Transcript of Open Board Meeting
March 4, 2016

CHAIR YELLEN. Good afternoon. I'd like to welcome our guests to the Federal Reserve today as we take another important step to enhance the resiliency and stability of our financial system.

In the financial crisis, we learned that the largest and most complex banks and financial institutions lent or promised to pay large amounts to other institutions that were also very large and complex. These credit extensions and promises did not eliminate risk, and in many cases they magnified it.

The single counterparty credit limit we are considering today targets that problem. The credit limit sets a bright line on total credit exposures between one large bank holding company and another large bank or major counterparty. For the very largest banks--those considered to be global systemically important banks, or G-SIBs--the exposure to another major counterparty is stricter than the limits placed on smaller banks and will be set at 15 percent of tier 1 capital.

I am pleased to be considering this rule, because we are determined to do as much as we can to reduce or eliminate the threat that trouble at one big bank will bring down other big banks.

I look forward to this discussion and will now turn to Governor Tarullo.

GOVERNOR TARULLO. Thank you, Madam Chair. Limits on commercial bank lending to a single borrower are a fundamental and longstanding element of prudential regulation. The regulation before us today would extend this safeguard by applying limits on the combined exposures to a single counterparty within all parts of large bank holding companies. The regulation would complement overall capital requirements, which are generally based on the size and nature of a bank's assets and do not address the risks of concentrated exposures to specific borrowers or counterparties.

I think a few points in particular are worth highlighting. First, this rule would apply only to the financial firms covered by section 165 of the Dodd-Frank Act--that is, bank holding companies with $50 billion or more in assets. Bank holding companies and banks below the $50 billion threshold are entirely exempt.

Second, as the Chair has already indicated, as has been our practice in our regulations implementing Dodd-Frank provisions related to these large banks, the proposed rule would impose increasingly tighter limits as their systemic importance increases.

For banks between $50 and $250 billion in assets, the regulation proposes to impose only the minimum requirement established in the statute--that is, a limit on aggregate net credit exposure to any one counterparty of 25% of all regulatory capital.

For banks with $250 billion or more in assets, the proposal would use the authority granted in the statute to impose a stricter limit--specifically, by basing the 25% limit on Tier 1, rather than all, regulatory capital, and that use of a different denominator is a change from the previous proposal.

Finally, again as the Chair noted, the eight domestic G-SIB banks and foreign banks with more than $500 billion of assets in their US holding companies would have an additional limit of 15%, again, of Tier 1 capital on exposures to one another and to other systemically important financial firms.

Third--my third point is that staff conducted substantial empirical analysis in preparing this proposal, including a quantitative impact study to help gauge its likely effects. The white paper that accompanies the proposal sets forth both the conceptual and quantitative foundations for the tighter limits that will apply to G-SIBs. Staff estimates that almost all of the roughly $100 billion in current exposures among domestic firms that would exceed these limits is attributable to exposures among G-SIBs, that is falling under that last and strictest of categories.

While regulatory reform and better risk management practices have reduced interconnections among the largest financial firms by roughly half from pre-crisis days, it is important to put safeguards in place to help prevent a return to those prior practices. Indeed, the broader issue of common large counterparty exposures among the largest banks is one that we should bear in mind as we continue to develop the macroprudential features of our annual stress tests and capital assessments.

And with that, Madam Chair, I will turn to Mike Gibson to lead the staff presentation.

MICHAEL GIBSON. Thank you, Governor Tarullo. The proposed rule before the Board today is another example of the staff's commitment to supporting the Board's tailored and data-driven approach to regulation and supervision. For example, as Governor Tarullo discussed, the proposal is supported by a quantitative impact study designed to help assess the likely impact of the proposal. As a result, the current proposal is more risk-sensitive and effective with--which both Jordan and Sean will discuss in additional detail. Also, the proposal before the Board benefits from the comments received on our original proposal.

Because it's supported by the international large exposure framework adopted by the Basel Committee on Banking Supervision, the current proposal will also be stronger and more effective. This is why Board staff helped persuade the Basel Committee to adopt that standard, which is designed to achieve objectives similar to those of the US single counterparty credit limit framework. Aligning our rules with the Basel standard will maintain a level playing field among global banks.

With that, I'll turn to Jordan Bleicher who will go into further detail on the single counterparty credit limit standards before the Board today.

JORDAN BLEICHER. Thanks, Mike. Draft proposed rules would limit the amount of credit exposure that a large bank holding company, together with its subsidiaries, is permitted to have to a single counterparty. Single-counterparty credit limits would be designed to promote two main objectives. First, they'd be designed to make individual bank holding companies more resilient by preventing them from having outsized credit exposures to particular counterparties. And second, they would be designed to make the system as a whole more resilient by limiting the risk that the failure of a large financial institution would result in the failure of other large financial firms.

The proposed rules are generally similar to the single-counterparty credit limits that the Board proposed in 2011 and 2012, although some modifications have been made to increase the risk sensitivity and effectiveness of the framework. The proposed requirements would be tailored based on the systemic footprint of the firms to which they would apply.

In a few minutes, my colleague, Sean Campbell, will discuss the rationale for applying a tighter 15% limit to exposures of the US G-SIB to another systemically important firm. In addition, bank holding companies with more than $250 billion in total consolidated assets would be subject to single-counterparty credit limits based on Tier 1 capital instead of the broader concept of total regulatory capital. Staff use of the Tier 1 capital base for larger bank holding companies is critical to reducing the likelihood that the failure of one large financial institution would result in the failure of other large financial firms. For this goal to be realized, single-counterparty credit limits for larger bank holding companies need to be imposed relative to a measure of a firm's ability to absorb losses before reaching the point failure.

Unlike Tier 2 capital, Tier 1 capital consists only of common equity and other instruments that are designed to take losses on ongoing concern basis. Use of a Tier 1 capital base is also consistent with the fact that during the financial crisis creditors and counterparties of firms tended to heavily discount lower quality forms of capital.

Now, I will discuss how credit exposure to a counterparty would be measured under the proposed rules. Based on the quantitative impact study we performed to help gauge the effect of the proposed requirements, we believe that derivative transactions in general and credit derivative hedges in particular would be two of the main drivers of credit exposure between covered companies and their counterparties.

For most derivative transactions, the proposal would permit firms to measure exposure to their counterparties using methodologies that they are permitted to use under the risk-based capital rules. These methodologies currently include the standardized current exposure method for all covered companies and the internal models methodology for covered companies that are subject to the Board's advanced approaches capital rules.

However, the draft Federal Register notice notes that firms could be required ultimately to use the Basel Committee's revised and standardized approach for derivatives, known as SA-CCR, for purposes of single-counterparty credit limits at such time as the Board incorporates SA-CCR into the risk-based capital rules. In addition to promoting consistency across firms, use of a standardized measure such as SA-CCR would provide greater transparency to the public about how covered companies are measuring their exposure to derivatives counterparties.

With respect to credit derivatives, the proposal would require a firm that purchases credit protection to recognize an exposure to the credit protection seller in all instances. This component of the rule is designed to reduce the risk of scenarios similar to that of AIG in 2008 with the near failure of a firm that had sold the large amounts of credit protection to large banks threatened to destabilize the system as a whole. When a covered company uses credit derivatives to hedge an exposure to a financial entity such as a bank or securitization, the covered company would be required to recognize an exposure to the credit protection seller equal to the full notional amount of the derivative. By contrast, when a covered company uses credit derivatives to hedge an exposure to a non-financial entity, such as a commercial corporation, the covered company typically would be required to recognize an exposure to the credit protection seller in an amount less than the full notional of the derivative. The purpose of this bifurcated approach is to apply a tighter treatment where risks to financial stability are elevated.

Securities financing transactions are another important driver of credit exposure for some covered companies. Estimates of a covered company's exposure to a counterparty in a securities financing transaction depend on assumptions about the amount of time it would take the covered company to close out or liquidate the transaction following the counterparty's default. The longer the assumed liquidation period, the greater the exposure.

Under the 2011 proposal, the covered company would have been required to estimate its exposure to securities financing counterparty based on a ten-day liquidation period. Under the revised proposal, covered companies would be required to estimate exposure to a securities financing counterparty based on a five-day liquidation period. Use of a five-day liquidation period aligns with the risk-based capital rules. The proposal also seeks comment and several additional modifications that could potentially make the treatment of securities financing transactions more risk-sensitive.

Like the original proposal, this proposal would provide an exclusion for exposures to the US government. In addition, the draft proposed rules would exempt exposures to foreign sovereigns that receive a 0% risk weight under the Board's standardized risk-based capital rules, as well as trade exposures to qualifying central counterparties. This treatment of exposures to high-quality sovereigns, qualifying central counterparties is designed to reduce the risk of disrupting transactions that are either collateralized by high-quality sovereign debt or cleared by well-supervised central counterparties.

Turning to foreign banking organizations, or FBOs, this proposal would build on the enhanced prudential standards adopted by the Board in 2014 for FBOs with $50 billion or more in total consolidated assets. Under that rule, an FBO with the US non-branch assets of $50 billion or more is required to form a US intermediate holding company, or US IHC, to hold its interests in US bank and non-bank subsidiaries. US IHCs will be subject to enhanced credential standards on a consolidated bases, including capital requirements, liquidity requirements, and risk management standards.

Certain enhanced prudential standards also will apply to an FBO's combined US operations, which would include an FBO's US branches and agencies as well as its US subsidiaries. Like other enhanced prudential standards--and standards for FBOs, the single-counterparty credit limits in this proposal would only apply to FBOs with $50 billion or more in total consolidated assets. For such FBOs, the limits would apply separately to the US IHC and combined US operations. Single-counterparty credit limits for an IHC would limit the IHC's net credit exposure to another counterparty relative to the IHC's capital. Single-counterparty credit limits for an FBO's combined US operations would limit the net credit exposure of the combined US operations to a counterparty relative to the foreign bank parent's capital.

Similar to the proposal for domestic bank holding companies, single-counterparty credit limits for US IHCs and an FBO's combined US operations would be tailored based on the systemic footprint of the IHCs and FBOs to which they would apply. Most other aspects of the proposed single-counterparty credit limits for FBOs would also be similar to the proposed requirements for US firms.

With that, let me turn to Sean Campbell to discuss the justification for applying a tighter limit--a tighter 15% limit to certain inter-SIFI exposures.

SEAN CAMPBELL. Thanks, Jordan. Under the revised proposal, a tighter 15% limit would apply to the exposures of the US G-SIBs, US IHCs with $500 billion or more in total consolidated assets, and the combined US operations of foreign banking organizations with $500 billion or more in total consolidated assets to a major counterparty.

The principal rationale for applying a tighter single counterparty credit limit to exposures between these entities, which I'll refer to as SIFIs for convenience, is that these exposures are expected to result in a heightened degree of risk to SIFI lenders than would otherwise be the case of the SIFI were extending credit to a non-SIFI, such as a non-financial corporate borrower. This heightened risk arises because SIFIs are engaged in common business lines and have common counterparties and funding sources. This creates a significant degree of commonality in their economic performance. In particular, factors that would likely cause the distress of a SIFI borrower would also likely be expected to adversely affect a SIFI lender. Accordingly, the default of a SIFI borrower would erode the SIFI lender's capital base at precisely the same time that the lender itself comes under stress from some of the same shocks that resulted in the default of the borrower.

A white paper that is being released concurrently with the proposed rule analyzes data on the correlation between SIFIs as well as data on the correlation between SIFIs and a sample of non-SIFI companies. The analysis supports the view that the correlation between SIFIs is measurably higher than the correlation between SIFIs and non-SIFI counterparties. This finding further supports the view that the credit extensions between SIFIs present a higher degree of risk than other credit extensions.

The more stringent credit limit of 15% is informed by the results of a credit risk model that is described in detail in the white paper. Data on the correlations described above are used to calibrate a credit risk model that is then used to identify a range of single-counterparty credit limits for exposures between SIFIs so that the total risk incurred on such inter-SIFI credit extensions are equilibrated with the total credit risk incurred on other credit exposures. The resulting model produces a single-counterparty credit limits for exposures between SIFIs that are in lined with the proposed limit of 15%.

In additional consideration that is not explicitly considered in the context of the white paper's credit model is the relative difference in the adverse consequences arising from multiple SIFI defaults relative to the default of a SIFI and a non-SIFI counterparty. The financial stability consequences of the default of a SIFI borrower and a resulting default of a SIFI lender are likely greater than the adverse consequences that would result from the default of a single SIFI lender and a single non-SIFI borrower. This consideration supports an appropriate inter-SIFI limit that would be even lower than that suggested by the credit risk model described in the white paper.

As Governor Tarullo and Director Gibson have noted, Board staff have conducted a quantitative impact study to help assess the likely effect of the revised proposal. Based on this study, staff believes firms would be able to comply with the proposed framework without materially disrupting their activities. Staff estimates that there would be less than $100 billion in aggregate excess credit exposure among all domestic covered BHCs that would be subject to the proposed requirements. The overwhelming majority of the estimated excess credit exposure would be on inter-SIFI credit exposures. Accordingly, the principal effect of the proposal would be to reduce concentrations of credit risk between SIFIs, concentrations that can generate outsized levels of systemic risk as explained in the white paper and demonstrated in the financial crisis.

Staff anticipates that US firms would be able to eliminate their excess exposure amounts largely by compressing derivatives trades, collecting more collateral from their counterparties, increasing their use of central clearing with qualifying central counterparties and rebalancing their portfolios among their counterparties. All of these measures represent sound risk management practices that should strengthen the resilience of covered firm, as well as the overall financial stability.

That concludes staff's prepared remarks.

CHAIR YELLEN. Thank you very much. A couple of questions for you, first on derivatives. This proposal differs substantially in its treatment of derivatives relative to the earlier proposal, and I wonder if you could explain a bit more about the changes and whether or not you think the current treatment is sufficiently strong.

JORDAN BLEICHER. Yeah, so, the proposal would really have two components for addressing exposure for derivatives. The first would deal with derivatives generally, and the second would be focused on credit derivative hedges, and we think that both pieces of the framework would be risk-sensitive and effective.

With respect to derivatives generally, this proposal would permit firms to use approaches that they're allowed to use under the risk-based capital rules. In 2011, that proposal would have required firms to use the current exposure method, or CEM, and CEM is really not a particularly risk-sensitive tool. Effectively with CEM, a firm's exposure to a derivatives counterparty is its mark-to-market exposure plus some percentage of the notional amount if its trades with the counterparty. So it's a fairly blunt tool.

Ultimately, again, as I sort of suggested in my remarks, we would expect that the Board would consider incorporating into this framework the Basel Committee's revised standardized approach, or SA-CCR. SA-CCR is designed to be really more risk-sensitive than CEM. It would produce higher estimates of exposure in cases where a firm's trades with the counterparty are correlated but lower estimates of exposure where the trades are more diversified.

With respect to credit derivatives, this proposal would require a firm to recognize an exposure to a credit protection provider in all instances. In cases where a credit derivative is being used to hedge an exposure to a financial entity like a bank, that exposure would be equal to the full notional amount of the hedge. In other cases, where credit derivatives for example are being used to hedge exposures to commercial corporations, a somewhat less stringent treatment would apply, and the reason for that bifurcated approach is that--Sean sort of suggested in his remarks--we think that credit derivatives used to hedge exposures to financial entities pose more systemic risk.

Sean mentioned in his remarks, financial entities tend to default in certain clusters at similar points in time, and also at points when the financial system as a whole is facing more stress. And so for that reason, we think the sort of bifurcated approach again is more risk-sensitive.

CHAIR YELLEN. Thank you very much. One more question, if I might, and it concerns market liquidity. As you know, there are considerable concerns at the moment about a possible deterioration in market liquidity, and I notice that in response to the previous proposal, a number of commenters were concerned that these limits-reducing the limits would have disruptive effects on markets, and one of the concerns was market liquidity. So I guess I would ask whether or not this is a potential impact of this proposal in diminishing market liquidity.

SEAN CAMPBELL. Sure. So in the context of thinking about market liquidity, I think the first thing to sort of state right off about is that this rule in principle constrains a bank's ability to take a single concentrated exposure to a single counterparty. It does in no way limit a bank's ability to face an entire market. So, in that sense, staff doesn't believe that it will be having a first order effect on market liquidity because banks can face an entire market, all of the counterparties that comprise a market without any difficulty. This rule is only about actually a specific exposure to a single large counterparty.

You know, that being said, there are certain elements of the proposal and of the exposure calculations that could in some cases, for example in the case of derivatives, could at one point in time, you know, bind a particular counterparty and could have some ramifications for a bank's ability to provide liquidity to that specific counterparty. In the context of derivatives, as Jordan already alluded to and in the context of other transaction types, such as repurchase agreements and securities financing transactions, staff estimates of the combined impact of those aspects of the rule are such that we think that the excess exposure that would be generated from those kinds of transactions is extremely small in general. And so we don't, as a general matter, think that this rule will have significant consequences for market liquidity.

CHAIR YELLEN. Thank you very much. Question?

VICE CHAIRMAN FISCHER. Thanks, Madam Chair. You mention the--some of $100 billion as--how should we think about that in relation to the size of the markets in which they're operating? Is this a big deal or a small deal?

MARK VAN DER WEIDE. So I think it's a small to medium deal. The excess exposures concentrated primarily in derivatives and securities financing transactions. For some of those derivatives, the measurement technology in the proposal is notional amount. So for some of the CDS, it's notional amount. For others of the derivatives, it's some fraction of the notional amount. For securities financing transactions, it's a net exposure that reflects the collateral. So I think the exposure in aggregate for the G-SIBs is one that we consider to be manageable. We think reductions in their inter-SIFI credit exposures in that amount useful to mitigate systemic risks in those transactions. But we think the mechanisms that they'll be able to use to get back down under the limit, the time what we'll give them to do that will be such that, you know, the movement to the new regime will not be one that will be disruptive to the markets.

VICE CHAIRMAN FISCHER. OK, thank you. Thanks, Madam Chair.

CHAIR YELLEN. OK. Governor Tarullo.

GOVERNOR TARULLO. Thank you, Madam Chair. I'm following up on the Vice Chair’s line of inquiry. Can you--and, Sean, you may be the best person to do this, but if others are going to chime in, that's fine. Given that the interconnections among the largest banks have at least by our estimate has been reduced by about half, were the kinds of--were the patterns of exposures that existed pre-crisis just sort of roughly composed of the same kinds of exposures proportionately as those that currently exist but they were just twice as many of them? Or have the nature of those exposures and interconnections proportional to the total amount changed in the post-crisis period?

SEAN CAMPBELL. So I can give that a try and then others in the table may want to sort of amend my thoughts or remarks. I think, you know, given sort of the data that we've looked at with respect to the exposures that banks had around the time of the crisis and how that has evolved post-crisis, I think it's generally not the case that the exposures have come down one-for-one sort of in a proportionate manner across all exposure types. And so, in the specific context of derivatives, there have been a number of market reforms since the crisis, in particular, the advent of central clearing, which has basically moved a lot of trades out of the bilateral space where you would take a direct exposure to another large financial institution. But rather now, you would take an exposure to a CCP where you're providing initial margin up front and you're collateralizing that trade on a daily basis. So I think in some of the data that we looked at, at least my initial reaction-slash-recollection is that we've seen more of a compression in the exposure that results from derivative transactions than for other kinds of credit that might be provided, such as like short-term interbank lending and money placements. And so, there has been a sort of larger decline in the exposures that we see in the context of some transaction types.

GOVERNOR TARULLO. And if we--Sean, we think about the narrative, the prevailing narrative of what happened once the stresses hit in 2007 and more saliently in 2008. With the amplification of stress associated with the nature of the interconnections, which often themselves were very short-term or rollable transaction, would--other than the kind of derivatives transactions you're talking about, would that, too, have changed over the course of the last seven or eight years?

SEAN CAMPBELL. The relatively short term nature?

GOVERNOR TARULLO. Yeah.

SEAN CAMPEBLL. I think that has changed less so. I mean there might be other people I--To be honest, I don't have an extremely fine-grain view on that at the present time. But my basic understanding is that the kind of credit exposures that tend to exist, especially among large SIFI institutions, tend to be more of the short-term rollable variety that are not--these are not five-year commitments generally speaking.

GOVERNOR TARULLO. So that they would--that would still be something that we may want to be paying attention to either in the context of overall liquidity requirements--

SEAN CAMPBELL. Right.

GOVERNOR TARULLO. --or as I was alluding to earlier, something that looked at collective exposures of big banks to--

SEAN CAMPBELL. That's right.

GOVERNOR TARULLO. --collections of other big banks?

SEAN CAMPBELL. That's right. So there's still a significant amount of maturity transformation going on in the financial sector, and there are still “when the music stops” issues that arise. Even if the exposure to any given bank is relatively small in the aggregate, banks are still engaging in maturity transformation at the industry level. I think that's right.

MARK VAN DER WEIDE. But there has been progress though in part due to our efforts with the LCR and the NSFR and our enhanced liquidity supervision. So you are seeing a meaningful amount of turning out of various [inaudible] exposures among the big financial institutions. There's more, more progress that we’d like to see, but I think it has come a long way.

GOVERNOR TARULLO. And, Mark, you would say even, even among [inaudible]--

MARK VAN DER WEIDE. Yeah, some.

GOVERNOR TARULLO. --and not just with SIFIs and third parties but [inaudible] as well. Thank you, Madam Chair.

GOVERNOR POWELL. Thank you, Madam Chair. I think we've done a nice job--you've done a nice job with the size tailoring of these requirements. Of course the requirements also hit different activities in different ways--different business models will be affected in different ways. And I think I recall that the custodial activities were thought by--those involved in custodial activities were thought that the earlier proposal would affect them "negatively". So is this proposal different in material in respects from that? And if so, how and why?

JORDAN BLEICHER. Yeah, it is materially different from our 2011 proposal. Again, estimates of exposure from securities lending transactions depends fairly heavily on what you assume about the amount of time following a counterparty's default that it would take you to liquidate your transactions with that counterparty. Our 2011 proposal included a ten-day liquidation period, whereas this revised proposal would be based on a five-day liquidation period. And this technical change from ten to five days, we estimate would reduce exposure from those transactions by about 40%. Custodian banks and others may still argue that this proposal is too conservative because of assumptions it makes essentially about correlations among securities loaned to a counterparty and correlations among securities received back from that counterparty as collateral. And the preamble does describe a few further modifications to the approach that could be used to address those kinds of concerns.

In general though, there is a tradeoff. On the one hand, some of those modifications could potentially increase risk sensitivity, but they would also add somewhat to the complexity of the framework. There probably also would be a somewhat higher risk of understating exposure in some cases. So this is an area where we'll be interested to hear what commenters have to say.

CHAIR YELLEN. Brainard.

GOVERNOR BRAINARD. Thank you, Madam Chair. I thought the staff did a really nice job of taking into account some of the comments they received on the earlier proposal in terms of particular exposure types, and I really like the substantially tighter limit on the credit exposures among the largest and most interconnected group of banking organizations for precisely reasons that you laid out, because of the very high degree of correlation among these firms in terms of their funding sources and the kinds of activities they do, and of course the greater risk to the system. It also seem like the calibration methodology that's included in the white paper is very intuitive and a nice basis for the particular limits that you set out.

CHAIR YELLEN. OK. Let me ask my colleagues if they would be willing to state positions on the proposal. Vice Chair?

VICE CHAIRMAN FISCHER. I'm in favor of the proposal.

GOVERNOR TARULLO. As am I.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. As am I, Madam Chair.

CHAIR YELLEN. Governor Brainard.

GOVERNOR BRAINARD. I support it.

CHAIR YELLEN. And likewise. OK. Seeing that we are all supportive, I need a motion to approved publishing for public comment the proposed rules to implement single-counterparty credit limits on large US bank holding companies and foreign banking organizations as required under section 165(e) of the Dodd-Frank Act, and second, to authorize staff to make technical and minor changes to the proposed rules and related Federal Register document for publication.

VICE CHAIRMAN FISCHER. So moved.

CHAIR YELLEN. Thank you. Second?

GOVERNOR TARULLO. Second.

CHAIR YELLEN. All in favor?

ALL. Aye.

CHAIR YELLEN. OK, I think it's unanimous. Thanks so much to the staff and to Governor Tarullo and your colleagues on the banking committee for your excellent work on this and bringing this proposal out again to--for comment. Thanks. We're adjourned.