Meeting of the Board of Governors
and the Federal Advisory Council
September 20, 2013

Participants: Chairman Ben S. Bernanke, Vice Chair Janet L. Yellen, Governor Sarah Bloom Raskin, Governor Jeremy C. Stein, and Governor Jerome H. Powell (Federal Reserve Board members); Robert Frierson, Linda Robertson, Mark Carey, Gretchen Weinbach, Jon Hiratsuka, Pam Martin, Barbara Lipman, Maria Martin, Shahera Williams, and Wanda Quick (Federal Reserve Board staff)

Joseph L. Hooley, James P. Gorman, Bharat B. Masrani, James E. Rohr, Kelly S. King, Daryl G. Byrd, David W. Nelms, D. Bryan Jordan, Patrick J. Donovan, Jonathan M. Kemper, Ralph W. Babb Jr., and J. Michael Shepherd (Council members); James Annable and Shani Schechter (Council staff)

Summary: Members of the Federal Reserve Board met with the Federal Advisory Council ("the Council"), a statutorily created advisory group that is composed of twelve representatives of the banking industry (one member from each Federal Reserve District). The Council ordinarily meets four times a year to provide the Board with information from the banking industry's perspective.

The Council presented its views on the recent Basel III capital reforms and the proposed supplementary leverage ratio (Docket No. R-1460) and on prudential standards for nonbank systemically important financial institutions. The Council also discussed with Board members the potential effects on the market for mortgage lending to first-time homeowners and low-income borrowers, in light of the recent qualified mortgage rulemaking from the Consumer Financial Protection Bureau and the interagency proposed rulemaking on risk retention, which includes provisions for qualified residential mortgages (Docket No. R-1411).

The information on regulatory reform related to the Dodd-Frank Act that was collected from the Council at the meeting is summarized in the attachment. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

Basel III and Supplemental Leverage Ratio

> **The Board and the other federal banking agencies recently implemented the Basel III capital reforms and proposed a supplemental leverage ratio for the eight largest systemically significant U.S. banking organizations.**
>
> **What changes in banks' portfolios and activities does the Council anticipate in response to these new regulations?**

Final Basel III Capital Rule:

- Large U.S. banks are ready for Basel III and significant further focus on the impact of risk- based capital regulations is not necessary. Changes to large bank portfolios and activities are likely limited to the following areas:
  - Available For Sale (AFS) portfolios will likely shorten in duration as banks seek to reduce the amount of gains/losses from interest rate moves reported in Other Comprehensive Income (OCI) that will now be recognized in capital.
  - There will likely be a shift in derivative activities with corporates, pension funds, and sovereigns to European banks because the European implementation of Basel III rules exempts exposure to these counterparties from the Counterparty Valuation Adjustment (CVA) add-on capital charges.
- For smaller banks, the modifications to the U.S. final rule, particularly the reversion to the Basel I 50/100% risk weighting for residential mortgages, the one-time opt-out of inclusion of OCI in capital for non-advanced approaches banks, and the permanent inclusion of trust preferred securities in tier 1 capital were helpful. However, the complexity of Basel III requirements continues to pose challenges and significant costs for small banks, and in general, the new capital rules will likely increase the cost of credit and reduce its availability.

Enhanced Supplementary Leverage Ratio:

- The impact on banks from the proposed U.S. Supplementary Leverage Ratio (SLR) is different and more severe. Under the current proposal, the U.S. SLR becomes the dominant capital constraint for large U.S. banks given that banks are already well in excess of risk-based capital requirements. This presumably was not the intended consequence. There is a significant risk that the very effective and thoughtful CCAR process will be less important in time as the more simplistic leverage calculation drives management's behavior.
- The most significant issue with the SLR is its crudeness as a measure of risk: it takes no account of balance sheet liquidity or asset quality and creates the incentive to focus on higher-return assets at the expense of liquid, low-risk, lower-return alternatives. Indeed, the SLR may constrain the absolute size of banks' activities but in doing so may well harm many highly desirable product areas, including Treasuries, fixed-income and equity securities, and corporate lending.
- The implication of the SLR is that banks will focus on gross balance sheet size as the most relevant capital constraint. As a result, management will likely take action that drives some or all of the following:

    - Reduction in balance sheets via inventories of liquid low-risk assets, notably inventories of U.S. Treasuries and Agencies. The reduction in inventories held on bank balance sheets ultimately reduces the effectiveness of monetary policy.
    - Unwillingness to accept deposits during times of stress, particularly those associated with securities payments and settlement activities.
- In addition, these actions may:
    - Adversely impact liquidity of securities as dealers reduce bond inventories given the increased cost of repo financing and balance sheet constraints of secured lenders.
    - Increase the financing costs for repo and other secured financing transactions as lenders require higher returns to satisfy their cost of capital for on-balance-sheet exposures.
    - Reduce the availability and increase the pricing of lending commitments to corporations.
- Implementation of the SLR is also likely to result in increased compression of outstanding derivative notionals, which is consistent with policy objectives. (Note: Compression is where two or more parties identify trades that naturally offset and agree to terminate the related transactions at little or no cost to all parties.)
- Unfortunately, a looming issue is the meaningfully different approach taken by the international regulators through Basel III.
- Under the proposed Basel III SLR, repo netting is <u>disallowed</u>, requiring a gross-up of borrowing (repo) and lending (reverse) transactions. U.S. GAAP provides for repo netting under FIN 41 subject to a strict set of conditions that include identical maturities, identical counterparty, settlement through an identical clearing agent, and equal subjection to legally enforceable set-off in the event of default. The importance of repo netting is discussed in more detail in the next section.
- The proposed Basel III SLR also increases the gross asset amount associated with derivatives by eliminating the netting benefit of collateral from the calculated asset amount. This approach is inconsistent with the demonstrated benefits of high-quality collateral in reducing banks' exposure to counterparties in the event of default. However, it is important to note that while the Basel III rule drives a higher denominator (notional balance sheet), the required leverage ratio of 3% is notably lower than the U.S. level of 5% at holding companies and 6% at depositories.

What are the likely effects on financial markets, including the repo market, from changes in international leverage requirements?

- The recently proposed changes to the international version of the Basel III SLR could have a significant adverse impact on financial markets, including securities lending activities. In contrast to the proposed U.S. SLR, which recognizes U.S. GAAP netting of securities financing transactions (e.g., repo), the international proposal disallows such netting, thereby increasing the amount of gross assets recorded in the denominator of the capital ratio. Balance sheet netting is a cornerstone of the securities lending market because it allows dealers to recognize the legal right to offset borrows and loans with the same counterparty and because it is based on a set of strict criteria established by accounting standards bodies.

- Disallowing netting for securities financing transactions will materially increase the break- even return on such transactions because significantly more capital would be required to support these low-margin, fully collateralized lending agreements. It is noteworthy that both large and small banks are likely to suffer from the adverse effects associated with the disallowance of repo netting.
- For dealers, this may mean:
  - Reduced inventories reflecting higher financing costs and limited ability to pledge securities as collateral.
  - Market making would have wider bid-offer spreads with less liquid/less deep securities markets, driving increased price volatility.
  - Reduced margins at smaller banks as they exit from repo markets and shift their borrowing to higher-cost medium- and long-term funding sources
- For investors, this may mean:
  - Increased transaction costs associated with buying and selling securities and reduced availability of inventory selection.
  - Increases in rates charged to finance holdings.
- For corporate and government borrowers, this may mean:
  - Increased cost of financing through publicly traded debt due to increased market frictions.
- Analysts estimate that large European banks are currently ~50 basis points below the 3% leverage ratio minimum and will be forced to reduce balance sheets by ~€700 billion and raise ~€50 billion of new capital to meet existing Basel III leverage requirements. The proposed modifications to the international rule would require further reductions in balance sheets and additional capital raises. Consistent with analysts' assessments, two of the largest Eurozone banks have publicly announced plans to reduce their inventories of securities and related financing transactions, derivatives, and, most notably, liquidity pools by ~€380 billion ($500 billion). Needless to say, were the international view to be implemented with the higher U.S. leverage ratio of 5%/6% required by U.S. regulators, there would be a dramatic restructuring of U.S. balance sheets with very material consequences to securities trading, bank lending, and the broader financing markets.

Nonbank SIFI Designation

The Financial Stability Oversight Council recently made determinations that certain nonbank firms are systemically important financial institutions (SIFIs). What is the Council's view of the process for SIFI designation? Does the process adequately address the concerns raised about SIFIs?

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Prudential standards for nonbank SIFIs

- While the Council supports designation of nonbanks as SIFIs, members are concerned that the largely bank-focused heightened prudential standards for SIFIs currently in effect or proposed by U.S. regulators will be inappropriate for nonbanks. For example, both insurance companies and asset managers operate under dramatically different business models and regulatory regimes than banks, and applying bank-like regulations (capital, liquidity, credit concentration) to such firms would threaten their business model and would not appropriately target whatever systemic risks they may pose. U.S. regulators should provide substantial additional clarity with respect to the regulatory implications of nonbank SIFI designation and, if needed, develop new heightened prudential standards relevant to nonbank market participants.