Transcript of Open Board Meeting
June 14, 2018

CHAIRMAN POWELL. Good afternoon, everyone. I'd like to welcome our guests here at the Federal Reserve and also our online viewers as well.

Today we're here to consider a rule to establish single counterparty credit limits, restricting overall credit exposures between very large banks. This rule is required under Section 165 of the Dodd-Frank Act, which establishes the enhanced prudential standards that apply to these banks. We put earlier versions of the rule out for comment in 2011 and 2016. We received and have carefully considered public comments on these proposals, and today, we're considering a revised version of the rule for final adoption.

Rules like the one under consideration today are an important part of our work since the financial crisis in strengthening the financial system so that it will be able to provide vital support to the economy in both good times and tough times. We also seek to tailor our requirements based on the activities, size, and risk of the institutions we regulate.

The financial crisis showed that financial interconnections between our largest and most complex institutions, for example, lending and borrowing between such firms, can threaten the stability of the financial system. And the final rule we are considering today will limit these exposures and their associated risks. The credit limits are tailored to the size of the firm, so for the very largest banks, the maximum exposure to another large bank will be set at 15 percent of Tier 1 capital. Firms that are smaller will face less stringent requirements. I would note that the limit for the very largest banks is tougher than that required by statute, and that is supported by a careful analysis showing that the financial system as a whole faces increasing risks when these firms have too much exposure to each other.

This proposed final rule is another step in sustaining an effective and efficient regulatory regime that keeps our financial system strong and protects our economy while imposing no more burden than is necessary to get the job done.

Thank you, and with that, I'd like to turn it over to Vice Chairman Quarles to begin the meeting.

VICE CHAIRMAN FOR SUPERVISION QUARLES. Thank you, Mr. Chairman.

The final rule we're considering today addresses an important contributing factor to the financial crisis: contagion caused by interconnectivity among the large banks. It was, in part, because of large exposures among large firms that the original shocks from the financial crisis spread so quickly through the entire financial system. This final rule, which limits the exposures that large firms can have to each other from a wide range of activity, is intended to reduce the threat of contagion to financial stability.

I view this rule as a useful complement to the principle protections against contagion which are the robust capital and liquidity positions of the financial system today. This resilience decreases the likelihood and severity of stress, so that contagion should occur less often with less potency. In addition, the financial system more broadly has adjusted in the period since the crisis to reduce potential contagion by shrinking harmful transmission channels among banks. Central clearing of derivatives is an example of such a reduction in interconnectedness. But this rule adds to these protections by setting out clear limits on credit exposures among the largest banking firms. I'm pleased by this final rule’s efficient approach to setting limits that are appropriately adjusted for firms of lesser systemic importance. The final rule also reflects the principles of simplicity and transparency by defining the firms and counterparties that are scoped into the rule based on clear and well understood accounting standards. And it also adjusts the exposure

measurement methodology for securities financing transactions to be more risk-sensitive and consistent with the methods that are used in our risk-based capital rules. I would expect that as we implement the revisions to the Basel III reform package that were agreed at the end of last year, additional improvements to the securities financing transaction methodology will be reflected in this rule as well. All of these adjustments to the proposal make meaningful compliance with the rule more likely, and I applaud the staff's responsiveness to that and other feedback in the final rule.

I'll close by noting that the final rule applies only to firms with greater than $250 billion in assets, which is consistent with the recently passed Economic Growth, Regulatory Reform, and Consumer Protection Act. Board staff is working on a comprehensive proposal for determining which enhanced prudential standards might continue to apply to firms with $100 billion to $250 billion in assets, and I will look forward to considering that proposal in due course.

Now let's turn to the Director of Supervision and Regulation, Mike Gibson.

DIRECTOR OF SUPERVISION AND REGULATION MIKE GIBSON. Thank you, Vice Chairman Quarles.

The final rule the Board is considering today represents another in the Board’s set of post crisis reforms. The rule would apply to the largest banking organizations, placing limits on a firm’s credit exposures to a single counter party. These limits address the risks to the economy that are created when large banks are highly connected with one another. The rule would include more stringent limits on exposures between systemically important firms. These more stringent limits are supported by the staff's quantitative analysis and are consistent with the Board's approach to tailoring. These limits will help to increase the safety and soundness of the financial

system overall. I will now turn the presentation over to Lucy Chang and Jeffrey Zhang, who will describe the key features of the draft final rule in more detail, including how the limits are tailored across different firms and counterparties.

LUCY CHANG. Thank you, Mike.

In March 2016 the Board invited comment on a notice of proposed rulemaking to impose single counterparty credit limits for large banking organizations. The key elements of the final rule under consideration today are substantially similar to the proposed rule. The draft final rule contains certain key modifications to that proposal to respond to concerns raised by commenters and to reflect the recent passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act. The draft final rule, like the proposal, would limit the amount of credit exposure that a large bank holding company may have to a single counterparty. Single counterparty credit limits serve important prudential and financial stability goals by reducing the risk of an individual bank holding company's failure or distress, as well as the likelihood of distress or failure among interconnected financial firms. These limits are designed to make individual bank holding companies more resilient by limiting their exposure to individual counterparties and to make the financial system as a whole more resilient by limiting the risk that the distress or failure of a large financial institution would cause other large financial firms to experience distress or failure. As seen during the financial crisis, large exposures between financial firms can serve as conduits for contagion of financial distress. Consistent with recent legislation, the draft final rule would apply to U.S. bank holding companies with $250 billion or more in total consolidated assets and global systemically important banking organizations or GSIBs, which the rule refers to as “covered companies”. The draft final rule would impose two limits: a general limit on counterparty exposures that applies to all firms and a limit that applies only to exposures

between GSIBs. Both of these limits are stricter than the statutory limit. The statute authorizes the Board to establish tougher limits if those limits are determined to be necessary to mitigate risks to the financial stability of the United States. Staff has conducted careful analysis and recommends that the Board establish limits that are tougher than the statutory standard in order to mitigate risks to U.S. financial stability. The draft final rule generally would prohibit firms from having aggregate net credit exposure to a single counterparty of more than 25 percent of Tier 1 capital. GSIBs would be further restricted to having aggregate net credit exposure of no more than 15 percent of Tier 1 capital to a GSIB counterparty. These limits are unchanged from the proposal. The draft final rule would apply similar limits to foreign banking organizations of $250 billion or more in total consolidated assets, and my colleague, Jeffrey Zhang, will discuss these limits in a few moments. Staff continues to believe that setting the limits based on Tier 1 capital would substantially promote the resiliency of these companies and overall U.S. financial stability. Since it is a strong measure of a firm's ability to absorb losses before it fails. During the financial crisis, market participants significantly discounted the going concern value of hybrid capital instruments and subordinated debt issued by banks, instruments that no longer count as Tier 1 capital but continue to count in the total regulatory capital of banking firms. If single counterparty credit limits are to meaningfully reduce the likelihood of a firm's failure, they must be based upon a measure of the firm's ability to absorb losses before reaching the point of failure. Staff also continues to believe that the more stringent 15 percent of Tier 1 capital limit on exposure to GSIBs is justified. As explained in the staff analysis published with the proposal, exposures between GSIBs present a heightened degree of systemic risk because these companies are typically engaged in common business lines and have common counterparties and funding sources. The Board did not receive specific comments on this staff analysis, and the draft final

rule retains this 15 percent of Tier 1 capital limit. In the proposal, a covered company included companies that the firm controls for purposes of the Bank Holding Company Act. Some commenters argued that adoption of a financial consolidation standard for defining a covered company would better capture the firm's true exposures and reduce the complexity and compliance costs of the final rule. Similar comments were received in a response to the proposal's definition of "counterparty" to include a company and all entities that are at least 25 percent owned or controlled by that company. Staff has analyzed these comments carefully and believes that moving to a financial consolidation standard would reduce burden on covered companies and their counterparties and would better align the final rule's core definitions with relevant accounting standards and the Board's regulatory capital, liquidity, and swap margin rules. Therefore, the draft final rule would adopt a financial consolidation standard for defining both a covered company and a counterparty. In addition, the proposal would have required a firm to aggregate its exposures to separate counterparties that are economically interdependent or tied through certain control relationships. Many commenters argued that these tests were highly subjective and could be costly and burdensome to implement in practice because they required information that might be difficult to acquire from a counterparty. The draft final rule continues to require aggregation of counterparties due to certain economic interdependence and control relationship tests but limits the cases in which a firm would have to apply the tests to the firm's most significant counterparties. In addition, several of the factors in these tests have been modified to make them clearer and easier to implement. Staff believes that these revisions should reduce burden while still requiring aggregation of counterparties connected by key economic and interdependence and control relationships. My colleague, Jeffrey Zhang, will now discuss how

the final rule directs firms to calculate their credit exposures and its application to foreign banking organizations.

JEFFREY ZHANG. Thank you, Lucy. The draft final rule, like the proposal, would apply single counterparty credit limits on a firm's aggregate net credit exposure, which is the firm's gross credit exposure reduced by the amount of certain credit risk mitigants, such as collateral and hedges. Under the draft final rule, firms are required to calculate exposures to a counterparty resulting from a variety of transactions, including loans, securities financing transactions, and derivatives. Under the proposal, a firm generally would have been authorized to calculate its derivatives exposures using any methodology authorized under the board's risk-based capital rules, including internal models. Some commenters requested that the board similarly permit firms to use internal models to measure credit exposures for securities financing transactions, or, in the alternative, permit them to use the revised standardized approach for credit risk that was recently finalized by the Basel committee on banking supervision. These commenters argued that the proposal's standardized methodology overstated credit exposures resulting from securities financing transactions and provided an incentive for firms to structure these transactions as derivatives. Staff agrees with commenters and believes it is appropriate to align the rule's treatment of these transactions with other commonly used regulatory standards. Therefore, the draft final rule permits a firm to measure the exposure of both derivatives and securities financing transactions using any methodology that it may use under the board's risk-based capital rules. The proposal would have applied a similar credit limits framework to the U.S. operations of foreign banking organizations or FBOs, and would have applied those limits at two levels. First, the combined U.S. operations of an FBO would have been subject to a limit based on the capital of the entire FBO. Second, any U.S. intermediate holding company or IHC, of the FBO

that had $50 billion or more in total consolidated assets, would have been subject to the limit based on the capital of the IHC. Some commenters argued that application of the limits of the combined U.S. operations of the FBO would subject the FBO to overlapping regulatory limits of both its home country and the United States, thereby increasing those regulatory burden on FBOs. The draft final rule retains both sets of limits to be consistent with the statute and maintain competitive quality. However, to the extent an FBO is subject to similar credit limits framework on a consolidated basis in its home country, the FBO would comply with the rule with respect to its combined U.S. operations by certifying to the Board that complies with its home country's framework. This modification should address, in large part, the regulatory burden concerns raised by foreign bank commenters. Under the draft final rule, a U.S. IHC that is a subsidiary of an FBO with at least $250 billion in total consolidated assets would be subject to credit limits based on its asset size. This approach is unchanged from the proposal and continues to be tailored based on the risk of the IHC. First, a U.S. IHC with total consolidated assets of at least $50 billion but less than $250 billion will be prohibited from having aggregate net credit exposure to a counterparty of more than 25 percent of its capital stock and surplus. Second, a U.S. IHC with total consolidated assets of $250 billion or more but less than $500 billion would be prohibited from having aggregate net credit exposure to a counterparty of more than 25 percent of its Tier 1 capital. Third, a U.S. IHC with $500 billion or more in total consolidated assets would be prohibited from having aggregate net credit exposure to a GSIB in excess of 15 percent of its Tier 1 capital and would face up to 25 percent of its Tier 1 capital limit for any other counterparty. Most other aspects of the final rule would be similar to the requirements imposed on covered companies. Under the proposal, covered companies and FBOs would have been required to comply with the rule approximately one year after the board issues the final

rule. In order to reduce compliance burdens, the draft final rule would extend this compliance period to January 1st of 2020, for U.S. and foreign GSIBs and would allow all other covered companies and FBOs to comply by July 1st, 2020. In light of these and other changes that have been made to address commenters' concerns and reflect recent legislation, staff believes that the draft final rule is unlikely to impose significant regulatory burden. In recent years, large banking firms have reduced their direct connections to each other. For example, by increasing the volume of their transactions that are centrally cleared. This draft rule would help preserve those gains. Staff also seeks to invite public comment on a proposed reporting form and associated notice requirements that would provide the Federal Reserve with information to monitor compliance with the draft final rule. That concludes our prepared remarks. We'd be pleased to answer any questions.

CHARIMAN POWELL. Thanks. Thanks very much. You know, I've been a longtime member of the Supervision and Regulation Committee, I spend a lot of time on this role, so I don't have a lot of questions, but Lucy, I would ask you, you referred to the staff analysis about why we moved to 15% for exposures between the GSIBs -- and I actually referred to it in my remarks. Is there anything more you can share about that analysis and what went into it, what came out of it?

LUCY CHANG. Sure, that analysis -- and Jeffrey Zhang will probably add to these remarks as well -- looked at considering subsets of counterparties, some just GSIB to GSIB and some GSIB exposures to non-GSIBs and looked to correlation of default for those different counterparty sets. After looking at those comparisons and thinking about how to equalize the risk associated with those different sets of counterparties, the white paper came into the conclusion

that a 15 percent of Tier 1 capital limit would be appropriate and in line with those heightened expectations.

CHAIRMAN POWELL. Great. O.K. Thank you. Questions?

VICE CHAIRMAN FOR SUPERVISION QUARLES. So, single counterparty credit limits have been part of bank regulation for a long time, maybe since the first Venetian gold merchant set up his bench on the Rialto. How does this proposal compare with, say, those for national banks?

CHRIS CALLANAN. So I can answer that question. So there's a lot of similarity between the final rule and lending limits rule under the OCC. Both limit credit exposure between firms. Both seek to increase safety and soundness. A key difference is the SCCL final rule applies at a holding company level on a consolidated basis, whereas the lending limit rule applies at the bank level. So, this will cover more exposures for these large firms. In addition, the SCCL rule has a restrict limit on these exposures which is 25 percent of Tier 1 capital, or in the case of GSIB to GSIB transaction 15 percent of Tier 1 capital and generally under the OCC's rule it's 25 percent of capital and surplus, which is a broader base.

CHAIRMAN POWELL. If no further questions, then I'd like to ask each of my colleagues for your position on this proposed rule as well as any comments you may have.

VICE CHAIRMAN FOR SUPERVISION QUARLES. I support the proposal.

GOVERNOR BRAINARD. Thank you.

I am pleased we are finalizing the single counterparty credit limits rule today for the largest banking institutions.

As we saw in the crisis very starkly, limiting the interconnectedness of large bank holding companies is vital to ensure that the distress at one of these large complex institutions

does not ricochet around the global financial system, leading to cascading failures and widespread distress. The limits that we're finalizing today will reduce the chances that such outsized exposures could spread financial distress and undermine financial stability, as we saw during the crisis. The rule that we are finalizing today implements common sense guardrails, the large exposure limits effectively build on the traditional bank lending limits that have proven useful by well over 100 years by updating them for today's challenges, recognizing the many ways in which banks and their affiliates take on credit exposure beyond direct extensions of loans.

The rule places guardrails on an expanded class of credit exposures between large banking institutions and, in my view, it appropriately assesses that against Tier 1 capital, which is a more reliable measure of a firm's ability to withstand losses than the previous more expansive benchmark of capital and surplus, and we saw that too during the crisis when investors and analysts tended to focus on Tier 1 capital.

It's also important, in my view, that the rule is tailored to apply more stringent credit limits to the very largest firms because these large complex institutions are typically engaged in common business lines and have common funding sources and counterparties there's an elevated correlation of distress and default among them. As Lucy explained, staff analysis indicates that the higher correlations warrant the more restrictive 15 percent limit compared with 25 percent on large, less complex firms.

This is a welcome step forward as we move closer to completing the necessary work to safeguard the resilience of our financial system through the cycle. In particular, it will be important to also finalize the second rule that's been outstanding since 2016, the net stable funding ratio. In addition, I look forward to examining the applicability of this and other

important post-crisis rules to institutions in the $100 to $250 billion range, pursuant to recent statutory changes.

I appreciate the extensive efforts undertaken by the staff, and I support the final rule.

CHAIRMAN POWELL. Thank you. I also support the final rule, and I want to thank staff for all of your hard work over many years in bringing this to fruition. Now we're going to vote separately on three motions. First, I need a motion to approve a final rule establishing single counterparty credit limits for U.S. bank holding companies and foreign banking organizations with $250 billion or more in total consolidated assets.

VICE CHAIRMAN FOR SUPERVISION QUARLES. So moved.

CHAIRMAN POWELL. Second?

CHAIRMAN POWELL. Without objection. Second, I need a motion to approve a proposal to implement a new reporting form, FR-2590, to monitor a firm's compliance with the final rule, establishing a single counterparty credit limits for U.S. bank holding companies and foreign holding companies.

VICE CHAIRMAN FOR SUPERVISION QUARLES. Move it.

CHAIRMAN POWELL. Second?

GOVERNOR BRAINARD. Second.

CHAIRMAN POWELL. Without objection. Third, I need a motion to authorize staff to make technical and minor changes to prepare the Federal Register documents for publication.

VICE CHAIRMAN FOR SUPERVISION QUARLES. So moved.

CHAIRMAN POWELL. Second?

CHAIRMAN POWELL. Without objection. And with that, our work here is done today. Thanks again, everybody, for your hard work, and that concludes our meeting. Thank you.