a legal standpoint, there are some risk-mitigating factors to consider in relation to the asset management industry. Typically, asset managers invest money on behalf of their clients. There is a legal separation between a firm's assets and the assets of its customers. Asset managers serve as fiduciaries with a legal and fiduciary obligation to invest assets according to guidelines set by clients. Furthermore, there is already a regulatory framework in place to oversee asset managers.

Most academic and market research has concluded that the asset management industry and the individual companies do NOT pose a systemic risk. The Council agrees. However, the Council believes that the financial supervisory agencies should focus on risk products and specifically monitor the following when assessing potential risks:

Redemption Risk

The growing imbalance between the size and growth of certain asset classes and the market-provided liquidity of these asset classes, a direct result of new regulation aimed at the banking industry, has increased the likelihood of volatile price movements in these asset classes. The growth of mutual funds, ETFs, credit default swaps, and similar investment instruments, at the same time that the Volcker Rule has caused investment banks to take less risk and function less as a traditional counterparty in the market, may have contributed to large dislocations in what have historically been considered orderly markets. The chart below illustrates this point:



In addition to the growing gap between mutual fund asset and dealer inventories, there exists a significant concentration of fixed-income assets of a few large firms (e.g., Blackrock, PIMCO). With respect to redemption/liquidity risk, regulators should consider the following:

- Consider potential unintended consequences of the impact of new capital rules for banks, in combination with the Volcker Rule, on market liquidity.

- Create an industry working group to assess the asset management industry's preparedness for redemption risk.
- Consider conducting a stress test on selected fixed-income funds.
- Consider market-structure changes to encourage broader liquidity.

Over-the-Counter Derivatives

Over-the-counter derivative markets are a prime source of counterparty risk. This risk exists at both traditional and alternative asset managers. Credit default swaps (CDS), in particular, have grown significantly as an instrument of choice at asset managers. They are particularly popular at large fixed-income asset managers that have difficulty gaining desired exposures in cash markets and at hedge funds that want to trade quickly in and out of both long and short credit positions. While CDS can be used to hedge risk, they also can be used to amplify total risk, as notional amounts have the potential to significantly exceed underlying cash amounts. CDS that are not centrally cleared create a bigger problem because long and short risks are not netted out, greatly amplifying the total counterparty risk and making it difficult to unwind counterparty risk. Finally, complications surrounding CDS settlement in the event of a default are an area for potential distortion in credit markets. The experience of AIG, among others, has shown that counterparty risk can become systemic as problems with one counterparty can lead to a domino effect of problems at other counterparties. Asset managers should be monitored both in terms of their contribution to this systemic risk and their potential to be the central player in a CDS risk event. The first area of focus in addressing derivative counterparty risk should be to move as much trading to centrally cleared markets as possible. Much progress has been made in this area, and this work should continue. Asset managers should also report to regulators their CDS positioning and counterparties. Total notional exposure, degree of hedged versus outright risk, and size of positioning versus underlying cash markets should all be considered in determining if a manager is creating a systemic risk.

Money Market Funds (MMF)

MMF created systemic risk in 2008, resulting in a near collapse of the commercial paper market and the resulting inability of large corporations to meet short-term funding needs. The Council believes that regulators have addressed this risk with MMF reform, including floating net asset values and potential liquidity fees and gates. However, with expected implementation of MMF reform not scheduled until October 2016, regulators should continue to monitor the risk posed by MMF.

Item 5: CCAR

How do Council members assess this year's CCAR process compared with the process in previous years? What features of the process should be preserved and which should be changed? To what extent have banks started to integrate the CCAR process into their strategic plans and should banks be encouraged to do so?

Review of this Year's Comprehensive Capital Assessment and Review (CCAR) Process

- Council members and other CCAR banks agree that the CCAR process has proven to be an effective risk management tool. The ability to integrate risks of various types and report them within a well-governed end-to-end framework has been helpful in determining the appropriate levels of capital needed and will be a valuable tool for the industry as future stress events are experienced.

- The process this year was smoother than in previous years, primarily as a result of more organization around the review of the CCAR submission. Most Council members noted that the increased and improved interaction between banks and their examination teams has provided them with the opportunity to clarify guidance and expectations and to communicate planned improvements to their processes.
- Council members also noted that the additional guidance on industry best practices for capital planning and stress testing and the detailed guidance on the content for the memoranda, as well as supporting materials and templates for the CCAR submission, were extremely helpful and a positive aspect of this year's process.
- The release of the supervisory scenarios early was cited as a positive change this year. Conversely, nearly all of the respondents cited the poor conversion from the Excel-based submission to the XML format. The consensus opinion was that the late communication of this submission requirement and the change in the edit check process did not provide the time needed to adequately test the new process.
- Some CCAR banks took advantage of the opportunity to respond by expressing their appreciation for the announced change in the future CCAR submission date from January to April, believing that the new submission date will align with the close of the year and their bank's strategic planning processes.

<u>Features to Be Preserved</u>

- Respondents agreed that the process of sharing best practices should be preserved. The consensus was that the sharing of best practices allows an institution to benchmark their current performance against the best practices noted, thereby providing them with the information needed to enhance their capital planning processes.

<u>Recommendations to Enhance the Process</u>

- While communication has improved, many respondents noted continuing communication challenges, particularly in getting answers to questions asked of their examination teams. They felt open communication with the subject-matter experts would allow for follow-up questions and dialogue.
- Some Council members noted that because each risk evaluation team (RET) has its area of expertise, many examiners expect models and governance processes to stress certain line items on the balance sheet or income statement that, when looked at from a macro viewpoint, have an immaterial impact on the bank's overall capital position. Therefore, many respondents recommended that examination teams should consider the materiality and benefit of modeling additional line items on the balance sheet and income statement.
- Smaller regional banks suggested that the templates are designed for the most complex banks with little regard for the differences of smaller regional banks or the time and resources required to comply with multiple changes to the FR Y-14 reports in a given year. The ABA also highlighted this point by stating that the continual changes to the data request, which provide little time for banks to develop new or reprogram existing systems, increase the risk of errors as well as diminish the resources available to effect the systems changes needed to respond to changing customer needs.

- Given that banks are reporting on a Basel III phased-in basis as of 2015, some respondents suggested that the Federal Reserve should no longer require institutions to calculate the Basel I Tier 1 Common Ratio.
- Some CCAR banks recommended that there be more flexibility to allow for subsequent changes to capital actions. Furthermore, the predominant feeling among Council members and CCAR banks is that an institution that demonstrates that it has adequate capital to withstand a severely stressed scenario and the ability to continue to provide credit in a difficult environment should be allowed to determine its dividend-payout ratio.
- While some Council members noted the lack of visibility or transparency with the Federal Reserve's models, one Council member addressed the issue by recommending the Federal Reserve consider allowing an institution to determine its requested capital actions after the Federal Reserve has published its assessment of an institution's capital adequacy, as required by the Dodd Frank Act Stress Test (DFAST) requirements.

<u>Integration of CCAR into Strategic Planning Processes</u>

- In regard to the question about to what extent have banks started to integrate the CCAR process into their strategic plans and to what extent should they be encouraged to do so, Council members and CCAR banks had varying opinions.
- Respondents acknowledged that it was a logical progression and while many stated that they already incorporate the CCAR process into their strategic planning process, others stated that it is still a work in progress. Some banks reported that they use the base scenario as the basis for their strategic plan and use the stress scenarios to inform them of where they might want to cap growth so as to reduce their risk to a certain segment in a stressed environment.
- Most of the Council members recommended that the Federal Reserve remain cautious about forcing banks to integrate supervisory stress testing processes into their strategic plans.

Beyond the current CCAR process, the Council continues to believe that there are material issues, which should be addressed in future discussions, including:

1. Maximum dividend-payout percentage
2. Total payout limits
3. The ability of boards to commit to suspending the "approved" capital plan well before the 9-quarter period, should the Federal Reserve determine we are all in fact in a severely adverse scenario.
4. The impact of separating DFAST applications from capital activity requests and, by so doing, removing the current "mulligan" rule.

<u>Item 6</u>: <u>Payment System Improvement</u>

The Federal Reserve has recently initiated a broad discussion of ways to improve the nation's payment system. What steps should be taken to address the most significant risks in the current system and what other aspects of the system are most in need of improvement? In the Council's view, how will banks compete or cooperate with technology companies and other organizations to provide payment

services? Are there regulatory changes within the Federal Reserve's purview that should be considered to foster the efficiency or safety of the nation's payment system?

Overview:

The Federal Reserve deserves credit for bringing all the stakeholders together to discuss how to protect the long-run health and stability of our payment system, while adapting to the evolving needs of our economy in an era when new technology offers many new approaches. Council members believe that to preserve the integrity of the payment system, all payment providers must adhere to the same regulatory standards. Given the speed to market of nontraditional payment providers, timely introduction of such generally accepted standards is imperative.

What steps should be taken to address the most significant risks in the current system?

Overall, the U.S. Payment System is quite robust, thanks to the public-private coordination between the Federal Reserve and entities under its regulatory purview. There are, of course, opportunities to improve and strengthen the system in support of our economy.

- **Close regulatory gaps:** Ensure that payment and deposit activities are subject to uniform standards and enforcement across banks and nonbanks. The current migration of payment transactions and deposits away from regulated channels increases safety-and-soundness risk. If a firm holding value or transferring funds fails, it will undermine confidence in all electronic deposit and payment products – putting the entire system at risk.
- **Protect consumer privacy:** As payment data become more accessible and portable, the industry needs to consider standards to ensure consumers' transactional data are not exploited without their knowledge and explicit consent. Many of the new entrants into the payments industry are eyeing the data and will process transactions just to track private details of users and tap into their purchase behavior.
- **Reduce fraud:** Fraud remains a material risk to consumer confidence and the industry's integrity. We've observed that much of the fraud is entering the system via soft endpoints. While the banks have invested heavily to secure inter- and intra-bank systems, retailers and nonbanks that process or store account data and personally identifiable information remain attractive targets. These groups should continue to make investments to secure their customers, such as adopting EMV, encrypting customer data, deploying tokens, and perhaps even leveraging bank authentication/ID services.
- **Defeat cyber-attacks:** Together we should establish protocols for cooperation to more quickly identify and defeat threats. Today's risks are inherently dynamic, and they should be met with an equally dynamic defense that is enhanced by a strong private-public partnership.
- **Boost resiliency:** The payments system must be able to sustain multiple hits and still recover in a timely basis to support the payment needs of the economy. Where single points of failure exist, they should be inventoried and addressed.
- **Reduce liquidity risk**: Address rules that may allow participants in the payment system to create liabilities that exceed their capacity for liquidity. Specifically, originating depository financial institutions that generate ACH-debits should not be permitted to generate debit requests in excess of their capital position.

What other aspects of the system are most in need of improvement?

- **Speed of payments:** Developing faster payments capabilities will be important for the banking industry's digital transformation. Future payment applications and growth of digital services will require secure, continuous, and immediate communication that balances speed with risk.
- **Consumer choice:** The existing payment system is quite remarkable in that it provides customers with payment products that offer performance-based pricing that matches supply and demand within a spectrum of products that move money at varying degrees of speed and surety. In the end, providing the customer with choice is a hallmark of a healthy, free market.
- **Investment encouragement:** Recognizing that it is critical to attract consistent levels of investment in the payment infrastructure, we observe that actions to override market pricing could reduce investment from the private sector (i.e., debit card and ACH). Over time, underinvestment would weaken those systems and reduce innovation. In contrast, private card networks have made substantial investments to tokenize card data as the demands of the marketplace evolved.
- **Authentication standards:** User authentication is a critical step in the processing of payments. Since banks are in the best position to know their customers, we believe continuing to encourage consumers to initiate transactions secured by bank authentication (either in bank channels or through partnerships) will lead to a more secure environment.
- **Secure account credentials:** We can reduce account-credential exposure by obscuring it through tokenization. We are already utilizing tokenization in multiple instances, such as clearXchange for person-to-person and business-to-consumer transactions, and card tokenization for the industry-leading mobile wallets. Additional opportunities to tokenize exist.
- **Nonbank risk:** Some nonbank players avoid regulation by creating synthetic payment systems (a.k.a., payment hacks) that move money by using bits and pieces of the regulated system in unintended ways. Banks help patrol the gates, but beyond the gates, in the world of virtual currencies for example, there is little regulation safeguarding consumer deposits or the integrity of what consumers believe are payment transactions shielded by consumer protection statutes.

How will banks compete or cooperate with technology companies and other organizations to provide payment services?

Banks and technology companies have long had a symbiotic partnership. Banking is a technology-intensive business and the broader ecosystem (consumers, business, regulators, technology firms, and banks) have benefited from decades of close collaboration.

- **Healthy competition:** Over the years, banks have tried to become providers of technology, and technology companies have tried to provide banking services. In the end, the success or failure of each effort has been shaped by market forces and, to some extent, the regulations designed to maintain public confidence and support the economy.
- **Invite innovation with incentives:** Private-sector participants are aggressively competing to address the opportunities that lie ahead. Over the long arc of history, market incentives have proven to attract innovators and efficiently allocate resources.

- **Regulatory certainty:** Regulation has an important role in encouraging collaboration. By establishing clear rules, promoting standards, and providing consistent enforcement, regulators can help markets develop. Removing uncertainty reduces the friction and confusion that can misdirect or delay investment.

- **Partnerships with nonbanks:** Banks stand ready to support the innovators who bring new and compelling ideas to the financial marketplace. In fact, there is robust competition to partner, power, and work with these companies. Firms who skirt regulatory guidance, however, can be seen shopping for more permissive institutions.
- **Partnerships among banks:** Periodically, there are opportunities in the industry that are not being actively served by technology companies. In those instances, banks have stepped into the void with joint ventures, such as Early Warning Services and clearXchange, to reduce fraud and improve ubiquity, and to do it in a secure and compliant way.
- **Clarify role of standards:** Standards play an important role in facilitating new markets, promoting innovation, and achieving ubiquity. To this end, the Federal Reserve should continue to champion standards among the thousands of banks that make up our unique system and interface to other countries' payment systems.

Are there regulatory changes within the Federal Reserve's purview that should be considered to foster the efficiency or safety of the nation's payment system?

- **Balance:** The conversation around faster payments is focused on entirely new payments infrastructure, leaving existing systems without the attention and financial support they require to continue to adapt to the evolving needs of the economy. We need to balance the conversation by also talking about making strategic improvements to legacy systems such as ACH.
- **Tempering rising regulatory costs:** The regulatory burden placed on banks and payment processors has dramatically increased operating costs since 2001. The banks, who serve as guardians of the payment system, make huge investments on an individual and collective basis to participate in the system.
- **Nonbank Regulations:** Although the Federal Reserve generally does not have broad-based authority to regulate and supervise nonbank payment providers, given the Federal Reserve's interest in improving the U.S. payment system, it should be aware of the risks nonbanks pose and evaluate appropriate approaches to manage that risk. One potential path is to improve the state regulatory frameworks applicable to money transmitters and money-services businesses, including both substantive obligations and supervisory and examination programs.
- **Fair practices:** The Federal Reserve is unique in its role as both a bank regulator and direct competitor with the firms it oversees. This inherent conflict of interest requires the Federal Reserve to vigilantly apply the private sector adjustment to avoid crowding out investment.
- **National settlement:** As new payment systems are developed, the Federal Reserve has the opportunity to support them. Accordingly, our request is that the Federal Reserve work diligently to make the National Settlement System (NSS) available to support the banks as we innovate. Specifically, we'd like the NSS to accommodate more frequent settlement windows, extend its operating hours, and make an explicit commitment to support innovation.

In the end, private markets have a history of extraordinary innovation over the long arc of history. Private markets also have a long history of underinvesting in resiliency and safety where there is a public policy implication. Accordingly, the Federal Reserve should focus on the minimum amount of regulation necessary to ensure the safe and efficient operation of the payment system.

<u>Item 7</u>: <u>Monetary Policy</u>:

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

- The Council sees the current stance of monetary policy in the U.S. as appropriate based on underlying conditions and as highly accommodative. Recent economic data suggest that economic and financial conditions have shown less improvement over the past quarter than originally forecast by most observers, leading to expectations that any increase in rates by the Federal Reserve will be somewhat delayed from the market forecasts at the beginning of the year.
- The FOMC has stated that any rate increase would be dependent upon data that showed both further improvement in the labor market and evidence that inflation was moving back towards the 2% target over the medium term. The Council recognizes that neither of these two criteria was met during the first quarter.
- New job creation was only 126,000 in March, below projections, and the unemployment rate remained static at 5.5%. Neither evidenced a labor market improvement, although severe weather and a decline in oil and energy industry jobs may have had some impact and masked underlying progress.
- Core PCE inflation was only1.35% in March, with no strong indication that it will return to the 2% level. Wages are growing at around 2%, but this is far below the 3% to 4% wage growth seen before the recession.
- In March, the central tendency of the FOMC participants' projections for the unemployment rate over the longer term fell to 5.0% from 5.2%. This represents a substantially lower and tighter projection than in 2012 when the central tendency stood at 5.2% to 6.0%. The Council concurs that continued significant improvement in labor market conditions is consistent with the Federal Reserve's pursuit of its dual mandate of fostering maximum employment and stable prices.
- The FOMC members' judgments about the appropriate path of the federal funds rate target have also shifted down. In March, the median projection for the federal funds rate target range at the end of 2015 stood at 50 to 75 basis points, well below the median projection of 100 to 125 basis points made just last December. Similarly, in March the mean projection for the federal funds rate target over the longer term stood at 366 basis points, down from a mean projection of 425 basis points back in December 2012.
- The Treasury yield curve has priced in a lower trajectory and a lower long-run level of short-term rates than either laid out in the consensus forecast or implied by the FOMC projections, as some market participants have assigned a higher probability to a scenario that involves a "secular stagnation" hypothesis with low real GDP growth, low inflation, and a continued low equilibrium federal funds rate.
- The continued slow pace of real GDP growth in the U.S., coupled with a worldwide slowdown in economic growth despite increasingly accommodative monetary policy by other central banks, and the strengthening dollar all support this hypothesis.

- However, there is also a risk is that market participants could abandon the stagnation hypothesis, thus putting upward pressure on yields of long-dated assets. This could make removing accommodation more complicated.
- Council members believe that the normalization of monetary policy does not need to wait for both sides of the Federal Reserve's dual mandate to be fully satisfied. (We think it will be appropriate for the Federal Reserve to increase its benchmark interest rates in June of 2015.)
- The current zero bound rate level was initiated as an emergency response to the crisis of the recession. We are no longer in a crisis environment, and a crisis level of rates is no longer warranted.
- Asset prices are being heavily influenced by the low interest rate environment and might tend to stray from fundamental value if policy remains too easy for too long.
- The impact of long-term near-zero interest rates has potentially played out its effectiveness. We continue to see a lack of capital expenditures by business and relatively slow loan demand. This has led to banks' holding unprecedented levels of reserves at the Fed. Normally, low interest rates would stimulate loan demand and lead to an increase in the money supply. Instead, the M2 money multiplier sits at an all-time low. No potential borrower is not borrowing because interest rates are too high.
- A small, measured, and clearly communicated increase in interest rates, with the caveat that an increase does not automatically lead to future increases, would be supported by the Council. Insofar as such an action signals that the economy is on a sustainable path of expansion, it may engender greater business confidence and hence spur additional hiring and capital expenditures.

12:00 pm – Luncheon for Council and Board members in the Board Room