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Board of Governors of the Federal Reserve System
20th & Constitution Avenue, NW
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Fax: 872-7565
Online FOIA Request Form

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

September 29, 2014

Re: Freedom of Information Action Request 2014-285

This is in response to your correspondence dated June 15, 2014, and received by the Board's Freedom of Information Office on June 24. Pursuant to the Freedom of Information Act, 5 U.S.C. § 552, you request a copy of each response to a Question for the Record provided to Congress by the Federal Reserve System since January 1, 2009.

Staff searched Board records and found documents responsive to your request. The Board's Freedom of Information Office will provide you with copies of these documents under separate cover. Your request for information, therefore, is granted in full.

Very truly yours,

Margaret M Shanks

Margaret McCloskey Shanks
Deputy Secretary of the Board

09-2882

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 31, 2009

RECEIVED
OFFICE OF THE SECRETARY
RECORDS SECTION
2009 APR -2 P 2:46

The Honorable Lindsey O. Graham
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the March 3, 2009, hearing before the Senate Budget Committee titled, "Economic and Budget Challenges for the Short and Long Term." A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

(Signed) Ben Bernanke

Enclosure

(B-37. 09-2882)

For files
P. Elliff/

Chairman Bernanke subsequently submitted the following in response to written questions received from Senator Lindsey Graham in connection with the March 3, 2009, hearing before the Senate Committee on the Budget:

Is it wise to raise taxes during a recession?

Most economists feel that raising *overall* taxes would be counterproductive to the necessary efforts to help achieve a financial and economic recovery during the current recession. Once the economy has been put onto a sustainable path to recovery, however, policymakers will need to make the difficult choices associated with addressing fiscal imbalances that might include raising taxes.

President Obama has proposed limiting itemized deductions for upper income taxpayers. What do you think will be the impact of this proposal on charitable contributions? What would be the impact of limiting the mortgage interest deduction on the housing market?

As you know, during my tenure as Chairman of the Federal Reserve Board I have avoided taking a position on explicit tax and spending issues. I believe that these are fundamental decisions that must be made by the Congress, the Administration, and the American people. Instead, I have attempted to articulate the principles that I believe most economists would agree are important for the long-term performance of the economy and for helping fiscal policy to contribute as much as possible to that performance. In that regard, a general economic principle of tax reform is that the economic efficiency of a tax system can usually be enhanced if tax rates can be kept as low as possible while at the same time broadening the tax base in order to raise the desired amount of revenue. However, reforming the tax structure is not easy as it involves not only setting tax rates but also the difficult decisions of how to broaden the tax base. Indeed, changes to the structure of the tax system that may improve its efficiency may not be judged to be equitable. Nevertheless, the choices that are made regarding both the size and structure of the federal tax system will affect a wide range of economic incentives that will be part of determining the future economic performance of our nation.

Congress is likely to take up legislation to allow bankruptcy judges to reduce the principal amount of mortgage loans for borrowers (known as "cram down"). Do you support this policy change? How do you think this proposal will impact mortgage rates?

Providing bankruptcy judges with the ability to adjust mortgage terms and reduce outstanding principal should result in more sustainable mortgage obligations for some borrowers and thus help reduce preventable foreclosures. Such an approach has several advantages. In particular, because of the costs and stigma of filing for bankruptcy, mortgage borrowers who do not need help may be unlikely to turn to the bankruptcy system for relief. Bankruptcy judges may also be able to assess the extent to which a borrower truly needs assistance. Because the bankruptcy system is already in place, this approach could be implemented very quickly, and these changes to the bankruptcy code would likely involve no financial outlay from the taxpayer.

These advantages, however, could come at the cost of restricting borrower access to mortgage credit. The academic literature has not reached a consensus as to whether these changes to the bankruptcy code would result in material limitations on the availability of mortgage credit. Studies of regulations in other lending markets, however, suggest that such a tradeoff may exist. As these changes to the bankruptcy code would be permanent, it is possible that these changes could have long-lasting effects on credit availability. Thus, while these modifications to the bankruptcy code would not impose direct costs on taxpayers, they could impose indirect costs through higher interest rates or more stringent lending standards.

In addition, some private-label mortgage-backed securities (MBS) contain so-called "bankruptcy carve-out" provisions requiring that losses stemming from bankruptcies be shared across the different tranches of the securities. The implication is that the investors holding the AAA-rated tranches would bear most of the losses from principal write-downs allowed by the legislation because they account for most of the outstanding deals. Large holders of AAA-rated MBS, including the housing GSEs, might thus face material losses if bankruptcy judges were permitted to reduce the principal amount of mortgages. Such an outcome might further de-stabilize conditions in financial markets.

As the Congress considers whether to enact modifications to the bankruptcy code, it will need to weigh these various factors.

Questions for the Record for Federal Reserve Chairman Ben Bernanke
Senator Lindsey O. Graham
March 3, 2009

Is it wise to raise taxes during a recession?

President Obama has proposed limiting itemized deductions for upper income taxpayers. What do you think will be the impact of this proposal on charitable contributions? What would be the impact of limiting the mortgage interest deduction on the housing market?

Congress is likely to take up legislation to allow bankruptcy judges to reduce the principal amount of mortgage loans for borrowers (known as "cram down"). Do you support this policy change? How do you think this proposal will impact mortgage rates?

CLO: #B - 37
CCS: 09- 2882
RECVD: 3/4/09

For files
P. Elliff/

JOHN M. SPRATT, JR., SOUTH CAROLINA
CHAIRMAN

THOMAS S. KAHN, STAFF DIRECTOR
AND CHIEF COUNSEL
(202) 226-7200

PAUL RYAN, WISCONSIN, RANKING MEMBER

AUSTIN SMYTHE, REPUBLICAN STAFF DIRECTOR
(202) 226-7270

U.S. House of Representatives

COMMITTEE ON THE BUDGET

Washington, DC 20515

May 28, 2009

CLO: #B - 114
CCS: 09-7316
RECVD: 5/28/09

The Honorable Benjamin S. Bernanke, Ph.D.
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Chairman Bernanke:

I am writing to invite you to testify before the House Committee on the Budget at a hearing on the challenges facing the economy on Wednesday, June 3rd at 10:00 a.m. in Room 210 of the Cannon House Office Building.

Please deliver to the Committee 100 copies of your statement the day of the hearing. The copies should be delivered to the Committee in Room 207 of the Cannon House Office Building. We also require an electronic copy of your statement in Microsoft Word or WordPerfect format at least 24 hours in advance of the hearing. Please send this as an e-mail attachment to Marcus.Stephens@mail.house.gov.

Following the hearing, you may receive questions for the record. Please comply with the due date as the hearing materials will be made available on the Internet the following week.

I look forward to seeing you on June 3rd. Should you have any questions, please contact Marcus Stephens of my staff at (202) 226-7200.

Sincerely,

John M. Spratt, Jr.
Chairman

cc: files
P. Eliff

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OCT 29 P 4: 52

09-7548

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SANDRA F. BRAUNSTEIN
DIRECTOR
DIVISION OF CONSUMER
AND COMMUNITY AFFAIRS

July 2, 2009

The Honorable Daniel K. Akaka
United States Senate
Washington, D.C. 20510

Dear Senator:

I am pleased to respond to the question you posed subsequent to my testimony for the April 29, 2009, hearing entitled "The Federal Government's Role in Empowering Americans to Make Informed Financial Decisions." My response to your question is discussed in the enclosure to this letter. A copy of this letter has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Sandra F Braunstein

Enclosure

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2009 JUL -7 P 5: 22

JMH (256, 09-7548)
bcc: J. Hogarth

For files
P. Elliff

Post-Hearing Questions for the Record

Submitted to Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System from Senator Daniel K. Akaka

"The Federal Government's Role in Empowering Americans to Make Informed Financial Decisions" April 29, 2009

1. Credit card statements fail to include all of the information necessary to allow individuals to make fully informed financial decisions. Additional disclosure is needed to ensure that individuals completely understand the implications of their credit card use. In your written statement, you mentioned that English and Spanish versions of credit card repayment calculators were launched recently to help consumers learn more about the true costs of making only the minimum payments. Have you tested what impact that this information has on consumers and, if so, what have you learned from that testing?

We launched the calculators on April 16, 2009 and by the end of May had 8800 visits to the English site and 1300 visits to the Spanish site. We believe the calculators have not been in existence long enough to know the impact. However in conducting usability testing as we developed the site, many of the consumers expressed shock that the median credit card balance of $3,000 at the average credit card interest rate of 13% could take as long as 16 years to pay off. Our testers were also surprised that they would pay back nearly as much in interest as in principal ($2,800 and $3,000, respectively). While this is only anecdotal evidence, it does show that calculators such as this can be powerful tools when consumers use them.

The newly-signed Credit CARD Act requires that everyone receive payoff information for making minimum payments on their statements; we believe this will be a truly teachable moment for consumers, as they will immediately see the payback time and interest required to pay off their balance. As a point of comparison, consumers also will see the payments needed to pay off their balances in 36 months. Board staff are working on the regulations for these new disclosures.

CLO: #256
CCS: 09-7548
RECVD: 6/14/09

Post-Hearing Questions for the Record
Submitted to Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System
From Senator Daniel K. Akaka

"The Federal Government's Role in Empowering Americans to Make Informed Financial Decisions"
April 29, 2009

1. Credit card statements fail to include all of the information necessary to allow individuals to make fully informed financial decisions. Additional disclosure is needed to ensure that individuals completely understand the implications of their credit card use. In your written statement, you mentioned that English and Spanish versions of credit card repayment calculators were launched recently to help consumers learn more about the true costs of making only the minimum payments. Have you tested what impact that this information has on consumers and, if so, what have you learned from that testing?

For files
P. Elliff

09-7552

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

RECEIVED
OFFICE OF THE SECRETARY
RECORDS SECTION
2009 OCT 23 A 7 59

October 20, 2009

The Honorable Marcy Kaptur
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the questions you posed following the June 3, 2009, hearing before the House Budget Committee on "Challenges Facing the Economy." Your questions dealt with the Federal Reserve's Term Asset-Backed Securities Loan Facility and with monetary policy and inflation. A copy of my response has also been forwarded to the Committee for inclusion in the hearing record.

I hope this information is helpful. Please let me know if I can provide any further assistance.

Sincerely,

(Signed) Ben Bernanke

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Congresswoman Marcy Kaptur in connection with the June 3, 2009, hearing before the House Budget Committee:

1. How much TARP money has AIG disbursed since January 1, of this year and who were the recipients?

As part of the restructuring by the U.S. Treasury Department and the Federal Reserve of the government's assistance to the American International Group, Inc. (AIG), announced on March 2, 2009, the U.S. Treasury created a new preferred stock facility under which the Treasury has committed for five years to provide funds from the Troubled Asset Relief Program (TARP) of up to $29.835 billion. As of August 31, 2009, AIG has drawn down $3.21 billion of this facility to improve the capitalization of various operating companies. This facility is in addition to the $40 billion in preferred securities of AIG the Treasury purchased in November 2008, the proceeds of which were used to repay amounts outstanding on the Federal Reserve 's Revolving Credit Facility. for AIG approved in September 2008.

2. How much more of our rising debt is being provided by foreign creditors now as our debt rises?

Foreigners purchased about $351 billion of U.S. Treasury securities in 2009 through July 1. However, they sold about $127 billion of U.S. agency, or government sponsored enterprise (GSE), securities through July (including periodic coupon repayments on agency asset-backed securities). Therefore, foreign net purchases of U.S. government debt totaled $224 billion for the first seven months of 2009. At an annualized rate of $384 billion, foreigners are acquiring U.S. government debt at a slower pace than in 2008, when foreign net purchases totaled an unusually high $536 billion. The slower pace results primarily from fewer net purchases of U.S. Treasury securities.

3. Copies of the contracts between the Fed and BlackRock.

The Federal Reserve Bank of New York has retained BlackRock Financial Management, Inc. (BlackRock) as the investment manager for three special purpose vehicles, which hold assets acquired in connection with the Federal Reserve Bank of New York's loans to facilitate the acquisition of Bear Stearns, Maiden Lane LLC (Maiden Lane I) and to stabilize AIG, Maiden Lane II LLC (Maiden Lane II) and Maiden Lane III LLC (Maiden Lane III). BlackRock was also retained to serve as one of four investment managers for the Federal Reserve's Agency Mortgage-Backed Securities Purchase Program (Agency MBS Program). Effective September 15, 2009, BlackRock, along with two of the three other investment managers, no longer serves as an investment manager for the Agency MBS program. BlackRock does continue to provide portfolio analytics services to the Agency MBS program. Finally BlackRock has been engaged to provide advisory services in connection with the arrangement among

Citigroup Inc., the Federal Reserve, the Federal Deposit Insurance Corporation and the Department of the Treasury. Copies of all of these contracts are available on the public website of the Federal Reserve Bank of New York.
http://www.newyorkfed.org/aboutthefed/vendor_information.html.

4. What is the value of assets being managed by BlackRock and any of these contracts in total?

The only assets currently managed by BlackRock are the assets of the three Maiden Lane entities. As of September 30, 2009, the fair value of the net portfolio holdings of these entities was as follows: Maiden Lane I, approximately $26.26 billion; Maiden Lane II, approximately $14.75 billion; and Maiden Lane III, approximately $20.57 billion. These amounts reflect paydowns of principal and accrual of interest through September 30, 2009, and valuations as of June 30, 2009. Valuations are updated quarterly and the third quarter revaluations will be available in the H.4.1 at the end of October 2009.

5. What is BlackRock being paid for each contract?

The fees the Federal Reserve Bank of New York has agreed to pay BlackRock are specified in exhibits to the contracts for each of the BlackRock engagements. These contracts and fee schedule exhibits are available on the public website of the Reserve Bank. In negotiating fees with BlackRock for these engagements, the Federal Reserve has been committed to pay only fees that are commercially reasonable and are as consistent as possible with fees assessed to clients in comparable investment management engagements.

6. Do you know which foreign countries and companies are part of BlackRock's transactions?

During the time that BlackRock served as an investment manager for the Agency MBS Program, BlackRock, along with all of the other investment managers, were authorized to purchase only U.S. Agency MBS and only through trades with primary dealers in U.S. government securities, which include certain U.S. broker-dealers that are owned by foreign banks. The following is the current list of authorized dealers:

BNP Paribas Securities Corp.
Banc of America Securities LLC
Barclays Capital Inc.
Cantor Fitzgerald & Co.
Citigroup Global Markets Inc.
Credit Suisse Securities (USA) LLC
Daiwa Securities America Inc.
Deutsche Bank Securities Inc.
Goldman, Sachs & Co.
HSBC Securities (USA) Inc.
J. P. Morgan Securities Inc.
Jefferies & Company, Inc.
Mizuho Securities USA Inc.
Morgan Stanley & Co. Incorporated
Nomura Securities International, Inc.
RBC Capital Markets Corporation
RBS Securities Inc.
UBS Securities LLC.

In managing the assets held by each of the three Maiden Lane entities, BlackRock's primary objective as investment manager is to maximize long-term cash flows generated by the portfolio assets and their disposition to pay off the loans to the entities from the Federal Reserve Bank of New York. In carrying out these objectives, BlackRock may trade with those financial firms that deal and invest in the types of assets involved, including U.S. mortgage-related securities, U.S. dollar-denominated residential and commercial loans, and associated hedges (Maiden Lane I), U.S. dollar-denominated residential mortgage-backed securities (Maiden Lane II), U.S. dollar-denominated collateralized debt obligations (Maiden Lane III), and short-term U.S. Treasury and agency obligations (all three entities). BlackRock is required to carry out each transaction through an intermediary that offers the "best execution." These intermediaries may include foreign-owned firms if the firms meet this requirement.

7. What actions are taken by the Fed to examine and prevent conflicts of interest of any kind when awarding no bid contracts? What processes are in place? Please include copies of the documents of the evaluation of conflict of interest in regard to all BlackRock contracts, both those that BlackRock might have bid on and those that were no-bid contracts.

BlackRock was selected as the manager of the assets of the three Maiden Lane entities under an exception to the normal competitive bidding procedures required by the New York Reserve Bank's Acquisition Guidelines that allows for sole source contracts in exigent circumstances. The Reserve Bank determined in each case that the unique time pressures associated with the unexpected and rapid collapse of Bear Stearns and AIG prevented the Bank from following the normal bidding procedures. Consequently, senior management at the New York Reserve Bank carefully considered the issue and determined that an exception to the competitive bidding provisions of the Acquisition Guidelines was appropriate with respect to the selection of an investment manager. BlackRock was retained as the investment manager for the Maiden Lane entities because of its technical expertise with respect to the portfolio assets involved, its operational capacity, and its track record.

BlackRock was selected as one of four investment managers for the Agency MBS Program through a public and competitive bidding process that was employed to select the investment managers and a custodian. A competitive request for proposal ("RFP") process was employed because of the size and complexity of the Program. The selection criteria were based on the institution's operational capacity, size, overall experience in the MBS market and a competitive fee structure.

The New York Reserve Bank has extensive procedures in place to guard against conflicts of interest in the procurement of services for the Bank, both in competitive solicitations and in procurements under exceptions to the competitive solicitation policy. For instance, the Bank's contract representatives are prohibited from participating personally and substantially in an acquisition in which, to the representatives' knowledge, the representatives or certain related interests have a financial interest that is directly impacted by the decision to select a particular vendor.

Moreover, the contracts with BlackRock require BlackRock to have in place conflict of interest policies and procedures that are designed to identify material conflicts of interest, that require reporting of such conflicts, and that prevent the use of confidential information obtained in the course of the engagement from being used outside of the engagement. These provisions are integrated into each contract as enforceable terms. The Reserve Bank monitors BlackRock's compliance with the terms of its contract, as appropriate.

8. Can you explain to me why the Federal Reserve Bank of New York is expected to regulate Wall Street, and yet on its board are Wall Street Executives? Isn't this a conflict of interest from your perspective? Please elaborate here. Do we really trust Wall Street to regulate itself?

By statute, the boards of directors of each of the Reserve Banks are composed of nine members divided into three classes of three directors each. 12 U.S.C. § 302-305. Under the statute, Class A directors are elected by the commercial banks that hold stock in the Reserve Bank and are required to be "representative of" these member commercial banks. Accordingly, in virtually every case, Class A directors are affiliated with, and own stock in, banks or bank holding companies that are supervised by the Reserve Bank on whose board they serve.

Also by statute, Class B directors are elected by the member banks of the Reserve Bank, and Class C directors are designated by the Board of Governors. Class B and Class C directors must represent the public and be elected or designated with due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor, and consumers. No Class B or Class C director may be an officer, director, or employee of any bank or bank holding company. In addition, Class C directors are prohibited from owning stock of any bank or bank holding company.

To the extent the statutorily prescribed structure of Reserve Bank boards of directors may give rise to potential conflicts of interest, there are statutory and policy protections in place to address improper conflicts in the governance of the Reserve Banks. With respect to the supervisory responsibilities of Reserve Banks over individual banking institutions, the directors of the Banks are not involved. Supervision over banking organizations is conducted by the Reserve Banks pursuant to authority delegated to the Banks by the Board of Governors, and the directors of the Reserve Bank are not consulted regarding examinations, possible enforcement actions, merger or other supervisory approvals, or other supervisory issues that involve organizations being supervised by their Bank.

In addition, Reserve Bank directors are explicitly included among the officials subject to the federal conflict of interest statute. 12 U.S.C. § 208. This statute imposes criminal penalties on Reserve Bank directors who participate personally and substantially as a director in any particular matter that, to the director's knowledge, will affect the director's financial interest or those of his immediate family or businesses interests. Reserve Banks routinely provide training for their new directors that includes specific training on the federal conflicts of interest statute and Reserve Bank corporate secretaries have the expertise to respond to inquiries by directors regarding possible conflicts of interest in order to assist them in complying with the statute. Moreover, the Board of Governors' policy on Reserve Bank directors provides that their personal financial dealings should be above reproach and information obtained by them as directors should never be used for personal gain. The policy provides that, in carrying out their Federal

Reserve responsibilities, directors should avoid any action that may result in or create the appearance of conflicts of interest.

9. Why does the Federal Reserve buy Treasury notes? Isn't this just money shuffling, especially since the Treasury has $200 billion deposited in the Fed right now through the Treasury Supplemental Financing Program?

The Federal Reserve is buying longer-term Treasury securities, as well as securities issued or guaranteed by the federal housing agencies, to help put downward pressure on longer-term interest rates and more generally to improve conditions in private credit markets. By putting downward pressure on yields such as those on mortgage securities and corporate bonds, the Federal Reserve's asset purchases help lower the cost of borrowing to households and firms. Lower financing costs in turn help support spending, which promotes output, employment, and income growth. The Treasury's Supplemental Financing Program contributes to the Federal Reserve's ability to control the federal funds rate, which is its primary means of implementing monetary policy in routine circumstances.

10. The Federal Reserve Bank of New York is the only bank of the 12 with an established vote on interest rates; the seven governors have a vote, the Federal Reserve Bank of New York has a vote, and the other 11 banks rotate through the other 4 votes. Why is the NY Fed so special?

The Federal Reserve Act provides that the Federal Reserve Bank of New York has a permanent vote on the Federal Open Market Committee. The status accorded the New York Fed is in recognition of the unique role that the Bank plays in the Federal Reserve System. For example, because the New York Fed is located in the financial capital of the United States, all of the open market operations--the buying and selling of U.S. government securities in the secondary market to influence money and credit conditions in the economy--that the Federal Reserve conducts are carried out by the New York Fed. Moreover, in light of its close proximity to, and interactions with, major financial institutions, the New York Fed plays a particularly important role in gathering financial information that is used by the Federal Open Market Committee in making monetary policy.

11. How much was now Secretary Geithner involved in the drafting of the trust agreement between the Federal Reserve Bank of New York and AIG – at the time Mr. Geithner was serving as President of the Federal Reserve Bank of New York?

As a condition of the Federal Reserve's Revolving Credit Facility for AIG approved on September 16, 2008, AIG was required to issue to a trust for the sole benefit of the U.S. Treasury convertible preferred stock with voting power equal to approximately 78 percent of AIG's common stock. The agreement relating to this trust was drafted by the Federal Reserve Bank of New York, in consultation with the Board of Governors and the Treasury Department, beginning in late September 2008. Subsequently, certain terms of the trust agreement were negotiated with the three individuals who were appointed as trustees under the trust. The trust agreement was executed in final on January 16, 2009. In late November 2008, because of his status as the apparent nominee for Secretary of the Treasury in the new administration, Mr. Geithner removed himself from involvement in the day-to-day affairs of the New York Reserve Bank. Prior to that time, Mr. Geithner was informed of developments relating to the terms of the trust as part of his oversight of the Reserve Bank's relationship with AIG, but was not involved in the actual drafting or negotiation of the provisions of the trust agreement.

12. Do you think it is appropriate for the President of the Federal Reserve Bank of New York to have close ties with the CEO's and other key management of the very banks one is regulating?

Like all employees of the Federal Reserve Banks, the President of the Federal Reserve Bank of New York is prohibited from having financial ties with the financial institutions that are regulated by the Federal Reserve that could give rise to potential conflicts of interest. In particular, Reserve Bank employees, including the Presidents of the Reserve Banks, are prohibited generally by the Banks' codes of conduct from owning debt or equity interests in depository institutions or their affiliates and, if the employee has access to confidential information of the Federal Open Market Committee, such as a Reserve Bank President, in any primary securities dealer or a company that owns a primary dealer. Reserve Bank employees, including the President of the Reserve Bank, additionally are generally barred from accepting gifts, meals, and entertainment from institutions that are supervised by the Federal Reserve. Reserve Bank employees are also directed to avoid any situation that might give rise to an actual or even apparent conflict of interest. Like Reserve Bank directors, Reserve Bank officers and employees, including the President of the Reserve Bank, are subject to the federal conflicts of interest statute, which imposes criminal penalties on officers and employees who participate personally and substantially as an officer or employee in any particular matter that, to the person's knowledge, will affect the person's financial interest or those of his or her immediate family or businesses interests.

Each Reserve Bank President collects information from the institutions, including banks, industrial firms, consumer groups, labor organizations, small businesses, and other local leaders, about the state of the economy and business activities in the Bank's district. The Reserve Bank Presidents serve as the eyes and ears of the Federal Reserve in the financial markets and must be sensitive to developments in those areas. The Federal Reserve Board and the Federal Open Market Committee take the information gathered by the Presidents and weigh it along with all the other information the System collects to set monetary policy.

13. Given that the taxpayers are at this time currently losing money through the obligations accrued through the purchases of securities from AIG and Bear Stearns, is there any real hope that the taxpayers will be paid back in full?

The portfolio holdings of each of Maiden Lane LLC ("Maiden Lane"), Maiden Lane II LLC ("ML-II") and Maiden Lane III LLC ("ML-III") are revalued in accordance with generally accepted accounting principles ("GAAP") as of the end of each quarter to reflect an estimate of the fair value of the assets on the measurement date. The fair value determined through these revaluations may fluctuate over time. In addition, the fair value of the portfolio holdings that is reported on the weekly H.4.1 Statistical Release reflects any accrued interest earnings, principal repayments, expense payments and, to the extent any may have occurred since the most recent measurement date, realized gains or losses. The fair values as of September 30, 2009--and reported in greater detail in the H.4.1 release for that date--are based on quarterly revaluations as of June 30, 2009.

Because the collateral assets for the loans to Maiden Lane, ML-II, and ML-III are expected to generate cash proceeds and may be sold over time or held to maturity, the current reported fair values of the net portfolio holdings of Maiden Lane, ML-II, and ML-III do not reflect the amount of aggregate proceeds that the Federal Reserve could receive from the assets of the respective entity over the extended term of the loan to the entity. The extended terms of the loans provide an opportunity to dispose of the assets of each entity in an orderly manner over time and to collect interest on the assets held by the entity prior to their sale, other disposition, or maturity. Each of the loans extended to Maiden Lane, ML-II, and ML-III is current under the terms of the relevant loan agreement.

In addition, JPMorgan Chase will absorb the first $1.1 billion of realized losses on the assets of Maiden Lane, should any occur. Similarly, AIG has a $1 billion subordinated position in ML-II and a $5 billion subordinated position in ML-III, which are available to absorb first any loss that ultimately is incurred by ML-II or ML-III, respectively. Moreover, under the terms of the agreements, the FRBNY is entitled to any residual cash flow generated by the collateral assets held by Maiden Lane after the loans made by the FRBNY and JPMorgan Chase are repaid, and 5/6ths and 2/3rds of any residual cash flow generated by the collateral held by ML-II and ML-III, respectively, after the senior note of the FRBNY and the subordinate position of AIG or its affiliates for these facilities are repaid.

14. Can you give me your thoughts on why AIG was saved, and Chrysler and GM allowed to enter bankruptcy? Sure you were involved in each discussion to some degree.

As I explained in greater detail in my testimony on AIG before the House Financial Services Committee in March, the Federal Reserve, with the support of Treasury, supplied emergency liquidity to AIG in September 2008 under section 13(3) of the Federal Reserve Act to avoid the imminent bankruptcy of the company, which, under prevailing conditions, would have posed unacceptable risks for the global financial system and our economy. A failure of AIG would likely have resulted in harm to the holders of policies issued by AIG's insurance subsidiaries, to state and local governments that lent funds to AIG, to workers whose 401(k) plans had purchased insurance from AIG, to global banks and investment companies that were counterparties of AIG in loans and derivatives transactions, and to money market mutual funds and other investors that held AIG's commercial paper. Moreover, as broad market dislocations precipitated by the bankruptcy of Lehman Brothers have shown, there was a serious risk that the harm of an AIG default would spread to the financial system as a whole. As I explained in my testimony, an AIG failure could have exacerbated problems in the commercial paper market, could have led to a run on the broader insurance industry by policyholders and creditors, and could have led financial market participants to pull back even further from commercial and investment banks.

Certain federal financial assistance to General Motors and Chrysler has been provided by the Treasury from the TARP, subject to certain conditions. Pursuant to section 3(9)(B) of the

Emergency Economic Stabilization Act of 2008, given that the disorderly bankruptcy of GM or Chrysler likely would result in material job losses and place further, meaningful downward pressure on U.S. economic performance, I concurred with the determination of the Secretary of the Treasury that the loans to be provided to GM and Chrysler and the equity instruments to be acquired in connection with these loans are financial instruments that may be purchased as troubled assets with TARP funds. The decisions relating to whether further assistance under this Program should have been provided to these companies prior to their recent bankruptcy filings are within the authority of the Treasury.

For non-financial businesses like General Motors and Chrysler, the reorganization regime contained in the Bankruptcy Code can, with financial assistance and oversight from the Treasury, serve as an effective mechanism to avoid the negative systemic effects of a disorderly failure and to work with the company's creditors to restructure its core business and preserve the residual value of the franchise. However, this regime does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and the economy. The damaging effects of a disorderly insolvency of such an institution would be much more quickly and pervasively transmitted to the financial system.

15. Why do you think that Chrysler and GM were given far less money than the banks through TARP with restrictions and conditions on what was to happen at each before there was any more infusion of capital from the TARP into the companies, and the banks can keep coming back and are barely asked to do even reporting in return?

The Administration, through its Auto Task Force, set the terms and conditions under which Chrysler and GM were granted assistance from the government and determined the actions each company would be required to take as their part of the agreement. As you know, the largest banks that received TARP capital in October 2008 were asked to take that capital in order to prevent a collapse in lending to households and businesses and a breakdown of some financial markets. A couple of these firms that subsequently requested additional TARP capital are subject to reporting on lending and a number of constraints, such as those on executive compensation, and are being closely reviewed by their supervisors. In addition, the 19 largest banks have been subjected to a rigorous supervisory capital assessment, aimed at ensuring that they will have sufficient capital on hand to allow them to withstand a harsher-than-expected macroeconomic climate over the next two years and still emerge with sufficient capital to allow them to continue performing their critical role of providing credit to credit-worthy businesses and households. Through the course of that assessment, these institutions were required to divulge a great deal of detailed information to their supervisors about loss rates, portfolio compositions, and earnings prospects. As of the beginning of October 2009, ten of these firms that had TARP capital have returned approximately $67 billion to the U.S. Treasury.

16. Were you present in any meeting in which the Bank of America acquisition of Merrill Lynch was discussed? Please state when each meeting took place, where each meeting was held, the other attendees of the meeting, and go into detail on what was discussed. In addition to the aforementioned, how involved were people such as Larry Summers and other Members of the President's Economic Advisory Council or the President's Working

Group on Financial Markets? Other bank CEOs? Do you feel it was appropriate for the federal government to play a role in the activities of private banks, and in particular, the matter of Bank of America and Merrill Lynch?

My involvement and the involvement of other Federal Reserve personnel in the acquisition by Bank of America Corporation of Merrill Lynch & Co. is described in detail in my statement on June 25, 2009, before the House Committee on Oversight and Government Reform. A copy of that statement is attached. I believe that Mr. Summers was made aware of the broad outlines of the Bank of America/Merrill Lynch situation, but he was not actively involved to any significant degree in the details of the response to that situation as far as I am aware. We did not consult with the CEOs of other banking organizations about the Bank of America/Merrill Lynch acquisition.

17. Would you welcome a full audit of the PPIP program now and regularly? Why or why not?

The Public-Private Investment Partnership (PPIP) program is part of the Administration's Financial Stability Plan for implementing the Troubled Asset Relief Program (TARP) and restoring confidence in, and liquidity to, the financial system. Under the PPIP program, the Treasury will co-invest with private investors in newly established public-private investment funds (PPIFs) that will purchase legacy assets from U.S. banking organizations and financial institutions. The FDIC also may guarantee debt issued by PPIFs that purchase legacy loans from banking organizations. Purchases of legacy assets by PPIFs are designed to help free up capital at financial institutions to make new loans, strengthen the balance sheets of the selling institutions, and promote liquidity and price discovery in the markets for legacy assets. The program is administered by the Treasury and the FDIC and specific questions with respect to the program are best addressed to those agencies.

18. Do you [support creation of a] resolution authority and a financial product safety commission? Why or why not on each item?

The Board supports development of a new resolution regime that would facilitate the orderly wind down of systemically important nonbank financial institutions, including bank holding companies. In our view, such a regime is a key element of a comprehensive strategy to contain systemic risk and to address the related problem of too-big-to-fail institutions.

In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, the Lehman and AIG experiences are powerful support for the proposition that there needs to be a third option between the choices of bankruptcy and bailout.

The Administration's recent proposal for strengthening the financial system would create such an option by allowing the Treasury to appoint a conservator or receiver for a systemically important nonbank financial institution that has failed or is in danger of failing. The conservator or receiver would have a variety of authorities--similar to those provided the Federal Deposit

Insurance Corporation with respect to failing insured banks--to stabilize and either rehabilitate or wind down the firm in a way that mitigates risks to financial stability and to the economy. For example, the conservator or receiver would have the ability to take control of the management and operations of the failing firm; sell assets, liabilities, and business units of the firm; and repudiate contracts of the firm. Importantly, the Administration's proposal also would allow the government, through a receivership, to impose "haircuts" on creditors and shareholders of the firm, either directly or by "bridging" the failing institution to a new entity, when consistent with the overarching goal of protecting the financial system and the broader economy. This aspect of the proposal is critical to addressing the too-big-to-fail problem and the moral hazard effects that it engenders.

We believe the contours of the resolution framework included in the Administration's proposal for systemically important financial institutions would significantly improve the resiliency of the financial system and the government's ability to protect the public's interest. We look forward to working with the Congress, the Administration, and other interested parties to elaborate the details of a resolution mechanism as the legislative process moves forward.

The Administration's proposal also would create a new agency--the Consumer Financial Protection Agency--and transfer to such agency broad responsibility for writing and enforcing consumer protection regulations concerning consumer financial disclosures, unfair practices in financial transactions, and fair lending. Currently, much of this authority is vested with the Federal Reserve alone in the case of rule-writing, and is shared among the Federal Reserve, the other federal banking agencies, and the Federal Trade Commission in the case of enforcement.

In considering this proposed change, I believe it is important for Congress to carefully weigh the costs, as well as the potential benefits, of transferring rule-writing and enforcement authority to an agency that did not also have prudential supervision responsibilities. Both the substance of consumer protection rules and their enforcement are complementary to prudential supervision. Poorly designed financial products and misaligned incentives can at once harm consumers and undermine financial institutions. Indeed, as with subprime mortgages and securities backed by these mortgages, these products may at times also be connected to systemic risk. At the same time, a determination of how to regulate financial practices both effectively and efficiently can be facilitated by the understanding of institutions' practices and systems that is gained through safety and soundness regulation and supervision. Similarly, risk assessment and compliance monitoring of consumer and prudential regulations are closely related, and thus entail both informational advantages and resource savings.

We understand that a good case can be made for creating a dedicated single-mission consumer protection agency. We also believe that the Federal Reserve is well-positioned to address consumer protection issues in the financial services marketplace. In the last three years, the Federal Reserve has adopted strong consumer protection measures in the mortgage and credit card areas. These regulations benefited from the supervisory and research capabilities of the Federal Reserve, including expertise in consumer credit markets, retail payments, banking operations, and economic analysis. Involving all these forms of expertise is important for tailoring rules that prevent abuses while not impeding the availability of sensible extensions of credit.

One important issue that should be addressed going forward, regardless of whether a new consumer protection agency is established, is the large supervisory and enforcement gap for independent nonbank lenders and financial services providers. Currently, these entities are regulated by a combination of the Federal Trade Commission (FTC) and the states. However, the FTC does not have the authority, tools, or resources to conduct routine on-site examinations of these entities to monitor and enforce compliance, which is the norm for depository institutions. And, while several states have put forth noteworthy efforts in this regard, the state enforcement scheme across the country is still uneven, with inadequate resources being a primary concern.

19. You have been quoted as stating that in looking back, it was probably a mistake to let Lehman fail. Please elaborate on this matter.

As I have explained in previous public statements, before its failure in September 2008, Lehman Brothers was a large and complex investment bank that was deeply embedded in our financial system. As the firm approached default, the Treasury and the Federal Reserve sought private-sector solutions, but none was forthcoming. With respect to public sector solutions, we determined that the available collateral fell well short of the amount needed to secure a Federal Reserve loan sufficient to pay off the firm's counterparties and continue operations. Because Lehman Brothers experienced its crisis during the financial stress that preceded enactment of the Emergency Economic Stabilization Act of 2008 (EESA), the Treasury did not have the authority to provide capital to the company. Accordingly, the failure of Lehman Brothers was unavoidable given the legal constraints and the absence of any alternative solution. The Federal Reserve and the Treasury had no choice but to try to mitigate the fallout from that event using the limited tools available. Specifically, the Federal Reserve sought to cushion the effects by implementing a number of measures, including substantially broadening the collateral accepted by the Federal Reserve's Primary Dealer Credit Facility and the Term Securities Lending Facility to ensure that the remaining primary dealers would have uninterrupted access to funding. Following the failure of Lehman Brothers, Congress enacted EESA, which made funds available from the Troubled Assets Relief Program to deal with financial strains facing institutions important to the financial system. In addition, to address the kind of concerns that arose from the Lehman Brothers bankruptcy, the Federal Reserve recommends that Congress enact a new resolution process for systemically important nonbank financial firms that would allow the government to wind down a troubled systemically important firm in an orderly manner.

Attachment: Chairman Bernanke's June 25, 2009, statement before the House Committee on Oversight and Government Reform.

CLO: #B - 126
CCS: 09-1552
RECVD: 6/10/09

Representative Marcy Kaptur

Requests of Chairman Bernanke:

How much TARP money AIG has disbursed since January 1 of this year and who were recipients?

How much more of our rising debt is being provided by foreign creditors now as our debt rises?

Copies of the contracts between the Fed and BlackRock.

What is the value of assets being managed by BlackRock and any of these contracts in total?

What is Blackrock being paid for each contract?

Do you know which foreign countries and companies are part of Black Rock's transactions?

Questions for the Record:

For files
P. Elliff

What actions are taken by the Fed to examine and prevent conflicts of interest of any kind when awarding no bid contracts? What processes are in place? Please include copies of the documents of the evaluation of conflict of interest in regard to all BlackRock contracts, both those that BlackRock might have bid on and those that were no-bid contracts.

Can you explain to me why the Federal Reserve Bank of New York is expected to regulate Wall Street, and yet on it's board are Wall Street Executives? Isn't this a conflict on interest from perspective? Please elaborate here. Do we really trust Wall Street to regulate itself?

Why does the Federal Reserve buy Treasury notes? Isn't this just money shuffling, especially since the Treasury has $200 billion deposited in the Fed right now through the Treasury Supplemental Financing Program?

The Federal Reserve Bank of New York is the only bank of the 12 with an established vote on interest rates; the seven governors have a vote, the Federal Reserve Bank of New York has a vote, and the other 11 banks rotate through the other 4 votes. Why is the NY Fed so special?

How much was now Secretary Geithner involved in the drafting of the trust agreement between the Federal Reserve Bank of New York and AIG – at the time Mr. Geithner was service as President of the Federal Reserve Bank of New York.
Do you think it is appropriate for the President of the Federal Reserve Bank of New York to have close ties with the CEO's and other key management of the very banks one is regulating?

Given that the taxpayers are at this time currently losing money through the obligations accrued through the purchases of securities from AIG and Bear Sterns, is there any real hope that the taxpayers will paid back in full?

:an you give me your thoughts on why AIG was saved, and Chrysler and GM llowed to enter bankruptcy? Sure you were involved in each discussion to some legree.

Vhy do you think that Chrysler and GM were given far less money than the banks hrough TARP with restrictions and conditions on what was to happen at each before here was any more infusion of capital from the TARP into the companies, and the ›anks can keep coming back and are barely asked to do even reporting in return?

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Would you welcome a full audit of the PIPP program now and regularly? Why or why not?

Do you resolution authority and a financial product safety commission? Why or why not on each item?

You have been quoted as stating that in looking back, it was probably a mistake to let Lehman fail. Please elaborate on this matter.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DONALD L. KOHN
VICE CHAIRMAN

September 9, 2009

OFFICE OF THE SECRETARY
2009 SEP 29 A 11: 23

The Honorable Melvin Watt
Subcommittee on Domestic Monetary Policy
and Technology
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are my responses to the questions you submitted following the July 9, 2009, hearing before the Subcommittee on "Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation." A copy has also been forwarded to the Committee for inclusion in the hearing record.

I hope this information is helpful. Please let me know if I can provide any further assistance.

Sincerely,

Donald L. Kohn

Enclosure

For files
P. Elliff

Vice Chairman Donald Kohn subsequently submitted the following in response to written questions received from Chairman Melvin Watt in connection with the July 9, 2009, hearing before the Subcommittee on Domestic Monetary Policy and Technology:

(1) Should Federal Reserve Board monetary policy decisions be subject to different levels of transparency than a) the Board's supervisory and regulatory functions and b) single company credit facilities such as Bear Stearns and AIG? Describe the levels of transparency you believe should be applicable to these areas of responsibility.

Audits and reviews by the Government Accountability Office (GAO) are an appropriate means of promoting transparency for most areas of Federal Reserve activity, including our supervisory and regulatory functions and our single-company credit facilities. An array of information related to these activities is available to the public on the Board's web site, including information on applications filed by financial institutions and actions taken by the Board on those applications, legal interpretations issued, and aggregate and institution-specific data derived from public reports. The Federal Reserve Bank of New York provides substantial additional information on the single-company credit facilities on its web site, including detailed descriptions of transactions and copies of relevant agreements.

The Federal Reserve Board is also highly transparent in monetary policy. Experience has shown that granting central banks operational independence in the conduct of monetary policy leads to improved economic performance, but monetary policy independence does not imply a lack of transparency. Indeed, to some extent it necessitates even greater efforts to promote or ensure transparency. For example, the Federal Reserve publishes a semiannual *Monetary Policy Report to the Congress,* issues statements and minutes after monetary policy meetings, and makes available on our website information on all aspects of monetary policy. In addition, Federal Reserve officials regularly testify before the Congress and give speeches to the public on monetary policy.

However, in the area of monetary policy, financial markets are keenly aware of the potential for inflationary outcomes when short-term political pressures influence policy actions. GAO reviews of monetary policy actions taken by the Federal Reserve would likely be perceived by the market as an attempt by Congress to influence Federal Reserve decisionmaking. A reduction in the perceived independence of the Federal Reserve to conduct monetary policy would likely increase long-term interest rates and reduce economic and financial stability. It is for this reason that the Congress, after debating the issue in 1978, purposely excluded monetary policy from the scope of potential GAO reviews.

(2) What specific additional resources does the Fed need from Congress to adequately staff both existing responsibilities for executing monetary policy and proposed new responsibilities for implementing systemic risk regulation?

The Federal Reserve continuously evaluates its staffing levels and expertise in light of changing needs and challenges. As we discussed at the hearing, since the beginning of the financial crisis, both the Board and the Reserve Banks have added staff with appropriate skills to ensure that critical functions are performed in a thorough and timely fashion. For example, additional staff resources have been required to supervise several large financial firms previously not subject to mandatory consolidated supervision that elected to become bank holding companies--including Goldman Sachs, Morgan Stanley, and American Express. While the number of additional financial institutions that would be subject to supervision under the Administration's proposal would depend on standards or guidelines adopted by the Congress, the criteria offered by the Administration suggest that the initial number of newly regulated firms would probably be relatively limited. The new responsibilities and authorities that are contemplated in the Administration's proposal would require some expansion of staff but we anticipate that expansion would be an incremental and a natural extension of the Federal Reserve's existing supervisory and regulatory responsibilities. Given the manner in which Federal Reserve operations are financed, no appropriation would be required to fund any necessary increases in staff.

(3) If the Federal Reserve is granted powers to regulate systemically significant entities, how would the Fed harmonize systemic risk and monetary policy responsibilities with other central banks around the world?

With the world's economies and financial systems becoming increasingly integrated, and with financial stability a prerequisite to achieving our dual mandate of maximum employment and price stability, the Federal Reserve already places a high priority on close cooperation with foreign regulators and monetary policymakers. Federal Reserve officials discuss monetary and economic policy issues with their foreign counterparts in a broad array of forums, including regular meetings sponsored by the BIS, OECD, G8, and G20. Similarly, the Basel Committee and Financial Stability Board, among other groups, provide a framework for addressing the common challenges to financial stability around the world. Outside of such venues, Federal Reserve officials maintain close contact with foreign authorities in a wide range of countries in order to share information and lay the basis for further cooperation. If the Federal Reserve were given additional responsibilities, the need for additional international consultation would need to be carefully considered in light of the exact nature of those responsibilities. In any case, as the global economy becomes ever more tightly knit, and as the role of the Federal Reserve evolves, we will continue to work closely with our counterparts abroad.

CLO: #347
CCS: 09-8886
RECVD: 7/23/09

QUESTIONS FOR THE RECORD FROM CHAIRMAN MELVIN L. WATT

The Financial Services Committee, Subcommittee on Domestic Monetary Policy & Technology appreciates your participation in the hearing entitled, "*Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation*" on July 9, 2009. Please provide written responses to these questions for the record within 30 days of receipt.

Vice Chairman of the Fed – Donald Kohn

(1) Should Federal Reserve Board monetary policy decisions be subject to different levels of transparency than a) the Board's supervisory and regulatory functions and b) single company credit facilities such as Bear Stearns and AIG? Describe the levels of transparency you believe should be applicable to these areas of responsibility.

(2) What specific additional resources does the Fed need from Congress to adequately staff both existing responsibilities for executing monetary policy and proposed new responsibilities for implementing systemic risk regulation?

(3) If the Federal Reserve is granted powers to regulate systemically significant entities, how would the Fed harmonize systemic risk and monetary policy responsibilities with other central banks around the world?

For files
P. Elliff

09-[illegible]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ELIZABETH A. DUKE
MEMBER OF THE BOARD

August 31, 2009

The Honorable Melvin L. Watt
Chairman
Subcommittee on Domestic Monetary
Policy and Technology
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to enclose my responses to your questions received following the July 16, 2009, hearing before the Committee entitled, "*Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve.*"

Please let me know if I can be of further assistance.

Sincerely,

(signed) Elizabeth A. Duke

Enclosure

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RECORDS SECTION
2010 SEP -8 P 2: 54

For files
P. Elliff

Governor Elizabeth Duke subsequently submitted the following in response to written questions received from Congressman Watt in connection with the July 16, 2009, hearing before the Subcommittee on Domestic Monetary Policy and Technology:

1. **If the Federal Reserve had authority to issue rules implementing the Home Ownership and Equity Protection Act (HOEPA) beginning in 1994, why did the Fed wait until 2008 to issue rules?**

The Federal Reserve Board has primary rule writing responsibility for the Truth in Lending Act and the Home Ownership and Equity Protection Act (HOEPA), which amended TILA. The Board has exercised this authority to respond to various consumer protection concerns that have arisen in the mortgage marketplace. The most recent of these rulemakings was issued in July 2008, which strengthened consumer protections, and further augmented rules finalized in 2001, and industry guidance issued in 2006 and 2007.

In March 1995, the Board published rules to implement HOEPA, which are contained in the Board's Regulation Z. These rules became effective in October 1995. HOEPA also gives the Board responsibility for prohibiting acts or practices in connection with mortgage loans found to be unfair or deceptive. The statute further requires the Board to conduct public hearings periodically, to examine the home equity lending market, and the adequacy of existing laws, and regulations in protecting consumers, and low-income consumers in particular. Under this mandate, the Board held public hearings to gather information about mortgage lending practices of concern in 1997, 2000, 2006, and 2007.

The 2000 hearings led the Board to expand HOEPA's protections in December 2001 to respond to concerns about predatory or abusive practices in the marketplace at the time. Those rules, issued in December 2001, included the following consumer protections: lowered HOEPA's rate trigger to extend the act's protections to a potentially larger number of high-cost loans; expanded its fee trigger to include single-premium credit insurance to address concerns that high-cost HOEPA loans were "packed" with products that increased loan cost without commensurate benefit to consumers; added an anti-loan flipping restriction, and strengthened HOEPA's prohibition on unaffordable lending by advising creditors generally to document and verify the borrower's ability to repay a high-cost HOEPA loan.

Most recently, the Board held hearings in 2006 and 2007, to gather information on concerns about new "predatory lending" practices that had emerged as the subprime market continued to grow. Issues cited related to increasing use by mortgage lenders of relaxed underwriting practices, including qualifying borrowers based on discounted initial rates and the expanded use of "stated income" or "no doc" loans. In 2006 and 2007, the Board and other federal financial regulatory agencies adopted interagency guidance for banking institutions addressing certain risks and emerging issues relating to non-traditional and subprime mortgage lending practices, particularly adjustable-rate mortgages. The issuance of interagency guidance was viewed as a more expedient means than rule writing to address practices of concern in the marketplace at the time, although it did not apply to nonbank lenders.

In light of the information received at the 2006 hearings and the rise of defaults that began soon after, the Board held an additional hearing in June 2007, to explore how it could use its authority under HOEPA to curb the abusive practices without unduly restricting credit. At the 2007 hearing, and from hearing-related public comments, the Board received input from a broad spectrum of informed parties. Following these hearings, in December 2007, the Board proposed sweeping new rules to strengthen protections for consumers seeking mortgage credit. Final rules were issued in July 2008.

Among other things, the new HOEPA rules strengthened consumer protections for a newly defined category of "higher-priced mortgage loans" by: prohibiting a lender from making a loan without regard to the borrower's ability to repay the loan from income and assets other than the home's value; requiring creditors to verify the income and assets they rely upon to determine repayment ability; and banning any prepayment penalty if the payment can change in the initial four years. For other higher-priced loans, a prepayment penalty period cannot last for more than two years, and creditors are required to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

For all mortgage loans secured by a borrower's principal dwelling, the rules prohibit creditors and mortgage brokers from engaging in certain practices, such as pyramiding late fees. In addition, servicers are required to credit consumers' loan payments as of the date of receipt and provide a payoff statement within a reasonable time of request. Creditors must provide consumers with transaction-specific mortgage loan disclosures within three business days after application. Finally, the rules also address deceptive mortgage advertisements and unfair practices related to real estate appraisals and mortgage servicing.

With the benefit of hindsight, the Federal Reserve could have acted more quickly to adopt rules to reign in harmful lending practices. The process of identifying emerging issues, proposing rules, reviewing comments, developing final rules, and allowing reasonable time for implementation was too protracted given the rapid changes in the mortgage market, including loan terms, pricing, underwriting standards, and marketing practices. We also recognize the value of holding public hearings to gather information about mortgage lending practices with greater frequency, in order to identify emerging risks to consumers on a more timely basis.

The Board is fully committed to continuing its efforts to enhance consumer protections in the residential mortgage market. Last month, we proposed significant changes to Regulation Z intended to improve the disclosures consumers receive in connection with mortgage transactions. These proposed rules also prohibit payments to a mortgage broker or a loan officer that are based on the loan's interest rate or other terms; and they prohibit a mortgage broker or loan officer from "steering" consumers to transactions that are not in their interest in order to increase mortgage broker or loan officer compensation. These actions are further described in our response to question number three on page 6.

2. **What is the Federal Reserve's current staffing and budget levels allocated to safety and soundness in FY 2009? What are the staffing and budget levels for consumer protection in FY 2009?**

The budget and staffing numbers in the table below reflect the 2009 budget amounts for most Federal Reserve System resources that are directly involved in consumer protection and prudential supervision activities. Some costs are not included in these figures as explained further below the table. Furthermore, actual expenses and staffing levels for 2009 are likely to exceed the budgeted amounts given the additional resources needed to respond to recent events. For example, the budget numbers do not reflect anticipated costs for the development of a program for consumer compliance examinations of nonbank subsidiaries of bank holding companies. Also, prudential and consumer supervision resource needs are likely to increase due to the recent conversion of several large, complex organizations to bank holding companies.

	2009 Budget (Direct Costs)	2009 Budgeted ANP*
Consumer Protection Supervision and Rule writing	$65.3 million	396
Prudential Supervision	$330.3 million	1,851
Other Supervisory Activities for both Consumer Protection and Prudential Supervision	$145.7 million	905

*The term average number of personnel (ANP) describes levels and changes in employment at the Reserve Banks. ANP is the average number of employees in terms of full-time positions for the period. For instance, a full-time employee who starts work on July 1 counts as 0.5 ANP for that calendar year; two half-time employees who start on January 1 count as one ANP. Budgeted staff positions at the Board of Governors are also included.

Consumer Protection Supervision and Rule Writing - This category includes expenses for the Board's Division of Consumer and Community Affairs, which develops and oversees programs for rule writing, consumer compliance supervision, community affairs, consumer complaint call center and complaint resolution, the Consumer Advisory Council, and consumer education and research which includes consumer testing. It also includes consumer compliance examinations and other related supervisory expenses in the twelve Reserve Banks.

Prudential Supervision - This category includes expenses for the Board's Division of Bank Supervision and Regulation, which has responsibility for developing and overseeing programs for prudential supervision and regulation of state member banks and bank and financial holding companies. It also includes expenses for the twelve Reserve Banks for examinations and related supervisory activities.

Other Supervisory Activities - This category includes those costs in the Reserve Banks for activities that benefit both consumer protection and prudential supervision and cannot be easily separated, including bank and holding company applications processing, examiner training and commissioning programs, some automation and IT support, regulatory reports processing, shared national credit review, and supervisory policy and research.

Not Included in Costs Above - It is also important to note that the budget amounts provided do <u>not</u> include community affairs staff in all twelve Reserve Banks as well as some general administrative support costs for both functions. Certain national IT costs, such as data processing charges related to the National Information Center, maintaining supervisory databases such as the National Examination Data, and servers and network costs are under the responsibility of the Board's and System central information technology functions and are not included. Also, the figures above do not include costs incurred by other divisions and functions at the Board, such as economic research, information technology, and bank operations, for activities that benefit consumer protection or safety and soundness supervision. Some Board research economists conduct research and collect and analyze data that support the consumer and community affairs functions, such as understanding consumer finances and wealth building, and providing analytical support for rule writing. For example, economists reviewed available data on mortgage pricing to help the Board determine the appropriate threshold to define which mortgage loans should be considered "high cost" and, therefore, subject to new rules issued under the Board's HOEPA authority as described in question one. Likewise, research economists played a significant role in the recent Supervisory Capital Assessment Program (SCAP) analysis for prudential supervision, but their costs are also not included.

3. **During the current financial crisis, the Fed was responsible for both safety and soundness and consumer protection, yet did not discover abuses in subprime mortgages and other abuses until too late. Has the Fed performed any analyses of what went wrong? If so, please provide copies of each such analysis.**

We have considered the many factors that contributed to problems in subprime lending and the recent economic crisis and have focused on identifying areas where we can make improvements in our programs for both safety and soundness supervision and consumer protection. As Chairman Bernanke and Governor Tarullo noted in their recent testimony, the roots of this crisis included global imbalances in savings and capital flows, the rapid integration of lending activities with the issuance, trading, and financing of securities, the existence of gaps in the regulatory structure for the financial system, and widespread failures of risk management across a range of financial institutions. The crisis revealed supervisory shortcomings among all regulators, and demonstrated that the framework for supervision and regulation had not kept pace with changes in the structure, activities, and growing interrelationships of the financial sector.

Consumer Protection

With respect to consumer protection, gaps in supervision and enforcement with respect to nonbank mortgage lenders contributed to the inability of supervisors to detect and contain abusive lending practices. Most subprime loans were issued by entities outside the supervisory jurisdiction of the Federal Reserve and other federal bank regulators, and consequently, these entities were not subject to examinations to assess compliance with federal consumer protection laws. With respect to nonbank entities owned by bank holding companies, the Federal Reserve's consumer compliance examination authority is limited to only certain laws.

The Federal Reserve has worked to overcome this gap through a multiagency partnership initiated in June 2007, to conduct targeted consumer compliance reviews of selected nonbank lenders with significant subprime mortgage operations. The joint effort represented the first time multiple agencies have collaborated to plan and conduct consumer compliance reviews of independent mortgage lenders and nonbank subsidiaries of bank and thrift holding companies, as well as mortgage brokers doing business with, or working for, these entities. The pilot program has been completed, and the Federal Reserve is fully committed to implementing its own program of supervision of nonbank subsidiaries of holding companies on an ongoing basis. As with the pilot, we will continue to work cooperatively and share information with other agencies with overlapping jurisdictions. We have also created a special unit to oversee consumer protection issues in the subsidiaries of the largest financial institutions that are active in consumer credit and payment services and have expanded our complaint resolution program to include these institutions.

The current crisis has also illustrated clearly that consumer protection issues and safety and soundness risks are linked and can affect financial stability. We have been committed to strengthening our consumer protection program to more effectively detect and respond to changing and emerging markets and products, particularly for those that pose risks to consumers. Along these lines, we have added resources and worked to strengthen our internal processes to detect and address emerging risks and issues facing consumers. We have also expanded resources to improve timeliness of rule writing and to better identify consumer needs through consumer testing. Specifically, we have conducted extensive consumer testing as part of the rule writing process to improve the effectiveness of disclosures to provide consumers with useful information when they are shopping for credit. Consumer testing has also served to identify issues that can only be remedied through substantive regulation and to direct consumer education efforts. Finally, we have also instituted a web-based comment system to improve consumer access for making comments on proposed rules.

We have also learned that disclosures alone may not always sufficiently protect consumers from unfair practices. As such, we have taken a number of specific actions to strengthen consumer protections through rule-making. Over the last year, the Federal Reserve issued sweeping new mortgage and credit card rules that significantly expand protections for consumers of these credit products. For mortgage loans, the Board has issued rules that establish comprehensive new regulatory protections for consumers in the residential mortgage market. Importantly, these rules apply to all mortgage lenders, not just the depository institutions that are supervised by the federal banking and thrift agencies. The rules are designed to provide transaction-specific disclosures early enough to facilitate shopping and to protect consumers from unfair or deceptive acts or practices in mortgage lending, while supporting sustainable home ownership. They are intended to respond to the most troublesome practices in the mortgage industry that contributed to the recent subprime market meltdown. The Board also adopted rules governing mortgage advertisements to ensure that they provide accurate and balanced information and do not contain misleading or deceptive representations. Further, this past July the Board proposed significant new rule changes to improve consumer disclosures for all mortgage transactions. In particular, the proposed disclosures focus consumer attention on understanding the risks they are taking by identifying "key questions to ask." Many of the proposed disclosures are the result of extensive consumer testing, a technique that has become integral to the Board's rule making.

Prudential Supervision

With respect to prudential supervision, the Federal Reserve, acting within its existing statutory authorities, is taking steps to strengthen the supervision of banks and bank holding companies to respond to lessons learned from the recent crisis. Working with other domestic and foreign supervisors, we have been engaged in a series of initiatives to strengthen capital, liquidity, and risk management at banking organizations. Regarding capital adequacy, for example, there is little doubt that in the period before the crisis capital levels were insufficient to serve as a needed buffer against loss. Efforts are under way to improve the quality of the capital used to satisfy minimum capital ratios, to strengthen the capital requirements for on- and off-balance-sheet exposures, and to establish capital buffers in good times that can be drawn down as economic and financial conditions deteriorate.

Recent experience has also reinforced the value of holding company supervision in addition to, and distinct from, bank supervision. Large organizations increasingly operate and manage their businesses on an integrated basis with little regard for the corporate boundaries that typically define the jurisdictions of individual functional supervisors. In October, we issued new guidance for consolidated supervision of bank holding companies that provides for supervisory objectives and actions to be calibrated more directly to the systemic significance of individual institutions and clarifies supervisory expectations for corporate governance, risk management, and internal controls of the largest, most complex organizations. We are also adapting our internal organization of supervisory activities to take better advantage of the information and insight that the economic and financial analytic capacities of the Federal Reserve can bring to bear in financial regulation.

Finally, we are prioritizing and expanding our program of horizontal examinations to assess key operations, risks, and risk-management activities of large institutions. In addition to onsite examination activities for the largest and most complex firms, we are creating an enhanced surveillance program that will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole. This work will likely be performed by a multi-disciplinary group including experts in economic and market research, bank supervision, market operations, and accounting and legal issues.

4. If legislation is passed to create the Consumer Financial Protection Agency, what are the impediments, if any, to current Federal Reserve staff being transferred to the CFPA?

The current proposals for a new Consumer Financial Protection Agency offer some helpful ideas in considering how best to handle the challenging task of combining staff from a number of agencies with minimum disruption to those affected. Nonetheless, there are some issues with the transfer of key staff and potential loss of expertise that would need to be addressed. Federal Reserve consumer protection staff members routinely utilize the consumer expertise of staff members engaged primarily in other central bank functions. For example, research economists analyze HMDA data or other consumer data, but also perform other important research and are not likely to transfer to a new agency. Furthermore, roughly half of the System consumer compliance examiners are cross trained or have expertise in safety and soundness supervision, including expertise in accounting, audit, commercial real estate lending, information technology, assessments of corporate governance and enterprise risk management. Transferring those examiners may cause the Federal Reserve to lose important skills needed for other functions and would require additional investments in staff training to make up the lost expertise. Conversely, should some of the cross-trained examiners elect to remain with the Federal Reserve; the new agency would not have the benefit of their expertise in consumer compliance.

Additionally, the call center infrastructure that supports the Federal Reserve System consumer complaint and inquiry program also supports the call center needs of other functions across the Federal Reserve System.

Finally, there are other issues to address related to data systems and IT support. Data bases for the Home Mortgage Disclosure Act (HMDA) data, consumer complaints (CAESER), and other examination tools for analyzing fair lending and compliance with CRA, may be difficult to transfer and blend with systems from other agencies. Supervisory information for both consumer protection and prudential supervision is housed in shared databases, potentially leading to difficulties in determining how to provide access and to separate or maintain the information going forward. Given some of the staffing, information technology and operational issues, a new agency may require some time after enactment to become fully operational.

5. Describe the Federal Reserve's present statutory mission and the extent to which this mission includes consumer protection?

Through the Federal Reserve Act and other laws, Congress has assigned several duties and responsibilities to the Federal Reserve. These include responsibility for conducting monetary policy to achieve the objectives set forth in section 2A of the Federal Reserve Act, providing financial services to depository institutions, the U.S. government and foreign official institutions, and operating and overseeing aspects of the nation's payments system.

The Federal Reserve also has statutory responsibility conveyed through various laws, including the Federal Reserve Act, Federal Deposit Insurance Act, and the Bank Holding Company Act for supervising and regulating bank holding companies, state member banks, and certain other types of financial institutions (collectively, banking organizations) for prudential purposes. In connection with our safety and soundness examinations of state member banks and bank holding companies, we evaluate the adequacy of the organization's risk-management systems, including the systems used to ensure compliance with consumer protection and other laws and regulations. The Federal Reserve also conducts regular examinations of state member banks to evaluate compliance with consumer protection laws, the fair lending laws, and the Community Reinvestment Act.

In addition, Congress has vested the Federal Reserve with authority for writing regulations to implement a wide variety of consumer protection laws designed to protect consumers in financial transactions. These include the Truth in Lending Act, the Truth in Savings Act, and the Equal Credit Opportunity Act, among others. For many of these statutes, the rules established by the Federal Reserve apply to all lenders or depository institutions within the scope of the relevant act - not just those supervised by the Federal Reserve for prudential purposes.

The Federal Reserve is committed to improving consumer protections and promoting responsible lending practices through each of the roles we play as supervisor for safety and soundness and consumer compliance, and as rule writer. In my testimony, I suggested certain actions that Congress could take to help ensure that the commitment demonstrated by the Board to consumer protection in financial services is maintained over time. One way would be for Congress to formally codify consumer protection as a core mission or responsibility for the Federal Reserve, similar to banking supervision and regulation. This would provide a clear and ongoing understanding that consumer protection matters should be viewed as an integral part of the Federal Reserve's overall mission. In addition, Congress could require the Chairman of the Federal Reserve Board to report periodically regarding the "state of consumer protection" in the financial services industry, similar to the semiannual monetary policy report to the Congress. Such reporting could include a comprehensive review of the Federal Reserve's actions taken to strengthen consumer protection, the adequacy of existing consumer protection laws and regulations, planned future actions to address potentially unfair and deceptive acts and practices, enforcement actions taken on consumer protection matters, studies of consumer finances, and the availability of financial services especially in underserved areas.

6. **Please provide the Subcommittee with specific example(s) of conflicts that the Federal Reserve has experienced arising from the exercise of your consumer protection and prudential supervisory responsibilities? How were these conflicts resolved?**

Rule writing requires extensive analysis from a number of perspectives, which highlights the complementary nature of rule writing with other functions in the Federal Reserve that I mentioned in my testimony. Any effort to develop new rules involves weighing the costs and benefits of those rules to consumers, as well as implementation and compliance costs for the industry. Implementing unduly strict limitations on product features or practices can result in reduced access to affordable credit or services for consumers, and rules that are costly to implement can result in reduced efficiency for the provider and higher costs that are ultimately passed on to consumers.

Every rule writing exercise that the Board has undertaken in recent years, including rules for home equity lines of credit (HELOCs), credit cards, mortgage lending, and the current review of overdraft protections, has involved weighing a number of issues and the relative costs and benefits to consumers, as well as the impact on the institutions' ability to offer the credit or service at an affordable price. In conducting the analysis, staff routinely identifies issues for which different interests need to be reconciled at an early enough stage in the process to allow for timely issuance of well crafted rules. For example, rule changes can affect the business model, risk profile, and potentially the profitability of lending for institutions, and they also ultimately affect the pricing and availability of credit for consumers. Issues such as these have been reviewed, studied, and resolved as part of the rule writing process, with input from experts in consumer regulation, prudential supervision, payments systems, and economic analysis. If consumer protection rule writing is separated from prudential supervision, provision should be made for interagency consultation early in the rule writing process. Early consultation could reduce the likelihood of later unresolved conflicts, or extension of the time required for rule writing. In addition, such consultation could surface issues that might otherwise lessen the availability or increase the cost of financial services.

Similarly, the conduct of consumer protection and prudential supervisory responsibilities often require close coordination in order to avoid conflicting supervisory policy direction or messages to individual institutions through examinations. The recent experience with home equity lines of credit provides an example of the need for supervisors to balance prudential and consumer protection concerns. Many individuals and small businesses rely on home equity lines of credit to finance their businesses and pursue new opportunities. Given current economic conditions, prudential supervisors may have concerns about the size of individual institutions' credit exposures, while consumer compliance supervisors may cite concerns with cutting available credit lines, particularly for creditworthy borrowers who have made payments as agreed. Issues such as this are currently resolved within the agency during the course of policy development or for individual institutions, during an examination prior to issuing a final examination report. If unresolved, institutions would receive conflicting messages and direction affecting their home equity lending programs. In addition to policy issues, potential areas requiring coordination may also involve lower level issues related to coordination of examination schedules, the relative weight examiners give to supervisory concerns, and recommended corrective actions. Thus, it would also be important to determine a process to resolve differences among the agencies that arise in both rule writing and in the conduct of supervision.

7. **In your written testimony, you indicate that the Federal Reserve has completed a multiagency pilot program of targeted consumer compliance reviews for selected nonbank lenders and "is fully committed to implementing its own program of supervision of nonbank subsidiaries of holding companies on an ongoing basis."**

   a. **What clarifications of the Federal Reserve's supervisory authority for non-bank subsidiaries under Gramm-Leach-Bliley would assist in your ability to protect consumer interests and conduct consumer compliance examinations for these institutions?**

As noted in the response to question 3 on page 5, the Federal Reserve is fully committed to implementing a program for supervision of nonbank affiliates of bank holding companies for consumer compliance. To be fully effective, consolidated supervisors need the information and ability to identify and address risks throughout an organization. However, the Bank Holding Company Act as amended by the so-called "Fed-lite" provisions of the Gramm-Leach-Bliley Act, places material limitations on the ability of the Federal Reserve to examine, obtain reports from, or take actions to identify or address risks with respect to both nonbank and depository institution subsidiaries of a bank holding company that are supervised by other agencies. It also places limits on the authority of the Federal Reserve to obtain reports from or examine other non-functionally-regulated subsidiaries. Consistent with these provisions, we have worked with other regulators and, wherever possible, sought to make good use of the information and analysis they provide. In the process, we have built cooperative relationships with other regulators--relationships that we expect to continue and strengthen further.

Nevertheless, the restrictions in current law still can present challenges to timely and effective consolidated supervision in light of, among other things, differences in supervisory models. At times, organizations have used the "Fed-lite" provisions to challenge the Federal Reserve's authority to request or obtain certain information. To ensure that consolidated supervisors have the necessary tools and authorities to monitor and address safety and soundness and consumer protection concerns in all parts of an organization on a timely basis, we would urge statutory modifications to the Fed-lite provisions of the Gramm-Leach-Bliley Act. Such changes, for example, should remove the limits first imposed in 1999 on the examination and information-gathering authority that the Federal Reserve has over subsidiaries of bank holding companies in furtherance of its consolidated supervision responsibilities, and on the ability of the Federal Reserve to take action against subsidiaries, whether or not they are also supervised by another agency, to address unsafe and unsound practices and enforce compliance with applicable law.

b. What gaps, if any, still remain in the supervision and enforcement of non-banking mortgage originators?

Strong rules are the foundation for ensuring consumer protections, but strong oversight and enforcement are critically important. Gaps in enforcement and oversight, particularly with nonbank lenders, contributed to current problems in mortgage lending. Most subprime loans were originated by entities outside the supervisory jurisdiction of the Federal Reserve or other federal bank regulators and thus, not subject to examinations to assess their compliance with federal consumer protection laws. Our efforts to overcome this supervisory gap through collaboration among various agencies are discussed in the response to question three.

Currently, independent nonbank lenders and financial services providers are regulated by a combination of the Federal Trade Commission (FTC) and the states. However, the FTC does not have the authority, tools, or resources to conduct routine on-site examinations of these entities to monitor and enforce compliance, which is the norm for depository institutions. While several states have put forth noteworthy efforts in this regard, the state enforcement scheme across the country is still uneven, with inadequate resources being a primary concern. We believe it is appropriate that Congress consider alternatives to close this gap as part of ongoing discussions of regulatory reform.

CLO: #382
CCS: 09-93416
RECVD: 8/3/09

QUESTIONS FOR THE RECORD FROM CHAIRMAN MELVIN L. WATT

The Financial Services Committee, Subcommittee on Domestic Monetary Policy & Technology appreciates your participation in the hearing entitled, *"Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve"* on July 16, 2009. Please provide written responses to these questions for the record within 30 days of receipt.

Elizabeth Duke - Federal Reserve Governor

(1) If the Federal Reserve had authority to issue rules implementing the Home Ownership and Equity Protection Act (HOEPA) beginning in 1994, why did the Fed wait until 2008 to issue rules?

(2) What are the Federal Reserve's current staffing and budget levels allocated to safety and soundness in FY 2009? What are the staffing and budget levels for consumer protection in FY 2009?

(3) During the current financial crisis, the Fed was responsible for both safety and soundness and consumer protection, yet did not discover abuses in subprime mortgages and other abuses until too late. Has the Fed performed any analyses of what went wrong? If so, please provide copies of each such analysis.

(4) If legislation is passed to create the Consumer Financial Protection Agency, what are the impediments, if any, to current Federal Reserve staff being transferred to the CFPA?

(5) Describe the Federal Reserve's present statutory mission and the extent to which this mission includes consumer protection?

(6) Please provide the Subcommittee with specific example(s) of conflicts that the Federal Reserve has experienced arising from the exercise of your consumer protection and prudential supervisory responsibilities? How were these conflicts resolved?

For files
P. Elliff

(7) In your written testimony, you indicate that the Federal Reserve has completed a multiagency pilot program of targeted consumer compliance reviews for selected nonbank lenders and "is fully committed to

implementing its own program of supervision of nonbank subsidiaries of holding companies on an ongoing basis."

a. What clarifications of the Federal Reserve's supervisory authority for non-bank subsidiaries under Gramm-Leach-Bliley would assist in your ability to protect consumer interests and conduct consumer compliance examinations for these institutions?

b. What gaps, if any, still remain in the supervision and enforcement of non-banking mortgage originators?

CLO: #491
CCS: 09-11947
RECVD: 10/15/09

Congressman Donald Manzullo
Questions for the Record
Committee on Financial Services
Hearing entitled "HR 1207, the Federal Reserve Transparency Act of 2009"
September 25, 2009

Questions for the Federal Reserve:

1.) Is it the Federal Reserve's position that inflation is a hidden tax on the American people?
2.) Does the Federal Reserve still use Modern Money Mechanics as guidelines for a fractional reserve system? If not, what literature is available that is equivalent?

09-12616

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

December 7, 2009

RECEIVED
OFFICE OF THE SECRETARY
RECORDS SECTION
2009 DEC -8 A 4:09

The Honorable David Vitter
United States Senate
Washington, D.C. 20510

Dear Senator:

I am pleased to enclose my responses to the questions you submitted in connection with the October 14, 2009, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy of my responses has been forwarded to the Chief Clerk of the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

(signed) Daniel K. Tarullo

Enclosure

For files
P. Elliff

Governor Daniel Tarullo subsequently submitted the following in response to written questions received from Senator Vitter in connection with the October 14, 2009, hearing before the Committee on Banking, Housing, and Urban Affairs:

Mr. Tarullo, I am concerned about the Federal Reserve overstepping the authority Congress has granted. News reports about the Federal Reserve giving itself the authority to veto pay packages is beyond the pale.

- **Can you please submit for the record, where in the Federal Reserve Act the Fed [is] given the authority to regulate compensation agreements?**
- **Why should the Federal Reserve be allowed to veto pay agreements that are approved by a company's board of directors?**
- **How involved has Chairman Bernanke been in drafting this illegal rulemakeing?**
- **Which Federal Reserve Governor has been pushing the Federal Reserve's policy on this issue?**

The Federal Reserve's proposed supervisory guidance and related supervisory initiatives regarding incentive compensation practices derive from our statutory mandate to protect the safety and soundness of the banking organizations we supervise. The proposed guidance was developed in consultation with all Board members and all Board members voted in favor of issuing the proposed guidance for public comment.

Recent events have highlighted that improper compensation practices can contribute to safety and soundness problems at financial institutions and to financial instability. Compensation practices were not the sole cause of the crisis, but they certainly were a contributing cause--a fact recognized by 98 percent of the respondents to a 2009 survey conducted by the Institute of International Finance of banking organizations engaged in wholesale banking activities.[1] The Federal Reserve and the other Federal banking agencies regularly issue supervisory guidance to identify practices that the agencies believe would ordinarily constitute an unsafe or unsound practice, or to identify risk management systems, controls, or other practices that the agencies believe would ordinarily assist banking organizations in ensuring that they operate in a safe and sound manner.

The proposed supervisory guidance, which currently is out for public comment,[2] is based on three key principles: (1) incentive compensation arrangements at a banking organization should not provide employees incentives to take risks that are beyond the organization's ability

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[1] See The Institute of International Finance, Inc. (2009), *Compensation in Financial Services: Industry Progress and the Agenda for Change* (Washington: IIF, March).

[2] Board of Governors of the Federal Reserve System (2009), "Federal Reserve Issues Proposed Guidance on Incentive Compensation," press release, October 22, 2009.

to effectively identify and manage; (2) they should be compatible with effective controls and risk management; and (3) they should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. Consistent with these principles, the Federal Reserve's efforts are focused on ensuring that the way in which banking organizations structure their incentive compensation arrangements do not--intentionally or unintentionally--encourage excessive risk-taking, and that banking organization's have the types of policies, procedures, internal controls, and corporate governance structures to promote and maintain sound incentive compensation arrangements.

Importantly, the proposed guidance does not mandate that banking organizations follow any particular method for achieving appropriately risk-sensitive incentive compensation arrangements. In fact, the guidance expressly recognizes that the methods used to achieve risk-sensitive compensation arrangements likely will differ across and within firms, and that use of a single, formulaic approach is unlikely to consistently promote safety and soundness.

2. Is it the Federal Reserve's official position that executive compensation is a cause of systemic risk?

- **If so, can you please provide this Committee with documentation to support this position?**

Pay practices for risk-taking employees at many levels in banking organizations, not just top executive pay practices, were one among many contributors to the crisis. The role of compensation practices in the crisis has been widely recognized by both industry and supervisors, both here and overseas. For example, in their responses to a survey conducted by the Institute of International Finance, a global association of major financial institutions, 36 of 37 large banking organizations engaged in wholesale activities agreed that compensation practices were a factor underlying the crisis.[3] The Senior Supervisors Group, which is composed of senior financial supervisors from seven major industrialized countries (the United States, Canada, France, Germany, Japan, Switzerland, and the United Kingdom), also reported that many firms and their supervisors had determined that failures of incentives and controls throughout the industry, including those related to compensation, contributed to systemic vulnerability during the crisis.[4] Moreover, the Financial Stability Board, a group composed of senior representatives of national financial authorities, international financial institutions, standard setting bodies, and committees of central bank experts, has identified compensation practices as a factor contributing to the crisis.[5]

[3] See The Institute of International Finance, Inc. (2009), Compensation in Financial Services: Industry Progress and the Agenda for Change (Washington: IIF, March).
[4] See Senior Supervisors Group (2009), Risk Management Lessons from the Global Banking Crisis of 2008.
[5] See Financial Stability Board (2009), Principles for Sound Incentive Compensation Practices.

3. What comments has the Federal Reserve received on this proposal from the banks it regulates?

The comment period closed on November 27, 2009. The Board has received twenty-nine comments on the proposed guidance, four of which were submitted on behalf of individual banking organizations, five of which were submitted on behalf of groups representing multiple banking organizations, and two of which were submitted on behalf of groups representing both banking and nonbanking organizations. Public comments on the proposal are made available on the Board's website at
http://www.federalreserve.gov/generalinfo/foia/index.cfm?doc_id=OP%2D1374&doc_ver=1.

4. Mr. Tarullo, regarding the specifics of the proposal:

- **Would the Federal Reserve require companies to "clawback" money that's already been paid to employees?**

- **Is there a threshold a bank must meet to qualify for a review of executive compensation arrangements?**

The proposed guidance provides that incentive compensation arrangements should not encourage excessive risk-taking, and describes several methods that are currently used by banking organizations to make compensation more sensitive to risk. These methods can be broadly described as risk adjustment of awards, deferral of payment, longer performance periods, and reduced sensitivity to short-term risk. As noted in the proposed guidance, the deferral of payment method is sometimes referred to in the industry as a ''clawback.'' The term ''clawback'' also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur.

Importantly, the proposed guidance does not require a banking organization to use any particular method, including those described in the guidance, to ensure that its incentive compensation arrangements do not encourage employees to take excessive risks. In fact, the proposed guidance expressly recognizes that the methods discussed in the guidance have their own advantages and disadvantages, and that banking organizations will need flexibility in determining how best to achieve balanced incentive compensation arrangements in light of the particular activities, structure, and other characteristics of the organization.

The proposed supervisory guidance would apply to all banking organizations that are supervised by the Federal Reserve. These organizations are primarily responsible for ensuring that their incentive compensation arrangements do not encourage excessive risk-taking or pose a threat to the safety and soundness of the organization. To help promote and monitor the development of safe and sound incentive compensation arrangements, the Federal Reserve also has announced two, separate supervisory initiatives. These two separate programs are designed to reflect the differences among the universe of banking organizations supervised by the Federal Reserve. The first initiative involves a special, horizontal review of incentive compensation practices at large, complex banking organizations (LCBOs). LCBOs warrant special supervisory attention because they are significant users of incentive compensation arrangements and because flawed practices at these institutions are more likely to have adverse effects on the broader financial system.

A separate program will apply to the thousands of other organizations supervised by the Federal Reserve, including community and regional banking organizations. Supervisory staff will review incentive compensation arrangements at these organizations as part of the regular risk-focused examination process. These reviews, as well as our supervisory expectations for these organizations, will be tailored to reflect the more limited scope and complexity of these organizations' activities--a fact also recognized in various aspects of our guidance.

The Banking, Housing and Urban Affairs Committee
"The State of the Nation's Housing Market"
Office of Senator Vitter
Questions for the Record
October 14, 2009

CLO: #509
CCS: 09- 12616
RECVD: 10/27/09

Questions for Daniel Tarullo, Federal Reserve Board:

- Mr. Tarullo, I am concerned about the Federal Reserve overstepping the authority Congress has granted. News reports about the Federal Reserve giving itself the authority to veto pay packages is beyond the pale.
    - Can you please submit for the record, where in the Federal Reserve Act the Fed given the authority to regulate compensation agreements?
    - Why should the Federal Reserve be allowed to veto pay agreements that are approved by a company's board of directors?
    - How involved has Chairman Bernanke been in drafting this illegal rulemaking?
    - Which Federal Reserve Governor has been pushing the Federal Reserve's policy on this issue?

- Is it the Federal Reserve's official position that executive compensation is a cause of systemic risk?
    - If so, can you please provide this Committee with documentation to support this position?

- What comments has the Federal Reserve received on this proposal from the banks it regulates?

- Mr. Tarullo, regarding the specifics on the proposal:
    - Would the Federal Reserve require companies to "clawback" money that's already been paid to employees?
    - Is there a threshold a bank must meet to qualify for a review of executive compensation agreements?

For files
P. Elliff

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 11, 2011

The Honorable Mike Crapo
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Crapo:

1. Do you agree with the testimony from economists Carmen Reinhart and Ken Rogoff that, once our gross debt reaches 90 percent of GDP, that it creates a significant drag on our economic growth to the extent that we basically lose a full percentage point, so that, for example, if our economy otherwise would have grown at a 4 percent rate, we will actually only see 3 percent growth?

Persistently high and rising levels of government debt relative to GDP can have a number of negative effects on the economy. An elevated and growing ratio of federal debt to GDP will eventually put upward pressure on real interest rates and thus inhibit capital formation, productivity, and economic growth. Indeed, increased expectations of steadily expanding federal debt in the future could make households and businesses more cautious now about spending, capital investment, and hiring, thus slowing economic growth even before federal debt actually moves up to higher levels. Large government debts also can increase our reliance on foreign lenders, implying that the share of U.S. national income devoted to paying interest to foreign investors will increase over time and that a lesser share of U.S. national income would be available for domestic consumption. Moreover, an increasingly large cost of servicing a growing national debt could require significant fiscal actions to cover these costs, which would tend to slow economic growth by reducing incentives to work, save, hire, and invest. Finally, a large federal debt decreases the flexibility of policymakers to take actions needed to counteract adverse shocks to the economy, thus leaving the economy more vulnerable to the negative effects of recessions and financial crises.

It is difficult to identify an exact threshold at which federal debt would begin to pose more substantial costs and risks to the U.S. economy or to know precisely what the magnitude of those negative effects would be. What we do know, however, is that the costs and risks to the U.S. economy will grow if the ratio of federal debt to GDP is allowed to increase to progressively higher levels. Indeed, the historical experience of countries that have faced fiscal crises indicates that interest rates could rise suddenly and rapidly, imposing substantial costs on our economy, if global financial market participants were to lose confidence in the ability of the United States to manage its fiscal policy. In light of the uncertainty about when such a development might occur, the prudent course is for fiscal policymakers to move quickly to put in place a credible plan in order to stabilize, and potentially reduce, the ratio of federal debt to GDP over the medium and longer term. The sooner a credible fiscal plan is established, the more time affected individuals will have to prepare for the necessary changes, likely making the necessary adjustments less painful and more politically feasible. Moreover, acting now to develop a credible program to reduce future deficits would not only enhance economic growth in the long run, these actions could also yield substantial near-term benefits for the economy from lower long-term interest rates and increased consumer and business confidence.

2. The most expensive government bailouts will be those of Fannie Mae and Freddie Mac – the largest housing lenders that purchased home loans, packaged them into investments and then guaranteed them against default. According to a January 2010 CBO background paper titled "CBO's Budgetary Treatment of Fannie Mae and Freddie Mac," CBO

"believes that the federal government's current financial and operational relationship with Fannie Mae and Freddie Mac warrants their inclusion in the budget (p. 7)." Do you agree with the CBO report that the debt obligations of Fannie Mae and Freddie Mac should be included in the federal budget?

In September 2008, the Director of the Federal Housing Finance Agency placed the two mortgage-related government-sponsored enterprises (GSEs) – Fannie Mae and Freddie Mac – into conservatorship with the federal government, which took a major ownership interest in both of these GSEs. In the judgment of the Congressional Budget Office (CBO), those actions effectively made Fannie Mae and Freddie Mac part of the federal government and implied that all of their operations should be reflected in the federal budget. However, the Administration's Office of Management and Budget (OMB) has continued to treat Fannie Mae and Freddie Mac as non-government entities, though their financial transactions with the Treasury have been recorded in the federal budget. Ultimately, the OMB makes the final decision about the treatment of Fannie Mae and Freddie Mac in the federal budget. Neither the CBO nor the OMB incorporates the debt securities or the mortgage-backed securities issued by Fannie Mae and Freddie Mac in their estimates of federal debt held by the public, which is defined as including only debt issued directly by the Treasury.

3. Some analysts are warning about the potential for defaults in the $2.8 trillion municipal bond market while others say those predicting widespread defaults are exaggerating the connection between budget pressure and failure to meet payments on general-obligation bonds. This healthy debate has led some to speculate that rather than letting a state default on its bonds, the Federal Reserve would take the unprecedented action of buying state bonds. What is the state of the municipal bond market and is it accurate that you would oppose any pressure for a back-door bailout by having the Federal Reserve buy state bonds?

Conditions in the municipal market generally reflect the continued pressures on state and local budgets. The recession caused state and local tax revenues to decline substantially, and the weak labor market boosted their spending for Medicaid and other transfers as the rolls of these programs swelled. Although increased federal grants-in-aid have helped offset some of the decline in their tax revenues, state and local governments have reduced their hiring and spending for many programs in order to address their budget shortfalls. However, as the economy has recovered, state tax revenues have trended up over the last year. While a continued firming in the recovery should lead to further growth in state revenues, federal stimulus grants will be winding down this year and next year. As a result, state and local governments are likely to face tight budgets for some time. Moreover, in the longer run, state and local governments will have to confront issues relating to the funding of pensions and health-care benefits for retired state and local employees.

The municipal bond market has experienced some strains over recent months, although the market currently seems to be functioning reasonably well. Investor concerns about the fiscal situations of many governmental entities, including some very large states, led to an increase in spreads of yields on municipal securities over those on comparable-maturity Treasuries and wider credit default swap spreads on state debt around the turn of the year. However, these measures of risk in the municipal market have generally receded more recently, although the market continues to price in higher levels of default risk than before the recession. Some pullback by investors has also been evident in recent activity at tax exempt bond funds, which have recorded significant outflows since last November following large inflows over the previous year and a half, although preliminary data suggest some moderation of these outflows more recently. Gross municipal bond issuance slowed last month, but much of the drop-off seems to have been associated with the outsized amount of issuance in the fourth quarter of last year in anticipation of the expiration of the Build America Bonds program at the end of 2010. While it is unclear how the situation in the municipal bond market will develop, our best judgment at this point is that states will ultimately be able to take steps to shore up their budget situation; further defaults by some local municipalities are probable, but such defaults seem likely to remain relatively limited in size. The Federal Reserve monitors the municipal bond market carefully along with other markets in making its assessments of financial market conditions and the economic outlook.

Regarding potential purchases of state bonds, section 14 of the Federal Reserve Act (FRA) provides the Federal Reserve only very limited authority to purchase certain types of municipal obligations. In particular, the FRA authorizes the Federal Reserve Banks, subject to the rules and regulations of the Board of Governors and the instructions of the Federal Open Market Committee, to buy and sell bills, notes, revenue bonds, and warrants so long as they have a maturity from date of purchase of six months or less and have been issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by a State, county, district, political subdivision or municipality. The Federal Reserve has not purchased municipal obligations under this authority for many decades. More broadly, the Federal Reserve has long opposed suggestions that it should provide financial assistance to municipal governments. The Congress wisely established limitations on the ability of the Federal Reserve to purchase municipal securities, and these limitations help support fundamental principles such as the independence of the central bank and a strong federal system of government in which states and municipalities have powers and responsibilities that are not subject to review or oversight at the national level. Because decisions regarding the possible allocation of federal funds to state and municipal governments are inherently political, these matters should be discussed and ultimately determined by elected officials rather than appointed officials such as those at the Federal Reserve.

4. The commercial real estate (CRE) market continues to face significant challenges and community banks are expected to take large losses since many of the institutions hold large exposures. In order to jumpstart new lending in the small balance CRE sector and help clear the inventory of seriously delinquent CRE loans, some are suggesting a commercial real estate guarantee proposal that would have Treasury issue up to $25 billion of credit guarantees of individual small-balance commercial real estate loans. What do you think of this idea?

At the end of the third quarter of 2010, approximately $3.2 trillion of outstanding debt was associated with CRE, including loans for multifamily properties. Of this amount, about one-half, or $1.6 trillion, was held on the balance sheets of commercial banks and thrifts. An additional $700 billion represented collateral for CMBS, and the remaining balance of $900 billion was held by a variety of investors, including pension funds, mutual funds, and life insurance companies.

During 2010, delinquency rates on construction and development loans began to improve slightly, falling 1 percent in the first three quarters of 2010. Additionally, delinquency rates on loans backed by existing nonfarm, nonresidential properties leveled off in 2010. Still, even if CRE delinquency metrics continue improving, there remains a sufficiently large overhang of distressed CRE at commercial banks such that loss rates for this portfolio will likely stay high for some time.

At this time, it is difficult to assess whether or not a program to provide up to $25 billion of credit guarantees for small-balance CRE loans would generate new lending activity. Moreover, a program of this size would likely not have a material impact on the overall condition and performance of CRE related markets.

Continued progress on working through the overhang of distressed CRE will take time and will depend on banks taking strong steps to ensure that losses are recognized in a timely manner, that loan loss reserves and capital appropriately reflect risk, that loans are modified in a safe and sound manner, and that loans continue to be made available to creditworthy borrowers. Nonetheless, I can assure you that the Federal Reserve will continue to work with lenders to ensure that bank management and supervisors take a balanced approach to ensuring safety and soundness and serving the credit needs of the community.

Mike Crapo

Questions for the Record
From Senator Crapo
For Chairman Ben Benanke
Hearing on the U.S. Economic Outlook
January 7, 2011
Senate Budget Committee

CLO: #B - 7
CCS: 11-0982
RECVD: 1/10/11

Question 1: Do you agree with the testimony from economists Carmen Reinhart and Ken Rogoff that, once our gross debt reaches 90 percent of GDP, that it creates a significant drag on our economic growth to the extent that we basically lose a full percentage point, so that, for example, if our economy otherwise would have grown at a 4 percent rate, we will actually only see 3 percent growth?

Question 2: The most expensive government bailouts will be those of Fannie Mae and Freddie Mac – the largest housing lenders that purchased home loans, packaged them into investments and then guaranteed them against default. According to a January 2010 CBO background paper titled "CBO's Budgetary Treatment of Fannie Mae and Freddie Mac," CBO "believes that the federal government's current financial and operational relationship with Fannie Mae and Freddie Mac warrants their inclusion in the budget (p.7)." Do you agree with the CBO report that the debt obligations of Fannie Mae and Freddie Mac should be included in the federal budget?

Question 3: Some analysts are warning about the potential for defaults in the $2.8 trillion municipal bond market while others say those predicting widespread defaults are exaggerating the connection between budget pressure and failure to meet payments on general-obligation bonds. This healthy debate has led some to speculate that rather than letting a state default on its bonds, the Federal Reserve would take the unprecedented action of buying state bonds. What is the state of the municipal bond market and is it accurate that you would oppose any pressure for a back-door bailout by having the Federal Reserve buy state bonds?

Question 4: The commercial real estate (CRE) market continues to face significant challenges and community banks are expected to take large losses since many of the institutions hold large exposures. In order to jumpstart new lending in the small balance CRE sector and help clear the inventory of seriously delinquent CRE loans, some are suggesting a commercial real estate guarantee proposal that would have Treasury issue up to $25 billion of credit guarantees of individual small-balance commercial real estate loans. What do you think of this idea?

10- 5806

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

July 23, 2010

The Honorable Marcy Kaptur
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the June 9, 2010, hearing before the House Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Kaptur:

1. Mr. Chairman, what role, if any, should the Federal Reserve System play in working to solve the housing crisis continues to ravage our nation's communities?

The Federal Reserve has addressed the housing market crisis with a variety of policy actions. First, the Federal Reserve has used conventional and less conventional monetary policy tools, maintaining the federal funds rate near zero and purchasing $1.7 trillion of securities, including more than $1.25 trillion in mortgage-backed securities guaranteed by the housing-related government-sponsored enterprises. Mortgage interest rates are now, in part because of these efforts, at historically low levels.

Second, the Federal Reserve has taken a number of regulatory actions designed to protect consumers and restore confidence in the housing market. Specifically, the Federal Reserve finalized revisions to Regulation Z in 2008, which provide a layer of protections and restrictions on higher-priced mortgage loans. Currently, the Board is engaged in a comprehensive review of the mortgage disclosures required under the Truth in Lending Act, to improve their utility and effectiveness. The Board has also joined fellow banking regulators in proposing rules under the S.A.F.E. Act.

Third, we have worked with market participants and other governmental agencies to encourage sustainable loan modifications and other activity to prevent avoidable foreclosures whenever possible. We have developed a number of consumer education materials, such as a series of advertisements in targeted movie theatres warning consumers about "foreclosure rescue" scams. For struggling communities, we have supported stabilization efforts, including a Federal Reserve system-wide research initiative to benefit communities engaged in HUD's Neighborhood Stabilization Program (NSP). We are also in the midst of several efforts (joint with other regulators) to alter the Community Reinvestment Act in part to encourage bank participation in hard-hit communities.

2. Mr. Chairman, the Treasury is pouring money into Fannie and Freddie, keeping it afloat to support the current structure of housing finance. What should be done to stop us from dumping money into Fannie and Freddie to cover the losses of bad paper dumped into both institutions by big banks at profits and to return our housing finance system to a prudent lending, sound system that supports homeownership and affordable housing?

There are a variety of organizational forms that might replace Fannie Mae and Freddie Mac that could likely provide mortgage credit without the systemic risks associated with these institutions in the past. I have spoken on this topic at length, arguing that we must strive to design a housing financing system that ensures the successful funding and securitization of mortgages during times of financial stress, but that does not create institutions that pose systemic risks to our financial market and the economy.[1] The Secretary of Treasury has also testified at length on this issue and the Administration is currently soliciting the public's views about how best to reform

[1] See Ben Bernanke "The Future of Mortgage Finance in the United States," at the UC Berkeley/UCLA Symposium on "The Mortgage Meltdown, the Economy, and Public Policy," October 31, 2008.

the housing finance system.[2] Among the objectives of reform he described was the need for accurate, transparent and risk-based pricing of government guarantees. I agree with the Secretary that any reform proposal should encourage this type of pricing for government guarantees. Such explicit pricing is a key step toward stopping any transference of bad assets by the private sector to government agencies or enterprises, and for encouraging prudent lending and a sound mortgage finance system that supports homeownership and affordable housing.

3. Mr. Chairman, in the House bill on financial regulatory reform, we created the Consumer Financial Protection Agency. In the Senate bill, a bureau was created within the Federal Reserve System, underneath the Board of Governors. The conference is using the Senate bill as the base bill for discussion. Therefore, Mr. Chairman, do you feel that the Federal Reserve should have any responsibility for consumer protection? Do you feel that this fits in with the roles of the Federal Reserve System, which is to formulate the nation's monetary policy, supervise and regulate banks, and provide a variety of financial services to depository financial institutions and the federal government? Please include any related information to support your responses.

The Federal Reserve Board believes that consumer protection is vitally important to the strength of the economy and to maintaining financial stability. Strong consumer protection helps preserve households' savings, promotes confidence in financial institutions and markets, and adds materially to the strength of the financial system. We have seen in this crisis that flawed or inappropriate financial instruments can lead to bad results for families and for the stability of the financial sector. It is essential that consumers be protected from unfair and deceptive practices in their financial dealings. The Federal Reserve System will support the new Consumer Financial Protection Bureau and will work to efficiently and effectively carry out the will of Congress regarding responsibility for consumer protection.

[2] See written testimony to the House Committee on Financial Services by Treasury Secretary Geithner March 23, 2010.

CLO: #B-75
CCS: 10-5806
RECVD: 6/18/10

Budget Committee Hearing

State of the Economy

Questions for the Record

Questions for the Record

Congresswoman Kaptur

1. Mr. Chairman, what role, if any, should the Federal Reserve System play in working to solve the housing crisis continues to ravage our nation's communities?

2. Mr. Chairman, the Treasury is pouring money into Fannie and Freddie, keeping it afloat to support the current structure of housing finance. What should be done to stop us from dumping money into Fannie and Freddie to cover the losses of bad paper dumped into both institutions by big banks at profits and to return our housing finance system to a prudent lending, sound system that supports homeownership and affordable housing?

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10-5803

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

July 14, 2010

The Honorable Robert B. Aderholt
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the June 9, 2010, hearing before the House Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Aderholt:

1. On April 1, the Federal Reserve began requiring escrow accounts to be established for first-lien higher-priced mortgage loans. Many community banks protested this requirement since they do not have the resources to create these escrow accounts. Since the rule went into effect, many community banks, including one in my district, have stopped offering these mortgages. Is the Federal Reserve reviewing this policy and how it affects community banks? Do you foresee the Federal Reserve exempting community banks from this regulation in the near future?

As you note, the Board's rules for higher-priced mortgage loans require that creditors establish escrow accounts for taxes and insurance. The Board issued these rules in July 2008 using its authority under the Home Ownership and Equity Protection Act to prohibit unfair practices in connection with mortgage loans. Compliance with the rule did not become mandatory until this year because the Board recognized that some lenders would need time to develop the capacity to escrow.

As background, the Board adopted the escrow requirement to address specific concerns. The Board found that lenders generally did not establish escrow accounts for consumers with higher-priced loans. The Board was concerned that when there is no escrow account, lenders might disclose a monthly payment that includes only principal and interest. As a result, consumers might mistakenly base their borrowing decision on an unrealistically low assessment of their total mortgage-related obligations. The Board was also concerned that consumers not experienced at handling taxes and insurance on their own might fail to pay those items on a timely basis.

Nonetheless, we do appreciate the concerns you have raised about the cost of establishing escrow accounts, and whether the cost may be prohibitive for lenders that make a small number of loans and hold them in portfolio. In fact, community banks also have raised these concerns with the Board directly during the past several months. As a result, we have been discussing with their representatives the potential impact of the escrow rule. Please be assured that the Board is monitoring implementation of the new escrow rule by small lending institutions and the availability of credit in the communities they serve. If it is determined that the costs of the rule outweigh the benefits, we will explore alternatives that do not adversely affect consumer protection.

2. I hear stories from community bankers in my district about overzealous regulators going so far as to demand changes on individual $8,000 car loans. Do you believe that some of this over regulation could hinder our economic recovery more than help it? Will increased regulations in the financial reform legislation in Congress decrease the availability of credit to consumers, especially from small banks?

In retrospect, loan underwriting standards became too loose during the run up to the recent financial crisis. Accordingly, some tightening of underwriting standards from the practices that prevailed just a few years ago was needed. However, as your question suggests, there is a risk that over-correction by banks and supervisors could unnecessarily constrain credit. To address this risk, the Federal Reserve and the other banking agencies have repeatedly instructed their examiners to take a measured and balanced approach to reviews of banking organizations and to encourage efforts by these institutions to work constructively with existing borrowers that are experiencing financial difficulties. Examples of such guidance include the November 12, 2008 Interagency Statement on Meeting the Needs of Creditworthy Borrowers and an October 30, 2009 interagency statement designed to encourage prudent workouts of commercial real estate loans and facilitate a balanced approach by field staff to evaluating commercial real estate credits (SR 09-7). More recently, on February 5, the Federal Reserve and other regulatory agencies issued a joint statement on lending to creditworthy small businesses. This statement is intended to help to ensure that supervisory policies and actions are not inadvertently limiting access to credit. If bankers in your district believe that Federal Reserve examiners have taken an inappropriately strict approach on a supervisory matter, they should discuss their views with bank supervision management at their local Reserve Bank or raise their specific concerns with the Federal Reserve's ombudsman (see details on the Board's website at http://www.federalreserve.gov/aboutthefed/ombudsman.htm).

Regulation imposes costs on small banks and can affect their capacity and willingness to lend. However, on balance, it is likely that the benefits of implementing reforms to prevent a future financial crisis outweigh the costs of these changes. Indeed, a repeat of the recent crisis in all likelihood would be far more costly to community banks and consumers seeking credit than the costs of the proposed financial reform package.

3. During the hearing, you stated that some banks are taking second looks at loan applications to ensure consumers get the credit they deserve. In discussion with small bankers in my district, I have learned that many community banks are taking second, third and fourth looks. While it is good that they are reviewing these applications, it is slowing down access to credit. The fact is that many of these banks are afraid to lend money. What is the Federal Reserve doing to give community banks more confidence in lending and free up credit for consumers?

As discussed above, the Federal Reserve has developed guidance for its examiners to ensure that they are taking a measured approach to evaluating lending activities at small banks. In addition, the Federal Reserve has supplemented these issuances with training programs for examiners and outreach to the banking industry to underscore the importance of the guidance and ensure its full implementation. Also, in an effort to better understand small business lending trends, the Federal Reserve System this month is completing a series of more than 40 meetings across the country to gather information that will help the Federal Reserve and others better respond to the credit needs of small businesses. As part of this series, the Federal Reserve Bank of Atlanta hosted five small business roundtable discussions at locations across its district during the spring and summer. Emerging themes, best practices, and common challenges identified by the meeting series were discussed and shared at a conference held at the Federal Reserve Board in Washington in early July.

CLO: #B-74
CCS: 10-5803
RECVD: 6/18/10

Budget Committee Hearing

State of the Economy

Questions for the Record

Robert B. Aderholt

Budget Federal Reserve Chairman Ben Bernanke

1. On April 1, the Federal Reserve began requiring escrow accounts to be established for first-lien higher-priced mortgage loans. Many community banks protested this requirement since they do not have the resources to create these escrow accounts. Since the rule went into effect, many community banks, including one in my district, have stopped offering these mortgages. Is the Federal Reserve reviewing this policy and how it affects community banks? Do you foresee the Federal Reserve exempting community banks from this regulation in the near future?

2. I hear stories from community bankers in my district about overzealous regulators going so far as to demand changes on individual $8,000 car loans. Do you believe that some of this over regulation could hinder our economic recovery more than help it? Will increased regulations in the financial reform legislation in Congress decrease the availability of credit to consumers, especially from small banks?

3. During the hearing, you stated that some banks are taking second looks at loan applications to ensure consumers get the credit they deserve. In discussion with small bankers in my district, I have learned that many community banks are taking second, third and fourth looks. While it is good that they are reviewing these applications, it is slowing down access to credit. The fact is that many of these banks are afraid to lend money. What is the Federal Reserve doing to give community banks more confidence in lending and free up credit for consumers?

10-7581

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

LOUISE L. ROSEMAN
DIRECTOR
DIVISION OF
RESERVE BANK OPERATIONS
AND PAYMENT SYSTEMS

September 15, 2010

The Honorable Melvin L. Watt
Chairman
Subcommittee on Domestic Monetary Policy
and Technology
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the July 20, 2010, hearing before the Subcommittee on Domestic Monetary Policy and Technology for inclusion in the hearing record. Also, I have provided recommendations for changes to the Presidential $1 Coin Act, as you requested during the hearing.

Please let me know if I can be of further assistance.

Sincerely,

Louise L. Roseman

Enclosure

Email: Louise.Roseman@frb.gov
Phone: (202) 452-2789 • Fax: (202) 452-2746

<u>Questions for The Honorable Louise Roseman, Director, Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System, from Chairman Melvin L. Watt:</u>

1 (a) Please describe the formal and informal working relationship between the U.S. Mint, Bureau of Engraving and Printing, Federal Reserve, and the United States Secret Service regarding U.S. coins and currency.

Maintaining confidence in and the integrity of U.S. currency are shared responsibilities of the Federal Reserve, the Treasury Department and its Bureau of Engraving and Printing (BEP), and the United States Secret Service (USSS). The Board of Governors of the Federal Reserve System (the Board) is the issuing authority for U.S. currency. The Secretary of the Treasury has sole authority for the design of U.S. currency, and the BEP is the government's printer of security documents (primarily Federal Reserve notes). The United States Secret Service, formerly an agency of the Department of the Treasury, has responsibility for investigating counterfeit activity.

Almost 30 years ago, the Secretary of the Treasury and the Chairman of the Board chartered the Advanced Counterfeit Deterrence (ACD) Steering Committee, consisting of senior representatives of the Treasury, the BEP, the Federal Reserve, and the USSS to establish policy for the U.S. currency program and for making design recommendations to the Secretary of the Treasury. The ACD Steering Committee meets regularly to discuss trends in currency usage and counterfeit activity, as well as topics of mutual interest, such as threats to U.S. currency, developments in new security features and new currency designs, and the public education program for new currency designs.

The ACD Steering Committee is supported by policy and technical specialists within the Federal Reserve, the BEP, and the USSS through the Interagency Currency Design Committee and its Technical Working Group. These groups generally meet at least monthly.

In addition, the Board is a member of a consortium of central banks known as the Central Bank Counterfeit Deterrence Group (CBCDG), which seeks international solutions to common counterfeiting threats such as opportunistic counterfeiting. The BEP and the USSS provide technical staff to support the work of the CBCDG.

The Federal Reserve, the BEP, and the USSS also work together on the Reprographic Research Center (RRC) and the Central Bank Cash Machine Group (CBCMG). The RRC is a central bank center for the member countries to conduct adversarial analysis on new currency designs and to determine the robustness of proposed security features. In addition to the Board, the BEP and USSS also participate in counterfeit deterrence activities at the center.

The CBCMG provides a forum for technical experts and program managers from the Board, the Reserve Banks' Currency Technology Office, the BEP, and the USSS, together with their counterparts in other countries, to form cooperative relationships with the manufacturers of equipment that accepts and dispenses currency. The CBCMG enables us to better understand how these manufacturers use characteristics of banknotes to authenticate U.S. currency. The work of the CBCMG will also help ensure that currency functions smoothly for all types of transactions, including person-to-machine transactions, as we change currency designs.

Informally, the Board regularly collaborates with the Treasury Department, the BEP, and the USSS on a broad range of currency-related topics that are of common concern to the three agencies.

The Federal Reserve also collaborates with the United States Mint; however, our role is different in that the Mint is the issuing authority for coin. The Reserve Banks' national Cash Product Office (CPO) works closely with the United States Mint to discuss, for example, monthly coin orders, annual projections, and planning for new coin releases. In addition, the CPO, Mint, and Board staffs participate on a working group that meets monthly to discuss issues that are relevant to each entity. Senior staff from the Board and the U.S. Mint meet quarterly to discuss topical issues and to reach mutual understanding of factors that affect the coin business.

1 (b) How do the agencies collectively report to Congress?

The Federal Reserve Board provides coin and currency information to the Congress in its *Annual Report* and its *Annual Report: Budget Review,* and provides more-detailed information regarding the Presidential $1 Coin Program in a separate annual report, as required by the Presidential $1 Coin Act of 2005.[1] The agencies, however, do not collectively report to Congress.

In the past, the agencies have reported collectively in special cases about specific topics that the Congress has asked about. For example, the Treasury Department provided a triennial report to the Congress on work conducted by all three agencies as part of the International Currency Awareness Program (ICAP), pursuant to the Antiterrorism and Effective Death Penalty Act of 1996 (PL 104-132).[2] The final report was delivered to Congress in 2006. At the time the Congress imposed this requirement, there were few formal channels from which the U.S. government could obtain reliable data about the use and counterfeiting of U.S. currency abroad. In more recent years, however, we have developed much more robust information channels. These channels include the global wholesale banknote dealers (commercial banks) in Europe and Asia that distribute new banknotes to and repatriate old-design and unfit banknotes from customers around the world, under contract with the Federal Reserve. These dealers provide market intelligence on the use of U.S. currency and assist law enforcement with its investigations of counterfeit activity. In addition, we understand that law enforcement has developed effective relationships and ongoing communications with law enforcement entities around the world, largely through the contacts made during the earlier ICAP visits. In addition, through its

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[1] See *2009 Annual Report* of the Board of Governors of the Federal Reserve System, pages 176-177, http://www.federalreserve.gov/boarddocs/rptcongress/annual09/pdf/AR09.pdf;
Annual Report: Budget Review, pages 23-25,
http://www.federalreserve.gov/boarddocs/rptcongress/budgetrev10/ar_br10.pdf;
Annual Report to the Congress on the Presidential $1 Coin Program,
http://www.federalreserve.gov/BoardDocs/RptCongress/dollarcoin/2010/dollarcoin2010.pdf.

[2] *The Use and Counterfeiting of United States Currency Abroad,* January 2000, March 2003, September 2006;
http://www.ustreas.gov/press/releases/reports/counterfhp154.pdf;
http://www.ustreas.gov/press/releases/reports/2003.pdf;
http://www.ustreas.gov/press/releases/reports/the%20use%20and%20counterfeiting%20of%20u.s.%20currency%20abroad%20%20part%203%20september2006.pdf

USDollars website, the USSS collects real-time information on suspect counterfeit activity around the world.[3]

1 (c) Are there changes needed in the formal reporting structure to ensure that Congress is properly informed about any issues arising regarding U.S. coins and currency?

No. The Board will continue to inform Congress about issues regarding U.S. coins and currency through its normal reporting channels (identified in question 1(b)).

Issues Relating to the Presidential $1 Coin Program

You had asked at the July 20th hearing for recommendations for how Congress could save taxpayer funds, particularly with respect to requirements related to coins.

We believe that both the Federal Reserve and the United States Mint have taken appropriate and reasonable steps to remove barriers to the improved circulation of $1 coins. Along with the Mint, we have conducted regular outreach with the banking industry, armored carriers, retailers, and federal entities to educate them about the Presidential $1 Coin Program and to gather feedback about obstacles to $1 coin circulation. We have used the information we learned from that outreach to make changes to some of our distribution practices. For example, we distributed each new design in advance of the release date so that the coins were available throughout the distribution network on the public release date, we distributed the new coins in rolls as well as bags, and we ensured that the new coins were distributed in unmixed quantities to avoid commingling of $1 coin designs. We also informed all federal entities of the Presidential $1 Coin Act requirement that they accept and dispense $1 coins. Despite these efforts, the public has not embraced the use of $1 coins for routine transactions. We, therefore, offer the following recommendations for legislative action:

- **Remove the requirement that the Federal Reserve make unmixed supplies of each new Presidential $1 coin design available for an introductory period.** The Reserve Banks now hold more than one billion $1 coins, and we project that they could hold more than $2 billion in $1 coins by the time the Presidential $1 Coin Program is expected to end. This inventory growth is due, in large part, to the legislative requirement that the Reserve Banks make each new presidential design available to their customers for an introductory period. We have no such requirement for any other coin. Therefore, absent a legislative change, the Federal Reserve must continue to order each new presidential design from the Mint even though it already has more-than-ample inventories to meet demand.

- **Eliminate the requirement that the Mint and the Board submit annual reports to the Congress on the Presidential $1 Coin Program.** The primary circulation obstacle for $1 coins is the same as it was before the Presidential $1 Coin Program: The public generally prefers to use $1 notes. We would recommend that the report be eliminated.

[3] USDollars URL address is: https://www1.usdollars.usss.gov/usd/dollarbills.nsf/Home?opennavigator.

CLO: #484
CCS: 10-7581
RECVD: 8/20/10

QUESTIONS FOR THE RECORD FROM CHAIRMAN MELVIN L. WATT

The Financial Services Committee, Subcommittee on Domestic Monetary Policy and Technology appreciates your participation in the hearing entitled, *"The State of U.S. Coins and Currency"* on July 20, 2010. Please provide written responses to these questions for the record within 30 days of receipt.

Federal Reserve – Ms. Louise Roseman

1. Please describe the formal and informal working relationship between the U.S. Mint, Bureau of Engraving and Printing, Federal Reserve and U.S. Secret Service regarding U.S. coins and currency. How do the agencies collectively report to Congress? Are there changes needed in the formal reporting structure to ensure that Congress is properly informed about any issues arising regarding U.S. coins and currency?

ROBERT MENENDEZ
NEW JERSEY

COMMITTEES:
BANKING, HOUSING, AND URBAN AFFAIRS
FINANCE
FOREIGN RELATIONS

United States Senate

WASHINGTON, DC 20510-3005

528 SENATE HART OFFICE BUILDING
WASHINGTON, DC 20510
(202) 224-4744

ONE GATEWAY CENTER
11TH FLOOR
NEWARK, NJ 07102
(973) 645-3030

208 WHITE HORSE PIKE
SUITE 18-19
BARRINGTON, NJ 08007
(856) 757-5353

December 7, 2011

Mr. Scott Alvarez
General Counsel
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

CLO: #2
CCS: 12-0938
RECVD: 12/7/11
NRN

Dear Mr. Alvarez:

As the Chairman of the Subcommittee on Housing, Transportation and Community Development of the Senate Committee on Banking, Housing and Urban Affairs, I am writing to confirm that you will participate in a modified capacity before the Subcommittee at our hearing entitled: "Helping Homeowners Harmed by Foreclosures: Ensuring Accountability and Transparency in Foreclosure Reviews." The hearing is scheduled for Tuesday, December 13th, 2011, at 2:30 pm in the Senate Banking Committee Hearing Room, Room 538 of the Dirksen Senate Office Building.

The Subcommittee requests that the Federal Reserve confirms its participation for the hearing: the Federal Reserve will submit testimony specifically addressing the Consent Orders that were reached by the Federal Reserve last spring with the major mortgage servicers and the foreclosure reviews that will result from them. Specifically, we ask you to discuss efforts to enhance transparency, accountability, and consistency in these foreclosure review efforts; the action plans and their ongoing implementation and enforcement including both benefits they will provide to homeowners and servicers and any areas of concern associated with them; an update on the engagement letters; the borrower outreach program; and the ongoing effects on homeowners and servicers stemming from the foreclosure crisis. Additionally, while the Federal Reserve will not have a witness present at the hearing, it will fully answer any Questions for the Record that are submitted by participating Senators.

For purposes of the Committee Record and printing, you must provide a written statement in both electronic and printed form by no later than noon on Monday, December 12th. The electronic form of your written statement should be sent by e-mail to michael_passante@menendez.senate.gov and dawn_ratliff@banking.senate.gov, or on a CDRW in WordPerfect (or other comparable program) format, double spaced. Additionally, two original copies of the statement must be included for the printers, along with 73 copies for the use of Committee members and staff. Those copies should be delivered to the Committee office at Dirksen Senate Office Building Room 534. Your oral statement, which may be shorter than your written statement, should be approximately five minutes in duration and does not need to be submitted to the Committee. Your full statement will be part of the hearing record.

If you have any questions regarding this hearing, please contact Michael Passante at (202) 224-3551.

Sincerely,

Robert Menendez

ROBERT MENENDEZ
United States Senate

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

April 18, 2011

The Honorable Bill Nelson
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Nelson:

1. The Federal Reserve Board of Governors and the Federal Open Market Committee are mandated by the Congress to use their authority over monetary policy to promote the goals of maximum employment, stable prices, and moderate long-term interest rates. Some influential Members of Congress have recently indicated their desire to change the Federal Reserve's statutory objective to focus solely on maintaining stable prices. In your view, what is the appropriate mandate for the Federal Reserve?

Since 1978, the Federal Reserve's statutory mandate for monetary policy has been to promote maximum employment, stable prices, and moderate long-term interest rates. Achieving the first two of these objectives would be expected to lead to success on the third as well, so this mandate is often referred to as the "dual mandate." I believe that this mandate is appropriate, and the Federal Reserve is not seeking a change to its statutory mandate. Of course, we would honor any change that the Congress made. However, it is worth noting that a flexible inflation objective of the sort that is common around the world would not necessarily have led to policy decisions that differed appreciably from those that we made in recent quarters. For example, our decision last fall to provide additional accommodation through further purchases of longer-term Treasury securities reflected the Committee's judgment that unemployment was above and inflation somewhat below the levels that it thought were consistent with its dual mandate. A central bank that had only a price stability objective might well have looked at the low and declining level of inflation and judged that additional policy accommodation was appropriate to return inflation to target and to limit the risk of deflation. Moreover, with considerable slack in resource markets, such policymakers would likely have seen considerable scope for policy easing without running the risk of inflation rising above their objective.

2. Going forward, assuming Congress has the opportunity to revisit and amend the Dodd-Frank Wall Street Reform and Consumer Protection Act, what improvements, if any, would you like to see?

The Board has made considerable progress in carrying out its assigned responsibilities under the Act. As we continue to work through our rulemaking and other implementation projects, we will communicate challenges, including technical or substantive errors we encounter in the legislation, to you in response to this inquiry.

3. What are the key criteria you will use to determine whether the $600 billion asset purchase program announced in November has been a success? Alternatively, what indicators would suggest to you that the program has been a failure?

Although large-scale purchases of longer-term securities are a different monetary policy tool than the more familiar approach of targeting the federal funds rate, the two types of policies affect the economy in similar ways. Conventional monetary policy easing works by reducing short-term interest rates and also by lowering market expectations for the future path of short-term interest rates, which in turn reduces the current level of longer-term interest rates and contributes to an easing in broader financial conditions. These changes not only reduce businesses' and households' borrowing costs, they also lower the rates at which investors discount future cash flows and thus tend to raise asset prices. Lower borrowing costs and higher asset prices, in turn, bolster household and business spending and thus support an increase in economic activity. By comparison, the Federal Reserve's purchases of longer-term securities have not affected very short-term interest rates, which remain close to zero, but instead have put downward pressure directly on longer-term interest rates. By easing conditions in credit and financial markets, these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy, thereby bolstering the economic recovery.

A wide range of market indicators supports the view that the Federal Reserve's securities purchases have been effective at easing financial conditions. For example, since August, when we announced our policy of reinvesting maturing securities and signaled that we were considering more purchases, equity prices have risen significantly, volatility in the equity market has fallen, corporate bond spreads have narrowed, and inflation compensation as measured in the market for inflation-indexed securities has risen from low to more normal levels. Yields on 5- to 10-year Treasury securities initially declined markedly as markets priced in prospective Fed purchases; these yields subsequently rose as investors became more optimistic about economic growth and as traders scaled back their expectations of future securities purchases. All of these developments are what one would expect to see when monetary policy becomes more accommodative, whether through conventional or less conventional means. Moreover, these developments are remarkably similar to those that occurred during the earlier episode of asset purchases, notably in the months following our March 2009 announcement of a significant expansion in our securities holdings. The fact that financial markets responded in very similar ways to each of these policy actions supports the conclusion that these actions had the expected effects on markets and are thereby providing significant support to job creation and the economy.

Some have expressed concern that the Federal Reserve's asset purchase program would lead to a sizable increase in expected inflation rather than to a stronger recovery, or that it would set the stage for future financial instability by encouraging potential borrowers to employ excessive leverage to take advantage of low financing costs and by leading investors to demand too little compensation for bearing risks as they seek to enhance rates of return in an environment of very low yields. We take these concerns seriously. My colleagues and I have said that we will review the asset purchase program regularly in light of incoming information--including information on the economic outlook, the efficacy of the program, and any unintended consequences that might arise--and will adjust it as needed to promote maximum employment and stable prices. The Federal Reserve is carefully monitoring economic and financial indicators for signs that expected inflation is heating up and for potential threats to financial stability.

United States Senate
WASHINGTON, DC 20510-0905

CLO: #B - 4
CCS: 11-0979
RECVD: 1/10/11

Questions for the Record
from Senator Bill Nelson
for Federal Reserve Chairman Ben S. Bernanke
Hearing on the U.S. Economic Outlook
January 7, 2011
Senate Budget Committee

Question #1:

The Federal Reserve Board of Governors and the Federal Open Market Committee are mandated by the Congress to use their authority over monetary policy to promote the goals of maximum employment, stable prices, and moderate long-term interest rates. Some influential Members of Congress have recently indicated their desire to change the Federal Reserve's statutory objective to focus solely on maintaining stable prices. In your view, what is the appropriate mandate for the Federal Reserve?

Question #2:

Going forward, assuming Congress has the opportunity to revisit and amend the Dodd-Frank Wall Street Reform and Consumer Protection Act, what improvements, if any, would you like to see?

Question #3:

What are the key criteria you will use to determine whether the $600 billion asset purchase program announced in November has been a success? Alternatively, what indicators would suggest to you that the program has been a failure?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 11, 2011

The Honorable Chuck Grassley
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Grassley:

1. What evidence do we have that the Treasury securities purchase program is having the intended effect?

From December 2008 through March 2010, the FOMC purchased about $1.7 trillion in longer-term Treasury, agency debt, and agency mortgage-backed securities. In August 2010, we began reinvesting the proceeds from all securities that matured or were redeemed in longer-term Treasury securities, so as to keep the size of our securities holdings roughly constant. Around the same time, we began to signal to financial markets that we were considering providing additional monetary policy accommodation by conducting further asset purchases. And in early November, we announced a plan to purchase an additional $600 billion in longer-term Treasury securities by the middle of this year.

Although large-scale purchases of longer-term securities are a different monetary policy tool than the more familiar approach of targeting the federal funds rate, the two types of policies affect the economy in similar ways. Conventional monetary policy easing works by reducing short-term interest rates and also by lowering market expectations for the future path of short-term interest rates, which, in turn, reduces the current level of longer-term interest rates and contributes to an easing in broader financial conditions. These changes not only reduce businesses' and households' borrowing costs, they also lower the rates at which investors discount future cash flows and thus tend to raise asset prices. Lower borrowing costs and higher asset prices, in turn, bolster household and business spending and thus support an increase in economic activity. By comparison, the Federal Reserve's purchases of longer-term securities have not affected very short-term interest rates, which remain close to zero, but instead have put downward pressure directly on longer-term interest rates. By easing conditions in credit and financial markets, these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy, thereby bolstering the economic recovery.

A wide range of market indicators supports the view that the Federal Reserve's securities purchases have been effective at easing financial conditions. For example, since August, when we announced our policy of reinvesting maturing securities and signaled that we were considering more purchases, equity prices have risen significantly, volatility in the equity market has fallen, corporate bond spreads have narrowed, and inflation compensation as measured in the market for inflation-indexed securities has risen from low to more normal levels. Yields on 5- to 10-year Treasury securities initially declined markedly as markets priced in prospective Fed purchases; these yields subsequently rose as investors became more optimistic about economic growth and as traders scaled back their expectations of future securities purchases. All of these developments are what one would expect to see when monetary policy becomes more accommodative, whether through conventional or less conventional means. Moreover, these developments are remarkably similar to those that occurred during the earlier episode of asset purchases, notably in the months following our March 2009 announcement of a significant expansion in our securities holdings. The fact that financial markets responded in very similar ways to each of these policy actions supports the conclusion that these actions had the expected effects on markets and are thereby providing significant support to job creation and the economy.

2. The Treasury purchase program has led to some devaluation of the dollar and rise in commodity prices. How confident are you that Fed will act quickly enough to unwind asset purchases and prevent significant increases in inflation? If the economy is slowly gaining momentum, as recent data suggest, is the Fed considering ending or reversing Treasury purchases before June 2011?

We have seen significant increases in many commodity prices as well as some depreciation of the dollar in recent months. However, the increase in commodity prices has largely resulted from rapid growth in demand from fast-growing emerging market economies coupled, in some cases, with constraints on supply. The changes in the foreign exchange value of the dollar over this period appear to have reflected developments both in the United States and abroad.

Despite these recent moves in commodity prices and the dollar, overall inflation remains quite low in the United States: Over the 12 months ending in December, the price index for personal consumption expenditures (a measure of prices for all the goods and services purchased by households) increased by only 1.2 percent, down from 2.4 percent over the prior 12 months. To assess underlying trends in inflation, economists also follow several alternative measures of inflation; one such measure is core inflation, which excludes the more volatile food and energy components and therefore can be a better predictor of where overall inflation is headed. Core inflation was only 0.7 percent in 2010, compared with around 2-1/2 percent in 2007, the year before the recession began. The downward trend in price inflation is not surprising, given the substantial slack in the economy. Moreover, longer-run inflation expectations have remained stable; for example, the rate of inflation that households expect over the next 5 to 10 years, as measured by the Thompson Reuters/University of Michigan Surveys of Consumers, has remained in a narrow range over the past few years. With levels of resource utilization likely to increase only gradually, and with longer-run inflation expectations stable, FOMC participants project that inflation will remain subdued for some time.

Nonetheless, my colleagues and I recognize that the FOMC must withdraw monetary stimulus once the recovery has taken hold and the economy is improving at a healthy pace. As your question suggests, the timing of that step will depend in part on the contours of the economic recovery this year. Importantly, the Committee remains unwaveringly committed to price stability and does not seek inflation above the level of 2 percent or a bit less that most FOMC participants see as consistent with our mandate to promote maximum employment and stable prices.

My colleagues and I have said that we will review the asset purchase program regularly in light of incoming information--including information on the economic outlook, the efficacy of the program, and any unintended consequences that might arise--and will adjust it as needed to promote maximum employment and stable prices. In particular, it bears emphasizing that we have the necessary tools to smoothly and effectively exit from the current accommodative stance of monetary policy at the appropriate time. Our ability to pay interest on reserve balances held at the Federal Reserve Banks will allow us to put upward pressure on short-term market interest rates and thus to tighten monetary policy when required, even if bank reserves remain high. We have developed additional tools that will allow us to drain or immobilize bank reserves as needed to facilitate the smooth withdrawal of policy accommodation. If needed, we could also tighten policy by redeeming or selling securities.

3. The Treasury purchase program includes purchasing assets with long durations. If interest rates rise, the long-dated assets will have declined in value. How does the Federal Reserve plan to handle the interest rate risk associated with owning long-duration assets? How will the Federal Reserve manage the losses?

Currently, the Federal Reserve's System Open Market Account (SOMA) portfolio is in a modest overall unrealized gain position of about $70 billion. Through time however, if interest rates rise and the market value of the securities in the portfolio decline, the portfolio could have unrealized losses. The Federal Reserve does not realize losses on its portfolio unless a security is sold. As a result, even if the securities in the SOMA portfolio were to decline in value, there would be no implication for Federal Reserve earnings if the assets were not sold. Moreover, we currently expect that realized losses on any potential sales of securities will be far more than offset by the substantial interest income that the Federal Reserve earns, and is expected to continue to earn, on the SOMA portfolio.

Federal Reserve accounting rules call for net income to be remitted to Treasury, after setting aside funds to cover operations, to pay dividends to member banks, and to reserve funds to equate surplus capital to paid-in capital. Under most scenarios, given the Federal Reserve's low interest expense, we will continue to remit significant earnings to the Treasury. Indeed, over the past two years we have remitted to the Treasury about $125 billion.

However, if interest rates were to rise more than is implied by current market rates, or if the Federal Reserve were to sell assets relatively rapidly, realized losses would be higher than expected, reducing the Federal Reserve's net income. Under some particularly adverse scenarios, asset sales could lead to realized losses that exceed net interest income, and as a result, Federal Reserve remittances to the Treasury could fall to zero for a time. To appropriately assess the cost of the asset-purchase program, however, it is important to compare any potential losses in the future with the high level of remittances we have seen in the early years of the program. In addition, to the extent that the policy is successful in stimulating economic growth, the Treasury should receive increased tax revenues resulting from the stronger economy.

Chuck Grassley

Questions for the Record
From Senator Charles E. Grassley
For The Honorable Ben S. Bernanke
Chairman, Board of Governors of the Federal Reserve System
The U.S. Economic Outlook: Challenges for Monetary and Fiscal Policy
January 7, 2011
Senate Budget Committee

CLO: #B - 5
CCS: 11-0980
RECVD: 1/10/11

Question #1

In November 2010, the FOMC announced its intention to purchase $600 billion in Treasury securities by the end of June 2011. This purchase program by the FOMC is intended to provide price stability by pushing down yields on bonds and ultimately maintain low interest rates. However, in recent months, long-term Treasury yields have actually risen, and stand above 3 percent today. In light of this, what evidence do you have that the Treasury purchase program is having the intended result? MA

Question #2

The Treasury purchase program was meant to stimulate the economy primarily by lowering interest rates on securities of longer maturities. This action has led to a devaluation of the dollar somewhat, and may be causing an increase in oil, food and other commodity prices.

How confident are you that the Federal Reserve will act quickly enough to unwind this position and prevent significant increases in inflation? If the economy is slowly gaining momentum, as recent data suggests, is the Federal Reserve considering ending or reversing the purchase plan prior to June 2011? MA

Question #3

The Treasury purchase program includes purchasing assets with long durations. If interest rates rise, the long-dated assets will have declined in value. How does the Federal Reserve plan to handle the interest rate risk associated with owning long-duration assets? How will the Federal Reserve manage the losses?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 1, 2011

The Honorable Debbie Stabenow
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Stabenow:</u>

1. When derivatives legislation was initially implemented, Chairman Dodd and Lincoln clearly stated in a June 30, 2010 letter that the Act "does not authorize the regulators to impose margin on end users." Chairmen Peterson and Frank also unequivocally stated that their intentions were the same. Chairman Peterson noted, "[W]e have given the regulators no authority to impose margin on anyone who is not a swap dealer or a major swap participant," while Chairman Frank responded that, "[T]he gentleman is absolutely right. We do differentiate between end users and others." In response to questions offered at a recent hearing, you indicated that end-users do not contribute to systemic risk when you said, "The Board does not believe that end-users other than major swap participants pose the systemic risk that the legislation is intended to address."

- **In spite of these clear statements of Congressional intent, do you believe that legislation either requires or at a minimum gives regulators the authority to require swap dealers to collect margin from its non-major swap participant end-user counterparties?**

- **A number of organizations have estimated the economy-wide effects of collateral requirements could total hundreds of billions, or even in excess of a trillion dollars. Has the Board conducted its own analysis of the impact of collateral-intensive provisions of the Act?**

- **If the Board believes it is either required to or has authority to impose such a requirement, does the Board believe such a requirement is critical for the mitigation of systemic risk and that the risk-reducing benefits of such a requirement outweigh the economic costs?**

- **Since non-systemically significant end users have not been associated with systemic risk concerns, is the Board concerned that requiring entities that are not swap dealers or major swap participants to post margin could reduce prudent risk management, harm economic growth or create other unintended consequences?**

Although section 723 of the Act provides an explicit exemption for certain end users from the swaps clearing requirement, there is no exclusion in section 731 or section 764 of the Act from the margin requirements for a swap dealer or major swap participants (MSPs) swaps with end users. Sections 731 and 764 of the Act require the CFTC, SEC, Board, and other prudential regulators to adopt rules for swap dealers and MSPs imposing initial and variation margin requirements on all non-cleared swaps. The statute directs that these margin requirements be risk-based. Although development of a proposed rule is still underway, the Board and the other prudential regulators are giving serious consideration to how the relatively low risk posed by commercial end users engaged in hedging activities should be reflected in the amount of margin that dealers and MSPs need to collect from them. For example, we are considering whether it would be appropriate to allow a banking organization that is a swap dealer or MSP to establish a threshold, with respect to an end user counterparty, based on a credit exposure limit that is reviewed, monitored, and approved in accordance with the banking organization's standard credit approval processes, below which the end user would not have to post margin. The Board and the other prudential regulators are working to estimate the costs of margin requirements in order to inform the interagency rule-making process.

As you noted, the Board expressed its view in a prior hearing that end users, other than MSPs, do not pose systemic risk. The Board has long been of the view that derivatives are valuable tools for the management of risk, and it is committed to working with the Congress and other regulators to ensure that the benefits and costs from the use of these instruments are appropriately balanced, both for end users and for other market participants.

2. Does the Board believe that imposing margin on a swap dealer, when that dealer transacts with an end user that is not a major swap participant, is a critical policy tool for containing systemic risk or does it believe that other policy tools in the Act – including central clearing between financial entities, capital requirements applicable to swap dealers and major swap participants, and margin requirements applicable when swap dealers and major swap participants trade with each other – are sufficient for containing systemic risks?

The Act creates a comprehensive regulatory system governing the derivatives trading activities of swap dealers and major swap participants. Central clearing, which is required for certain swap transactions, provides another tool for mitigating counterparty credit risk. Another important tool is the creation of trade repositories which will support regulatory oversight and policymaking through provision of more comprehensive data on the derivatives market. These statutory requirements form the core of reform efforts designed to reduce the likelihood of OTC derivatives transmitting shocks through the financial system.

3. The CFTC will release its proposed rule on margin for trades with non-bank swap dealers in the next couple of weeks. Given the significant uncertainty that this issue creates for businesses, do you anticipate that the Federal Reserve and other prudential regulators will release its proposed rule on margin for trades with bank swap dealers soon? Can you provide any indication of timing?

The Board and other prudential regulators are jointly developing a rule on margin for swaps involving swap dealers and major swap participants that are banks. The timing is somewhat uncertain because of the need for all the prudential regulators to concur on the language, but we are striving to seek public comment in the near future and to adopt final rules by July of this year. The prudential regulators have begun a consultation process on these rules with the CFTC and the SEC and plan to continue that process as the rules are developed.

Debbie

CLO: #B - 3
CCS: 11-0977
RECVD: 1/10/11

Questions for the Record
From Senator Debbie Stabenow
For The Honorable Ben Bernanke
The U.S. Economic Outlook: Challenges for Monetary and Fiscal Policy
Friday, January 7, 2011
Senate Budget Committee

Question #1:

When derivatives legislation was initially implemented, Chairmen Dodd and Lincoln clearly stated in a June 30, 2010 letter that the Act "does not authorize the regulators to impose margin on end users." Chairmen Peterson and Frank also unequivocally stated that their intentions were the same. Chairman Peterson noted, "[W]e have given the regulators no authority to impose margin on anyone who is not a swap dealer or a major swap participant," while Chairman Frank responded that, "[T]he gentleman is absolutely right. We do differentiate between end users and others." In response to questions offered at a recent hearing, you indicated that end-users do not contribute to systemic risk when you said, "The Board does not believe that end-users other than major swap participants pose the systemic risk that the legislation is intended to address."

- In spite of these clear statements of Congressional intent, do you believe that legislation either requires or at a minimum gives regulators the authority to require swap dealers to collect margin from its non-major swap participant end-user counterparties?

- A number of organizations have estimated the economy-wide effects of collateral requirements could total hundreds of billions, or even in excess of a trillion dollars. Has the Board conducted its own analysis of the impact of collateral-intensive provisions in the Act?

- If the Board believes it is either required to or has authority to impose such a requirement, does the Board believe such a requirement is critical for the mitigation of systemic risk and that the risk-reducing benefits of such a requirement outweigh the economic costs?

- Since non-systemically significant end users have not been associated with systemic risk concerns, is the Board concerned that requiring entities that are not swap dealers or major swap participants to post margin could reduce prudent risk management, harm economic growth or create other unintended consequences?

Question #2:

Does the Board believe that imposing margin on a swap dealer, when that dealer transacts with an end user that is not a major swap participant, is a critical policy tool for containing systemic risk or does it believe that other policy tools in the Act – including central clearing between financial entities, capital requirements applicable to swap dealers and major swap participants, and margin requirements applicable when swap dealers and major swap participants trade with each other – are sufficient for containing systemic risks?

Question #3:

The CFTC will release its proposed rule on margin for trades with non-bank swap dealers in the next couple of weeks. Given the significant uncertainty that this issue creates for businesses, do you anticipate that the Federal Reserve and other prudential regulators will release its proposed rule on margin for trades with bank swap dealers soon? Can you provide any indication of timing?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

May 20, 2011

The Honorable John Cornyn
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 7, 2011, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Cornyn:</u>

Chairman Bernanke, I have a number of questions regarding the Federal Reserve's $600 billion bond-purchase program, known as quantitative easing, or QE2, announced this past November.

At the time QE2 was announced, some argued against it, saying it would only add to excess reserves in the banking system and those reserves already amounted to about $1 trillion. Supporters of QE2 said the policy would help the economy by reducing long-term interest rates. But now long-term Treasury yields are significantly higher than they were at the time QE2 was announced. Mortgage rates are also noticeably higher.

1. What I am wondering is what are the objective criteria by which we can judge the effectiveness of QE2 and whether the program is helping the economy, or whether the economy is improving on its own without any assistance from QE2?

From December 2008 through March 2010, the Federal Open Market Committee (FOMC) purchased about $1.7 trillion in longer-term Treasury, agency, and agency mortgage-backed securities. In August 2010, we began reinvesting the proceeds from all securities that matured or were redeemed in longer-term Treasury securities, so as to keep the size of our securities holdings roughly constant. Around the same time, we began to signal to financial markets that we were considering providing additional monetary policy accommodation by conducting further asset purchases. And in early November, we announced a plan to purchase an additional $600 billion in longer-term Treasury securities by the middle of this year.

Although large-scale purchases of longer-term securities are a different monetary policy tool than the more familiar approach of targeting the federal funds rate, the two types of policies affect the economy in similar ways. Conventional monetary policy easing works by reducing short-term interest rates and also by lowering market expectations for the future path of short-term interest rates, which, in turn, reduces the current level of longer-term interest rates and contributes to an easing in broader financial conditions. These changes not only reduce businesses' and households' borrowing costs, they also lower the rates at which investors discount future cash flows and thus tend to raise asset prices. Lower borrowing costs and higher asset prices, in turn, bolster household and business spending and thus support and increase in economic activity. By comparison, the Federal Reserve's purchases of longer-term securities have not affected very short-term interest rates, which remain close to zero, but instead have put downward pressure directly on longer-term interest rates. By easing conditions in credit and financial markets, these actions encourage spending by households and businesses through essentially the same channels as conventional monetary policy, thereby bolstering the economic recovery.

A wide range of market indicators supports the view that the Federal Reserve's securities purchases have been effective at easing financial conditions. For example, since August, when we announced our policy of reinvesting maturing securities and signaled that we were considering more purchases, equity prices have risen significantly, volatility in the equity market has fallen, corporate bond spreads have narrowed, and inflation compensation as measured in the market for inflation-indexed securities has risen from low to more normal levels. Yields on 5- to 10-year Treasury securities initially declined markedly as markets priced in prospective Fed purchases; these yields subsequently rose as investors became more optimistic about economic growth and as traders scaled back their expectations of future securities purchases. All of these developments are what one would expect to see when monetary policy becomes more accommodative, whether through conventional or less conventional means. Moreover, these developments are remarkably similar to those that occurred during the earlier episode of asset purchases, notably in the months following our March 2009 announcement of a significant expansion in our securities holdings. The fact that financial markets responded in very similar ways to each of these policy actions supports the conclusion that these actions had the expected effects on markets and are thereby providing needed support to job creation and the economy.

2. When will the Federal Reserve make a determination that QE2 is working?

As noted in my response to question 1, we believe that our asset purchases are having a positive effect on financial conditions, and so are providing support for the recovery and helping to move inflation, over time, back to levels consistent with our mandate of maximum employment and stable prices.

3. Is it your intention to make this an open-ended program?

My colleagues and I have said that we will complete purchases of $600 billion of longer-term Treasury securities by the end of the second quarter, consistent with the intended asset purchase program we announced in November of 2010. We have also said that we will regularly review the size and composition of the Federal Reserve's securities holdings in light of incoming information and that we are prepared to adjust those holdings as needed to best foster maximum employment and price stability.

4. Once the Federal Reserve decides to wind down QE2 and reduce its multi-billion dollar bond portfolio, how long will it take to do so?

Once the recovery is sufficiently strong, the FOMC will need to consider withdrawing policy accommodation in order to avoid the risk of a buildup of inflation pressures. The Federal Reserve has the necessary tools to smoothly and effectively exit from the current extraordinary degree of accommodation at the appropriate time. Our ability to pay interest on reserve balances held at the Federal Reserve Banks will allow us to put upward pressure on short-term market interest rates and thus to tighten monetary policy when required, even if bank reserves remain high. We have developed additional tools that will allow us to drain or immobilize bank reserves as needed to facilitate the smooth withdrawal of policy accommodation. If needed, we could also tighten policy by redeeming or selling securities.

The FOMC intends to normalize the size and composition of the Federal Reserve's balance sheet over time. However, this adjustment should be conducted in a manner that is consistent with the achievement of the FOMC's objectives of maximum employment and price stability. In order to minimize market disruptions, sales of securities from the portfolio should be implemented in accordance with a framework communicated in advance and be conducted at a gradual pace that potentially could be adjusted in response to changes in economic and financial conditions. The actual timing and pace of sales will, therefore, depend on economic developments and the FOMC's assessment of the outlook.

In a response to a question I asked during the hearing, you stated that the Federal Reserve has a "very limited authority" to purchase state and local municipal debt.

5. Could you please provide a reference point in the statute that provides the Federal Reserve authority to purchase state and local debt?

Section 14(b)(1) of the Federal Reserve Act (12 U.S.C. § 355) authorizes Federal Reserve Banks, upon the direction of the FOMC, to purchase bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any state, county, district, political subdivision, or municipality. The last purchases of municipal bonds by Federal Reserve Banks under the authority of Section 14(b)(1) occurred in 1933.

6. Could you please explain the limitations, aside from those you mentioned from the Dodd-Frank Wall Street [Reform and Consumer Protection] Act (P.L. 111-203), that are imposed on the Federal Reserve's authority to purchase state and local municipal debt?

As set forth in the Response to (5) above, the Federal Reserve may only purchase municipal obligations that (A) have a maturity from date of purchase not exceeding six months; and that (B) are issued in anticipation of the collection of taxes or receipt of assured revenues. It is estimated that a very small percentage of municipal bonds currently outstanding would fall within the statutory limitations of Section 14(b)(1).

7. Does the Federal Reserve's charter place any limits on the maturity or amount of state and local municipal bonds that may be purchased?

As set forth in the Response to (5) above, the Federal Reserve's authority to purchase municipal securities is limited to those with a maturity from date of purchase of not exceeding six months. There is no statutory limit upon the amount of state and local municipal bonds that may be purchased.

JOHN CORNYN
TEXAS

John Cornyn

United States Senate

WASHINGTON, DC 20510-4305

CLO: #B - 6
CCS: 11-0981
RECVD: 1/10/11

Questions for the Record
Senator John Cornyn
Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System
Hearing on U.S. Monetary and Fiscal Policy
January 7, 2011
Senate Budget Committee

Questions #1-#4

Chairman Bernanke, I have a number of questions regarding the Federal Reserve's $600 billion bond-purchase program, known as quantitative easing, or QE2, announced this past November.

At the time QE2 was announced, some argued against it, saying it would only add to excess reserves in the banking system and those reserves already amounted to about $1 trillion. Supporters of QE2 said the policy would help the economy by reducing long-term interest rates. But now long-term Treasury yields are significantly higher than they were at the time QE2 was announced. Mortgage rates are also noticeably higher.

(1) What I am wondering is what are the objective criteria by which we can judge the effectiveness of QE2 and whether the program is helping the economy, or whether the economy is improving on its own without any assistance from QE2?
(2) When will the Federal Reserve make a determination that QE2 is working?
(3) Is it your intention to make this an open-ended program? WA
(4) Once the Federal Reserve decides to wind down QE2 and reduce its multi-billion dollar bond portfolio, how long will it take to do so?

Questions #5-#7

In a response to a question I asked during the hearing, you stated that the Federal Reserve has a "very limited authority" to purchase state and local municipal debt.

(5) Could you please provide a reference point in the statute that provides the Federal Reserve authority to purchase state and local municipal debt?
(6) Could you please explain the limitations, aside from the those you mentioned from the Dodd-Franks Wall Street Act (P.L. 111-203), that are imposed on the Federal Reserve's authority to purchase state and local municipal debt?
(7) Does the Federal Reserve's charter place any limits on the maturity or amount of state and local municipal bonds that may be purchased?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

November 9, 2011

The Honorable Lynn Westmoreland
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the August 16, 2011, hearing before the House Subcommittee on Financial Institutions and Consumer Credit. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Kevin M. Bertsch
Associate Director
Division of Banking Regulation and Supervision

Enclosure

<u>Questions for Kevin M. Bertsch, Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Representative Westmoreland:</u>

1. The regulators are under a tremendous pressure from Congress to be more thorough and proactive in their examinations. As a result of the increased scrutiny, banks are suffering a number of adverse consequences during inquiries including prohibitions against expansion activities whether or not the inquiry regards soundness issues, even before these examinations have been completed. Banks are given 15 days to respond to their initial notice of inquiry, yet regulators are not subjected to any timetable to determine if the bank has satisfactorily resolved the issue.

- **Consumer protection is certainly a top priority, but is it not adverse to those very same consumers to prohibit the expansion of otherwise healthy banks into communities where unstable banks have failed while regulators conduct what amounts to a fishing expedition?**

- **If penalties levied on a bank prior to an adverse determination by a regulator are necessary to prevent certain activities of bad actors, isn't it equally necessary and fair to ensure that the good actors are dealt with in a timely and cost-efficient manner?**

In evaluating expansionary proposals, whether or not they involve the acquisition of troubled or failing institutions, the Federal Reserve is required to assess certain statutory factors, among them, the bank's managerial resources and its record of serving the convenience and needs of its communities, including its performance under the Community Reinvestment Act ("CRA"). The Federal Reserve must evaluate the "competence, experience, and integrity of the officers, directors, and principal shareholders of the applicant, its subsidiaries and banks and bank holding companies concerned." Part of this evaluation includes consideration of the bank or bank holding company's compliance with laws and regulations (including those involving consumer protection), as well as the record of the applicant and its affiliates in fulfilling any commitments to, and any conditions imposed by, the Board in connection with prior applications.[1]

To allow any bank or bank holding company that is not in compliance with consumer protection laws and regulations to expand prior to correcting identified consumer compliance weaknesses could potentially extend the harm resulting from the less-than-satisfactory compliance to new customers, potential customers, and communities. Similarly, permitting banks and bank holding companies having less-than-satisfactory records of complying with the CRA, which was passed to ensure that banks help meet the credit needs of the communities where they have deposit-taking facilities, would be detrimental to a wider area and greater population.

The Federal Reserve considers the historical record of the bank or bank holding company when it evaluates the likelihood of management compliance in the future. A poor record of complying with consumer protection laws and/or the CRA reflects unfavorably on management's ability to

[1] Regulation Y, Section 225.13(b).

effectively identify and manage risk. In cases where an examination of the applicant is on-going and the examiners are investigating potentially significant issues, the Federal Reserve may await the results of the examination prior to making a decision on the application, depending upon the severity and number of issues involved, as well as the stage of the investigation.

In cases where an institution wishes to acquire (or to bid on) a troubled or failing institution (or its branches), it is very important that both the safety and soundness and consumer compliance (including the CRA) ratings be satisfactory.

Nevertheless, in limited circumstances, the Board has approved applications by bank holding companies that have affiliate banks with poor CRA records to expand when the target was in financial distress. In such cases, the Board found that the public benefits of preventing the failure and closure of a bank outweighed the convenience and needs factors associated with the applicant's record under the CRA.[2]

With respect to statutory timeframes for processing applications, the Federal Reserve is required to act upon expansionary applications within 91 days of receiving the last relevant material that is needed for the Board's decision. Applicants that are rated satisfactory or better for all areas that the Federal Reserve is required to consider in applications (i.e., safety and soundness, consumer compliance, and CRA ratings) may be eligible to use the Federal Reserve's expedited processing, assuming the proposal does not raise anticompetitive concerns or other substantive issues raised by public comment. Applications eligible for expedited processing are generally delegated to the Reserve Banks for approval and are often acted on within 30 days.

2. With the current economic situation here at home and the need for our economy to grow and produce jobs and with major institutions like HSBC closing bank branches in the US and other community banks getting out of the business due to over regulation.

- **What is the FDIC/OCC/Federal Reserve doing to ensure that we do not continue to see consolidation in commercial banking that produces even greater systemic risk to the US financial markets?**

- **Has the FDIC/OCC/Federal Reserve Board ever discussed consolidation in the banking industry as a good thing for the U.S. banking sector?**

When he spoke with community bankers during the annual meeting of the Independent Community Bankers of America (ICBA) earlier this year, Chairman Bernanke noted that "a major thrust of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is addressing the too-big-to-fail problem and mitigating the threat to financial stability posed by systemically important financial firms." He emphasized that competitive distortions created by the too-big-to-fail problem produced implicit subsidies to the largest institutions'

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[2] 76 *Federal Reserve Bulletin* 83-89 (February 1990) Approval Order for First Union Corporation, Charlotte, North Carolina, to acquire Florida National Banks of Florida, Inc., Jacksonville, Florida (December 22, 1989).

funding costs that were unfair to smaller competitors and that encouraged further consolidation and concentration within the financial services industry. Under the framework set forth in the Dodd-Frank Act, the Federal Reserve has been working closely with the other financial regulators in the U.S. to implement rules and other supervisory changes to address the too-big-to-fail problem.

These efforts include several components. For example, the Dodd-Frank Act requires the development of more stringent prudential standards for banking organizations with assets of $50 billion or more. These will include stronger capital and leverage requirements, expanded liquidity expectations, tighter counterparty credit limits, implementation of periodic stress tests, and the development by companies and regulators of resolution plans to wind down large firms if necessary. The requirements will be designed to take into account the costs imposed by the largest institutions on the financial system, and are expected to give those institutions regulatory incentives to reduce their size. In addition, the Dodd-Frank Act includes enhanced financial sector concentration limits--addressing a broader range of financial activities and considering a range of liabilities beyond deposits--that should militate against continued concentration. Moreover, the Dodd-Frank Act requires the Federal Reserve to consider financial stability effects when reviewing proposals by bank holding companies to acquire other banks and nonbanks. Complementing the requirements of the Dodd-Frank Act in addressing the too-big-to-fail problem, the regulatory agencies also have been working with international supervisors to develop and implement Basel III prudential standards that will raise requirements for the largest, most inter-connected banking organizations, calling on them to hold more and higher quality capital and to maintain more robust liquidity positions.

3. I have heard concerns the Ombudsmen Office offers little help to institutions. The function of this office seems token at best because these offices do not have the ability or teeth to do anything of substance. Ombudsmen serve to facilitate communications between the bank and the agency but do not resolve issues or serve as arbitration for real conflicts that arise between financial institutions and bank regulators.

(a) How will your agency make changes to make the office of Ombudsmen more substantive?

In 1995, the Federal Reserve established the position of Ombudsman and approved final guidelines to implement an intra-agency appeals process that was made immediately available to all financial institutions supervised by the Federal Reserve. Policy statements covering both of these functions were issued. The Federal Reserve System Ombudsman has four areas of responsibility:

- To act as a facilitator and mediator for the resolution of complaints concerning regulatory or supervisory actions;
- To direct complainants to the appropriate appeals process or other forum, where such forum exists, for the resolution of a complaint;

- To ensure that complaints about Board or Reserve Bank regulatory actions are addressed in a fair and timely manner; and
- To receive complaints of retaliation when a party has used the Ombudsman or any other existing avenue of appeal or complaint forum and take steps to resolve those complaints.

An inter-divisional team at the Board is currently working with the Ombudsman to update and improve policies governing appeals of material supervisory determinations (MSD appeals) and the Ombudsman role. Our aim is to revise the MSD appeals policy and streamline the MSD appeal process. We feel that doing so would improve efficacy and reduce costs to the appellant institutions. The revisions to the Ombudsman policy that we are considering would enable the Ombudsman to:

- Take a more active role in the MSD appeals process;
- Provide more meaningful conflict resolution assistance to parties; and
- Collect information and provide important feedback to senior Federal Reserve officials concerning systemic or recurring issues brought to the Ombudsman's attention.

(b) If an institution believes the Ombudsmen's office is not responsive, what legal recourse do financial institutions have if these financial institutions feel like they are being unfairly regulated or even punished for minor infractions?

Our Ombudsman makes every effort to be responsive to concerns that are raised within the scope of the authority granted to the function under the implementing statute (12 U.S.C. 4806). The Board actively encourages institutions to communicate with our Ombudsman even in situations that might be considered to involve minor infractions. Further, under the Board's Ombudsman policy, where appropriate, the Ombudsman has the authority to raise issues with senior Federal Reserve officials to attempt to reach a resolution.

It should be noted that the Board has robust procedures in place for contesting supervisory actions. Thus, as you are aware, where an institution wishes to contest any determination considered a material supervisory determination (which may include exam ratings, significant loan classifications and adequacy of loan loss reserves); the institution may pursue our appellate process. This process currently includes three separate levels of appeal; as noted above, we are working to streamline the process to improve efficacy and reduce costs to appellant institutions.

Where a formal enforcement action is proposed (such as an assessment of a civil money penalty or a cease or desist order), the institution may request a hearing before an administrative law judge (ALJ). The ALJ's decision is reviewed by the Board and the Board may either uphold or reverse the decision and issue an implementing order. The institution then has a further right to appeal to the court of appeals.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 18, 2011

The Honorable Ken Calvert
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 9, 2011, hearing before the House Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Calvert:

One area that I believe has a major impact on our nation's economic recovery is the stability of the commercial real estate industry. A healthy commercial real estate market provides more than 9 million jobs and generates billions of dollars in federal, state and local tax revenue. However, our commercial real estate market continues to suffer, and this has a direct and lasting impact on the stability of tens of thousands of small businesses and small and mid-size banks.

Despite the October 2009 interagency guidance on *Prudent Commercial Real Estate Loan Workouts,* anecdotal evidence shows that bank regulators/examiners are still being inconsistent with regards to commercial real estate workouts. Regions such as my area of southern California continue to suffer as property owners seeking to refinance existing loans find access to credit nearly nonexistent. I continue to hear stories where capital calls on loans are occurring on property that is near full capacity and where owners are paying their bills.

What else can be done to ensure that creditworthy borrowers, who have the willingness and capacity to repay their debts, obtain the necessary refinancing or term extension to stay afloat?

The Federal Reserve has conducted significant training for its examiners on this guidance to ensure that it is carefully implemented. In addition, we continue to strongly reinforce the guidance with our examiners and are focusing on evaluating compliance with the guidance as part of our regular monitoring of the examination process, which includes local management vettings of examination findings in the district Reserve Banks, review of a sample of examination reports in Washington, and investigation of any specific instances of possible undue regulatory constraints reported by members of the public.

Our monitoring to date suggests that examiners are appropriately considering the guidance in evaluating supervised institutions. However, to the extent that a banking organization in your state is concerned about supervisory restrictions imposed by Federal Reserve examiners, they should feel free to contact Reserve Bank or Federal Reserve Board supervisory staff with their concerns. Bankers may also confidentially discuss these concerns with the Federal Reserve Board's Ombudsman; information on the Ombudsman is available by phone at 1-800-337-0429 or on the Federal Reserve's website at: http://www.federalreserve.gov/aboutthefed/ombudsman.htm.

The most important step we can take to improve credit availability to businesses both large and small in addition to potential home buyers is to achieve a sustainable economic recovery. Over the course of the past two years, the Federal Reserve has taken aggressive action in response to the financial crisis to help improve financial market conditions and strengthen U.S. banking organizations. We have acted on multiple fronts, instituting accommodative monetary policy, providing market liquidity, and issuing additional supervisory guidance to our bank examiners.

The Financial Accounting Standards Board and International Accounting Standards Board have proposed new accounting rules that would force companies of all sizes to capitalize commercial real estate leases onto their balance sheets, which could significantly reduce the credit capacity of many borrowers. Are you concerned with this proposal, especially in light of the current commercial real estate credit crisis?

The standard setters have proposed a change in accounting that would require entities to record lease commitments on the balance sheet using a: "right-of-use" approach. The Federal Reserve and the other federal regulatory agencies (FDIC, OCC, OTS, and NCUA) provided a comment letter to the FASB in December 2010 on the proposal. The comment letter provided support for the objective of providing improved transparency related to leasing activities, but noted specific concerns related to the proposal. For example, we expressed concern that the application of the new standard could lead to technical defaults on debt covenants or similar contractual requirements. Please refer to the attached comment letter for more details about our view on the proposal.

Federal Deposit Insurance Corporation
Board of Governors of the Federal Reserve System
National Credit Union Administration
Office of the Comptroller of the Currency
Office of Thrift Supervision

December 16, 2010

Technical Director
Financial Accounting Standards Board
401 Merritt 7
Post Office Box 5116
Norwalk, Connecticut 06856-5116

RE: *File Reference No. 1850-100 – Proposed Accounting Standards Update, Leases (Topic 840)*

Dear Sir or Madam:

The five federal regulatory agencies responsible for supervising the safety and soundness of U.S. financial institutions (the Agencies) appreciate the opportunity to comment on the *Proposed Accounting Standards Update, Leases (Topic 840)* (the Exposure Draft). The Exposure Draft would improve the transparency of leasing activities and address concerns that existing accounting standards for leases permit some entities to achieve a particular accounting outcome by the careful structuring of lease transactions. Under existing rules, the bright-line distinction between operating leases and capital leases can result in leases that have similar economics receiving different accounting treatment while leases having dissimilar economics can receive the same accounting treatment. Moreover, the existing lease accounting standards permit lessees to accumulate substantial amounts of off-balance-sheet leverage. The Exposure Draft would enhance the comparability of companies that own and finance property to companies that obtain rights to use similar property and incur payment obligations through leasing.

We support the FASB's objective of providing financial statement users with more transparency into companies' leasing transactions and reducing structuring opportunities available under U.S. generally accepted accounting principles (GAAP). However, we have several specific concerns with the Exposure Draft, the most significant of which is the complexity of measurement, which we expand upon in the following comments and observations.

Recognition

We support the accounting recognition of a right-of-use asset and an associated liability for future lease payments by lessees. We concur with the Board's determination that a lessee's right to use leased property represents an asset of the lessee and a performance obligation (or a derecognition event) of the lessor. Similarly, future lease payments are an obligation that should be recognized as a liability of the lessee (and as an asset of the lessor).

We also support the two proposed accounting approaches for lessors: derecognition and performance obligation. We believe these two approaches would appropriately represent the different business strategies that exist among lessors. For example, financial institutions, as financers, typically offer leases and loans as different financing options to commercial customers to fund the acquisition of assets to be used in their businesses. When the financing option is in the form of a lease, the leasing activity would typically align with the derecognition model.

We concur with the comments in the Basis for Conclusions regarding lessee presentation that a right-of-use asset has traits in common with tangible assets such as property, plant, and equipment, more so than intangible assets. We request the FASB clarify in its final standard that a right-of-use asset is not an intangible asset.

Measurement

In developing the Exposure Draft, the FASB considered a number of measurement approaches; we support its decision to use amortized cost for initial measurement based on present value, with estimated cash flows discounted using either the lessee's incremental borrowing rate or the lessor's implicit lease rate. However, we believe the proposed measurement method is overly complex for many leases and a simpler approach could be allowed with minimal sacrifice to the relevance of information provided financial statement users.

In our view, the Exposure Draft's probability-weighted present value technique to measure contractual conditional elements[1] is unduly complex for many leases and would provide little if any net benefit over a simpler, more straightforward approach to measurement. We see significant merit to the position the FASB took during an earlier stage of the project to base the measurement on management's best estimate of conditional elements for purposes of estimating future cash flows. We are skeptical that probability-weighted present values will provide information that is materially more decision-useful to financial statement users than present values of best-estimate cash flows. Any difference between the estimates from the two approaches should be reduced by the Exposure Draft's requirement for subsequent reassessment when facts and circumstances indicate a significant change in a lease's estimated cash flows.

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[1] Conditional elements to a lease include (1) options for term extensions and termination and (2) variable lease payments that reference indices, such as a consumer price index; external non-index events, such as performance by tenants other than the lessee in a multi-tenant retail center; events within the lessee's control or influence, such as the lessee's sales in leased retail premises; or equipment usage, such as hours or distance. In many leases, conditional elements can span many years with consequential effects on estimated cash flows.

With regard to the comparative cost of the two measurement techniques, best-estimate present value is less costly and more straightforward to apply than probability-weighted present value. Cost considerations that favor best-estimate present value include its wide use as an analytical technique in business and finance and its flexibility to be adapted to different approaches among companies when analyzing buy-or-lease situations. It is also less quantitative and can be applied more readily where data are not available or objectively determinable or the use of probability-based present value analysis would not materially alter a buy-or-lease decision.

We consider a standard that factors conditional elements into the measurement of leases to be an improvement over existing accounting rules, which are focused on contractual minimums. This aspect alone should inhibit structuring opportunities and increase the transparency of leasing in financial statements. Although it may be attractive from a theoretical perspective, we do not believe the incremental benefit to financial statement users of requiring probability-weighted cash-flow analysis exceeds its additional costs to preparers. Therefore, we encourage the FASB to allow both the probability-weighted present value and the best-estimate present value in its final standard. A final standard that permits both present value techniques could be seen as a practical expedient that reduces burden and complexity, in particular for small public and privately held companies that have more limited resources for accounting compliance. We also believe that permitting both techniques would be consistent with FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, as amended,[2] and also would be consistent with the FASB's goal to issue principles-based accounting standards.

Lessor's Impairment Recognition Under the Performance Obligation Approach
In the discussion of financial statement presentation in the Basis for Conclusions, the FASB noted that the leased asset, the lease receivable, and the performance obligation are interdependent. We agree with this observation; however, we believe the existing standards on asset impairment and measurement of liabilities like the performance obligation do not reflect this relationship. In many leases, the risk of impairment (due to such factors as functional obsolescence) is shared in varying degrees between the lessor and the lessee. However, the Exposure Draft does not address the accounting from the lessor's perspective for the portion of risk that has been transferred to the lessee.

Given the acknowledged interdependency between the assets (both the leased property and the lease receivable) and the performance obligation, it seems reasonable that the risk transference should reduce the amount of any impairment loss measurement to be recognized by the lessor or reduce the performance obligation. We encourage the FASB to consider addressing the accounting for such risk transference in the final standard.

[2] For example, see paragraph 51 of Concepts Statement No. 7 regarding cost-benefit considerations.

Transition and Effective Date

We encourage the FASB to take into consideration the following issues when it evaluates the timeframe under which companies will adopt a final standard. First, leasing is widespread and, in some industries, is extensive. Among financial institutions supervised by the Agencies, an institution can be both a lessor and lessee and may also lend to companies that have extensive lease arrangements with third parties. We are concerned that the application of the new standard could lead to technical defaults on debt covenants or similar contractual requirements. Since leasing is a common means of financing, the FASB should consider this potential consequence, in addition to the typical record-keeping and systems issues, when deciding how soon to require the adoption of a final standard.

We also note that the FASB has numerous projects on its agenda. Some, such as a final standard on financial instrument accounting, may result in substantial differences from current practice that would require extensive changes to accounting systems. Resources available to preparers are not unlimited. The effective date of a leasing standard should take into account other changes to accounting standards that the FASB plans to issue. The FASB should weigh carefully comments from both users and preparers when assessing the needs of the former versus the capacity of the latter to accommodate extensive change. These comments should help inform the FASB about how to coordinate the effective dates of its new standards so as to balance the benefits gained with the disruption caused by changes.

The FASB also should consider the tradeoffs between the longer lead time necessary for companies to implement the simplified retrospective treatment required in the Exposure Draft, in some cases for leases that will have expired or will have been terminated before the standard's effective date, and an earlier application of a final standard under which outstanding leases would be recognized in accordance with the new accounting requirements, but need not be recast for prior comparative periods.

Lastly, we encourage the FASB to reflect on the information needs of financial statement users with respect to organizations that are not investor owned or are privately held. Financial institutions of this type are generally small companies for which the costs of applying new accounting standards can be disproportionately high. We encourage the FASB to consider whether a delayed effective date is warranted for these kinds of organizations.

Convergence

The efforts of the FASB and the International Accounting Standards Board (IASB) to issue closely aligned leasing proposals for review and comment by a worldwide audience should help to improve the quality of financial reporting, which bodes well for eventual harmonization. We believe that when the two standard-setting bodies issue similar proposals, as in this instance, it reduces uncertainty among preparers and allows them to better focus resources to comment on the proposals and plan for their efficient implementation. The FASB and the IASB should strive to achieve such close collaboration when formulating all accounting standards on their convergence agenda.

Although the FASB and the IASB are closely aligned on this project, we acknowledge their different approaches to revaluation of the right-of-use asset. We encourage the FASB and the IASB to address the difference. We support the current treatment of property, plant, and equipment under U.S. GAAP that would not permit a company to revalue a right-of-use asset other than to recognize an impairment loss.

* * * * * * *

The Agencies appreciate your consideration of our comments. We would be pleased to discuss in more detail our views on the Exposure Draft.

Sincerely,

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation

Arthur W. Lindo
Senior Associate Director and Chief Accountant
Board of Governors of the Federal Reserve System

Melinda Love
Director, Office of Examination and Insurance
National Credit Union Administration

Randall J. Black
Acting Chief Accountant
Office of the Comptroller of the Currency

Jeffrey J. Geer
Chief Accountant
Office of Thrift Supervision

2/9/11
Rep. Ken Calvert Questions for the Record
House Budget Committee Hearing: The State of the U.S. Economy

Questions for Ben Bernanke
Chairman, Board of Governors of the Federal Reserve System

Question #1:

One area that I believe has a major impact on our nation's economic recovery is the stability of the commercial real estate industry. A healthy commercial real estate market provides more than 9 million jobs and generates billions of dollars in federal, state and local tax revenue. However our commercial real estate market continues to suffer and this has a direct and lasting impact on the stability of tens of thousands of small businesses and small and mid-size banks.

Despite the October 2009 interagency guidance on *Prudent Commercial Real Estate Loan Workouts*, anecdotal evidence shows that bank regulators/examiners are still being inconsistent with regards to commercial real estate workouts. Regions such as my area of southern California continue to suffer as property owners seeking to refinance existing loans find access to credit nearly nonexistent. I continue to hear stories where capital calls on loans are occurring on property that is near full capacity and where owners are paying their bills.

What else can be done to ensure that creditworthy borrowers, who have the willingness and capacity to repay their debts, obtain the necessary refinancing or term extension to stay afloat?

Question #2:

The Financial Accounting Standards Board and International Accounting Standards Board have proposed new accounting rules that would force companies of all sizes to capitalize commercial real estate leases onto their balance sheets, which could significantly reduce the credit capacity of many borrowers. Are you concerned with this proposal, especially in light of the current commercial real estate credit crisis?

CLO: **#B - 39**
CCS: **11-**1983
RECVD: 2/16/11

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SARAH BLOOM RASKIN
MEMBER OF THE BOARD

June 16, 2011

The Honorable Carolyn Maloney
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed is my response to the written question you submitted following the February 17, 2011, hearing before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Sarah Bloom Raskin

Enclosure

Questions for The Honorable Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, from Representative Maloney:

1. Representative Maloney requested that the Board comment in writing on the review process that was conducted in advance of drafting the proposed rule.

The Board's staff developed surveys of issuers that would be subject to the interchange fee standards and payment card networks to obtain information regarding issuer costs, interchange fees, network fees, network exclusivity, and routing restrictions. The surveys also asked for information regarding fraud-prevention activities, fraud-prevention costs, and fraud losses. The Board's staff also arranged multiple public drop-in calls for industry participants to comment on the draft surveys (some calls had well over 100 participants) and accepted many written comments on the drafts; this input helped the Board's staff refine the survey instruments. Based on the industry input, the Board's staff also developed a survey of large merchant acquirers. The Board's staff distributed that survey on September 13, 2010, with responses due October 12. The Board's staff sent the issuer survey to 131 financial organizations with over $10 billion in assets: 89 responded with data; 13 indicated they did not have debit card programs; 3 declined to participate; and the Board's staff did not receive any communication from 26. The Board's staff distributed the network survey to all 14 networks that the Board's staff believes process debit card transactions and received responses with data from all 14. All 9 of the merchant acquirers that received the survey responded with data.

As input to the development of the proposed rule, the Board's staff also held 27 meetings with industry participants, including issuers, networks, merchant acquirers, merchants, and consumer representatives, and reviewed 47 written submissions by industry participants to deepen its understanding of the debit card industry and issues related to the rulemaking.

Regarding your request that I provide a list of studies related to interchange fees, please see the attached bibliography, which provides an overview of some of the many theoretical and empirical papers that were referred to regarding interchange fees and payment cards.

<u>Bibliography Of Papers On Interchange Fees And Payment Cards</u>

I. Economics of Payment Cards

A. Surveys

Chakravorti, Sujit (2003) "Theory of Credit Card Networks: A Survey of the Literature," *Review of Network Economics*, 2:2, pp. 50-68.

Evans, David and Richard Schmalensee (2005) "The Economics of Interchange Fees and Their Regulation: An Overview," MIT Sloan Working Paper No. 4548-05. Available at <u>http://www.kansascityfed.org/PUBLICAT/PSR/Proceedings/2005/Evans-Schmalensee.pdf</u>.

Evans, David S. and Richard Schmalensee (2005) *Paying with Plastic: The Digital Revolution in Buying and Borrowing*, Cambridge, MA: MIT Press.

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Hearing: "Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment" on February 17, 2011.

(1) Rep. Maloney (D-NY) - On pp. 12-14, Rep. Maloney asks that we comment on the "review process" that was conducted in advance of drafting the proposed rule. In particular, she mentions the fraud adjustment, and the surveys we conducted.

CLO: #136
CCS: 11-3122
RECVD: 3/29/11

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SARAH BLOOM RASKIN
MEMBER OF THE BOARD

June 16, 2011

The Honorable Shelley Moore Capito
Subcommittee on Financial Institutions
and Consumer Credit
House of Representatives
Washington, D.C. 20515

Dear Chairwoman:

Enclosed are my responses to the written questions you submitted following the February 17, 2011, hearing before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Sarah Bloom Raskin

Enclosure

<u>Questions for The Honorable Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, from Representative Capito:</u>

1. Do MasterCard and Visa impose network rules on the ATM industry that are similar to the rules that raised concerns in the point-of-sale context?

ATM networks differ in material respects from point-of-sale (POS) networks. In an ATM transaction, the issuer pays, rather than receives, the interchange fee. We understand that one or both of the major card networks may impose rules on ATM operators that restrict the ATM operators' routing choice and limit their ability to impose differential surcharges based on the network over which the transaction is routed. Such ATM rules, however, may not raise the same concerns that existed for similar POS network rules, which imposes restrictions on the party that pays the interchange fee.

2. Do MasterCard and Visa impose rules on ATM operators that would require them to route ATM transactions over their ATM networks?

We understand that at least one of the major card networks imposes routing restrictions that may require ATM operators to route transactions over that network in certain circumstances.

3. Do you think the Department of Justice should investigate whether the dominant payment card networks are imposing anticompetitive network rules on the ATM industry?

The Board does not have a view on whether the Department of Justice should investigate network rules in the ATM industry.

Congressman Shelley Moore Capito
Questions for the Hearing Record for Governor Raskin
February 17, 2011 Hearing on the Debit Interchange Rule

Do MasterCard and Visa impose network rules on the ATM industry that are similar to the rules that raised concerns in the point-of-sale context?

Do MasterCard and Visa impose rules on ATM operators that would require them to route ATM transactions over their ATM networks?

Do you think the Department of Justice should investigate whether the dominant payment card networks are imposing anticompetitive network rules on the ATM industry?

CLO: #138
CCS: 11-3121
RECVD: 3/29/11

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SARAH BLOOM RASKIN
MEMBER OF THE BOARD

June 16, 2011

The Honorable Steve Pearce
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed is my response to the written question you submitted following the February 17, 2011, hearing before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Sarah Bloom Raskin

Enclosure

<u>Questions for The Honorable Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, from Representative Pearce:</u>

1. During the February 17, 2011 hearing, Representative Pearce asked whether overdraft costs are "allowable" costs under the proposed rule, and I responded that I would provide an answer at a later time.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) directs the Board to consider the incremental costs incurred by an issuer to authorize, clear, and settle a particular electronic debit transaction, and to not consider other costs incurred by an issuer that are not specific to a particular electronic debit transaction. Dodd-Frank is silent regarding the treatment of issuer costs that are specific to a particular electronic debit transaction, but do not relate to authorizing, clearing, or settling a transaction, such as overdraft costs. The proposed rule did not include overdraft costs as allowable costs. However, the Board requested comment on whether to include further additional costs or to construe costs more narrowly. The Board received many comments regarding the costs the Board should consider as "allowable costs" in the final rule and we are currently evaluating those comments.

Questions submitted by Rep. Pearce
Hearing: "Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment" on February 17, 2011.

(2) Rep. Pearce (R-NM) - On pp. 67-69, Rep. Pearce asks about whether overdraft costs are "allowable" costs under the proposed rule.

CLO: #137
CCS: 11-3123
RECVD: 3/29/11

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

October 13, 2011

The Honorable Bill Posey
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the April 14, 2011, hearing before the Subcommittee on Capital Markets and Government Sponsored Entities. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Scott G. Alvarez

Enclosure

<u>Questions for The Honorable Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System, from Representative Bill Posey:</u>

1. Section 941 of the Dodd-Frank Act requires the "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. The securitizer is defined as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly...to the issuer." The Agencies concluded that the securitizer was the "sponsor" of the ABS and, in footnote 42 of the NPR, designated the CLO investment advisor as the sponsor of a managed CLO by declaring that "the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool and then manages the securitized assets once deposited in the CLO structure." While an investment advisor is typically involved in the initiation and origination of a CLO, it does not do so by selling or transferring assets to the issuer. Rather, as noted by the NPR itself, the manager selects assets to be purchased on behalf of the issuer from many different sellers. If the plain language expresses Congressional intent to have the seller of the assets retain the risk, how did the agencies determine that the CLO manager (as someone that selects the loans to be purchased) should be the retainer of risk? These sound like very different roles.

On March 31, 2011, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the U.S. Securities and Exchange Commission ("Commission"), the Director of the Federal Housing Finance Agency, and the Department of Housing and Urban Development (collectively, the "Agencies") invited public comment on a proposal that would implement the risk retention requirements under section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Section 941(b) generally provides for the Agencies to apply the risk retention requirement to a "securitizer" of an asset-backed security ("ABS"), with "securitizer" defined as (A) an issuer of ABS, or (B) a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer (15 U.S.C. § 78o-11(a)(3)). The second prong of the "securitizer" definition is substantially identical to the definition of a "sponsor" of a securitization transaction in the Commission's Regulation AB governing disclosures for ABS offerings registered under the Securities Act of 1933. On this basis, the Agencies proposed that a "sponsor" of an ABS transaction would be a "securitizer" for the purposes of section 941(b), in a manner consistent with the definition of that term in the Commission's Regulation AB.

The sponsor typically plays an active and direct role in arranging a securitization transaction and selecting the assets to be securitized. As explained in the preamble to the proposed rules, in the context of collateralized loan obligations ("CLOs"), the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool, and then managing the securitized assets once deposited in the CLO structure.

The Board and the other Agencies have received a number of comments on this proposal and are in the process of carefully considering those comments.

2. You did not appear to consider the recommendations from the Federal Reserve Study, which explicitly recommended that the Agencies "consider the potential for other incentive alignment mechanisms." In particular, the Fed noted that the CLOs, "alignment is typically accomplished by compensating the CLO managers using a performance-based fee structure." Why were other forms of alignment of interest absent in the Proposed Rules?

Section 941(b) of the Dodd-Frank Act generally requires that the Agencies jointly prescribe regulations that require a securitizer to retain not less than five percent of the credit risk for any asset that the securitizer, through the issuance of an ABS, transfers, sells, or conveys to a third party, unless an exemption from the risk retention requirements for the securities or transaction is otherwise available. Consistent with section 941(b), the proposed rules generally would require that a sponsor retain an economic interest equal to at least five percent of the aggregate credit risk of the assets collateralizing an issuance of ABS. In addition, the proposed rules would allow flexibility by providing several options sponsors may choose from in meeting the risk retention requirements. These permissible forms of risk retention are designed to take into account the heterogeneity of securitization markets and practices, and to reduce the potential for the proposed rules to negatively affect the availability and cost of credit to consumers and businesses.

As recommended in the Board's Report to the Congress on Risk Retention,[1] the Agencies, in developing the proposed rules, took into consideration the potential for other incentive alignment mechanisms to function as an alternative or a complement to the mandated risk retention requirement. Performance-based fees may help to align the interests of an asset manager, such as a CLO manager, and investors to a certain degree. However, a CLO manager's incentives to ensure proper underwriting of assets are different from those of a securitizer that is required to retain an economic interest in the credit risk of an asset under the Dodd-Frank Act. The Agencies have endeavored to create appropriate incentives for both the securitization sponsor and the originator(s) to maintain and monitor appropriate underwriting standards, respectively, without creating undue complexity. For example, the proposed rules permit a sponsor of a securitization to allocate a portion of its risk retention obligation to an originator that contributes a significant amount of assets to the underlying asset pool.

The Board and the other Agencies have specifically invited comment on whether each of the proposed forms of risk retention are appropriate and whether there are any kinds of securitizations for which a particular form of risk retention would not be appropriate. The Board and the other Agencies will take into consideration all comments in formulating the final rule, including comments regarding different possibilities for incentive alignment structures between the various participants in securitization markets.

[1] See generally Report to the Congress on Risk Retention, Board of Governors of the Federal Reserve System, at 8 (October 2010), available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

CLO: #231
CCS: 11-4960
RECVD: 5/19/11

Questions for the Record
Representative Bill Posey
May 13, 2011

Subcommittee on Capital Markets and Government Sponsored Enterprises hearing, "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention"

April 14, 2011

The following questions should be posed to the FDIC, OCC, Federal Reserve, and SEC:

1) Section 941 of the Dodd-Frank Act requires the "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. The securitizer is defined as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly…to the issuer." The Agencies concluded that the securitizer was the "sponsor" of the ABS and, in footnote 42 of the NPR, designated the CLO investment adviser as the sponsor of a managed CLO by declaring that "the CLO manger generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool and then manages the securitized assets once deposited in the CLO structure." While an investment adviser is typically involved in the initiation and origination of a CLO, it does not do so by selling or transferring assets to the issuer. Rather, as noted by the NPR itself, the manager selects assets to be purchased on behalf of the issuer from many different sellers. If the plain language expresses Congressional intent to have the seller of the assets retain the risk, how did the agencies determine that the CLO manager (as someone that selects the loans to be purchased) should be the retainer of risk? These sound like very different roles.

2) You did not appear to consider the recommendations from the Federal Reserve Study, which explicitly recommended that the Agencies "consider the potential for other incentive alignment mechanisms." In particular, the Fed noted that for CLOs, "alignment is typically accomplished by compensating the CLO managers using a performance-based fee structure." Why were other forms of alignment of interest absent in the Proposed Rules?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

October 20, 2011

The Honorable Randy Neugebauer
Chairman
Subcommittee on Oversight
and Investigations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the April 14, 2011, hearing before the Subcommittee on Oversight and Investigations. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

J. Nellie Liang

J. Nellie Liang
Director
Office of Financial Stability Policy and Research

Enclosure

<u>Questions for The Honorable J. Nellie Liang, Director, Office of Financial Stability Policy and Research, Board of Governors of the Federal Reserve System, from Chairman Neugebauer:</u>

Federal Reserve and Section 113 Determinations

1. In a recent speech, Federal Reserve Board Governor Daniel Tarullo said that the list of nonbank financial companies that would be deemed systemically significant will be short, and that the standard for designation set by Congress "should be quite high." Do you agree with this position? What is the danger of including many firms in the systemically significant category?

I believe that the FSOC should designate any nonbank financial company whose material financial distress or failure would pose a serious threat to financial stability. Whether a firm meets this standard inevitably involves a judgment on how its distress would be transmitted to the broader financial system and real economy. The FSOC is still developing its analytical framework and proposed rule for the designation process, and so it is too soon to know how many nonbank financial firms the FSOC will designate as systemically important. Firms that are designated will be subject to enhanced prudential standards, such as capital, leverage, and liquidity, and supervision by the Federal Reserve. Imposing new standards on firms that do not pose a systemic risk could require firms to adjust their business practices and raise costs unnecessarily, which would restrict credit and other financial intermediation services. In addition, designating firms that do not pose a systemic risk would stretch and divert limited energies and resources of regulators from the firms that require greater supervisory attention.

2. Could you describe the link between moral hazard and designations of nonbank financial institutions as systemically significant? Is the Federal Reserve concerned that designated firms will enjoy a lower cost of funding and other privileges because a designation appears to confer "too big to fail" status?

Designation itself is unlikely to create moral hazard; moral hazard prevails when nonbank financial firms expect government support in times of distress because of the serious threat their failure would have on overall financial stability, independent of designation. Indeed, most firms appear to be vigorously seeking to avoid designation. The intent and effect of the designation process and the accompanying enhanced regulatory standards in the Dodd-Frank Act is to reduce the systemic risk posed by these firms and reduce their ability to take on excess risk or expect government support. Under the Dodd-Frank Act, designated institutions will be subject to prudential standards that will include, among other requirements, enhanced risk-based capital and leverage requirements, liquidity requirements, and single-counterparty credit limits. The firms will also be required to submit recovery and resolution plans, to facilitate an orderly resolution process if necessary.

Global Competitiveness

1. Is there potential for the Volcker provisions in Section 619 to cause less regulated, "shadow banking system" participants to become primary providers of market liquidity?

Are the FSOC or the agencies prepared to address this as a potential market or systemic risk if significant liquidity in U.S. markets is diverted either to less regulated entities or to non-U.S. markets?

It is reasonable to expect that some portion of the activities that will be prohibited by the Volcker provisions in Section 619 to migrate from more regulated banking institutions to less regulated hedge funds or other non-bank institutions. Since most of these non-bank institutions are much smaller and less complex than the firms affected by Section 619, any risks created by their participation in providing market liquidity through proprietary investments or trading are much less likely to present a serious threat to financial stability in the event of a failure of any one firm. However, the Board and the Council will continue to monitor the systemic risk presented by these firms and will be prepared to take action through a variety of tools if the risk presented in aggregate becomes a serious threat to financial stability.

2. Will the Federal Reserve Board conduct an impact study to understand whether the implementation of the Volcker and Concentration Limit rules will cause U.S. markets to lose liquidity or place U.S. markets or institutions at a competitive disadvantage in relation to foreign markets and institutions?

The Board recognizes the importance of limiting the unintended consequences of these rules on the competitiveness of U.S. markets, and will review and monitor any impact that implementation has in potentially creating competitive disadvantages for U.S. firms in relation to foreign markets and institutions. As a member of the FSOC, the Board will encourage the Council to fully consider the impact of the timing and substance that related rulemaking has on the competitiveness of U.S. markets, and seek to mitigate that impact wherever feasible. In addition, the Board (together with other U.S. government regulatory agencies) has been working to preserve a level playing field that will continue to allow U.S. companies to compete effectively and fairly in the global economy through ongoing discussions with foreign supervisory authorities on possible changes to bank capital standards and other international rules affecting financial markets and firms.

Coordination with FSOC

1. The Dodd-Frank Act created the Office of Financial Research to serve the FSOC by collecting requisite data from affected entities and assessing certain firms to pay for its and the FSOC's work. Why is there a need for an "Office of Financial Stability Policy and Research" within the Federal Reserve? How will this be funded? Has the Fed made projections of the costs associated with this new Office, which, I might add, is not mandated by the Dodd-Frank Act?

The Office of Financial Stability Policy and Research (OFSPR) does not serve the same role as the OFR; rather, it was created to better coordinate and support the continuing efforts of the Federal Reserve Board in promoting financial stability. It contributes to the Federal Reserve System's multidisciplinary approach to the supervision of large, complex institutions, in supporting the Board's independent responsibilities to evaluate and mitigate risks to the financial system and banking sectors, and in supporting the Chairman's participation in the FSOC. Further, OFSPR is principally staffed by economists that are rotating through from other divisions of the Board and does not represent a substantial increase in costs.

2. Section 165 requires the firms that the Council has designated as "too big to fail" to file resolution plans with the Federal Reserve that demonstrate that these firms can be resolved quickly and in an orderly fashion, presumably for the purpose of showing that these firms are not, in fact, "too big to fail." Will these plans be made public? If not, why would these firms' creditors or the markets have any reason to think that these plans were credible, and that creditors' recoveries would be limited to the assets of the failed firm?

The proposed regulation implementing the resolution plan requirement calls for the submission of details regarding Covered Companies that are publicly available or otherwise are not sensitive and could therefore be made public, as well as sensitive confidential information. The Dodd-Frank Act directs the Federal Reserve and the FDIC to maintain the confidentiality of any non-publicly available information submitted as part of a resolution plan. This is the type of information that Covered Companies would not customarily make available to the public and that a Covered Company's primary federal regulator typically would have access to and could review as part of the supervisory process in assessing the overall condition, safety and soundness of, and compliance with applicable laws and regulation by a Covered Company. Public disclosure of the sensitive supervisory and proprietary information contained in these resolution plans would place these firms at a competitive disadvantage and could discourage the firms from being as candid and complete as possible in their submissions.

The Federal Reserve and the FDIC are working to determine what portions of a resolution plan may be publicly disclosed without revealing sensitive supervisory, propriety, or competitive information contained in the plans.

Questions for the Record
Oversight and Investigations Subcommittee Hearing on
"Oversight of the Financial Stability Oversight Council"

J. Nellie Liang, Director, Office of Financial Stability Policy and Research, Federal Reserve

Federal Reserve and Section 113 Determinations

1. In a recent speech, Federal Reserve Board Governor Daniel Tarullo said that the list of nonbank financial companies that would be deemed systemically significant will be short, and that the standard for designation set by Congress "should be quite high." Do you agree with this position? What is the danger of including many firms in the systemically significant category?

2. Could you describe the link between moral hazard and designations of nonbank financial institutions as systemically significant? Is the Federal Reserve concerned that designated firms will enjoy a lower cost of funding and other privileges because a designation appears to confer "too big to fail" status?

Global Competitiveness

1. Is there potential for the Volcker provisions in Section 619 to cause less regulated, "shadow banking system" participants to become primary providers of market liquidity? Are the FSOC or the agencies prepared to address this as a potential market or systemic risk if significant liquidity in U.S. markets is diverted either to less regulated entities or to non-U.S. markets?

2. Will the Federal Reserve Board conduct an impact study to understand whether the implementation of the Volcker and Concentration Limit rules will cause U.S. markets to lose liquidity or place U.S. markets or institutions at a competitive disadvantage in relation to foreign markets and institutions?

Coordination with FSOC

1. The Dodd-Frank Act created the Office of Financial Research to serve the FSOC by collecting requisite data from affected entities and assessing certain firms to pay for its and the FSOC's work. Why is there a need for an "Office of Financial Stability Policy and Research" within the Federal Reserve? How will this be funded? Has the Fed made projections of the costs associated with this new Office, which, I might add, is not mandated by the Dodd-Frank Act?

2. Section 165 requires the firms that the Council has designated as "too big to fail" to file resolution plans with the Federal Reserve that demonstrate that these firms can be resolved quickly and in an orderly fashion, presumably for the purpose of showing that these firms are not, in fact, "too big to fail." Will these plans be made public? If not, why would these firms' creditors or the markets have any reason to think that these plans were credible, and that creditors' recoveries would be limited to the assets of the failed firm?

Board of Governors of the Federal Reserve System
Federal Reserve Bank of New York

October 13, 2011

The Honorable Ron Paul
Chairman
Subcommittee on Domestic Monetary Policy
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are our responses to the written questions you submitted following the June 1, 2011, hearing before the Subcommittee on Domestic Monetary Policy. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let us know if we can be of further assistance.

Sincerely,

Scott G. Alvarez
General Counsel
Board of Governors of the
Federal Reserve System

Thomas C. Baxter, Jr.
General Counsel
Federal Reserve Bank of New York

<u>Questions for the Honorable Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System and Thomas C. Baxter, General Counsel, Federal Reserve Bank of New York, from Chairman Paul:</u>

1. In testimony before the Subcommittee on June 1, 2011, Federal Reserve Bank of New York (FRBNY) General Counsel, Thomas Baxter, indicated that the FRBNY's lending during the financial crisis was more heavily weighted toward foreign institutions because New York, as a leading financial center, attracted more foreign institutions. However, this response did not explain the disproportionate use of Federal Reserve lending facilities by foreign institutions. Can the Federal Reserve provide statistics on the proportion of foreign institutions relative to U.S. institutions that are part of the Federal Reserve System? Can the Federal Reserve explain the factors that contributed to disproportionate borrowing by foreign institutions, especially in the following lending facilities which provided more than 50% of their total lending to foreign institutions: Commercial Paper Funding Facility, Mortgage-Backed Securities Purchase Program, Term Auction Facility; and Term Securities Lending Facility?

As required by the provisions of the International Banking Act of 1978 and the Monetary Control Act of 1980, branches and agencies of foreign banks operating in the United States (foreign branches) have long had access to the Federal Reserve's lending facilities on the same basis as domestic depository institutions. Foreign branches have a large presence in U.S. financial markets; in aggregate, they provide substantial amounts of credit to U.S. households and businesses and are active participants in U.S. fixed-income markets. In aggregate, these institutions account for about 10 percent of bank credit extended in the United States. Unlike most domestic banks, foreign branches do not have a large retail deposit base. As a result, they rely heavily on wholesale funding sources such as large time deposits and repurchase agreements to fund their assets. For example, these funding sources account for about 70 percent of the total liabilities of foreign branches. In contrast, large time deposits and repurchase agreements account for only about 10 percent of the liabilities of U.S. chartered depository institutions. As a result, foreign branches were particularly vulnerable to the intense liquidity pressures evident during the crisis when wholesale funding markets were severely disrupted. These institutions turned to the Federal Reserve's liquidity programs to address their dollar liquidity pressures and to avoid fire sales of assets that would otherwise have been necessary. The availability of these liquidity programs to foreign-owned financial institutions operating in the United States helped to address the severe strains in U.S. financial markets during the crisis and to support the flow of credit to U.S. households and businesses.

2. The Federal Reserve created the Term Asset-Backed Securities Loan Facility (TALF), which was intended to "lend up to $200 billion...to holders of certain AAA-rated ABS [asset-backed securities]." When TALF data was released in December 2010, they revealed that 18% of TALF loans were backed by subprime credit card and auto loan securities, 17% were backed by "legacy" (i.e. troubled) commercial real estate securities, and 13% were backed by student loan securities. Similarly, the Term Securities Lending Facility (TSLF) was to "lend up to $200 billion...to primary dealers secured...by...securities, including federal agency debt, federal agency residential-mortgage-backed securities (MBS), and non-agency AAA/Aaa-rated private-label residential MBS." Data released for

the TSLF revealed that 14% of loans were backed by collateral rated below AAA. Over 50% of all collateral posted consisted of agency-backed MBS or CMO (collateralized mortgage obligations), whose ratings were not published. While it has generally been assumed that these Agency securities have a AAA rating due to their implicit government backing, the high collateral-to-loan ratio of the TSLF (4 to 1) implies that these securities were not in fact performing at a AAA level—not to mention that no one knew what any mortgage securities were actually worth during the financial crisis. Given that the Federal Reserve stated to the public that it would accept high-rated collateral in conducting loan operations through these facilities, yet nonetheless loaned funds against questionable or low-rated collateral, how is the public to trust the public statements made by the Federal Reserve? In accepting lower grade collateral than the lending facility originally intended, was there a protocol the Reserve Banks were to follow in accepting lower rated collateral? If not, how were determinations made about what collateral was acceptable? Additionally, what surety was given that AAA-rated collateral was truly AAA, especially given the uncertain quality of many MBS at the time?

The TALF program accepted only AAA-rated securities backed by loan types approved by the Board of Governors and consistent with the program terms published on the websites of the Federal Reserve Bank of New York and Board of Governors. In addition to the AAA credit rating requirement, there were a number of additional requirements designed to ensure the quality of the collateral pledged to the program. For example, each loan was fully collateralized and the value of all collateral was discounted in determining the size of the loan it could support; for non-mortgage-backed ABS, an outside auditor had to attest to the accuracy of the information provided by the sponsor and issuer of all newly issued collateral regarding compliance with TALF collateral eligibility requirements; legacy CMBS were subject to an additional internal credit review by FRBNY staff; and TALF borrowers always had their own money at risk in a first-loss position if the collateral did not perform to expectations. Partly in response to the conservative terms offered on the TALF program, about four-fifths of TALF loans have been repaid early, all outstanding collateral is performing to expectations, and all the outstanding loans remain well collateralized.

The Federal Reserve established the Term Securities Lending Facility (TSLF) in 2008 as a means of addressing the pressures faced by primary dealers in accessing term financing. When collateral markets became illiquid in 2008, primary dealers had increased difficulty obtaining funding and, therefore, were less able to support broader markets. The details, including the terms of acceptable collateral, were made public at the very start of the facility. Under this program, the Federal Reserve temporarily loaned its relatively liquid Treasury securities to primary dealers in exchange for less liquid securities that were harder to finance during a period of financial market stress. The TSLF loans were made with recourse to the borrower, meaning that the borrower was obligated to repay the loan regardless of the value of the collateral. In addition, the borrower pledged securities as collateral that met certain eligibility criteria, such as carrying an investment grade rating by major nationally recognized statistical rating organizations (NRSRO). All U.S. Treasury and U.S. government agency securities posted as collateral to the TSLF met the TSLF program criteria for collateral. The FRBNY conducts its own due diligence and analysis of collateral pledged against loans on a post-lending basis, primarily reviewing information provided by clearing banks, to ensure that these securities adhere to the eligibility requirements of the particular lending program in which the loan was made.

The collateral-to-loan ratio throughout the TSLF program was approximately 106%, not 400% as noted in the question. This ratio was driven by the haircuts specified on the collateral schedule and the composition of securities pledged as collateral. This ratio does not provide information on the performance of the pledged collateral. All credit extended under the TSLF has been fully repaid, with interest.

3. The Commercial Paper Funding Facility (CPFF) provided 60% of its total lending to foreign institutions. The CPFF also supplied funding predominantly to large firms, such as Harley Davidson, Chrysler, Caterpillar, ING, and AIG. To what extent did smaller firms that issued commercial paper know about and have access to the CPFF? What efforts were made by the Federal Reserve to ensure that all eligible parties were made aware of the facility?

The Board of Governors announced the creation of the facility on October 7, 2008 via a public press statement posted on its website. Information on how to access the facility was made available on both the FRBNY's website and the Board's website. As with other major Federal Reserve announcements, major media organizations reported on the CPFF to the general public. Following the initial announcement, FRBNY staff reached out to many CP market participants to inform them of the CPFF and receive feedback. The outreach included working with the FRBNY's Primary Dealers, the Depository Trust & Clearing Corporation (DTCC), the Securities Industry and Financial Markets Association (SIFMA) and the Commercial Paper Industry Working Group (CPIWG), who service or represent CP issuers in the market, to ensure information was disseminated to a wide group of CP market constituents.

The CPFF was open to any CP issuer who met the program eligibility requirements. To register for the facility, the CP issuer must have been a U.S. issuer issuing U.S. dollar-denominated commercial paper (including asset-backed commercial paper (ABCP)) that was rated at least A-1/P-1/F1 by a major NRSRO and, if rated by multiple major NRSROs, rated at least A-1/P-1/F1 by two or more major NRSROs. Only issuers that were active between January 1 and August 31, 2008 were eligible to issue to the facility. Inactive ABCP issuers were ineligible to participate in the CPFF from January 2009 on. An issuer was deemed inactive if it did not issue ABCP to entities other than the sponsoring institution for any consecutive period of three months.

Many large firms and a smaller-number of mid-sized firms registered for the program, though not all chose to issue to the facility. The composition of firms was largely reflective of the highly rated CP market more generally. Large firms with access to capital markets encompass the large majority of the CP market. Mid-sized firms have historically represented a much smaller segment of the highly rated CP market and small firms typically do not issue CP.

4. The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) loaned primarily to two firms, JP Morgan and State Street. Each of the Maiden Lane facilities was set up to assist a particular institution. To what extent were lending facilities set up for the benefit of specific firms facing financial difficulties? To what extent were lending facilities created at the behest of specific firms, either through formal or informal lobbying?

The AMLF was introduced to help money market mutual funds (MMMFs) meet investors' demands for redemptions in October 2008. While banking firms were intermediate participants in the AMLF, it was not established to assist banking firms. Under the AMLF, the Federal Reserve Bank of Boston lent to financial institutions that in turn used the funds to purchase asset-backed securities from MMMFs in order to allow MMMFs to meet redemption demands by customers. Eleven banking entities from six organizations borrowed from the AMLF. These firms used AMLF loans to finance purchases of assets from nearly 200 money funds. All AMLF loans were repaid in full, on time, with interest.

The Federal Reserve authorized the establishment of six special facilities to provide assistance to specific institutions under section 13(3) of the Federal Reserve Act in the pursuit of financial stability during the crisis. The establishment of these facilities was aimed at stabilizing the financial system and mitigating the impact of financial stresses on the economy. Two of these facilities, those set up for Citigroup and Bank of America, ultimately did not require a loan from the Federal Reserve.

The loans provided to the four remaining facilities, Maiden Lane LLC, Maiden Lane II LLC, Maiden Lane III LLC and AIG Revolving Credit Facility were fully collateralized. Maiden Lane LLC received a loan from the Federal Reserve Bank of New York of $28.8 billion to purchase assets from Bear Stearns to support JP Morgan Chase's acquisition of Bear Stearns. The Bear Stearns merger with JP Morgan Chase prevented a disorderly failure of Bear Stearns and potentially severe consequences on market functioning and the economy. Maiden Lane II LLC received a loan from the Federal Reserve Bank of New York of $19.5 billion to purchase residential mortgage-backed securities (RMBS) from AIG's insurance subsidiaries in order to alleviate capital and liquidity drains on AIG. Maiden Lane III LLC received a loan from the Federal Reserve Bank of New York of $24.3 billion to purchase collateralized debt obligations (CDOs) from certain counterparties of AIG Financial Products (AIGFP) in exchange for terminating the related credit default swaps (CDS) contracts between the counterparty and AIGFP which were contributing to capital and liquidity drains on AIG. The AIG Revolving Credit Facility (RCF) was a credit line extended by the Federal Reserve Bank of New York for up to $85 billion to AIG. The RCF, Maiden Lane II LLC and Maiden Lane III LLC prevented a failure of AIG which would have had widespread consequences for the economy and indirectly impacted millions of Americans.

5. Given that information pertaining to discount window transactions during the financial crisis has been disclosed to the public, through the Bloomberg News and Fox News FOIA requests, without causing any material harm to institutions that used the discount window,

will the Federal Reserve disclose the details of discount window transactions that occurred during the financial crisis on the Board's website in the same manner disclosures were made of the other facilities and programs conducted by the Federal Reserve during the crisis? If not, please provide an explanation of why the Federal Reserve will not make such information available.

The FOIA Service Center page of the Board's public website makes available to any person upon request a copy of the records released on March 31, 2011 in the *Fox News* and *Bloomberg* FOIA lawsuits. Any person wishing to obtain a copy may submit a request using the Board's electronic FOIA request form, or by calling the Board's FOIA Service Center. The Board's public announcement, describing the records released on March 31, 2011 and the method for obtaining copies can be found at: http://www.federalreserve.gov/generalinfo/foia/servicecenter.cfm.

The March 31, 2011 releases resulted from litigation under the Freedom of Information Act ("FOIA"). Because FOIA requires disclosure of documents, as opposed to the underlying data or information, the Board made responsive documents available to the requesters and the public as noted above.

The Board's December 1, 2010 disclosures of section 13(3) lending information were made pursuant to section 1109(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which requires publication of specified information "on [the Board's] website ...." 124 Stat. 2129.

The Federal Reserve's discount window has been an important source of liquidity for depository institutions, especially during times of financial stress. Discount window credit is a common and important tool among central banks around the world and one of the most important tools during a financial crisis. Unlike grant programs, the discount window involves the extension of credit on a fully secured basis. To date, the Federal Reserve has never lost money on discount window lending.

Depository institutions have argued that public disclosure of information regarding borrowing at the discount window will discourage use of the discount window. They contend that, because both healthy and troubled depository institutions access the discount window, the public may misconstrue use of the discount window as a sign of financial weakness. Indeed, disclosure of access to credit from the Bank of England by Northern Rock led to runs on that institution. In accordance with the Dodd-Frank Act, the Board will disclose information regarding borrowings through the discount window, including the identity of the borrowers, amount borrowed, terms of the borrowing and collateral information, no later than eight quarters following any discount window transaction entered into after July 21, 2010.

The Board believes that the disclosure of discount window borrowing after a reasonable delay appropriately balances the need to hold the Federal Reserve accountable for its lending activities with the concerns about the viability of discount window. We will continue to inform Congress of any concerns that arise as we implement this provision.

6. Given that information pertaining to certain "covered transactions", a definition which includes open market operations, will have to be disclosed to the public under the provisions of the Dodd-Frank Act, will the Federal Reserve disclose the details of open market operations that took place during the financial crisis and before the passage of Dodd-Frank, such as Single-Tranche Open Market Operations? If not, please provide an explanation of why the Federal Reserve will not make such information available.

As required by section 1109(c) of the Dodd-Frank Act, on December 1, 2010, the Board published detailed information on transactions conducted under the Federal Reserve's Agency Mortgage-Backed Securities Program, which were undertaken prior to the enactment of the Dodd-Frank Act pursuant to the System's open market operation (OMO) authority.

In addition, the Federal Reserve has released significant information about single-tranche OMOs, which were conducted with the intention of mitigating heightened liquidity stress that was occurring in funding markets during the financial crisis in 2008. The program itself had been disclosed publicly at the time of its inception, each auction was announced to the public on the website of the FRBNY at the same time it was announced to the primary dealers, and each auction's aggregated results were immediately posted to the same website. Additional aggregated information on the single tranche OMO program was included in the Board's H.4.1 weekly data release on the condition of the Federal Reserve Banks and in the System Open Market Account annual report for 2009. Information on single-tranche OMO transactions has also been made public in connection with the *Fox* FOIA litigation. On July 6, 2011, the Board published additional data concerning the program, including trade and settlement dates, counterparty names, amounts, and rates for all transactions under the program. This information may be found at: http://www.federalreserve.gov/monetarypolicy/bst_tranche.htm

7. Will the details of the "QE2" program and ongoing rollovers of maturing MBS into Treasury debt securities be disclosed to the public? If not, please provide an explanation of why the Federal Reserve will not publicize such information.

The Federal Reserve has provided to the public a substantial amount of information concerning the program to purchase longer-term Treasury bonds. The Federal Open Market Committee announced on November 3, 2010 that, in order to promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee would purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, at a pace of about $75 billion per month. The FOMC's announcement can be found at:

http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm. The program is part of the FOMC's open market operations ("OMO").[1]

Moreover, the current holdings of SOMA, including maturity date, CUSIP, coupon, par value and other information regarding securities held in SOMA can be found at: http://www.newyorkfed.org/markets/soma/sysopen_accholdings.html.

In the Dodd-Frank Act, Congress gave careful consideration to the public's interest in greater transparency in OMO transactions and to the legitimate expectations of confidentiality of parties to OMO transactions and the potential effects that premature disclosure of counter-party information could have on the Federal Reserve's ability to execute OMO transactions efficiently and at the best price. In striking this balance, Congress concluded that the Board should be permitted to delay the release of information about OMO transactions. In accordance with the Dodd-Frank Act, the Board will disclose counter-party information with respect to OMO transactions, including the reinvestments of maturing MBS into Treasury securities, conducted after July 21, 2010, no later than eight quarters after the transactions.

8. The documents released by the Federal Reserve in response to the Freedom of Information Act requests from Bloomberg News and Fox News contained large amounts of information that was redacted. The Federal Reserve has indicated that the information was determined not responsive to the FOIA requests and was therefore redacted. Is the Federal Reserve willing to release all of these records in their original form to the House Committee on Financial Services? If not, please explain why.

In providing to Bloomberg News and Fox News the documents at issue in their FOIA litigation, the Board redacted from those documents certain information that was not sought by the requests. Should the Board receive a request from the House Committee on Financial Services for the unredacted documents at issue in the *Bloomberg/Fox* FOIA litigation, it will work with the Committee, as it has in the past in response to other similar requests, to assist the Committee in accessing the information it needs.

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[1] Additional details regarding the program, including the Trading Desk at the Federal Reserve Bank of New York's plans for distributing purchases of Treasury securities for the System Open Market Account ("SOMA"), were made available November 3, 2010 on the Federal Reserve Bank of New York's website at: http://www.newyorkfed.org/markets/opolicy/operating_policy_101103.html. The Federal Reserve Bank of New York currently publishes a list of FAQs regarding the purchase program which provides information such as: the maturity sectors of Treasury securities the Desk planned to purchase, how much the Desk planned to purchase in each issue, how much the Desk planned to purchase each month in Treasury securities, and other information. The FAQs can be found at: http://www.newyorkfed.org/markets/lttreas_faq.html.

9. In the documents disclosed by the Federal Reserve on discount window transactions, it appears that banks, especially primary dealers, used the discount window like a revolving line of credit, essentially acquiring longer term funding through what is typically an overnight program. Why was the discount window used in such a fashion even when emergency lending facilities were set up to provide longer term financing through programs such as the TSLF or PDCF?

The Term Securities Lending Facility (TSLF) and the Primary Dealer Credit facility (PDCF) were liquidity facilities set up during the financial crisis for primary dealers. Under the TSLF, primary dealers engaged in temporary swap transactions with the Federal Reserve Bank of New York in which the dealer received Treasury securities and pledged other high-quality securities as collateral. The swaps were priced through competitive auctions and had maturities of 28 days. The PDCF extended overnight loans to primary dealers against collateral that was eligible for tri-party repurchase agreements. Primary dealers were discouraged from using the PDCF as a source of longer-term funds by usage fees that rose with the frequency of borrowing. All credit extended under both the TSLF and the PDCF has been fully repaid, with interest.

Discount window loans (primary, secondary, and seasonal credit) are available only to depository institutions, that is, commercial banks, thrifts, credit unions, and U.S. branches and agencies of foreign banks. None of the primary dealers at this time or over the past few years were depository institutions, so none of the primary dealers have had access to the discount window. Although there is no prohibition against primary dealers being depository institutions, currently all primary dealers are broker dealers. In several cases, however, the broker-dealer subsidiaries of bank holding companies are primary dealers. In such cases, the commercial bank subsidiary of the holding company is eligible to borrow from the discount window and the primary dealer /broker-dealer subsidiary would have been able to borrow from the other lending facilities established for the primary dealers.

Easing the terms on primary credit (discount window) loans was one of the first steps the Federal Reserve took in response to the financial crisis. The easing was intended to increase the liquidity of depository institutions and thereby support their ability to lend to businesses and households. On August 17, 2007, the Federal Reserve narrowed the spread of the primary credit rate over the FOMC's target rate from 100 basis points to 50 basis points, and lengthened the maximum maturity from overnight to 30 days. On March 16, 2008, the Federal Reserve lowered the spread to 25 basis points and extended the maximum maturity to 90 days. The easing of terms on discount window borrowing was part of the Federal Reserve's broader efforts to address strains in term funding markets and the liquidity strains in financial markets. As financial market conditions improved, the Federal Reserve normalized the terms on primary credit. Over the first few months of 2010, the Federal Reserve returned the typical maximum maturity on primary credit to overnight and widened the spread of the primary credit rate over the top of the FOMC's range for the federal funds rate to 50 basis points. By June 2010, borrowing had again fallen near zero.

10. What was the necessity of setting up Single-Tranche Open Market Operations (ST OMO) and programs such as the TSLF when they accomplished essentially the same task of providing 28-day credit? Was the existence of these separate operations due to the fact that the TSLF allowed the Fed to purchase secondary credit and not just primary credit, something not legally permissible under the ST OMO conducted through the Fed's open market operation authority?

Both the single-tranche (ST) OMO and the TSLF programs were aimed at relieving strains in the term funding markets. Since these strains were quite significant, the Federal Reserve provided more than one way to help alleviate the pressures. Both programs addressed term funding pressures for the primary dealers, though the mechanics were different, as was the list of eligible securities.

Mechanically, the ST OMO allowed primary dealers to bid at auction for direct 28-day financing of any of their OMO-eligible securities (i.e., U.S. Government securities and U.S. agency issued or guaranteed securities); they pledged their securities and received funds in exchange. With TSLF, however, the dealers bid at auction to essentially swap their program-eligible securities for U.S. Treasury securities, which they then had to finance in the market. Presumably it was easier for them to find term financing for the U.S. Treasury securities they received than it was for them to finance the securities they pledged into the program. So, after winning a TSLF auction, the primary dealer would still have to obtain financing for the U.S. Treasury securities they received from the FRBNY.

There are other key differences between the ST OMO and TSLF programs.

The ST OMO program relied on standard legal authorities for open market operations, and transactions under this program were very similar to the shorter-term repo operations long conducted by the Federal Reserve in implementing monetary policy. Under this program, primary dealers could deliver as collateral any of the types of securities--Treasuries, agencies, and agency MBS--that are typically accepted in open market operations.

The legal authority for a key part of the TSLF--the so-called "schedule 2" TSLF operations--relied partly on the Federal Reserve's emergency lending authority in section 13(3) of the Federal Reserve Act. Under TSLF, primary dealers could borrow Treasury securities from the Federal Reserve for a period of 28 days. In contrast to the ST OMO program, under the TSLF primary dealers could pledge as collateral a range of highly rated private securities. Rates and amounts borrowed by individual primary dealers under the TSLF were determined through competitive auctions. Initially, the securities accepted as collateral in TSLF operations were limited to AAA-rated securities. Later as the crisis intensified in September of 2008, the range of collateral accepted was expanded to include all investment-grade securities. The ability of primary dealers to finance private investment-grade securities through the TSLF was very important in addressing the disruptions in financial markets during the crisis.

11. Can the Federal Reserve provide to the Committee a graph and/or spreadsheet for each of the emergency lending facilities (including the ST OMO) showing the high, low, and average rates charged in the facility over its lifetime in conjunction with the prevailing market rate for the same type of transaction over the same period?

Please see attached response for this question.

Attachments in response to Question 11

The TALF was created to assist financial markets in accommodating the credit needs of consumers and businesses of all sizes by facilitating the issuance of asset-backed securities (ABS) collateralized by a variety of consumer and business loans; it was also intended to improve market conditions for ABS more generally. Under the TALF, nonrecourse loans were issued to holders of eligible ABS, which serve as collateral for the loan.

The TALF loan interest rates consisted of a base rate and a spread. The base rates were chosen to line up with the interest rate paid by the ABS to minimize basis risk. The spreads were chosen to compensate the Treasury and Federal Reserve for risk. In some cases, the spreads were also adjusted to reflect differences in the average level of the base rates; in particular, the prime rate exceeds Libor, which exceeds the federal funds rate. The interest rate spreads on TALF loans were set below spreads on highly-rated ABS prevailing during the early stages of financial crisis, but well above spreads during more normal market conditions to provide borrowers with an incentive to voluntarily repay once market conditions normalized. Over the course of the program, markets have improved and; subsequently, spreads on some TALF collateral asset classes have fallen below the TALF lending rate. As of August 2011, of the $71 billion in total TALF loans originally extended, only $11.6 billion remains outstanding. This steep reduction is almost entirely related to voluntary borrower prepayments.

The interest rate on TALF loans varies by the type of collateral securing the loan (and in some cases by the term of the loan):

- ABS backed by federally guaranteed student loans: 50 basis points over 1-month Libor.
- SBA Pool Certificates: federal funds target rate plus 75 basis points.
- SBA Development Company Participation Certificates:
    - Three-year TALF loans: 50 basis points over the 3-year Libor swap rate.
    - Five-year TALF loans: 50 basis points over the 5-year Libor swap rate.
- Commercial mortgage-backed securities:
    - Three-year TALF loans: 100 basis points over the 3-year Libor swap rate.
    - Five-year TALF loans: 100 basis points over the 5-year Libor swap rate.
- Other eligible fixed-rate ABS:
    - Three-year TALF loans: 100 basis points over the 1-year Libor swap rate for securities with a weighted average life less than one year, 100 basis points over the 2-year Libor swap rate for securities with a weighted average life greater than or equal to one year and less than two years, 100 basis points over the 3-year Libor swap rate for securities with a weighted average life of two years or greater.
- Private student loan ABS bearing a prime-based coupon: the higher of 1 percent and the rate equal to the Prime rate minus 175 basis points.
- Other eligible floating-rate ABS: 100 basis points over 1-month Libor.

Following is a breakdown of the interest rates on TALF loans at the time of issuance (most TALF loans have been repaid early as financial market conditions improved and borrowers switched to market-based funding):

- 62 percent of TALF loans were fixed-rate, with interest rates ranging from 1.78% to 3.87%

- 29 percent of TALF loans were floating-rate, at 100 basis points over 1-month Libor
- 4 percent of TALF loans were floating-rate, at the federal funds target rate plus 75 basis points
- 5 percent of TALF loans were floating-rate, at the higher of 1 percent and the rate equal to the Prime rate minus 175 basis points. Since the inception of the TALF, the Prime rate minus 175 basis points has been constant at 150 basis points.

At the time TALF loans were issued there was no active market for financing these types of ABS. In addition, TALF loans have unique features--they have restricted and fixed maturities (3- or 5-year), are non-recourse to the borrower, and have customized risk-based haircuts based on the nature of the underlying collateral. As a result, comparable loan products to the TALF do not exist in the market.

We provide credit spreads on the TALF collateral asset classes for which we have been able to find data. The spreads may be used as proxies for prevailing market rates. However, these spreads are very imperfect proxies since they reflect the market pricing of the collateral, as opposed to market rates for loans with TALF terms and conditions. For example, credit spreads are an indication of the market perception of the riskiness of a security and as such do not incorporate the additional credit protection provided by the haircuts applied to TALF loan collateral. This is particularly notable for legacy CMBS, for which the haircuts started at a minimum of 15% of par (see below for TALF haircut rates). Furthermore, the maturity dates of TALF collateral may have been shorter or longer than the related TALF loan.

TALF Haircuts

		ABS Average Life (years)						
Sector	**Subsector**	**0-<1**	**1-<2**	**2-<3**	**3-<4**	**4-<5**	**5-<6**	**6-<7**
Auto	Prime retail lease	10%	11%	12%	13%	14%		
Auto	Prime retail loan	6%	7%	8%	9%	10%		
Auto	Subprime retail loan	9%	10%	11%	12%	13%		
Auto	Motorcycle/ other recreational vehicles	7%	8%	9%	10%	11%		
Auto	Commercial and government fleets	9%	10%	11%	12%	13%		
Auto	Rental fleets	12%	13%	14%	15%	16%		
CMBS	Legacy	15%	15%	15%	15%	15%	16%	17%
Credit Card	Prime	5%	5%	6%	7%	8%		
Credit Card	Subprime	6%	7%	8%	9%	10%		
Equipment	Loans and Leases	5%	6%	7%	8%	9%		
Floorplan	Auto	12%	13%	14%	15%	16%		
Floorplan	Non-Auto	11%	12%	13%	14%	15%		
Premium Finance	Property and casualty	5%	6%	7%	8%	9%		
Servicing Advances	Residential mortgages	12%	13%	14%	15%	16%		
Small Business	SBA Loans	5%	5%	5%	5%	5%	6%	6%
Student Loan	Private	8%	9%	10%	11%	12%	13%	14%
Student Loan	Government guaranteed	5%	5%	5%	5%	5%	6%	6%

TALF loan rate spreads and comparable market interest rate spreads
Loans backed by Commercial Mortgage-Backed Securities (CMBS)

TALF Loan Type (CMBS):	3-Yr Fixed	5-Yr Fixed
TALF Loan Rate (CMBS):	3-Yr LIBOR Swap rate + **100** basis points	5-Yr LIBOR Swap rate + **100** basis points
Date	Super Senior 3-Yr AAA CMBS rate - 3-Yr LIBOR Swap rate	Super Senior 5-Yr AAA CMBS rate - 5-Yr LIBOR Swap rate
02/27/09	600	1300
03/27/09	400	1100
04/24/09	375	1025
05/29/09	300	600
06/26/09	300	650
07/31/09	250	400
08/28/09	260	425
09/25/09	260	405
10/30/09	235	350
11/27/09	245	370
12/25/09	240	330
01/29/10	225	300
02/26/10	225	275
03/26/10	200	275
04/30/10	200	270
05/28/10	210	285
06/25/10	210	280
07/30/10	195	245
08/27/10	165	230
09/24/10	155	210
10/29/10	205	290
11/26/10	195	270
12/31/10	195	275
01/28/11	190	260
02/25/11	175	235
03/25/11	180	230
04/29/11	170	215
05/27/11	180	235
06/24/11	200	255

TALF loan rate spreads and comparable market interest rate spreads
Loans backed by Commercial Mortgage-Backed Securities (CMBS)

TALF Loan Type (CMBS):	3-Yr Fixed	5-Yr Fixed
TALF Loan Rate (CMBS):	3-Yr LIBOR Swap rate + **100** basis points	5-Yr LIBOR Swap rate + **100** basis points
Date	Super Senior 3-Yr AAA CMBS rate - 3-Yr LIBOR Swap rate	Super Senior 5-Yr AAA CMBS rate - 5-Yr LIBOR Swap rate
02/27/09	600	1300
03/27/09	400	1100
04/24/09	375	1025
05/29/09	300	600
06/26/09	300	650
07/31/09	250	400
08/28/09	260	425
09/25/09	260	405
10/30/09	235	350
11/27/09	245	370
12/25/09	240	330
01/29/10	225	300
02/26/10	225	275
03/26/10	200	275
04/30/10	200	270
05/28/10	210	285
06/25/10	210	280
07/30/10	195	245
08/27/10	165	230
09/24/10	155	210
10/29/10	205	290
11/26/10	195	270
12/31/10	195	275
01/28/11	190	260
02/25/11	175	235
03/25/11	180	230
04/29/11	170	215
05/27/11	180	235
06/24/11	200	255

TALF loan rate spreads and comparable market interest rate spreads
Loans backed by Prime Auto Asset-Backed Securities (ABS)

TALF Loan Type (Prime Auto): 3-Yr Fixed w/ avg life >=2 years; 3-Yr Floating
TALF Loan Rate (Prime Auto): 3-Yr LIBOR Swap rate + **100** basis points; 1-Mo LIBOR rate + **100** basis points

Date	3-Yr Auto (Prime) AAA fixed-rate ABS rate - 3-Yr LIBOR Swap rate (basis points)	Date	3-Yr Auto (Prime) AAA floating-rate ABS rate - 1-Mo LIBOR rate (basis points)
2/27/09	350	2/26/09	510
3/31/09	300	3/26/09	427
4/30/09	225	4/30/09	377
5/29/09	200	5/28/09	367
6/30/09	165	6/25/09	346
7/31/09	120	7/30/09	309
8/31/09	80	8/27/09	257
9/30/09	65	9/24/09	226
10/30/09	50	10/29/09	218
11/30/09	55	11/25/09	192
12/31/09	50	12/31/09	233
1/29/10	35	1/28/10	187
2/26/10	25	2/25/10	168
3/31/10	20	3/25/10	176
4/30/10	20	4/29/10	167
5/28/10	30	5/27/10	166
6/30/10	20	6/24/10	130
7/30/10	20	7/29/10	94
8/31/10	17	8/26/10	88
9/30/10	22	9/30/10	84
10/29/10	25	10/28/10	77
11/30/10	30	11/25/10	101
12/31/10	28	12/30/10	135
1/31/11	28	1/27/11	129
2/28/11	25	2/24/11	146
3/31/11	35	3/31/11	168
4/29/11	33	4/28/11	141
5/31/11	28	5/26/11	120
6/30/11	27	6/30/11	123

TALF loan rate spreads and comparable market interest rate spreads
Loans backed by Credit Card Asset-Backed Securities (ABS)

TALF Loan Type (Credit Cards): 3-Yr Fixed w/ avg life >=2 years | 3-Yr Floating
TALF Loan Rate (Credit Cards): 3-Yr LIBOR Swap rate + **100** basis points | 1-Mo LIBOR rate + **100** basis points

Spread Date	3-Yr AAA Credit Card fixed-rate ABS rate - 3-Yr LIBOR Swap Rate (asis points)		3-Yr AAA Credit Card floating-rate ABS rate - 1-Mo LIBOR rate (basis points)
2/26/09	250	02/27/09	290
3/26/09	290	03/31/09	320
4/30/09	220	04/30/09	260
5/28/09	130	05/29/09	150
6/25/09	120	06/30/09	145
7/30/09	105	07/31/09	130
8/27/09	60	08/31/09	85
9/24/09	45	09/30/09	65
10/29/09	35	10/30/09	55
11/25/09	45	11/30/09	75
12/31/09	35	12/31/09	60
1/28/10	25	01/29/10	40
2/25/10	25	02/26/10	40
3/25/10	25	03/31/10	30
4/29/10	20	04/30/10	25
5/27/10	30	05/28/10	35
6/24/10	20	06/30/10	30
7/29/10	17	07/30/10	25
8/26/10	14	08/31/10	22
9/30/10	25	09/30/10	24
10/28/10	25	10/29/10	27
11/25/10	27	11/30/10	27
12/30/10	27	12/31/10	27
1/27/11	25	01/31/11	24
2/24/11	24	02/28/11	24
3/31/11	25	03/31/11	22
4/28/11	21	04/29/11	21
5/26/11	20	05/31/11	18
6/30/11	19	06/30/11	16

TALF loan rate spreads and comparable market interest rate spreads
Loans backed by Equipment Loan Asset-Backed Securities (ABS)

TALF Loan Type (Equipment):* 3-Yr Fixed w/ avg life >=2 years
TALF Loan Rate (Equipment): 3-Yr LIBOR Swap rate + **100** basis points

Spread Date	3-Yr AAA Equipment (large) fixed-rate ABS rate - 3-Yr LIBOR swap rate (basis points)
2/27/09	450
3/31/09	425
4/30/09	400
5/29/09	325
6/30/09	300
7/31/09	175
8/31/09	140
9/30/09	120
10/30/09	90
11/30/09	95
12/31/09	95
1/29/10	65
2/26/10	55
3/31/10	40
4/30/10	40
5/28/10	45
6/30/10	45
7/30/10	45
8/31/10	45
9/30/10	40
10/29/10	45
11/30/10	60
12/31/10	60
1/31/11	60
2/28/11	55
3/31/11	60
4/29/11	60
5/31/11	47
6/30/11	45

* *All TALF loans against equipment ABS were fixed-rate, therefore only the fixed 3 Year rate is provided.*

TALF loan rate spreads and comparable market interest rate spreads
Loans backed by Private Student Loan Asset-Backed Securities (ABS)

TALF Loan Type (Private Student Loans):	3-Yr (w/Prime-based coupon) Floating	5-Yr (w/Prime-based coupon) Floating		3-Yr (other coupon) Floating:	5-Yr (other coupon) Floating:
TALF Loan Rates (Private Student Loans):	Higher of (Prime rate - 175 basis points) and 100 basis points	Higher of (Prime rate - 175 basis points) and 100 basis points		1-Mo LIBOR rate + 100 basis points	1-Mo LIBOR rate + 100 basis points
Date	3-Yr AAA Private Student Loan floating-rate ABS rate - (Prime rate less 175 basis points) (basis points)	7-Yr AAA Private Student Loan floating-rate ABS rate - (Prime rate less 175 basis points) (basis points)	Date	3-Yr Private Credit Student Loan AAA floating-rate ABS rate - 1-Mo LIBOR	7-yr Private Credit Student Loan AAA floating-rate ABS rate - 1-Mo LIBOR
2/26/09	976	976	02/27/09	1000	1000
3/26/09	973	973	03/27/09	1000	1000
4/30/09	852	952	04/24/09	900	1000
5/28/09	617	717	05/29/09	700	800
6/25/09	610	710	06/26/09	700	800
7/30/09	498	598	07/31/09	600	700
8/27/09	386	486	08/28/09	500	600
9/24/09	378	478	09/25/09	500	600
10/29/09	328	428	10/30/09	450	550
11/25/09	325	425	11/27/09	450	550
12/31/09	325	425	12/25/09	450	550
1/28/10	275	400	01/29/10	400	525
2/25/10	175	250	02/26/10	300	375
3/25/10	179	254	03/26/10	300	375
4/29/10	184	259	04/30/10	300	375
5/27/10	204	279	05/28/10	300	375
6/24/10	204	279	06/25/10	300	375
7/29/10	197	272	07/30/10	300	375
8/26/10	180	255	08/27/10	300	375
9/30/10	179	254	09/24/10	300	375
10/28/10	179	254	10/29/10	300	375
11/25/10	179	254	11/26/10	300	375
12/30/10	180	255	12/31/10	300	375
1/27/11	155	230	01/28/11	275	350
2/24/11	156	231	02/25/11	275	350
3/31/11	130	205	03/25/11	275	325
4/28/11	77	152	04/29/11	200	275
5/26/11	45	120	05/27/11	170	245
6/30/11	45	120	06/24/11	170	245

TAF loan rates and comparable market interest rate
TAF auction dates
Percent

Date	TAF loan term (days)	TAF loan rate	Market rate	
28- and 35-Day TAF Loans				
17-Dec-07	28	4.65	4.97	1-month Libor
20-Dec-07	35	4.67	4.90	1-month Libor
14-Jan-08	28	3.95	4.08	1-month Libor
28-Jan-08	28	3.12	3.28	1-month Libor
11-Feb-08	28	3.01	3.14	1-month Libor
25-Feb-08	28	3.08	3.12	1-month Libor
10-Mar-08	28	2.80	2.94	1-month Libor
24-Mar-08	28	2.62	2.61	1-month Libor
7-Apr-08	28	2.82	2.72	1-month Libor
21-Apr-08	28	2.87	2.90	1-month Libor
5-May-08	28	2.22	2.70	1-month Libor
19-May-08	28	2.10	2.45	1-month Libor
2-Jun-08	28	2.26	2.46	1-month Libor
16-Jun-08	28	2.36	2.48	1-month Libor
30-Jun-08	28	2.34	2.46	1-month Libor
14-Jul-08	28	2.30	2.46	1-month Libor
28-Jul-08	28	2.35	2.46	1-month Libor
12-Aug-08	28	2.45	2.46	1-month Libor
25-Aug-08	28	2.38	2.47	1-month Libor
9-Sep-08	28	2.53	2.49	1-month Libor
22-Sep-08	28	3.75	3.18	1-month Libor
20-Oct-08	28	1.11	3.75	1-month Libor
17-Nov-08	28	0.51	1.47	1-month Libor
15-Dec-08	28	0.28	0.88	1-month Libor
12-Jan-09	28	0.25	0.34	1-month Libor
9-Feb-09	28	0.25	0.45	1-month Libor
9-Mar-09	28	0.25	0.56	1-month Libor
6-Apr-09	28	0.25	0.48	1-month Libor
4-May-09	28	0.25	0.41	1-month Libor
1-Jun-09	28	0.25	0.32	1-month Libor
29-Jun-09	28	0.25	0.31	1-month Libor
27-Jul-09	28	0.25	0.29	1-month Libor
24-Aug-09	28	0.25	0.26	1-month Libor
21-Sep-09	28	0.25	0.25	1-month Libor
19-Oct-09	28	0.25	0.25	1-month Libor
16-Nov-09	28	0.25	0.24	1-month Libor
14-Dec-09	28	0.25	0.23	1-month Libor
11-Jan-10	28	0.25	0.23	1-month Libor
8-Feb-10	28	0.25	0.23	1-month Libor
8-Mar-10	28	0.50	0.23	1-month Libor

84-Day TAF Loans

11-Aug-08	84	2.75	2.80	3-month Libor
8-Sep-08	84	2.67	2.82	3-month Libor
6-Oct-08	85	1.39	4.29	3-month Libor
3-Nov-08	84	0.60	2.86	3-month Libor
1-Dec-08	84	0.42	2.22	3-month Libor
29-Dec-08	83	0.20	1.46	3-month Libor
26-Jan-09	84	0.25	1.18	3-month Libor
23-Feb-09	84	0.25	1.25	3-month Libor
23-Mar-09	84	0.25	1.22	3-month Libor
20-Apr-09	84	0.25	1.10	3-month Libor
18-May-09	84	0.25	0.79	3-month Libor
15-Jun-09	84	0.25	0.61	3-month Libor
13-Jul-09	84	0.25	0.51	3-month Libor
10-Aug-09	84	0.25	0.46	3-month Libor
8-Sep-09	84	0.25	0.30	3-month Libor

Other TAF Loans

10-Nov-08	Forward	0.53	2.10	2-month Libor
24-Nov-08	Forward	0.38	2.03	2-month Libor
5-Oct-09	70	0.25	0.25	2-month Libor
2-Nov-09	70	0.25	0.26	2-month Libor
30-Nov-09	42	0.25	0.24	2-month Libor

Interest [discount] rate on ABCP purchased under the CPFF and comparable market interest rate
Daily
Percent

Date	CPFF ABCP rate	90-day AA ABCP rate
27-Oct-08	3.88	3.85
28-Oct-08	3.89	3.75
29-Oct-08	3.84	3.53
30-Oct-08	3.74	3.65
31-Oct-08	3.60	3.38
3-Nov-08	3.61	3.06
4-Nov-08	3.60	2.30
5-Nov-08	3.55	3.09
6-Nov-08	3.54	2.03
7-Nov-08	3.54	2.69
10-Nov-08	3.53	2.67
12-Nov-08	3.47	2.02
13-Nov-08	3.52	1.97
14-Nov-08	3.54	2.15
17-Nov-08	3.51	2.10
18-Nov-08	3.47	1.93
19-Nov-08	3.47	2.28
20-Nov-08	3.42	3.13
21-Nov-08	3.49	2.30
24-Nov-08	3.49	3.22
25-Nov-08	3.48	2.42
26-Nov-08	3.42	3.04
28-Nov-08	3.41	2.10
1-Dec-08	3.42	1.89
2-Dec-08	3.39	1.77
3-Dec-08	3.37	1.92
4-Dec-08	3.33	2.05
5-Dec-08	3.32	1.95
8-Dec-08	3.29	2.77
9-Dec-08	3.30	1.53
10-Dec-08	3.25	1.70
11-Dec-08	3.25	1.29
12-Dec-08	3.25	0.77
15-Dec-08	3.31	1.14
16-Dec-08	3.33	0.76
17-Dec-08	3.18	0.59
18-Dec-08	3.20	0.94
19-Dec-08	3.19	0.47
22-Dec-08	3.21	0.52
23-Dec-08	3.21	1.09
24-Dec-08	3.22	1.63
26-Dec-08	3.22	1.50
29-Dec-08	3.21	1.22
30-Dec-08	3.18	0.88
31-Dec-08	3.18	0.55
2-Jan-09	3.18	0.61
5-Jan-09	3.18	0.50
6-Jan-09	3.18	0.65
7-Jan-09	3.19	0.60
8-Jan-09	3.18	0.48
9-Jan-09	3.18	0.61
12-Jan-09	3.18	0.50
13-Jan-09	3.16	0.45
14-Jan-09	3.16	0.51
15-Jan-09	3.17	0.62
16-Jan-09	3.19	0.77
20-Jan-09	3.18	1.76
21-Jan-09	3.19	0.65

22-Jan-09	3.21	0.62
23-Jan-09	3.23	0.68
26-Jan-09	3.24	2.38
27-Jan-09	3.24	0.77
28-Jan-09	3.22	0.89
29-Jan-09	3.22	0.95
30-Jan-09	3.23	0.79
2-Feb-09	3.26	0.88
3-Feb-09	3.25	0.76
4-Feb-09	3.25	0.70
5-Feb-09	3.25	0.90
6-Feb-09	3.27	0.74
9-Feb-09	3.26	0.80
10-Feb-09	3.27	0.67
11-Feb-09	3.27	0.73
12-Feb-09	3.27	0.88
13-Feb-09	3.26	0.81
17-Feb-09	3.27	0.94
18-Feb-09	3.27	0.87
19-Feb-09	3.27	1.00
20-Feb-09	3.24	0.77
23-Feb-09	3.23	0.85
24-Feb-09	3.23	0.83
25-Feb-09	3.24	0.82
26-Feb-09	3.25	0.90
27-Feb-09	3.25	1.05
2-Mar-09	3.25	0.71
3-Mar-09	3.25	0.95
4-Mar-09	3.25	0.88
5-Mar-09	3.25	0.83
6-Mar-09	3.25	0.85
9-Mar-09	3.27	0.88
10-Mar-09	3.26	0.90
11-Mar-09	3.26	0.83
12-Mar-09	3.25	0.75
13-Mar-09	3.25	0.76
16-Mar-09	3.24	0.74
17-Mar-09	3.23	0.85
18-Mar-09	3.23	0.79
19-Mar-09	3.22	0.90
20-Mar-09	3.23	0.78
23-Mar-09	3.23	0.96
24-Mar-09	3.24	0.93
25-Mar-09	3.25	0.80
26-Mar-09	3.24	0.65
27-Mar-09	3.23	0.60
30-Mar-09	3.23	1.08
31-Mar-09	3.23	3.23
1-Apr-09	3.22	0.80
2-Apr-09	3.22	0.78
3-Apr-09	3.22	0.67
6-Apr-09	3.22	0.75
7-Apr-09	3.21	0.75
8-Apr-09	3.20	0.74
9-Apr-09	3.20	0.90
13-Apr-09	3.20	0.66
14-Apr-09	3.20	0.74
15-Apr-09	3.19	0.97
16-Apr-09	3.19	0.79
17-Apr-09	3.19	0.83
20-Apr-09	3.19	0.74
21-Apr-09	3.19	0.63
22-Apr-09	3.20	1.05
23-Apr-09	3.20	0.64

24-Apr-09	3.20	0.64
27-Apr-09	3.20	3.00
28-Apr-09	3.19	0.57
29-Apr-09	3.20	2.90
30-Apr-09	3.20	3.01
1-May-09	3.19	0.65
4-May-09	3.21	0.59
5-May-09	3.20	0.56
6-May-09	3.21	0.59
7-May-09	3.21	0.50
8-May-09	3.21	0.59
11-May-09	3.20	0.59
12-May-09	3.20	0.55
13-May-09	3.20	0.43
14-May-09	3.20	0.54
15-May-09	3.20	0.70
18-May-09	3.20	0.48
19-May-09	3.20	0.42
20-May-09	3.20	0.46
21-May-09	3.20	0.38
22-May-09	3.21	0.51
26-May-09	3.20	0.46
27-May-09	3.21	0.39
28-May-09	3.21	0.35
29-May-09	3.20	0.35
1-Jun-09	3.20	0.45
2-Jun-09	3.21	0.40
3-Jun-09	3.20	0.36
4-Jun-09	3.21	0.38
5-Jun-09	3.22	0.45
8-Jun-09	3.23	0.49
9-Jun-09	3.23	0.40
10-Jun-09	3.22	0.46
11-Jun-09	3.22	0.39
12-Jun-09	3.21	0.37
15-Jun-09	3.21	0.48
16-Jun-09	3.22	0.40
17-Jun-09	3.22	0,52
18-Jun-09	3.23	0.43
19-Jun-09	3.24	0.44
22-Jun-09	3.23	0.40
23-Jun-09	3.24	0.45
24-Jun-09	3.24	0.45
25-Jun-09	3.23	0.53
26-Jun-09	3.22	0.38
29-Jun-09	3.22	0.38
30-Jun-09	3.22	0.53
1-Jul-09	3.22	0.50
2-Jul-09	3.22	0.43
6-Jul-09	3.21	0.36
7-Jul-09	3.20	0.37
8-Jul-09	3.20	0.36
9-Jul-09	3.20	0.37
10-Jul-09	3.20	0.37
13-Jul-09	3.20	0.42
14-Jul-09	3.20	0.35
15-Jul-09	3.20	0.42
16-Jul-09	3.20	0.41
17-Jul-09	3.19	0.38
20-Jul-09	3.19	0.39
21-Jul-09	3.20	0.34
22-Jul-09	3.19	0.33
23-Jul-09	3.20	0.39
24-Jul-09	3.20	0.34

27-Jul-09	3.20	0.36
28-Jul-09	3.20	0.38
29-Jul-09	3.20	0.35
30-Jul-09	3.20	0.37
31-Jul-09	3.20	0.31
3-Aug-09	3.20	0.38
4-Aug-09	3.20	0.31
5-Aug-09	3.20	0.38
6-Aug-09	3.20	0.34
7-Aug-09	3.20	0.30
10-Aug-09	3.20	0.31
11-Aug-09	3.19	0.34
12-Aug-09	3.19	0.37
13-Aug-09	3.19	0.33
14-Aug-09	3.19	0.30
17-Aug-09	3.18	0.30
18-Aug-09	3.19	0.31
19-Aug-09	3.19	0.34
20-Aug-09	3.19	0.32
21-Aug-09	3.19	0.29
24-Aug-09	3.19	0.30
25-Aug-09	3.19	0.30
26-Aug-09	3.19	0.35
27-Aug-09	3.19	0.29
28-Aug-09	3.18	0.42
31-Aug-09	3.18	0.29
1-Sep-09	3.18	0.28
2-Sep-09	3.17	0.29
3-Sep-09	3.17	0.26
4-Sep-09	3.18	0.24
8-Sep-09	3.17	0.32
9-Sep-09	3.17	0.31
10-Sep-09	3.17	0.26
11-Sep-09	3.17	0.26
14-Sep-09	3.17	0.27
15-Sep-09	3.17	0.32
16-Sep-09	3.17	0.27
17-Sep-09	3.18	0.24
18-Sep-09	3.18	0.26
21-Sep-09	3.18	0.27
22-Sep-09	3.18	0.29
23-Sep-09	3.18	0.28
24-Sep-09	3.17	0.27
25-Sep-09	3.17	0.31
28-Sep-09	3.17	0.28
29-Sep-09	3.17	0.31
30-Sep-09	3.16	0.35
1-Oct-09	3.16	0.27
2-Oct-09	3.14	0.29
5-Oct-09	3.16	0.27
6-Oct-09	3.15	0.25
7-Oct-09	3.15	0.27
8-Oct-09	3.16	0.31
9-Oct-09	3.16	0.31
13-Oct-09	3.16	0.31
14-Oct-09	3.15	0.28
15-Oct-09	3.15	0.29
16-Oct-09	3.15	0.26
19-Oct-09	3.17	0.27
20-Oct-09	3.17	0.26
21-Oct-09	3.17	0.28
22-Oct-09	3.16	0.25
23-Oct-09	3.16	0.32
26-Oct-09	3.16	0.27

27-Oct-09	3.16		0.28
28-Oct-09	3.16		0.28
29-Oct-09	3.16		0.25
30-Oct-09	3.16		0.25
2-Nov-09	3.16		0.27
3-Nov-09	3.15		0.25
4-Nov-09	3.16		0.25
5-Nov-09	3.15		0.25
6-Nov-09	3.15		0.23
9-Nov-09	3.15		0.24
10-Nov-09	3.15		0.26
12-Nov-09	3.15		0.23
13-Nov-09	3.14		0.23
16-Nov-09	3.14		0.26
17-Nov-09	3.14		0.24
18-Nov-09	3.14		0.23
19-Nov-09	3.14		0.26
20-Nov-09	3.13		0.30
23-Nov-09	3.13		0.24
24-Nov-09	3.13		0.23
25-Nov-09	3.13		0.20
27-Nov-09	3.13	ND	
30-Nov-09	3.14		0.26
1-Dec-09	3.14		0.27
2-Dec-09	3.14		0.22
3-Dec-09	3.15		0.40
4-Dec-09	3.15		0.23
7-Dec-09	3.15		0.24
8-Dec-09	3.15		0.22
9-Dec-09	3.15		0.23
10-Dec-09	3.15		0.23
11-Dec-09	3.15		0.25
14-Dec-09	3.16		0.27
15-Dec-09	3.18		0.22
16-Dec-09	3.17		0.25
17-Dec-09	3.16		0.23
18-Dec-09	3.16		0.24
21-Dec-09	3.16		0.23
22-Dec-09	3.16		0.26
23-Dec-09	3.16		0.22
24-Dec-09	3.16		0.26
28-Dec-09	3.17		0.30
29-Dec-09	3.18		0.25
30-Dec-09	3.17		0.25
31-Dec-09	3.17		0.30
4-Jan-10	3.16		0.24
5-Jan-10	3.16		0.22
6-Jan-10	3.16		0.22
7-Jan-10	3.15		0.20
8-Jan-10	3.15		0.25
11-Jan-10	3.15		0.24
12-Jan-10	3.14		0.25
13-Jan-10	3.14		0.26
14-Jan-10	3.14		0.22
15-Jan-10	3.14		0.20
19-Jan-10	3.14		0.22
20-Jan-10	3.14		0.20
21-Jan-10	3.14		0.20
22-Jan-10	3.15		0.22
25-Jan-10	3.15		0.23

Interest [discount] rate on unsecured CP purchased under the CPFF* and comparable market interest rates
Daily
Percent

Note: On many days there was not sufficient commercial paper issuance to calculate market rates
* Includes 1.00% surcharge on unsecured commercial paper

Date	CPFF CP rate*	90-day AA non-financial CP rate	90-day AA financial CP rate
27-Oct-08	2.88	1.95	2.55
28-Oct-08	2.89	2.18	2.89
29-Oct-08	2.84	1.95	2.84
30-Oct-08	2.74	...	2.74
31-Oct-08	2.60	1.95	2.60
3-Nov-08	2.61	2.03	...
4-Nov-08	2.60	1.75	...
5-Nov-08	2.55	1.81	...
6-Nov-08	2.54	1.61	...
7-Nov-08	2.54	1.40	...
10-Nov-08	2.53	1.44	...
12-Nov-08	2.47	1.40	...
13-Nov-08	2.52	1.40	1.66
14-Nov-08	2.54	1.40	1.19
17-Nov-08	2.51	1.32	...
18-Nov-08	2.47	1.31	1.34
19-Nov-08	2.47	1.27	...
20-Nov-08	2.42	1.22	...
21-Nov-08	2.49	1.28	1.59
24-Nov-08	2.49	...	2.03
25-Nov-08	2.48	1.29	1.70
26-Nov-08	2.42	1.22	...
28-Nov-08	2.41	...	1.30
1-Dec-08	2.42	1.22	1.48
2-Dec-08	2.39	1.42	...
3-Dec-08	2.37	1.34	...
4-Dec-08	2.33	...	1.35
5-Dec-08	2.32	1.10	...
8-Dec-08	2.29	0.50	...
9-Dec-08	2.30	...	...
10-Dec-08	2.25	...	...
11-Dec-08	2.25	...	...
12-Dec-08	2.25	...	...
15-Dec-08	2.31	...	...
16-Dec-08	2.33	...	...
17-Dec-08	2.18	...	...
18-Dec-08	2.20	...	...
19-Dec-08	2.19	0.25	...
22-Dec-08	2.21	...	...
23-Dec-08	2.21	...	0.44
24-Dec-08	2.22	...	...
26-Dec-08	2.22	...	...
29-Dec-08	2.21	...	...
30-Dec-08	2.18	...	...
31-Dec-08	2.18	...	...
2-Jan-09	2.18	...	0.40
5-Jan-09	2.18	0.20	...
6-Jan-09	2.18	0.22	...
7-Jan-09	2.19	0.29	0.54
8-Jan-09	2.18	0.30	0.28
9-Jan-09	2.18	0.25	...
12-Jan-09	2.18	0.29	0.49
13-Jan-09	2.16	0.26	0.49
14-Jan-09	2.16	0.27	0.46
15-Jan-09	2.17	0.29	0.91

16-Jan-09	2.19	0.33	0.50
20-Jan-09	2.18	0.34	0.62
21-Jan-09	2.19	0.35	...
22-Jan-09	2.21	0.29	...
23-Jan-09	2.23	0.27	1.04
26-Jan-09	2.24	...	2.15
27-Jan-09	2.24	0.42	2.04
28-Jan-09	2.22	0.42	2.14
29-Jan-09	2.22	0.35	2.21
30-Jan-09	2.23	0.36	2.24
2-Feb-09	2.26	...	0.61
3-Feb-09	2.25	...	0.55
4-Feb-09	2.25	0.43	0.65
5-Feb-09	2.25	0.43	0.43
6-Feb-09	2.27	0.49	0.70
9-Feb-09	2.26	0.42	0.62
10-Feb-09	2.27	0.65	0.70
11-Feb-09	2.27	...	0.70
12-Feb-09	2.27	0.50	0.80
13-Feb-09	2.26	...	0.68
17-Feb-09	2.27	0.41	0.69
18-Feb-09	2.27	...	0.73
19-Feb-09	2.27	...	0.61
20-Feb-09	2.24	...	0.60
23-Feb-09	2.23	0.51	0.74
24-Feb-09	2.23	...	0.63
25-Feb-09	2.24	...	0.92
26-Feb-09	2.25	...	0.60
27-Feb-09	2.25	0.51	0.77
2-Mar-09	2.25	0.37	0.64
3-Mar-09	2.25	0.34	0.67
4-Mar-09	2.25	...	0.72
5-Mar-09	2.25	0.35	0.68
6-Mar-09	2.25	...	0.60
9-Mar-09	2.27	0.44	0.61
10-Mar-09	2.26	...	0.65
11-Mar-09	2.26	...	0.66
12-Mar-09	2.25	...	0.75
13-Mar-09	2.25	...	0.64
16-Mar-09	2.24	0.37	0.71
17-Mar-09	2.23	0.37	0.66
18-Mar-09	2.23	0.35	0.64
19-Mar-09	2.22	0.23	0.45
20-Mar-09	2.23	...	0.59
23-Mar-09	2.23	0.34	0.60
24-Mar-09	2.24	0.35	...
25-Mar-09	2.25	0.50	0.55
26-Mar-09	2.24	0.35	...
27-Mar-09	2.23	0.30	...
30-Mar-09	2.23	0.50	0.58
31-Mar-09	2.23	0.45	0.40
1-Apr-09	2.22	0.34	0.56
2-Apr-09	2.22	0.35	...
3-Apr-09	2.22	0.50	0.55
6-Apr-09	2.22	0.30	0.31
7-Apr-09	2.21	0.31	0.54
8-Apr-09	2.20	...	0.53
9-Apr-09	2.20	...	0.50
13-Apr-09	2.20	0.30	0.30
14-Apr-09	2.20	0.30	0.54
15-Apr-09	2.19	0.22	0.45
16-Apr-09	2.19	0.20	0.49
17-Apr-09	2.19	0.21	0.53
20-Apr-09	2.19	0.29	0.52

21-Apr-09	2.19	0.28	0.35
22-Apr-09	2.20	...	0.48
23-Apr-09	2.20	0.20	0.40
24-Apr-09	2.20	0.20	0.51
27-Apr-09	2.20	...	0.53
28-Apr-09	2.19	0.22	0.55
29-Apr-09	2.20	...	0.49
30-Apr-09	2.20	...	0.53
1-May-09	2.19	...	0.52
4-May-09	2.21	0.27	0.50
5-May-09	2.20	0.27	0.49
6-May-09	2.21	0.19	0.50
7-May-09	2.21	0.20	0.42
8-May-09	2.21	...	0.36
11-May-09	2.20	...	0.28
12-May-09	2.20	0.20	0.43
13-May-09	2.20	...	0.35
14-May-09	2.20	0.20	0.39
15-May-09	2.20	0.23	0.35
18-May-09	2.20	0.23	0.36
19-May-09	2.20	0.21	0.40
20-May-09	2.20	0.23	0.28
21-May-09	2.20	0.25	0.26
22-May-09	2.21	...	0.23
26-May-09	2.20	...	0.28
27-May-09	2.21	...	0.35
28-May-09	2.21	0.20	0.31
29-May-09	2.20	0.35	0.40
1-Jun-09	2.20	0.26	0.30
2-Jun-09	2.21	0.25	0.36
3-Jun-09	2.20	0.21	0.33
4-Jun-09	2.21	0.21	0.34
5-Jun-09	2.22	...	0.33
8-Jun-09	2.23	0.25	0.33
9-Jun-09	2.23	...	0.32
10-Jun-09	2.22	0.25	0.32
11-Jun-09	2.22	0.30	0.35
12-Jun-09	2.21	0.36	0.24
15-Jun-09	2.21	...	0.33
16-Jun-09	2.22	...	0.31
17-Jun-09	2.22	...	0.50
18-Jun-09	2.23	0.34	0.40
19-Jun-09	2.24	0.25	0.32
22-Jun-09	2.23	0.26	0.63
23-Jun-09	2.24	0.26	0.37
24-Jun-09	2.24	0.26	0.34
25-Jun-09	2.23	0.22	0.38
26-Jun-09	2.22	0.23	0.34
29-Jun-09	2.22	0.34	0.33
30-Jun-09	2.22	0.24	0.35
1-Jul-09	2.22	0.32	0.42
2-Jul-09	2.22	0.35	0.30
6-Jul-09	2.21	...	0.35
7-Jul-09	2.20	...	0.35
8-Jul-09	2.20	0.26	0.34
9-Jul-09	2.20	...	0.33
10-Jul-09	2.20	...	0.44
13-Jul-09	2.20	0.25	0.31
14-Jul-09	2.20	0.22	0.31
15-Jul-09	2.20	...	0.32
16-Jul-09	2.20	...	0.28
17-Jul-09	2.19	...	0.35
20-Jul-09	2.19	0.26	0.31
21-Jul-09	2.20	...	0.29

22-Jul-09	2.19	...	0.33
23-Jul-09	2.20	...	0.31
24-Jul-09	2.20	...	0.31
27-Jul-09	2.20	...	0.31
28-Jul-09	2.20	...	0.30
29-Jul-09	2.20	...	0.30
30-Jul-09	2.20	...	0.30
31-Jul-09	2.20	...	0.30
3-Aug-09	2.20	0.26	0.30
4-Aug-09	2.20	0.22	0.34
5-Aug-09	2.20	0.25	0.30
6-Aug-09	2.20	...	0.30
7-Aug-09	2.20	...	0.30
10-Aug-09	2.20	0.21	0.30
11-Aug-09	2.19	0.24	0.29
12-Aug-09	2.19	0.33	0.28
13-Aug-09	2.19	...	0.26
14-Aug-09	2.19	...	0.28
17-Aug-09	2.18	0.26	0.28
18-Aug-09	2.19	0.25	0.26
19-Aug-09	2.19	0.22	0.28
20-Aug-09	2.19	0.21	0.29
21-Aug-09	2.19	...	0.35
24-Aug-09	2.19	...	0.27
25-Aug-09	2.19	...	0.29
26-Aug-09	2.19	...	0.23
27-Aug-09	2.19	...	0.26
28-Aug-09	2.18	0.19	0.29
31-Aug-09	2.18	...	0.26
1-Sep-09	2.18	0.15	0.24
2-Sep-09	2.17	0.18	0.26
3-Sep-09	2.17	0.17	0.23
4-Sep-09	2.18	...	0.25
8-Sep-09	2.17	0.19	0.25
9-Sep-09	2.17	0.19	0.24
10-Sep-09	2.17	0.16	0.25
11-Sep-09	2.17	...	0.25
14-Sep-09	2.17	0.20	0.24
15-Sep-09	2.17	0.20	0.25
16-Sep-09	2.17	...	0.24
17-Sep-09	2.18	...	0.22
18-Sep-09	2.18	0.18	0.21
21-Sep-09	2.18	0.17	0.22
22-Sep-09	2.18	0.21	0.21
23-Sep-09	2.18	0.22	0.23
24-Sep-09	2.17	...	0.23
25-Sep-09	2.17	...	0.20
28-Sep-09	2.17	0.20	0.21
29-Sep-09	2.17	0.22	0.21
30-Sep-09	2.16	0.23	0.17
1-Oct-09	2.16	0.20	0.23
2-Oct-09	2.14	0.23	0.22
5-Oct-09	2.16	0.19	0.22
6-Oct-09	2.15	0.21	0.23
7-Oct-09	2.15	0.22	0.21
8-Oct-09	2.16	0.18	0.20
9-Oct-09	2.16	...	0.21
13-Oct-09	2.16	...	0.21
14-Oct-09	2.15	...	0.18
15-Oct-09	2.15	...	0.20
16-Oct-09	2.15	0.18	0.22
19-Oct-09	2.17	0.18	0.19
20-Oct-09	2.17	0.18	0.22
21-Oct-09	2.17	...	0.23

22-Oct-09	2.16	0.16	0.21
23-Oct-09	2.16	0.15	0.22
26-Oct-09	2.16	...	0.22
27-Oct-09	2.16	...	0.25
28-Oct-09	2.16	0.24	0.23
29-Oct-09	2.16	0.15	0.22
30-Oct-09	2.16	0.14	0.21
2-Nov-09	2.16	0.14	0.20
3-Nov-09	2.15	0.15	0.18
4-Nov-09	2.16	0.15	0.22
5-Nov-09	2.15	0.15	0.19
6-Nov-09	2.15	...	0.22
9-Nov-09	2.15	0.14	0.19
10-Nov-09	2.15	0.18	0.21
12-Nov-09	2.15	...	0.19
13-Nov-09	2.14	...	0.20
16-Nov-09	2.14	0.15	0.20
17-Nov-09	2.14	...	0.21
18-Nov-09	2.14	...	0.17
19-Nov-09	2.14	...	0.22
20-Nov-09	2.13	...	0.17
23-Nov-09	2.13	0.14	0.17
24-Nov-09	2.13	...	0.19
25-Nov-09	2.13	...	0.19
27-Nov-09	2.13	...	0.19
30-Nov-09	2.14	0.14	0.19
1-Dec-09	2.14	...	0.20
2-Dec-09	2.14	0.14	0.20
3-Dec-09	2.15	0.12	0.20
4-Dec-09	2.15	0.18	0.20
7-Dec-09	2.15	0.16	0.20
8-Dec-09	2.15	0.18	0.20
9-Dec-09	2.15	...	0.21
10-Dec-09	2.15	0.17	0.18
11-Dec-09	2.15	0.17	0.21
14-Dec-09	2.16	0.18	0.21
15-Dec-09	2.18	0.18	0.20
16-Dec-09	2.17	...	0.21
17-Dec-09	2.16	...	0.19
18-Dec-09	2.16	...	0.20
21-Dec-09	2.16	...	0.18
22-Dec-09	2.16	...	0.18
23-Dec-09	2.16	...	0.20
24-Dec-09	2.16	...	0.19
28-Dec-09	2.17	...	0.25
29-Dec-09	2.18	...	0.20
30-Dec-09	2.17	...	0.14
31-Dec-09	2.17	...	...
4-Jan-10	2.16	...	0.15
5-Jan-10	2.16	...	0.16
6-Jan-10	2.16	...	0.18
7-Jan-10	2.15	...	0.20
8-Jan-10	2.15	...	0.20
11-Jan-10	2.15	...	0.16
12-Jan-10	2.14	...	0.15
13-Jan-10	2.14	0.16	0.17
14-Jan-10	2.14	0.14	0.16
15-Jan-10	2.14	0.14	0.16
19-Jan-10	2.14	0.13	0.17
20-Jan-10	2.14	...	0.17
21-Jan-10	2.14	0.07	0.16
22-Jan-10	2.15	...	0.18
25-Jan-10	2.15	...	0.19

Estimated TSLF loan rate* and comparable market interest rate
Dates on which TSLF loans were made
Percent

* Estimated TSLF loan rate = auction-based TSLF lending fee + 1-month term GC repo rate

Date	TSLF Collateral Schedule	TSLF loan term (days)	Auction-based TSLF lending fee	1-month term GC repo rate	Estimated TSLF Lending Rate*	1-month term MBS repo rate
28-Mar-08	2	28	0.33	2.00	2.33	2.35
4-Apr-08	1	28	0.16	2.00	2.16	2.30
11-Apr-08	2	28	0.25	1.90	2.15	2.40
18-Apr-08	1	28	0.10	1.90	2.00	2.15
25-Apr-08	2	28	0.25	1.90	2.15	2.15
2-May-08	1	28	0.10	1.85	1.95	1.90
9-May-08	2	28	0.25	1.85	2.10	1.95
16-May-08	1	28	0.10	1.95	2.05	2.00
23-May-08	2	28	0.25	1.85	2.10	2.00
30-May-08	1	28	0.10	1.90	2.00	2.20
6-Jun-08	2	31	0.25	1.90	2.15	2.00
13-Jun-08	1	28	0.10	1.95	2.05	2.05
20-Jun-08	2	28	0.25	1.95	2.20	2.20
27-Jun-08	1	28	0.11	2.00	2.11	2.35
7-Jul-08	2	25	0.25	2.00	2.25	2.10
11-Jul-08	1	28	0.10	2.00	2.10	2.20
18-Jul-08	2	28	0.25	1.95	2.20	2.25
25-Jul-08	1	28	0.12	2.00	2.12	2.20
1-Aug-08	2	28	0.25	1.90	2.15	2.30
8-Aug-08	1	28	0.13	1.95	2.08	2.20
15-Aug-08	2	28	0.25	2.00	2.25	2.25
22-Aug-08	1	28	0.14	1.95	2.09	2.20
29-Aug-08	2	28	0.25	1.95	2.20	2.20
5-Sep-08	1	28	0.15	1.95	2.10	2.10
12-Sep-08	2	28	0.25	2.00	2.25	2.15
18-Sep-08	2	28	3.00	1.75	4.75	2.15
18-Sep-08	2	14	2.50	1.75	4.25	2.15
19-Sep-08	1	28	1.51	1.75	3.26	2.15
25-Sep-08	2	7	0.25	1.75	2.00	2.30
26-Sep-08	2	27	1.02	2.00	3.02	2.30
2-Oct-08	2	28	1.51	1.50	3.01	2.00
3-Oct-08	1	28	0.42	1.35	1.77	2.00
10-Oct-08	2	27	3.05	0.75	3.80	1.65
16-Oct-08	2	28	3.22	0.75	3.97	2.25
17-Oct-08	1	28	0.46	1.00	1.46	2.00
23-Oct-08	2	28	0.50	1.10	1.60	1.90
30-Oct-08	2	29	0.38	0.50	0.88	0.85
31-Oct-08	1	28	0.12	0.50	0.62	1.25
6-Nov-08	2	28	0.25	0.55	0.80	1.40
13-Nov-08	2	28	0.25	0.25	0.50	1.05
14-Nov-08	1	28	0.10	0.25	0.35	0.75
20-Nov-08	2	28	0.25	0.45	0.70	0.95
25-Nov-08	2	7	0.50	0.25	0.75	0.75
28-Nov-08	2	28	0.25	0.45	0.70	0.65
28-Nov-08	1	28	0.10	0.45	0.55	0.65
4-Dec-08	2	29	0.31	0.25	0.56	0.30
11-Dec-08	2	28	0.25	0.20	0.45	0.75
12-Dec-08	1	28	0.10	0.20	0.30	0.80
18-Dec-08	2	28	0.25	0.20	0.45	0.80

23-Dec-08	2	13	0.50	0.10	0.60	0.35
26-Dec-08	1	28	0.10	0.25	0.35	0.35
26-Dec-08	2	27	0.25	0.25	0.50	0.35
2-Jan-09	2	27	0.25	0.05	0.30	0.25
8-Jan-09	2	28	0.25	0.10	0.35	0.15
9-Jan-09	1	28	0.10	0.15	0.25	0.15
15-Jan-09	2	28	0.25	0.20	0.45	0.30
22-Jan-09	2	28	0.25	0.20	0.45	0.30
23-Jan-09	1	28	0.10	0.20	0.30	0.30
29-Jan-09	2	28	0.25	0.15	0.40	0.30
5-Feb-09	2	28	0.25	0.25	0.50	0.35
6-Feb-09	1	28	0.10	0.25	0.35	0.35
12-Feb-09	2	28	0.25	0.25	0.50	0.35
19-Feb-09	2	28	0.25	0.25	0.50	0.35
20-Feb-09	1	28	0.10	0.30	0.40	0.40
26-Feb-09	2	28	0.25	0.30	0.55	0.40
5-Mar-09	2	28	0.25	0.25	0.50	0.35
6-Mar-09	1	28	0.10	0.25	0.35	0.35
12-Mar-09	2	28	0.25	0.25	0.50	0.35
19-Mar-09	2	28	0.25	0.20	0.45	0.25
20-Mar-09	1	28	0.11	0.25	0.36	0.25
26-Mar-09	2	28	0.25	0.20	0.45	0.20
2-Apr-09	2	21	0.25	0.20	0.45	0.25
9-Apr-09	2	28	0.25	0.15	0.40	0.20
16-Apr-09	2	21	0.25	0.15	0.40	0.15
23-Apr-09	2	29	0.25	0.15	0.40	0.15
7-May-09	2	29	0.25	0.15	0.40	0.15
22-May-09	2	28	0.25	0.15	0.40	0.15
5-Jun-09	2	27	0.25	0.15	0.40	0.15
19-Jun-09	2	28	0.25	0.15	0.40	0.20
2-Jul-09	2	15	0.25	0.15	0.40	0.15
17-Jul-09	2	28	0.25	0.15	0.40	0.15

PDCF loan rates and comparable market interest rate
Dates on which PDCF loans were made
Percent

Date	PDCF interest rate	Overnight GC repo rate	Overnight MBS repo rate
17-Mar-08	3.25	2.00	2.95
18-Mar-08	2.50	0.95	2.85
19-Mar-08	2.50	0.34	2.05
20-Mar-08	2.50	0.51	2.30
24-Mar-08	2.50	0.47	2.10
25-Mar-08	2.50	0.93	2.35
26-Mar-08	2.50	0.46	1.80
27-Mar-08	2.50	0.72	2.00
28-Mar-08	2.50	2.15	2.60
31-Mar-08	2.50	1.43	2.40
1-Apr-08	2.50	2.36	2.60
2-Apr-08	2.50	2.39	2.40
3-Apr-08	2.50	2.39	2.40
4-Apr-08	2.50	2.21	2.20
7-Apr-08	2.50	2.28	2.20
8-Apr-08	2.50	2.15	2.20
9-Apr-08	2.50	2.04	2.05
10-Apr-08	2.50	2.28	2.20
11-Apr-08	2.50	2.25	2.10
14-Apr-08	2.50	2.22	2.30
15-Apr-08	2.50	2.15	2.15
16-Apr-08	2.50	2.15	2.20
17-Apr-08	2.50	2.15	2.20
18-Apr-08	2.50	2.19	2.20
21-Apr-08	2.50	2.13	2.20
22-Apr-08	2.50	2.01	2.10
23-Apr-08	2.50	1.88	1.95
24-Apr-08	2.50	2.03	2.00
25-Apr-08	2.50	1.90	1.95
28-Apr-08	2.50	1.88	1.90
29-Apr-08	2.50	2.02	2.10
30-Apr-08	2.25	1.96	2.00
1-May-08	2.25	1.86	1.90
2-May-08	2.25	1.85	1.90
5-May-08	2.25	1.89	1.90
6-May-08	2.25	1.90	1.90
7-May-08	2.25	1.87	1.90
8-May-08	2.25	1.99	1.95
9-May-08	2.25	2.01	1.95
12-May-08	2.25	2.03	1.95
13-May-08	2.25	2.01	1.95
14-May-08	2.25	1.93	1.95
15-May-08	2.25	2.05	2.00
16-May-08	2.25	1.98	2.10

19-May-08	2.25	1.98	1.90
20-May-08	2.25	2.01	1.90
21-May-08	2.25	1.97	1.90
22-May-08	2.25	2.08	2.00
23-May-08	2.25	2.09	2.10
27-May-08	2.25	2.16	2.20
28-May-08	2.25	2.24	2.25
29-May-08	2.25	2.34	2.35
30-May-08	2.25	2.19	2.20
2-Jun-08	2.25	2.22	2.20
3-Jun-08	2.25	2.12	2.10
4-Jun-08	2.25	2.05	2.00
5-Jun-08	2.25	2.04	1.95
6-Jun-08	2.25	2.02	1.95
9-Jun-08	2.25	2.07	1.95
10-Jun-08	2.25	2.11	2.05
11-Jun-08	2.25	2.12	2.05
12-Jun-08	2.25	2.10	2.00
13-Jun-08	2.25	2.12	2.00
16-Jun-08	2.25	2.19	2.10
17-Jun-08	2.25	2.02	1.95
18-Jun-08	2.25	1.96	2.00
19-Jun-08	2.25	1.94	1.90
20-Jun-08	2.25	1.99	1.95
23-Jun-08	2.25	1.97	1.95
24-Jun-08	2.25	1.94	2.00
25-Jun-08	2.25	1.91	2.00
26-Jun-08	2.25	1.97	2.10
27-Jun-08	2.25	2.11	2.40
30-Jun-08	2.25	1.72	3.15
1-Jul-08	2.25	2.10	2.15
11-Jul-08	2.25	1.93	2.00
24-Jul-08	2.25	1.96	2.05
11-Sep-08	2.25	2.06	2.10
15-Sep-08	2.25	1.66	3.50
16-Sep-08	2.25	1.03	2.25
17-Sep-08	2.25	0.25	2.25
18-Sep-08	2.25	0.76	2.25
19-Sep-08	2.25	1.82	2.50
22-Sep-08	2.25	1.75	2.50
23-Sep-08	2.25	0.68	1.90
24-Sep-08	2.25	0.26	1.90
25-Sep-08	2.25	0.31	1.25
26-Sep-08	2.25	1.08	1.25
29-Sep-08	2.25	0.88	1.55
30-Sep-08	2.25	0.33	1.55
1-Oct-08	2.25	0.76	1.55
2-Oct-08	2.25	0.23	0.45
3-Oct-08	2.25	0.11	0.45
6-Oct-08	2.25	0.15	0.55

7-Oct-08	2.25	0.36	1.65
8-Oct-08	1.75	0.10	1.25
9-Oct-08	1.75	0.21	1.25
10-Oct-08	1.75	0.10	1.25
14-Oct-08	1.75	0.10	1.25
15-Oct-08	1.75	0.12	1.25
16-Oct-08	1.75	0.11	0.75
17-Oct-08	1.75	0.11	0.75
20-Oct-08	1.75	0.31	0.75
21-Oct-08	1.75	0.96	1.05
22-Oct-08	1.75	1.01	1.10
23-Oct-08	1.75	1.03	1.15
24-Oct-08	1.75	0.82	1.05
27-Oct-08	1.75	0.96	1.20
28-Oct-08	1.75	0.86	0.85
29-Oct-08	1.25	0.21	0.30
30-Oct-08	1.25	0.20	0.15
31-Oct-08	1.25	0.15	0.25
3-Nov-08	1.25	0.26	0.20
4-Nov-08	1.25	0.16	0.05
5-Nov-08	1.25	0.14	0.10
6-Nov-08	1.25	0.14	0.10
7-Nov-08	1.25	0.18	0.10
10-Nov-08	1.25	0.15	0.15
12-Nov-08	1.25	0.17	0.15
13-Nov-08	1.25	0.26	0.15
14-Nov-08	1.25	0.17	0.10
17-Nov-08	1.25	0.19	0.15
18-Nov-08	1.25	0.27	0.25
19-Nov-08	1.25	0.30	0.25
20-Nov-08	1.25	0.28	0.40
21-Nov-08	1.25	0.49	0.60
24-Nov-08	1.25	0.58	0.50
25-Nov-08	1.25	0.40	0.25
26-Nov-08	1.25	0.34	0.30
28-Nov-08	1.25	0.25	0.30
1-Dec-08	1.25	0.30	0.30
2-Dec-08	1.25	0.29	0.20
3-Dec-08	1.25	0.20	0.10
4-Dec-08	1.25	0.17	0.10
5-Dec-08	1.25	0.03	0.03
8-Dec-08	1.25	0.02	0.05
9-Dec-08	1.25	0.02	0.05
10-Dec-08	1.25	0.01	0.05
11-Dec-08	1.25	0.03	0.10
12-Dec-08	1.25	0.08	0.10
15-Dec-08	1.25	0.08	0.10
16-Dec-08	0.50	0.10	0.05
17-Dec-08	0.50	0.05	0.05
18-Dec-08	0.50	0.03	0.05

19-Dec-08	0.50	0.04	0.10
22-Dec-08	0.50	0.05	0.10
23-Dec-08	0.50	0.06	0.10
24-Dec-08	0.50	0.07	0.10
26-Dec-08	0.50	0.08	0.10
29-Dec-08	0.50	0.06	0.05
30-Dec-08	0.50	0.05	0.05
31-Dec-08	0.50	0.03	0.05
2-Jan-09	0.50	0.07	0.05
5-Jan-09	0.50	0.07	0.10
6-Jan-09	0.50	0.05	0.05
7-Jan-09	0.50	0.04	0.10
8-Jan-09	0.50	0.06	0.10
9-Jan-09	0.50	0.07	0.05
12-Jan-09	0.50	0.06	0.05
13-Jan-09	0.50	0.07	0.10
14-Jan-09	0.50	0.17	0.25
15-Jan-09	0.50	0.21	0.25
16-Jan-09	0.50	0.28	0.30
20-Jan-09	0.50	0.21	0.30
21-Jan-09	0.50	0.19	0.25
22-Jan-09	0.50	0.26	0.30
23-Jan-09	0.50	0.24	0.30
26-Jan-09	0.50	0.17	0.25
27-Jan-09	0.50	0.12	0.15
28-Jan-09	0.50	0.19	0.20
29-Jan-09	0.50	0.23	0.30
30-Jan-09	0.50	0.26	0.25
2-Feb-09	0.50	0.30	0.30
3-Feb-09	0.50	0.23	0.30
4-Feb-09	0.50	0.24	0.25
5-Feb-09	0.50	0.29	0.30
6-Feb-09	0.50	0.26	0.30
9-Feb-09	0.50	0.26	0.25
10-Feb-09	0.50	0.26	0.20
11-Feb-09	0.50	0.26	0.20
12-Feb-09	0.50	0.28	0.25
13-Feb-09	0.50	0.30	0.30
17-Feb-09	0.50	0.33	0.30
18-Feb-09	0.50	0.25	0.30
19-Feb-09	0.50	0.26	0.20
20-Feb-09	0.50	0.28	0.25
23-Feb-09	0.50	0.25	0.25
24-Feb-09	0.50	0.24	0.25
25-Feb-09	0.50	0.24	0.20
26-Feb-09	0.50	0.29	0.25
27-Feb-09	0.50	0.26	0.25
2-Mar-09	0.50	0.31	0.25
3-Mar-09	0.50	0.27	0.20
4-Mar-09	0.50	0.26	0.25

5-Mar-09	0.50	0.29	0.25
6-Mar-09	0.50	0.26	0.25
9-Mar-09	0.50	0.28	0.25
10-Mar-09	0.50	0.28	0.25
11-Mar-09	0.50	0.26	0.20
12-Mar-09	0.50	0.26	0.20
13-Mar-09	0.50	0.11	0.10
16-Mar-09	0.50	0.25	0.20
17-Mar-09	0.50	0.23	0.20
18-Mar-09	0.50	0.19	0.15
19-Mar-09	0.50	0.22	0.20
20-Mar-09	0.50	0.22	0.15
23-Mar-09	0.50	0.25	0.20
24-Mar-09	0.50	0.22	0.20
25-Mar-09	0.50	0.17	0.10
26-Mar-09	0.50	0.13	0.10
27-Mar-09	0.50	0.15	0.10
30-Mar-09	0.50	0.15	0.15
31-Mar-09	0.50	0.17	0.20
1-Apr-09	0.50	0.24	0.20
2-Apr-09	0.50	0.22	0.15
3-Apr-09	0.50	0.17	0.10
6-Apr-09	0.50	0.16	0.10
7-Apr-09	0.50	0.15	0.10
8-Apr-09	0.50	0.19	0.15
9-Apr-09	0.50	0.17	0.15
13-Apr-09	0.50	0.17	0.15
14-Apr-09	0.50	0.17	0.10
15-Apr-09	0.50	0.12	0.10
16-Apr-09	0.50	0.13	0.05
17-Apr-09	0.50	0.15	0.10
20-Apr-09	0.50	0.15	0.15
21-Apr-09	0.50	0.14	0.10
22-Apr-09	0.50	0.14	0.10
23-Apr-09	0.50	0.15	0.10
24-Apr-09	0.50	0.14	0.05
27-Apr-09	0.50	0.14	0.10
28-Apr-09	0.50	0.14	0.10
29-Apr-09	0.50	0.14	0.10
30-Apr-09	0.50	0.16	0.15
1-May-09	0.50	0.23	0.20
4-May-09	0.50	0.24	0.20
5-May-09	0.50	0.23	0.20
6-May-09	0.50	0.21	0.15
7-May-09	0.50	0.21	0.15
8-May-09	0.50	0.19	0.15
11-May-09	0.50	0.20	0.10
12-May-09	0.50	0.16	0.15

AMLF loan rate and comparable market interest rates
Dates on which AMLF loans were made
Percent

Date	AMLF Interest Rate	30-day term federal funds rate	90-day term federal funds rate	30-day AA ABCP rate	90-day AA ABCP rate
22-Sep-08	2.25	1.98	1.92	4.57	3.52
23-Sep-08	2.25	1.93	1.86	3.70	3.27
24-Sep-08	2.25	1.90	1.80	3.68	4.20
25-Sep-08	2.25	1.89	1.79	3.72	3.80
26-Sep-08	2.25	1.81	1.67	5.55	5.25
29-Sep-08	2.25	1.81	1.58	4.23	4.06
30-Sep-08	2.25	1.81	1.70	6.05	4.41
1-Oct-08	2.25	1.74	1.63	4.19	4.22
2-Oct-08	2.25	1.56	1.47	4.08	4.49
3-Oct-08	2.25	1.41	1.42	4.06	4.38
6-Oct-08	2.25	1.38	1.32	4.03	4.20
7-Oct-08	2.25	1.61	1.36	5.45	4.66
8-Oct-08	1.75	1.50	1.24	4.43	4.85
9-Oct-08	1.75	1.46	1.24	4.33	4.66
10-Oct-08	1.75	1.32	1.14	4.77	4.55
14-Oct-08	1.75	1.29	1.18	4.43	4.49
15-Oct-08	1.75	1.23	1.10	4.70	4.48
16-Oct-08	1.75	1.21	1.10	3.95	4.23
21-Oct-08	1.75	1.07	1.07	3.51	3.75
22-Oct-08	1.75	1.10	1.00	3.19	3.31
24-Oct-08	1.75	1.05	0.89	2.97	3.10
4-Nov-08	1.25	0.51	0.63	1.95	2.30
13-Nov-08	1.25	0.42	0.54	1.31	1.97
21-Nov-08	1.25	0.42	0.46	1.25	2.30
26-Nov-08	1.25	0.42	0.41	1.39	3.04
1-Dec-08	1.25	0.40	0.40	1.72	1.89
8-Dec-08	1.25	0.24	0.34	1.68	2.77
6-Jan-09	0.50	0.15	0.21	0.60	0.65
16-Jan-09	0.50	0.14	0.19	0.53	0.77
22-Jan-09	0.50	0.17	0.23	0.60	0.62
26-Jan-09	0.50	0.16	0.25	0.51	2.38
27-Jan-09	0.50	0.16	0.24	0.56	0.77
28-Jan-09	0.50	0.16	0.22	0.52	0.89
29-Jan-09	0.50	0.16	0.22	0.55	0.95
30-Jan-09	0.50	0.16	0.27	0.58	0.79
3-Feb-09	0.50	0.23	0.26	0.54	0.76
4-Feb-09	0.50	0.24	0.28	0.49	0.70
12-Feb-09	0.50	0.23	0.26	0.82	0.88
23-Feb-09	0.50	0.22	0.24	0.72	0.85
26-Feb-09	0.50	0.22	0.25	0.95	0.90
5-Mar-09	0.50	0.23	0.26	0.80	0.83
12-Mar-09	0.50	0.22	0.26	0.71	0.75
24-Apr-09	0.50	0.15	0.19	0.47	0.64

30-Apr-09	0.50	0.15	0.20	0.85	3.01
5-May-09	0.50	0.20	0.21	0.62	0.56
6-May-09	0.50	0.20	0.21	0.55	0.59
7-May-09	0.50	0.20	0.21	0.51	0.50
8-May-09	0.50	0.19	0.21	0.48	0.59

Single-tranche open market operation auction statistics and comparable market interest rates
Dates on which ST OMOs were conducted
Percent

Date	Term (days)	Auction stop-out rate	Weighted avg. auction rate	4-week Treasury bill yield	1-month MBS repo rate
7-Mar-08	28	2.75	2.84	1.64	2.80
11-Mar-08	28	2.60	2.67	1.79	2.80
18-Mar-08	28	2.25	2.32	0.46	2.10
25-Mar-08	28	2.38	2.40	0.82	2.35
4-Apr-08	23	2.35	2.36	1.47	2.30
8-Apr-08	28	2.26	2.27	1.29	2.30
15-Apr-08	28	2.15	2.17	0.84	2.15
22-Apr-08	28	2.10	2.13	0.59	2.20
29-Apr-08	28	2.06	2.10	1.11	2.20
6-May-08	28	2.01	2.04	1.33	1.90
13-May-08	28	2.03	2.05	1.74	2.00
20-May-08	28	2.02	2.03	1.90	2.00
27-May-08	28	2.05	2.06	1.90	2.00
3-Jun-08	28	2.15	2.15	1.90	2.05
10-Jun-08	28	2.20	2.23	1.90	2.00
17-Jun-08	28	2.20	2.23	1.78	2.10
24-Jun-08	28	2.12	2.20	1.46	2.20
1-Jul-08	28	2.12	2.15	1.73	2.20
8-Jul-08	28	2.16	2.18	1.78	2.10
15-Jul-08	28	2.16	2.17	1.26	2.15
22-Jul-08	28	2.18	2.20	1.39	2.25
29-Jul-08	28	2.18	2.19	1.66	2.20
5-Aug-08	28	2.19	2.21	1.56	2.15
12-Aug-08	28	2.24	2.25	1.70	2.20
19-Aug-08	28	2.21	2.23	1.74	2.25
26-Aug-08	28	2.18	2.22	1.66	2.15
2-Sep-08	28	2.18	2.21	1.61	2.20
9-Sep-08	28	2.17	2.25	1.49	2.15
16-Sep-08	28	2.37	2.49	0.26	2.15
23-Sep-08	28	2.67	3.02	0.36	2.30
30-Sep-08	28	2.31	2.45	0.76	2.30
7-Oct-08	28	3.26	3.51	0.31	1.45
14-Oct-08	28	2.00	2.47	0.11	1.40
21-Oct-08	28	1.75	1.88	0.46	1.85
28-Oct-08	28	1.10	1.52	0.18	1.45
4-Nov-08	28	0.75	0.99	0.15	1.65
10-Nov-08	28	0.55	0.85	0.10	1.30
18-Nov-08	28	0.40	0.66	0.09	0.95
25-Nov-08	28	0.55	0.65	0.04	0.75
2-Dec-08	28	0.30	0.45	0.03	0.85
9-Dec-08	28	1.16	1.18	0.03	0.25
16-Dec-08	28	0.26	0.58	0.01	1.00
23-Dec-08	28	0.10	0.25	0.01	0.35
30-Dec-08	28	0.01	0.10	0.02	0.90

CLO: #262
CCS: 11-6066
RECVD: 6/15/11

Questions for the Record from Chairman Ron Paul (TX-14)
Subcommittee on Domestic Monetary Policy and Technology
Committee on Financial Services, U.S. House of Representatives

Hearing held on June 1, 2011, entitled
"Federal Reserve Lending Disclosure: FOIA, Dodd-Frank, and the Data Dump"
Witnesses: Scott G. Alvarez, General Counsel, Board of Governors, Federal Reserve System
Thomas C. Baxter, General Counsel, Federal Reserve Bank of New York

1. In testimony before the Subcommittee on June 1, 2011, Federal Reserve Bank of New York (FRBNY) General Counsel, Thomas Baxter, indicated that the FRBNY's lending during the financial crisis was more heavily weighted toward foreign institutions because New York, as a leading financial center, attracted more foreign institutions. However, this response did not explain the disproportionate use of Federal Reserve lending facilities by foreign institutions. Can the Federal Reserve provide statistics on the proportion of foreign institutions relative to U.S. institutions that are part of the Federal Reserve System? Can the Federal Reserve explain the factors that contributed to disproportionate borrowing by foreign institutions, especially in the following lending facilities which provided more than 50% of their total lending to foreign institutions: Commercial Paper Funding Facility, Mortgage-Backed Securities Purchase Program, Term Auction Facility; and Term Securities Lending Facility? **(MA)**

2. The Federal Reserve created the Term Asset-Backed Securities Loan Facility (TALF), which was intended to "lend up to $200 billion...to holders of certain AAA-rated ABS [asset-backed securities]." When TALF data was released in December 2010, they revealed that 18% of TALF loans were backed by subprime credit card and auto loan securities, 17% were backed by "legacy" (i.e. troubled) commercial real estate securities, and 13% were backed by student loan securities. Similarly, the Term Securities Lending Facility (TSLF) was to "lend up to $200 billion...to primary dealers secured...by...securities, including federal agency debt, federal agency residential-mortgage-backed securities (MBS), and non-agency AAA/Aaa-rated private-label residential MBS." Data released for the TSLF revealed that 14% of loans were backed by collateral rated below AAA. Over 50% of all collateral posted consisted of agency-backed MBS or CMO (collateralized mortgage obligations), whose ratings were not published. While it has generally been assumed that these Agency securities have a AAA rating due to their implicit government backing, the high collateral-to-loan ratio of the TSLF (4 to 1) implies that these securities were not in fact performing at a AAA level—not to mention that no one knew what any mortgage securities were actually worth during the financial crisis. Given that the Federal Reserve stated to the public that it would accept high-rated collateral in conducting loan operations through these facilities, yet nonetheless loaned funds against questionable or low-rated collateral, how is the public to trust the public statements made by the Federal Reserve? In accepting lower grade collateral than the lending facility originally intended, was there a protocol the Reserve Banks were to follow in accepting lower rated collateral? If not, how were determinations made about what collateral was acceptable? Additionally, what surety was given that AAA-rated collateral was truly AAA, especially given the uncertain quality of many MBS at the time? **(MA)**

3. The Commercial Paper Funding Facility (CPFF) provided 60% of its total lending to foreign institutions. The CPFF also supplied funding predominantly to large firms, such as Harley Davidson, Chrysler, Caterpillar, ING, and AIG. To what extent did smaller firms that issued commercial paper know about and have access to the CPFF? What efforts were made by the Federal Reserve to ensure that all eligible parties were made aware of the facility? **(MA)**

4. The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) loaned primarily to two firms, JP Morgan and State Street. Each of the Maiden Lane facilities was set up to assist a particular institution. To what extent were lending facilities set up for the benefit of specific firms facing financial difficulties? To what extent were lending facilities created at the behest of specific firms, either through formal or informal lobbying? **(MA)**

5. Given that information pertaining to discount window transactions during the financial crisis has been disclosed to the public, through the Bloomberg News and Fox News FOIA requests, without causing any material harm to institutions that used the discount window, will the Federal Reserve disclose the details of discount window transactions that occurred during the financial crisis on the Board's website in the same manner disclosures were made of the other facilities and programs conducted by the Federal Reserve during the crisis? If not, please provide an explanation of why the Federal Reserve will not make such information available. **(LEGAL)**

6. Given that information pertaining to certain "covered transactions", a definition which includes open market operations, will have to be disclosed to the public under the provisions of the Dodd-Frank Act, will the Federal Reserve disclose the details of open market operations that took place during the financial crisis and before the passage of Dodd-Frank, such as Single-Tranche Open Market Operations? If not, please provide an explanation of why the Federal Reserve will not make such information available. **(LEGAL)**

7. Will the details of the "QE2" program and ongoing rollovers of maturing MBS into Treasury debt securities be disclosed to the public? If not, please provide an explanation of why the Federal Reserve will not publicize such information. **(LEGAL)**

8. The documents released by the Federal Reserve in response to the Freedom of Information Act requests from Bloomberg News and Fox News contained large amounts of information that was redacted. The Federal Reserve has indicated that the information was determined not responsive to the FOIA requests and was therefore redacted. Is the Federal Reserve willing to release all of these records in their original form to the House Committee on Financial Services? If not, please explain why. **(LEGAL)**

9. In the documents disclosed by the Federal Reserve on discount window transactions, it appears that banks, especially primary dealers, used the discount window like a revolving line of credit, essentially acquiring longer term funding through what is typically an overnight program. Why was the discount window used in such a fashion even when emergency lending facilities were set up to provide longer term financing through programs such as the TSLF or PDCF? **(MA)**

10. What was the necessity of setting up Single-Tranche Open Market Operations (ST OMO) and programs such as the TSLF when they accomplished essentially the same task of providing 28-day credit? Was the existence of these separate operations due to the fact that the TSLF allowed the Fed to purchase secondary credit and not just primary credit, something not legally permissible under the ST OMO conducted through the Fed's open market operation authority? **(MA)**

11. Can the Federal Reserve provide to the Committee a graph and/or spreadsheet for each of the emergency lending facilities (including the ST OMO) showing the high, low, and average rates charged in the facility over its lifetime in conjunction with the prevailing market rate for the same type of transaction over the same period? **(MA)**

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

August 12, 2011

The Honorable Steve Stivers
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am enclosing my responses to the questions you submitted in connection with the June 16, 2011, hearing on "Financial Regulatory Reform: The International Context." A copy of my responses has been forwarded to the Chief Clerk of the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

<u>Questions for The Honorable Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System, from Representative Stivers:</u>

1. European regulators instituted risk retention rules on January 1, 2011. They are materially different from the Notice of Proposed Rulemaking (NPR) in the U.S. I am concerned this will create roadblocks for U.S. issuers who would like to access European investors, as well as roadblocks for European issuers who would like to access U.S. investors. What consideration was given to rules around the world? What is the scope for the inclusion of some sort of mutual recognition or other acceptance of existing rules in Europe?

The European Union's risk retention requirements are embodied in Article 122a of the Capital Requirements Directive (CRD) (the "EU risk retention rules"). The EU risk retention rules, similar to section 941 of The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), generally require that an originator, sponsor, or original lender retains at least a five percent interest in a securitization transaction.

The EU risk retention rules and the Dodd-Frank Act take different implementation approaches to risk retention. However, the EU risk retention rules take an "investor-based" approach, where investors--that is, the buyers of asset-backed securities--have the responsibility to ensure that a sponsor, originator, or original lender retains no less than five percent of the nominal value of the securitized exposures. In contrast, the Dodd-Frank Act directs relevant federal agencies to prescribe regulations that apply to securitizers.

The agencies issued the Notice of Proposed Rulemaking (NPR) to implement the risk retention requirements on March 30, 2011. The comment period was extended to August 1, 2011. The NPR proposes that U.S. sponsors issuing asset-backed securities abroad comply with the U.S. retention requirements in order to prevent arbitrage of regulatory regimes. Similarly, European sponsors who issue securities in the U.S. would generally have to comply with the U.S. risk retention requirements, unless a foreign transaction has limited connections with the United States and U.S. investors, and qualifies for the proposed safe harbor.

The agencies are in the process of receiving and reviewing comments, including comments related to the safe harbor for foreign-related transactions. The agencies will consider commenters' concerns and suggestions on how to address cross-border issues in a consistent manner.

2. It is clear that analysis was done for some aspects for the risk retention proposal. However, I am concerned there has not been much attention to what the proposal means for borrowers, housing markets, or for the economy in general. There is also little to no discussion of other major issues in housing markets, such as the resolution of the GSEs and changes to capital standards, and how all of these interact with the retention proposal. Would you discuss the process by which data was collected and analyzed, and also explain why the NPR shows little evidence of an economic impact analysis of the proposed rules? Do you think that uncertainty of regulation is a major factor holding back lending, securitization, and housing market more generally?

As mentioned, section 941 requires that the relevant agencies prescribe regulations that require securitizers generally to retain at least a five percent interest in securitized assets. In addition, the Dodd-Frank Act directs the regulators to define "qualified residential mortgages" (QRM) which are exempt from risk retention. In defining the QRM, the Dodd-Frank Act directs regulators to "take into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default."

In considering how to define QRM for purposes of the NPR, the relevant agencies relied in part on the large body of academic and practitioner literature on mortgage risk management. The NPR contained references to several of the more recently published studies. The overwhelming consensus of this literature is that a borrower's equity in a property and credit score, along with a few other factors, are key predictors of default. In addition to the existing literature, the proposed rule also relied on work done by analysts at various agencies using proprietary datasets that may not be available to academics or practitioners. Using data supplied by Lender Processing Servicers Applied Analytics covering the bulk of mortgages originated in the U.S. since 2005, the agencies analyzed the key variables associated with default. As an example, the NPR contains a graph showing default rates by loan-to-value (LTV) ratios based on these data; this graph shows that at LTVs above 80 percent, default rates jump significantly. Similarly, analysts from the Federal Housing Finance Agency (FHFA) used data on mortgages guaranteed by the government-sponsored enterprises (GSEs) to compute the additional default rates associated with relaxing various QRM criteria. All of this analysis was considered by the agencies in the QRM definition contained in the NPR, and was discussed in the preamble to the proposed rule.

The proposal also aimed to minimize the excess costs to borrowers falling outside the narrow QRM definition. The proposed QRM definition was not designed to be a minimum underwriting standard for prime mortgages. The rationale for keeping the proposed definition of QRM narrow was that loans would not be stigmatized for falling outside the definition and thus that the market for non-QRMs could remain liquid with little or no pricing difference between QRMs and non-QRMs related just to risk retention. In addition, the menu of risk retention options in the NPR is designed to accommodate a variety of market practices, seeking to make it relatively manageable for issuers to satisfy the risk retention requirement. Finally, it is noteworthy that the few private-label mortgage-backed securities (MBS) deals that have come to market since the financial crisis featured substantial risk retention. As the market revives further and investors once again begin purchasing private-label MBS, it is likely they will continue to demand significant risk retention by issuers regardless of the security's status as a QRM deal. Indeed, meaningful risk was routinely retained by issuers prior to the surge in MBS issuance that started around 2004, although this retention was often opaque and the form and amount varied across issuers.

The agencies carefully considered a variety of mortgage characteristics that are associated with higher rates of default and the potential impact of the proposed rules on lending. Given the complexity of the risk retention rules, the NPR asked for detailed comments on the proposed rules' impact on the market, housing prices and lending rates. These comments will be carefully considered prior to completion of the rule-making process. In addition, the agencies have noted their intent to return to this rule when the GSEs exit conservatorship and the role for private capital in the mortgage market becomes clearer.

3. The risk retention notice of proposed rulemaking (NPR) includes a so-called "premium capture." As proposed, this would force securitization issuers to hold back all profit earned at the time a securitization was done, and force it to be held back until all bonds in the deal are paid off, which could be 15 or 30 years down the road. The reaction to this proposal has been negative, with concerns that securitization won't happen if they cannot be profitable (just like any other business). Could you explain where the proposal came from, why it is expected that securitizers will essentially do their business without profit, why you supported it, and how you plan to fix it?

It is the agencies' expectation that issuers will be able to continue to profitably issue ABS and MBS and, in general, not trigger the premium capture provision of the rule. This provision seeks to prevent circumvention of the retention requirement.

More specifically, the premium capture account attempts to ensure that the risk retention required by the Dodd-Frank Act is economically meaningful by aligning the compensation of a sponsor with that of a balance sheet lender in order to encourage the sponsor to receive its profit over time. As a result, a portion of the sponsor's profit would be tied to the performance of the underlying collateral, instead of the sponsor earning all of its profits upfront in a riskless manner at the time when the transaction is closed.

The agencies have requested comments on all aspects of the risk retention proposal, including premium capture, and will carefully consider all comments as they move forward with finalizing the risk retention rule.

Financial Regulatory Reform: The International Context
Questions to be submitted for the record by Rep. Stivers
June 16, 2011

1. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   European regulators instituted risk retention rules on January 1, 2011. They are materially different from the notice of proposed rulemaking (NPR) in the US. I am concerned this will create roadblocks for US issuers who would like to access European investors, as well as roadblocks for European issuers who would like to access US investors. What consideration was given to rules around the world? What is the scope for the inclusion of some sort of mutual recognition or other acceptance of existing rules in Europe?

2. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   It is clear that analysis was done for some aspects for the risk retention proposal. However, I am concerned there has not been much attention to what the proposal means for borrowers, housing markets, or for the economy in general. There is also little to no discussion of other major issues in housing markets, such as the resolution of the GSEs and changes to capital standards, and how all of these interact with the retention proposal. Would you discuss the process by which data was collected and analyzed, and also explain why the NPR shows so little evidence of an economic impact analysis of the proposed rules? Do you think that uncertainty of regulation is a major factor holding back lending, securitization, and housing market more generally?

3. Addressed to the first panel: Chairman Bair, Under Secretary Brainard, Chairman Gensler, Chairman Schapiro, Governor Tarullo, Comptroller Walsh

   The risk retention notice of proposed rulemaking (NPR) includes a concept called "premium capture." As proposed, this would force securitization issuers to hold back all profit earned at the time a securitization was done, and force it to be held back until all bonds in the deal are paid off, which could be 15 or 30 years down the road. The reaction to this proposal has been negative, with concern that securitization won't happen if they cannot be profitable (just like any other business). Could you explain where this proposal came from, why it is expected that securitizers will essentially do their business without profit, why you supported it, and how you plan to fix it?

CLO: **#299**
CCS: **11-** 6538
RECVD: 6/16/11

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 21, 2011

The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, D.C. 20510

Dear Chairwoman:

Enclosed are my responses to the written questions you submitted following the June 15, 2011, hearing before the Senate Committee on Agriculture, Nutrition, and Forestry. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michael S. Gibson
Senior Associate Director
Division of Research and Statistics

Enclosure

Questions for Dr. Michael S. Gibson, Senior Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, from Chairwoman Stabenow:

1. The prudential regulators' margin rule would classify financial end users into high and low risk categories. Do prudential regulators have any reliable estimates of the number of "high-risk" financial end users identified by the proposed rule?

As noted in the notice of proposed rulemaking, the number of counterparties and the extent to which certain types of firms are likely to be counterparties are unknown. For this and other reasons, the Agencies have requested comment in the proposal regarding the quantitative impact of the proposed margin requirements, including with respect to the number and types of counterparties affected. With respect to persons likely to be classified as high-risk financial end users under the proposed rule, the Agencies expect that a large number of such persons will be hedge funds.

2. Is it your intent to apply margin to non-financial end users and their captive finance affiliates?

For swaps with a nonfinancial end user counterparty, the proposed rule would not specify a minimum margin requirement. Rather, it would allow a banking organization that is a dealer or major participant to establish a threshold, based on a credit exposure limit that is approved and monitored as part of the credit approval process, below which the end user would not have to post margin. The proposed rule would not impose any caps on the credit exposure limits for nonfinancial end user counterparties. In effect, the proposed rule would maintain the status quo for a bank swap dealer, where the dealer conducts due diligence on its counterparty, determines a credit exposure limit with respect to the counterparty that is consistent with the dealer's risk appetite and is documented in a credit support agreement, and does not require margin payments from the nonfinancial end user as long as the exposure remains below the limit.

Captive finance companies would be classified as nonfinancial end users under the proposed rule if they did not meet the proposed rule's definition of "financial end user" (e.g., by being predominantly engaged in financial activities).

3. Will the prudential regulators allow the flexible use of noncash collateral for purposes of margin as directed in the statute?

The proposed rule identifies a limited set of securities as eligible non-cash collateral for the initial and variation margin requirements, consistent with the statutory requirement that the rule permit non-cash collateral while preserving the "financial integrity of markets trading swaps" and the "stability of the United States financial system."

Non-cash collateral can be consistent with market integrity and financial stability when an appropriate haircut can be established. An appropriate haircut is one that is large enough so that if the counterparty defaults, the non-defaulting counterparty can sell the collateral at a price that offsets the cost of replacing the defaulted counterparty's swap positions. An appropriate haircut also takes account of the likelihood that the value of many types of non-cash collateral will be under stress when a derivatives counterparty defaults.

The notice of proposed rulemaking asked public commenters to respond to several questions about possible expansions of the set of eligible collateral, including how to determine an appropriate haircut. We will carefully consider the comments received in response to these and other questions posed in the proposed rulemaking when moving forward with a final rule.

Finally, it should be noted that collateral posted by non-financial end users for exposures below the credit exposure limit (as discussed in the answer to the previous question) is not limited to the set of eligible collateral in the proposed rule, because the proposed rule only applies to exposures above the credit exposure limit. Bank swap dealers would be free to continue to accept whatever collateral they currently accept from non-financial end users as long as the exposure stays below the credit exposure limit.

4. The OCC's Inspector General recently released an estimate of the potential cost of imposing margin on swap transactions. Do prudential regulators have any reliable estimates of the impact of Dodd-Frank on economic growth and job creation due to increased margin requirements?

Before moving ahead with a final rule, the Federal Reserve expects to use any information submitted by public commenters on the proposed rule to more precisely assess the costs and benefits of the margin requirements that are required under Dodd-Frank. It was not possible to make a precise estimate of the quantitative costs of the proposed margin rule prior to issuing it for comment for several reasons. First, there are many changes that are occurring in the derivatives market as a result of regulatory reform that will affect the cost of the margin rule, including uncertainty with respect to (i) which entities will be classified as swap dealers or major swap participants; (ii) the extent to which existing derivatives would be rolled-over or renewed; and (iii) the extent to which derivatives currently traded on an over-the-counter basis will move to central clearing. Second, there are a number of specific and technical aspects of the proposed rule that are difficult to assess without a large amount of highly detailed data on the size of derivative positions as well as the underlying rationale of bank swap dealers for maintaining those positions.

5. As the prudential regulators have noted, the definition of a financial end user is "substantially similar to, the definition of a financial entity that is ineligible to use the end user exemption from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act". While the proposed margin rule borrows from the Dodd-Frank Act's definition of financial entities, the definitions are not identical. Could you explain what "substantially similar" means in this context?

The proposed rule's definition of "financial end user," located as § __.2(h) of the proposed rule, contains seven prongs that, if met, would cause a person to be considered a financial end user for purposes of the proposed rule. The first four of these prongs, covering commodity pools, private funds, employee benefit plans, and persons predominantly engaged in financial activities, are identical to those used in the definition of "financial entity" for purposes of the mandatory clearing requirements added by sections 723 and 763 of the Dodd-Frank Act.

The latter three prongs of the proposed rule's definition are not included in the definition of "financial entity" for purposes of the mandatory clearing requirements. These prongs capture foreign commodity pools and private funds and foreign governments that the Agencies have proposed also to treat as financial end users, as well as any other entity that an Agency, in its discretion, designates as a financial end user for purposes of the proposed rule.

The definition of "financial entity" for purposes of the mandatory clearing requirements also contains two related provisions that are not included in the Agencies' proposed rule. First, the financial entity definition in sections 723 and 763 of the Dodd-Frank Act directs the CFTC and SEC to consider exempting small banks from the mandatory clearing requirement, savings associations, farm credit system institutions, and credit unions, which are otherwise covered by the definition because they are predominantly engaged in financial activities. Second, that financial entity definition includes a special "limitation" that excludes from the definition certain financing affiliates of commercial firms, if specified criteria are met.

6. The prudential regulators' margin rule would require all counterparties to document their "credit support arrangements." Would existing credit support arrangements meet the new requirements in the proposed rule and be deemed "appropriate"?

Whether an existing credit support arrangement would meet the requirements of the proposed rule will depend on the precise terms and conditions of that arrangement, in particular whether it specifies a covered swap entity's rights to collect initial and variation margin, the valuation methods for swaps, and dispute resolution procedures.

Senate Committee on Agriculture, Nutrition & Forestry
One Year Later-Wall Street Reform and Consumer Protection Act-Implementation of Title VII
June 15, 2011
Questions for the record
Dr. Michael Gibson

CLO: **#291**
CCS: **11-** 6429
RECVD: 6/24/11

Chairwoman Stabenow

1. The prudential regulators' margin rule would classify financial end users into high and low risk categories. Do prudential regulators have any reliable estimates of the number of "high-risk" financial end users identified by the proposed rule?

2. Is it your intent to apply margin to non-financial end users and their captive finance affiliates?

3. Will the prudential regulators allow the flexible use of noncash collateral for purposes of margin as directed in the statute?

4. The OCC's Inspector General recently released an estimate of the potential cost of imposing margin on swap transactions. Do prudential regulators have any reliable estimates of the impact of Dodd-Frank on economic growth and job creation due to increased margin requirements?

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6. The prudential regulators' margin rule would require all counterparties to document their "credit support arrangements." Would existing credit support arrangements meet the new requirements in the proposed rule and be deemed "appropriate"?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

September 25, 2011

The Honorable Jack Reed
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the written question you submitted following the June 15, 2011, hearing before the Senate Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michael R. Foley
Senior Associate Director
Division of Banking Supervision and Regulation

Enclosure

<u>Questions for Mr. Michael Foley, Senior Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Senator Reed:</u>

1. What is the purpose of the *Commercial Bank Examination Manual*? While certain sections were updated in April (which was identified as "Supplement 35"), it appears that there has been no comprehensive review and update of the entire manual. Does the Federal Reserve intend to conduct a comprehensive re-write of this manual?

The purpose of the *Commercial Bank Examination Manual* is to organize and formalize examination policies, objectives, and procedures that provide guidance to the examiner, and to enhance the quality of examinations and consistent application of examination processes and procedures. The manual also is intended to guide examiners in their efforts to encourage banks to improve their own internal risk management and compliance procedures, and to correct situations where there are deficiencies in, or a lack of compliance with, existing laws, regulations, supervisory guidance, or internal procedures.

The manual is not frequently rewritten because the extensive amount of time that this would take, coupled with a lengthy publication process, would result in the manual being substantially out of date. Instead, to keep the manual as current as possible, it is typically updated with semiannual supplements (in the spring and fall of each year), and special supplements may be issued if needed. For example, supplement 35, which updated nearly twenty sections, represented the 35^{th} update to the *Commercial Bank Examination Manual* since the most recent comprehensive rewrite in 1994. With each supplement, staff members in the Federal Reserve Board's Division of Banking Supervision and Regulation (BS&R) incorporate newly issued policies, guidance, legal interpretations, changes to regulations, and other supervisory material relevant to state member banks. In addition, BS&R staff members remove inactive information from the entire manual with each supplement.

CLO: #293
CCS: 11-6432
RECVD: 6/24/11

Enhancing Safety and Soundness: Lessons Learned and Opportunities for Continued Improvement
June 15, 2011

Questions for Mr. Michael Foley, Senior Associate Director, Banking Supervision and Regulation Division, Board of Governors of the Federal Reserve System, from Senator Reed:

1. What is the purpose of the *Commercial Bank Examination Manual?* While certain sections were updated in April (which was identified as "Supplement 35"), it appears that there has been no comprehensive review and update of the entire manual. Does the Federal Reserve intend to conduct a comprehensive re-write of this manual? Why or why not? _

CLO: #292
CCS: 11-6431
RECVD: 6/24/11

Enhancing Safety and Soundness: Lessons Learned and Opportunities for Continued Improvement
June 15, 2011

Questions for Mr. Michael Foley, Senior Associate Director, Banking Supervision and Regulation Division, Board of Governors of the Federal Reserve System, from Senator Merkley:

Question 1: Examination Staffing

Recent reports indicate the federal banking agencies are increasing their onsite examination teams at the largest banks. For each of the six largest banking organizations that your agency respectively supervises today, please detail: a) how many examiners you have had dedicated to supervising each such organization for each year beginning in 2005 through the present; b) whether those examiners resided on-site at the firm's headquarters permanently, whether those examiners resided on-site occasionally for examination periods, or whether those examiners remained at the agency (and if so, which office/Reserve Bank); and c) what the principal responsibilities of those examiners were (for example, data analysis of risk models, supervising management compliance with policies and procedures, etc.).

For those 6 largest banking organizations, please also quantify the number of personnel at each banking organization working in the risk management group, or the internal audit department.

Question 2: Examination Staffing

Please provide specific detail regarding the methodology you used/use for determining how many examiners you dedicate to firms you supervise. Please provide other information relevant to staffing levels and practices for your examinations, such as the FTE examination hours applicable per $10 billion of assets at the 10 largest banking organizations and the FTE examination hours applicable for $10 billion of assets at all other banking organizations.

Question 3: Examination Staffing

During the 2005 through 2010 period, please detail the dates on which peer reviews or other internal reviews were conducted within your organizations that evaluated the sufficiency of examination staffing for the six largest institutions under your supervision. Please state the staffing conclusions for each such peer review.

Enhancing Safety and Soundness: Lessons Learned and Opportunities for Continued Improvement
June 15, 2011

Question 4: Interagency Cooperation

Senior examiners have indicated that the largest banking organizations run their businesses without respect to the legal entity involved, and that specific business operations can straddle entities with different regulatory jurisdictions. In light of Dodd-Frank, how has the communication among agencies changed? When multiple regulators oversee a banking organization, what procedures do you have in place to review and follow-up on concerns raised by one regulator when such concerns may touch upon oversight conducted by other regulators or the entire firm?

Questions 5: Investigations

The HUD Inspector General has recently issued findings that at least one major financial institution has obstructed a state attorneys general investigation and a HUD investigation into foreclosure and servicing abuses. What specific steps have you taken to ensure that all institutions under your supervision are complying with both your supervision and with relevant investigations by other regulatory agencies and law enforcement officials?

Question 6: Documentation Oversight

Following the robo-signing scandal and the difficulty some banks have had documenting the claim of ownership on mortgages on which they are pursuing foreclosure, what steps have you taken to increase oversight of documentation requirements at large complex financial institutions?

Question 7: International

What systems do you have in place or do you envision needing to ensure the proper supervision of large complex foreign financial institutions which either operate in the U.S. or which materially affect U.S. financial markets?

Question 8: Trading Book

For the firms that now make up the six largest bank holding companies, what percentage of losses by those firms on a consolidated basis during the 2008 financial crisis were due to losses in their respective trading books as opposed to their banking books? Please include within that analysis assets which would have been losses had those assets not been transferred from the trading book to the banking book and therefore not subject to fair value accounting. Also include in those losses assets or positions that were placed on the books of that national bank, after the outbreak of the crisis, such as the liquidity puts that were used to bring back CDOs onto a bank's balance sheet.

Please provide relevant data/analysis as appropriate.

Question 9: Review of Trading Operations Under FRB Manuals

Section 2030.3 of the Federal Reserve's *Commercial Bank Examination Manual*, in effect since March 1994, lists certain specific procedures that examiners are expected to conduct in their supervision of commercial banks' trading operations. For example it asks examiners to "test for compliance with policies, practices, procedures, and internal controls. . . ." (#3); requests a series of schedules, including "an aged schedule of securities," "an aged schedule of trading account securities . . . held for trading or arbitrage purposes," "a schedule of loaned securities," etc. (#4); requests the examiner to "review customer ledgers, securities position ledgers, etc., and analyze the soundness of the bank's trading practices by . . . reviewing a representative sample of agency and contemporaneous principal trades . . . and reviewing significant inventory positions taken since the prior examination" (#9).

Today, some of the largest bank holding companies conduct their derivatives trading operations directly through Federal Reserve-regulated member banks. How frequently do examiners conduct the reviews directed by section 2030.3? Under what circumstances will you discipline an examination team for failing to follow policies and procedures set out in agency manuals – please describe up to three examples?

Enhancing Safety and Soundness: Lessons Learned and Opportunities for Continued Improvement
June 15, 2011

Question 10: Safety and Soundness Review of Trading Operations

The Federal Reserve *Trading and Capital Markets* manual sets out a wide range of approaches to monitoring firms' trading activities, in particular focusing on whether firms have in place policies and procedures to monitor risks. As part of this monitoring of risks, on what occasions might you make an independent evaluation of the trading positions themselves on a safety and soundness basis, rather than simply the policies and procedures regarding risk management?

For example, the former CEO of one large banking group said he couldn't be bothered with his firm's $43 billion dollar exposure on subprime CDOs because he had a $2 trillion balance sheet to manage. However, that $43 billion dollar exposure represented 1/3 of the group's capital. Meanwhile, community bank examiners regularly examine the substance of large loans for conformance with safety and soundness. Under what circumstances would a trading position such as the one outlined above be reviewed for the underlying risk by your examiners? Please detail at least three examples in the last five years.

How has oversight of trading activities changed between pre-financial crisis and now?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 21, 2011

The Honorable Saxby Chambliss
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the June 15, 2011, hearing before the Senate Committee on Agriculture, Nutrition, and Forestry. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michael S. Gibson
Senior Associate Director
Division of Research and Statistics

Enclosure

Questions for Dr. Michael S. Gibson, Senior Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, from Senator Chambliss:

1. Mr. Gibson, with respect to the CFTC's proposal regarding capital requirements for nonbank swap dealers, the CFTC states that they are prepared to recognize risk based Basel-consistent capital models currently recognized by the SEC and the Federal Reserve. What advice have you given to the CFTC regarding applying a capital regime resigned for banks to a commercial or other non-bank swap dealer?

Federal Reserve Board staff believe that Basel III capital rules generally would be appropriate to set a non-bank swap dealer's minimum capital requirement, and we have informally shared this view with CFTC staff.

Senate Committee on Agriculture, Nutrition & Forestry
One Year Later-Wall Street Reform and Consumer Protection Act-Implementation of Title VII
June 15, 2011
Questions for the record
Dr. Michael Gibson

CLO: **#294**
CCS: **11-**6430
RECVD: 6/24/11

Senator Saxby Chambliss

1. Mr. Gibson, with respect to the CFTC's proposal regarding capital requirements for nonbank swap dealers, the CFTC states that they are prepared to recognize risk based Basel-consistent capital models currently recognized by the SEC and the Federal Reserve. What advice have you given to the CFTC regarding applying a capital regime resigned for banks to a commercial or other non-bank swap dealer?
(Mike Gibson/Stephanie Martin)

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

August 16, 2011

The Honorable Blaine Luetkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the July 13, 2011, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Luetkemeyer:

1. Since 2008, the Federal Reserve has purchased several trillion dollars of U.S. Treasuries, many of which are still held by the bank. The credit markets have dictated in Europe that austere measures must be taken by the various troubled governments. If we do not get our fiscal house in order our own securities are likely to be downgraded. Considering the trillions of dollars of U.S. securities held by the bank, how will the solvency of the Federal Reserve be affected if this downgrade occurs?

The Federal Reserve currently holds about $1.6 trillion of Treasury securities and about $1 trillion of agency debt and mortgage-backed securities. Last year, income from its securities holdings totaled about $76 billion, and, after taking account of other sources of income and covering its costs, the Federal Reserve remitted more than $78 billion to the Treasury; more than $50 billion has been remitted to the Treasury so far this year. These securities are backed by the full faith and credit of the United States, so the Federal Reserve's portfolio holdings are essentially free of credit risk. Moreover, the credit rating of the Federal Reserve's securities holdings has no direct effect on Federal Reserve income or capital. It is worth noting that the decision by Standard and Poor's to downgrade the U.S. sovereign credit rating from AAA to AA+ does not appear to have led investors to become more concerned about the ability of the United States to meet its obligations. Indeed, the prices of Treasury securities have increased since the decision was announced on August 5.

That said, as I noted in testimony before the House Budget Committee earlier this year, the United States faces significant long-term fiscal challenges. The recent agreement to increase the debt limit included a number of steps to address these challenges, but even after those steps have been taken, the United States would remain on an unsustainable fiscal trajectory. The Congress and the Administration need to continue to work on a plan that would put the federal budget on a sustainable path over the long run, but in a way that does not put the current fragile recovery at risk.

2. The Federal Reserve recently extended the swap lines with the European Central Bank and other foreign central reserve banks. Simultaneously, we have seen the Eurozone plummet into a worsened situation, particularly in Greece, Ireland, Portugal, and Italy. What safeguards does the Federal Reserve have in place to protect U.S. assets and safeguard against exposure to future contagion? Is the United States in any danger of increased financial instability as a result of the worsening European situation?

The swap lines help improve liquidity conditions in U.S. and also foreign financial markets by providing foreign central banks the capacity to deliver U.S. dollar funding to institutions in their jurisdictions during times of market stress. Improved funding conditions in foreign dollar markets help guard against the spillover of volatility in foreign trading to U.S. money markets and thereby reduce funding pressures in our domestic markets. Thus, the swap lines help to prevent contagion to the United States. Without such action, we believe that there would be greater risk of increased financial instability in the United States should the European situation worsen further.

We judge our swap line exposures to be of the highest quality and safety. Each swap is a sale of dollars to a foreign central bank in exchange for foreign currency and a subsequent re-purchase of the dollars in exchange for the foreign currency at some point in the future. As a result, one important safeguard is the foreign currency held by the Federal Reserve during the term of the swap. Above and beyond that, our exposures are to the foreign central banks that draw on the lines, not to the institutions ultimately receiving the dollar liquidity in the foreign countries. We have longstanding relationships with these central banks, many of which hold substantial quantities of U.S. dollar reserves in accounts at the Federal Reserve Bank of New York, and these dealings provide a track record that justifies a high degree of trust and cooperation. The short tenor of the swaps, which ranges from overnight to three months at most, also offers some protection, in that positions could be wound down relatively quickly should circumstances warrant.

U.S. financial markets can be heavily influenced by European developments, as shown by recent market movements that were partly in response to fluctuating concerns over the European fiscal and financial situation. If the European situation were to worsen further, it could roil global financial markets and affect U.S. stock prices, credit spreads, and other financial variables. While U.S. financial institutions have relatively modest exposure to the European countries that are currently dealing with the biggest debt problems, they do have significant exposures to Europe more broadly and could experience financial losses were the situation in Europe to worsen significantly. As a consequence, we see it as important for U.S. financial institutions to continue to take steps to strengthen their financial positions so that they can better absorb any adverse shocks that might materialize, and we will continue to monitor developments in Europe closely.

CLO: #B - 226
CCS: 11-7708
RECVD: 7/26/11

Questions for the Record from
Rep. Blaine Luetkemeyer (MO-9)
Committee on Financial Services, U.S. House of Representatives

Hearing held on July 13, 2011, entitled
"Full Committee hearing to receive the testimony of Ben Bernanke, Chairman of the Federal Reserve Board of Governors, on the conduct of monetary policy and the state of the economy"

1. Since 2008, the Federal Reserve has purchased several trillion dollars of U.S. Treasuries, many of which are still held by the bank. The credit markets have dictated in Europe that austere measures must be taken by the various troubled governments. If we do not get our fiscal house in order our own securities are likely to be downgraded. Considering the trillions of dollars of U.S. securities held by the bank, how will the solvency of the Federal Reserve be affected if this downgrade occurs?

2. The Federal Reserve recently extended the swap lines with the European Central Bank and other foreign central reserve banks. Simultaneously, we have seen the Eurozone plummet into a worsened situation, particularly in Greece, Ireland, Portugal, and Italy. What safeguards does the Federal Reserve have in place to protect U.S. assets and safeguard against exposure to future contagion? Is the United States in any danger of increased financial instability as a result of the worsening European situation?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

February 16, 2012

The Honorable Charles Schumer
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the December 6, 2011, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Senator Schumer:</u>

1. The proposed regulatory framework under Section 619 of Dodd-Frank will certainly impact liquidity in the markets for many financial products to some degree. What analysis has been done to estimate the impact in various representative markets (e.g., corporate bonds)? What are the main elements of the proposed rules which you believe mitigate potential harm to market liquidity? To the extent the proposed rules contain such mitigating elements, do you believe those safeguards are adequate?

Section 619 of the Dodd-Frank Act prohibits proprietary trading, but provides an exemption for market making-related activities. The implementing rule proposed by the agencies contains the same market making exemption contained in the statute. Consistent with the statutory exemption for market making-related activities, the proposal is designed to permit firms to continue to engage in legitimate market-making activity and provide liquidity in all areas of the trading markets. The proposal is designed to take into account the fact that features of market making activities will vary depending on the type of asset involved and the relative liquidity of a particular market.

For example, the proposal offers a large number of metrics that are proposed to be developed over time and used for the purpose of helping banking firms and supervisors identify trading activity that warrants in-depth review. As explained in the interagency proposal, some metrics may be more useful for a given asset class than others, thereby allowing firms and the agencies flexibility in designing an approach that is most effective in meeting the statutory prohibitions in the Dodd-Frank Act and the exemption for market making-related activities. The agencies have also made clear in their proposal that we intend to take a gradual, heuristic approach to implementing and applying certain supervisory tools, such as metrics, that we have proposed to use to distinguish prohibited proprietary trading from permitted market making, revising and refining those tools during the conformance period so as to ensure they are appropriately tailored and do not chill market liquidity. The Federal Reserve and other rulemaking agencies have requested comment on the potential impact that particular parts of the rule might have on market liquidity and how any negative impacts might be minimized. We will carefully consider the public comments received on these points and take those comments into account, as appropriate, in crafting a final rule to implement section 619.

"Continued Oversight of the Implementation of the Wall Street Reform Act"
December 6, 2011

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Senator Schumer:

1. The proposed regulatory framework under Section 619 of Dodd-Frank will certainly impact liquidity in the markets for many financial products to some degree. What analysis has been done to estimate the impact in various representative markets (e.g., corporate bonds)? What are the main elements of the proposed rules which you believe mitigate potential harm to market liquidity? To the extent the proposed rules contain such mitigating elements, do you believe those safeguards are adequate?

CLO: **#403**
CCS: **11-** 13768
RECVD: 12/21/11

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

February 16, 2012

The Honorable Mike Crapo
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the December 6, 2011, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Senator Crapo:</u>

1. Last week the House Financial Services Committee passed unanimously a bill that exempts end-users from margin requirements. Proposed margin rules ignore the clear intent of Congress that margin should not be imposed on end-user transactions. Do you all agree that end-user hedging does not meaningfully contribute to systemic risk, that the economy benefits from their risk management activity and that they should be exempt from margin requirements, and are you working together to provide consistent rules to provide end-users with a clear exemption from margin requirements?

Although section 723 of the Dodd-Frank Act provides an explicit exemption for certain end users from the swap clearing requirement, there is no exemption from the margin requirement in section 731 or section 764 of the Act for a swap dealer's or major swap participant's (MSP's) swaps with end users. Sections 731 and 764 of the Act require the CFTC, SEC, Board, and other prudential regulators to adopt rules for swap dealers and MSPs imposing initial and variation margin requirements on all non-cleared swaps. The statute directs that these margin requirements be risk-based.

The prudential regulators' proposed rule implementing sections 731 and 764 follows the statutory framework and proposes a risk-based approach to imposing margin requirements for transactions with nonfinancial end users. Nonfinancial end users appear to pose minimal risks to the safety and soundness of swap dealers and to U.S. financial stability when they hedge commercial risks with derivatives and the related unsecured exposure remains below an appropriate credit exposure threshold. Accordingly, the proposed rule does not specify a minimum margin requirement for transactions with nonfinancial end users. Rather, the proposed rule, consistent with long-standing supervisory guidance, would permit a swap dealer to adopt, where appropriate, its own thresholds below which the swap dealer is not required to collect margin from counterparties that are nonfinancial end users. Such thresholds would be set forth in a credit support agreement and approved and monitored by the swap dealer as part of its own credit approval process.

In issuing the proposal, the prudential regulators requested comment on a number of questions related to the effect of the proposed margin requirements on nonfinancial end users, including whether alternative approaches are preferable. We have received a variety of comments from members of the public, including commercial firms that use swaps to hedge their risk. Some of these comments have raised concerns regarding aspects of the proposed rule that commenters believe (i) would be inconsistent with current market practices with respect to nonfinancial end users and/or (ii) would have a negative impact on commercial firms and their use of derivatives to hedge. The prudential regulators are carefully considering all comments, and coordinating with the CFTC and the SEC, as we evaluate the proposal in light of comments received and formulate a final rule, as required by statute.

"Continued Oversight of the Implementation of the Wall Street Reform Act"
December 6, 2011

<u>Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Senator Crapo:</u>

1. Last week the House Financial Services Committee passed unanimously a bill that exempts end-users from margin requirements. Proposed margin rules ignore the clear intent of Congress that margin should not be imposed on end-user transactions. Do you all agree that end-user hedging does not meaningfully contribute to systemic risk, that the economy benefits from their risk management activity and that they should be exempt from margin requirements, and are you working together to provide consistent rules to provide end-users with a clear exemption from margin requirements?

CLO: **#401**
CCS: **11-**137666
RECVD: 12/21/11

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

February 16, 2012

The Honorable Patrick Toomey
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the December 6, 2011, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Senator Toomey:</u>

1. **Under Dodd-Frank, the Volcker rule becomes effective on July 21, 2012 regardless of whether a rule is finalized. Banking entities then have 2 years to come into compliance – July 21, 2014.**

- **The proposed rule requires conformance "as soon as practicable" after July 21, 2012. Is that consistent with the statute which gives banking entities a full 2 years to come into compliance? What do you mean by "as soon as practicable?" How do banks plan around "as soon as practicable?"**

- **If the Volcker rule takes effect near or after July 21, 2012, will you give banking entities a reasonable amount of time to digest and come into compliance with the final rule?**

- **As written, the proposed interagency rule to implement the so-called "Volcker Rule" would impose new and very substantial and costly compliance burdens on many banks that do not have a standalone proprietary trading desk or substantial fund investments, and never have. Specifically, the proposed rule would require these institutions to establish, at a minimum, policies and procedures designed to prevent the occurrence of activities in which the institution is not engaged – in other words, the regulatory equivalent of proving a negative. It sounds to me like that could be a very costly undertaking for an institution that was never the intended target of the Volcker Rule. But more importantly, this makes even less sense given the economic challenges we face and the need to direct resources toward capital planning and lending.**

Can you comment on why this is necessary? Is there a less onerous way to implement the permitted activities?

The Dodd-Frank Act required the Federal Reserve to issue a final rule implementing the various conformance periods for activities and investments prohibited by the Volcker Rule by January 21, 2011 – a date long before the proposal implementing the substantive provisions of the Volcker Rule was due or proposed. In its final rule establishing the conformance periods, the Federal Reserve explained that it would revisit the conformance period rule in light of the requirements of the final rule implementing the substantive provisions of the Volcker Rule. In doing so, the Federal Reserve will carefully consider your suggestions – which have also been noted by other commenters.

In formulating the proposed rule, the agencies sought to limit the potential impact of the proposed rule on small banking entities and banking entities that engage in little or no activity prohibited by the Volcker Rule provisions of the Dodd-Frank Act. In particular, the agencies proposed to reduce the effect of the proposed rule on these banking entities by limiting the application of the reporting, recordkeeping, and the compliance program requirements of the proposed rule, to those banking entities that engage in little or no covered trading activities or covered fund activities and investments. The agencies also requested comment on a number of questions related to the costs and burdens associated with particular aspects of the proposal, as well as on any significant alternatives that would minimize the impact of the proposal on small banking entities. The Federal Reserve will carefully consider the public comments received on these points and take those comments into account in crafting a final rule consistent with the statute.

2. **FSOC's proposed guidance will initially screen nonbanks for systemic relevance on the same $50bn threshold for banks.**

- **How is this appropriate for the investment fund industry, where assets are managed not owned, and frequently in multiple funds none of which is $50bn but you have to add several funds together to get to the $50bn number?**

The FSOC has acknowledged in various statements that the same measurements of the size of an organization may not be appropriate for identifying the risk that organizations in different industries pose to the financial system. Indeed, in the preamble to its second notice of proposed rulemaking and proposed interpretive guidance, the FSOC recognized the need for further analysis of appropriate metrics for identifying the potential systemic risks posed by asset management companies and indicated its intent to consider whether asset management companies could in fact pose a threat to U.S. financial stability, the extent of any such threats, and whether such threats could be mitigated by subjecting these companies to Board supervision and prudential standards, or whether these threats would be better mitigated through other regulatory measures. The FSOC indicated that it may develop additional metrics and thresholds more appropriate for identifying asset management companies for further review.[1]

The FSOC also specifically noted that because a limited amount of data is currently available about hedge funds and private equity firms, it may establish additional metrics or thresholds tailored to evaluate these firms once these firms are required to provide data about their operations to the Securities and Exchange Commission, beginning in 2012, and this data becomes available for evaluation by the FSOC.

As a member agency of the FSOC, the Board is continuing to work with the FSOC and its member agencies to establish a methodology to identify systemically important nonbank financial companies.

[1] See 76 FR 64264 (2011).

"Continued Oversight of the Implementation of the Wall Street Reform Act"
December 6, 2011

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Senator Toomey:

1. Under Dodd-Frank, the Volcker rule becomes effective on July 21, 2012 regardless of whether a rule is finalized. Banking entities then have 2 years to come into compliance – July 21, 2014.

- The proposed rule requires conformance "as soon as practicable" after July 21, 2012. Is that consistent with the statute which gives banking entities a full 2 years to come into compliance? What do you mean by "as soon as practicable?" How do banks plan around "as soon as practicable?"

- If the Volcker rule takes effect near or after July 21, 2012, will you give banking entities a reasonable amount of time to digest and come into compliance with the final rule?

- As written, the proposed interagency rule to implement the so-called "Volcker Rule" would impose new and very substantial and costly compliance burdens on many banks that do not have a standalone proprietary trading desk or substantial fund investments, and never have. Specifically, the proposed rule would require these institutions to establish, at a minimum, policies and procedures designed to prevent the occurrence of activities in which the institution is not engaged – in other words, the regulatory equivalent of proving a negative. It sounds to me like that could be a very costly undertaking for an institution that was never the intended target of the Volcker Rule. But more importantly, this makes even less sense given the economic challenges we face and the need to direct resources toward capital planning and lending.

  Can you comment on why this is necessary? Is there a less onerous way to implement the permitted activities?

2. FSOC's proposed guidance will initially screen nonbanks for systemic relevance on the same $50bn threshold for banks.

   - How is this appropriate for the investment fund industry, where assets are managed not owned, and frequently in multiple funds none of which is $50bn but you have to add several funds together to get to the $50bn number?

CLO: **#402**
CCS: **11-**
RECVD: 12/21/11

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

February 16, 2012

The Honorable Richard Shelby
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the December 6, 2011, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Ranking Member Shelby:</u>

1. **Governor Tarullo, the Federal Reserve has recently started taking steps towards greater transparency. For example, the Fed has begun holding press conferences following monetary policy meetings. According to press reports, the Fed will next unveil a new communications policy to improve the clarity of its monetary policy objectives.**

- **Will the Fed's movement toward transparency be extended to the Fed's bank supervision?**

- **What steps could the Fed take to make it easier for Congress and the public to assess the Fed's regulation of banks?**

In 2011, the Federal Reserve initiated steps designed to provide greater transparency around our supervision and regulation of the largest, most complex, and systemically critical institutions. A key objective of our supervisory program for these institutions is to ensure they have adequate capital and liquidity to conduct their operations in a safe and sound manner and to make the adequacy of their capital and liquidity positions transparent to the public. An example of our effort to increase transparency is in the area of our Comprehensive Capital Analysis and Review (CCAR).

The CCAR is a broad supervisory exercise that considers a range of factors that could impact the capital adequacy of these institutions including their internal capital planning process, capital distribution policies, pro forma, post-stress capital ratios, and projected path to compliance with the revised Basel Committee on Bank Supervision regulatory capital standards. Recently, we implemented a capital plan rule that explains our supervisory process for assessing the capital adequacy of CCAR institutions, developed standardized publicly available forms and instructions that identify the specific information we require these institutions to submit, published papers on the CCAR process, and disclosed information on the economic scenarios used in the exercise. We intend to further increase CCAR transparency by providing the public with meaningful summary information on the 2012 CCAR results without violating our commitment to ensure the integrity of confidential supervisory information. As we implement our revised supervisory approach for assessing the liquidity plans of these institutions, we will endeavor to provide a similar level of transparency.

These types of actions are intended to make it easier for Congress and the public to obtain a clear understanding of the effectiveness of our supervisory program without jeopardizing the integrity of the process or disclosing confidential information that would place U.S. institutions at a competitive disadvantage to their international competitors. The Federal Reserve believes a similar level of transparency would be beneficial at systemically critical institutions located in other jurisdictions and is actively working through organizations such as the Basel Committee and the Financial Stability Board to achieve this objective.

2. **The agencies have submitted a proposed Volcker rule with over 1,300 questions, making it more of a concept release than a proposed rule. Additionally, the CFTC has not yet proposed its version of the Volcker Rule and might offer a competing version.**

- **Given the complexity of the issues involved and that the CFTC has not signed on, do you anticipate extending the comment period?**

- **Do you anticipate doing a re-proposal?**

On December 23, 2011, the Federal Reserve, FDIC, OCC and SEC each acted to extend for an additional 30 days, until February 13, 2012, the public comment period on the proposal to implement section 619 of the Dodd-Frank Act. On January 11, 2012, the CFTC sought public comments on a proposal to implement section 619 of the Dodd-Frank Act that is substantively the same as the proposal published by the Federal Reserve and the other agencies. The Federal Reserve and other agencies will carefully consider the public comments received and take those comments into account in crafting a final rule to implement section 619.

3. **The agencies missed the October 18th statutory deadline for adopting a final Volcker rule, and despite agency delays, the rule is still scheduled to go into effect in July 2012. The Dodd-Frank Act had contemplated at least a nine month timeframe of advance preparation for compliance.**

- **Do you believe there will be sufficient time for banking entities to adjust to all of the changes imposed by the rule?**

- **Would it make sense to phase in the implementation of the rule, so as to identify potential market disruptions caused by any single element of the rule?**

- **There is ample precedent for a phase-in, such as implementation of Regulation NMS. Do you believe the Volcker Rule calls for a similar phased-in approach?**

As part of the proposed rule, the Federal Reserve and other rule-writing agencies requested comment on potential alternative approaches for compliance with the proposed rule. The proposal specifically requested comment regarding whether a phased-in approach would be more effective than the approach contained in the proposed rule. The Federal Reserve and other agencies will carefully consider all public comments regarding this matter in crafting a final rule to implement section 619.

In addition, the Dodd-Frank Act required the Federal Reserve to issue a final rule implementing the various conformance periods for activities and investments prohibited by the Volcker Rule by January 21, 2011 – a date long before the proposal implementing the substantive provisions of the Volcker Rule was due or proposed. In its final rule establishing the conformance periods, the Federal Reserve explained that it would revisit the conformance period rule in light of the requirements of the final rule implementing the substantive provisions of the Volcker Rule. In doing so, the Federal Reserve will carefully consider your suggestions – which have also been noted by other commenters.

In formulating the proposed rule, the agencies sought to limit the potential impact of the proposed rule on small banking entities and banking entities that engage in little or no activity prohibited by the Volcker Rule provisions of the Dodd-Frank Act. In particular, the agencies proposed to reduce the effect of the proposed rule on these banking entities by limiting the application of the reporting, recordkeeping, and the compliance program requirements of the proposed rule, to those banking entities that engage in little or no covered trading activities or covered fund activities and investments. The agencies also requested comment on a number of questions related to the costs and burdens associated with particular aspects of the proposal, as well as on any significant alternatives that would minimize the impact of the proposal on small banking entities. The Federal Reserve will carefully consider the public comments received on these points and take those comments into account in crafting a final rule consistent with the statute.

CLO: #400
CCS: 11-13765
RECVD: 12/21/11

"Continued Oversight of the Implementation of the Wall Street Reform Act"
December 6, 2011

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Ranking Member Shelby:

1. Governor Tarullo, the Federal Reserve has recently started taking steps towards greater transparency. For example, the Fed has begun holding press conferences following monetary policy meetings. According to press reports, the Fed will next unveil a new communications policy to improve the clarity of its monetary policy objectives.

- Will the Fed's movement toward transparency be extended to the Fed's bank supervision?
- What steps could the Fed take to make it easier for Congress and the public to assess the Fed's regulation of banks?

2. The agencies have submitted a proposed Volcker rule with over 1,300 questions, making it more of a concept release than a proposed rule. Additionally, the CFTC has not yet proposed its version of the Volcker Rule and might offer a competing version.

- Given the complexity of the issues involved and that the CFTC has not signed on, do you anticipate extending the comment period?
- Do you anticipate doing a re-proposal?

3. The agencies missed the October 18th statutory deadline for adopting a final Volcker rule, and despite agency delays, the rule is still scheduled to go into effect in July 2012. The Dodd-Frank Act had contemplated at least a nine month timeframe of advance preparation for compliance.

- Do you believe there will be sufficient time for banking entities to adjust to all of the changes imposed by the rule?
- Would it make sense to phase in the implementation of the rule, so as to identify potential market disruptions caused by any single element of the rule?
- There is ample precedent for a phase-in, such as implementation of Regulation NMS. Do you believe the Volcker Rule calls for a similar phased-in approach?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

October 5, 2012

The Honorable Jeff Sessions
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the February 7, 2012, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Sessions:</u>

Over the last three years, the Federal Reserve has lent out trillions of dollars at fixed interest rates that won't be paid back for long periods of time. At the same time the Fed borrows money at changing interest rates over short periods of time.

1. What will happen if interest rates go up?

See response to question 2.

2. Won't the Fed lose money?

In response to the financial crisis that emerged in the summer of 2007, the Federal Reserve implemented a number of lending programs designed to support the liquidity of financial institutions and foster improved conditions in financial markets. After conditions in financial markets improved, however, these programs were wound down, and almost all of the loans have been repaid. Thus, Federal Reserve lending is unlikely to be a source of concern for income in coming years.

Beginning in late 2008, the Federal Reserve has purchased longer-term securities in an effort to ease overall financial conditions and to support a stronger economic recovery. These purchases have resulted in an increase in the quantity of reserve balances in the banking sector. (When the Federal Reserve purchases a security, it credits the account of the bank of the entity from whom it purchased the security, thus increasing reserve balances.) Because the rate earned on the Federal Reserve's securities holdings is above the rate the Federal Reserve pays on reserves, Federal Reserve income has increased significantly as its securities holdings have increased. After covering its costs and making adjustments to capital, the Federal Reserve remits its income to the Treasury. Over the 2009-11 period, such remittances totaled more than $200 billion, well above the usual level of remittances prior to the financial crisis.

As discussed in the minutes of the June 2011 FOMC meeting, at the appropriate time, the Federal Reserve will begin to remove policy accommodation and normalize the size and composition of its balance sheet. As part of this process, the Federal Reserve will likely raise the rate it pays on reserves to put upward pressure on short-term interest rates and also sell securities at a gradual pace over time. As short-term interest rates move higher, the Federal Reserve's interest expense on reserve balances will rise and the possibility of some realized losses on sales of securities could lead to lower Federal Reserve net income. Nonetheless, the odds are strong that the Fed's asset purchase programs, both through their net interest earnings and by strengthening the overall economy, will help reduce rather than increase the federal deficit and debt.

Questions for the Record
Senator Sessions
The Honorable Ben S. Bernanke
The Outlook for U.S. Monetary and Fiscal Policy
Tuesday, February 7, 2012
Senate Budget Committee

Questions:

Over the last three years, the Federal Reserve has lent out trillions of dollars at fixed interest rates that won't be paid back for long periods of time. At the same time the Fed borrows money at changing interest rates over short periods of time.

1. What will happen if interest rates go up?
2. Won't the Fed lose money?

CLO:	#B - 110
CCS:	12-63666
RECVD:	9/18/12

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

October 5, 2012

The Honorable Sheldon Whitehouse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the written question you submitted following the February 7, 2012, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Question for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Whitehouse:</u>

<u>Question</u>: Last week, I introduced legislation that would require the highest-earning Americans to pay an effective federal tax rate of at least 30%. This minimum would be phased in between $1 million and $2 million of adjusted gross income. As you may know, only about 0.1% of taxpayers earn over $1 million, so 99.9% would not be affected by my bill - the Paying a Fair Share Act (S. 2059). We are awaiting an official revenue estimate from JCT, but outside groups have estimated the bill would generate tens of billions of dollars a year in revenue. If that is correct, would you expect it to have a significant impact on our deficits and borrowing costs? I expect many of my Republican colleagues will oppose the bill reasoning it would hinder job creation by taxing "job creators." Is there any evidence to support the theory that requiring those at the very top to pay a 30% tax rate would lead them to behave in a way that would create fewer jobs? Is there any evidence that increases in the top marginal tax rate during the 1990s hindered job creation?

<u>Answer</u>: I believe that it is appropriate for me to leave it to the Congress and the President to make the judgments about what specific actions are most appropriate in regard to tax and budget policies. However, it is clear that the decisions made about the size and the structure of the federal tax system have important consequences on the performance of the economy, fairness, and the size of government. These decisions entail balancing many factors to implement policies that reflect our values and priorities as a nation. In regard to economic performance, a basic principle of public finance is that the economic efficiency of a tax system can usually be enhanced if tax rates can be kept as low as possible while at the same time making the tax base as broad as is feasible in order to raise the necessary amount of revenue. Tax reforms that lower effective tax rates could provide tangible economic benefits by improving incentives to work, save, hire, and invest.

Questions for the Record
By Senator Sheldon Whitehouse
February 7, 2012
Senate Budget Committee

For Chairman Bernanke:

Last week, I introduced legislation that would require the highest-earning Americans to pay an effective federal tax rate of at least 30%. This minimum would be phased in between $1 million and $2 million of adjusted gross income. As you may know, only about 0.1% of taxpayers earn over $1 million, so 99.9% would not be affected by my bill – the Paying a Fair Share Act (S. 2059). We are awaiting an official revenue estimate from JCT, but outside groups have estimated the bill would generate tens of billions of dollars a year in revenue. If that is correct, would you expect it to have a significant impact on our deficits and borrowing costs? I expect many of my Republican colleagues will oppose the bill reasoning it would hinder job creation by taxing "job creators." Is there any evidence to support the theory that requiring those at the very top to pay a 30% tax rate would lead them to behave in a way that would create fewer jobs? Is there any evidence that increases in the top marginal tax rate during the 1990s hindered job creation? R&S

CLO:	**#B - 109**
CCS:	**12-**6365
RECVD:	9|18|12

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

June 29, 2012

The Honorable Carolyn McCarthy
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the January 18, 2012, hearing before the Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Representative McCarthy:</u>

Following up on a question that my colleague Mr. Watt asked with regard to the Dodd-Frank Act statute as it applies to the insurance industry, exempting them from proprietary trading but ambiguity as to whether the industry is exempt from the ban on investing in securities defined as "covered funds."

My understanding from my colleague's inquiry as well as your responses is that there is a clear exemption for the business of insurance for trading, but not for investments, and you will use the feedback from the industry to determine if they should be exempt.

My question to you both is two-fold:

1. What would be the public policy reason for not extending the exemption given that state investment laws applied to insurance companies domiciled in that state already impose limitations on the categories of investments that insurance companies may hold?

2. Do you have the statutory authority to exempt the business of insurance from covered fund investment restrictions?

Section 619 of the Dodd-Frank Act itself provides an exemption for the purchase, sale, acquisition, or disposition of specified financial products by a regulated insurance company directly engaged in the business of insurance for the general account of the company, so long as the enumerated criteria are satisfied. Additionally, the statute provides a separate exemption that authorizes the Federal Reserve, the OCC, FDIC, SEC, and CFTC to permit additional activities if it is determined they would promote and protect the safety and soundness of banking entities and the financial stability of the United States. The Federal Reserve has received comments on the treatment of insurance company's interests in covered funds and is carefully considering these comments in crafting a final rule consistent with the statute.

Questions for the Record: Joint Capital Markets Subcommittee & Financial Institution Subcommittees Hearing
"Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
January 18, 2012
Rep. Carolyn McCarthy (NY-04)

Panel 1: Governor Tarullo and Chairwoman Shapiro-

Following up on a question that my colleague Mr. Watt asked with regard to the Dodd-Frank Act statute as it applies to the insurance industry, exempting them from proprietary trading but ambiguity as to whether the industry is exempt from the ban on investing in securities defined as "covered funds".

My understanding from my colleague's inquiry as well your responses is that there is a clear exemption for the business of insurance for trading, but not for investments, and you will use the feedback from the industry to determine if they should be exempt.

My question to you both is two-fold:

1. What would be the public policy reason for not extending the exemption given that state investment laws applied to insurance companies domiciled in that state already impose limitations on the categories of investments that insurance companies may hold?

2. Do you have the statutory authority to exempt the business of insurance from covered fund investment restrictions?

CLO: #23
CCS: 12-1465
RECVD: 2/24/12

Carolyn McCarthy

Panel 2: All Witnesses-

1. I have had meetings with many stakeholders on this issue, and while I have a good sense of the areas of concern, not much has been offered as solutions.

    a. What are some proposed changes and revisions the regulators should think about as they seek to finalize the rule?

2. Do you feel substantive changes that may be necessary as a result of stakeholder feedback on the hundreds of questions within the proposed rule?

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 29, 2012

The Honorable Gary Peters
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the January 18, 2012, hearing before the Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Representative Peters:</u>

Many observers have raised concerns that the Volcker Rule could lead to a decrease in market liquidity because banks would be wary of holding large inventories of certain types of assets. There has also been speculation that if banks are unable to engage in as much market making activity, that other actors or new entrants could find an economic incentive to engage in market making. My questions for the witnesses are:

- **Do you agree that covered entities may decrease market making activity?**
- **If, so do you believe that other parties will step forward to provide liquidity.**
- **If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to provide the liquidity necessary for well-functioning markets, and what kinds of regulatory scrutiny are those institutions subject to?**
- **Are there any negative consequences that can be anticipated from this change?**

Section 619 of the Dodd-Frank Act prohibits proprietary trading, but provides an exemption for market making-related activities. The implementing rule proposed by the agencies contains the same market making exemption contained in the statute. Consistent with the statutory exemption for market making-related activities, the proposal is designed to permit firms to continue to engage in market-making activity and provide liquidity in all areas of the trading markets.

The proposal is designed to take into account the fact that features of market making activities will vary depending on the type of asset involved and the relative liquidity of a particular market. For example, the proposal suggested a number of metrics for the purpose of helping banking firms and supervisors identify trading activity that warrants in-depth review to ensure compliance with the prohibition on proprietary trading. As explained in the interagency proposal, some metrics may be more useful for a given asset class than others, thereby allowing firms and the agencies flexibility in designing an approach that is most effective in meeting the statutory prohibitions in the Dodd-Frank Act and the exemption for market making-related activities. The Federal Reserve and other rulemaking agencies have requested comment on the potential impact that particular parts of the rule might have on market liquidity and how any negative impacts might be minimized. We will carefully consider the public comments received on these points and take those comments into account in crafting a final rule to implement section 619.

Questions for the Record Submitted by Rep. Gary Peters
"Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
January 18, 2012

Question for:

- The Hon. Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System
- The Hon. Mary Schapiro, Chairman, Securities and Exchange Commission
- The Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission
- The Hon. Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation
- Mr. John Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency
- Mr. Anthony J. Carfang, Partner, Treasury Strategies, on behalf of the U.S. Chamber of Commerce
- Mr. Douglas J. Elliott, Fellow, Economic Studies, The Brookings Institution
- Mr. Scott Evans, Executive Vice President, President of Asset Management, TIAA-CREF
- Prof. Simon Johnson, Ronald A. Kurtz (1954) Professor of Entrepreneurship, MIT Sloan School of Management
- Mr. Alexander Marx, Head of Global Bond Trading, Fidelity Investments
- Mr. Douglas J. Peebles, Chief Investment Officer and Head of Fixed Income, AllianceBernstein, on behalf of the Securities Industry and Financial Markets Association Asset Management Group
- ~~Mr. Mark Standish, President and Co-CEO, RBC Capital Markets, on behalf of the Institute~~ of International Bankers
- Mr. Wallace Turbeville, on behalf of the Americans for Financial Reform

Thank you for your appearance before the January 18, 2012, House Financial Services Subcommittees on Capital Markets and Government Sponsored Enterprises and, Financial Institutions and Consumer Credit joint hearing entitled, "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation." To follow up on the discussion, I would like to submit questions to the aforementioned witnesses and have the answers included in the official hearing record.

I support the goals of Section 619 of the law, otherwise known as the "Volcker Rule," which was included in the Dodd Frank Act to prohibit banks that have access to taxpayer funds from putting these funds at risk for their own benefit, or simply shift these proprietary trading operations to a separate entity under its control by investing in or sponsoring hedge funds and private equity funds.

Many observers have raised concerns that the Volcker Rule could lead to a decrease in market liquidity because banks would be wary of holding large inventories of certain types of assets. There has also been speculation that if banks are unable to engage in as much market making activity, that other actors or new entrants could find an economic incentive to engage in market making. My questions for the witnesses above witnesses are:

- Do you agree that covered entities may decrease market making activity?

CLO: **#19**
CCS: **12-** 1461
RECVD: 2/24/12

- If so, do you believe that other parties will step forward to provide liquidity?
- If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to provide the liquidity necessary for well functioning markets, and what kind of regulatory scrutiny are those institutions subject to?
- Are there any negative consequences that can be anticipated from this change?

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 12, 2012

The Honorable Bill Huizenga
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the January 18, 2012, hearing before the Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K Tarullo

Enclosure

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Representatives Huizenga and Peters:

1. Because of its ownership interest in EnerBank, CMS Energy would be considered a "banking entity" under the proposed Volcker Rule. Furthermore, an investor that owns as little as five percent of CMS Energy could also become subject to the Volcker Rule. This could create a significant disincentive for institutional investors to invest in CMs Energy. We would like to know whether the regulators have proposed the Volcker Rule are aware of the problem outlines above, and if so, could it be addressed in revisions to the proposed rule?

2.. The proposed Volcker Rule appears to apply to commercial companies that own a thrift or an industrial loan company, as well as all of the companies in which these covered entities may have a significant investment that makes the recipient of the investment an "affiliate." While the Volcker Rule was designed to limit risks at insured depositories so that banks wouldn't be using government insured deposit funds to gamble through proprietary trading or fund investing, it appears that it will also cover all sorts of industrial and commercial companies that are in some way affiliated with a depository. Do the regulators believe that non-financial companies should be subject to the same restrictions as financial entities? What kind of enforcement and examination regime would regulators impose on non-financial entities that are required to comply with the Volcker Rule because of their affiliation with a financial entity?

The prohibitions and restrictions of section 619 of the Dodd-Frank Act apply by their terms not only to insured depository institutions (e.g., insured banks, savings associations, industrial loan companies), but also to any affiliate or subsidiary of an insured depository institution, without regard to the nature of activities (e.g., financial or commercial) in which the affiliate or subsidiary engages. See Section 619(h)(1) of the Dodd-Frank Act. The joint proposal issued by the Federal Reserve, OCC, FDIC, and SEC requested comment on a wide variety of issues, including with respect to the definition of "banking entity." The Federal Reserve is carefully reviewing comments received on these issues, and we are considering these comments as we work to finalize implementing rules.

Questions for the Record Submitted by Rep. Bill Huizenga and Rep. Gary Peters
"Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
January 18, 2012

- The Hon. Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System
- The Hon. Mary Schapiro, Chairman, Securities and Exchange Commission
- The Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission
- The Hon. Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation
- Mr. John Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency

Thank you for your appearance before the January 18, 2012, House Financial Services Subcommittees on Capital Markets and Government Sponsored Enterprises and, Financial Institutions and Consumer Credit joint hearing entitled, "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation." To follow up on the discussion, we would like to submit questions to the aforementioned witnesses and have the answers included in the official hearing record.

Both questions concern the impact that the Volcker Rule will have on CMS Energy, a company that provides energy to approximately 6.8 million of Michigan's 10 million residents. CMS Energy, which has roughly $16 billion in total assets, owns a $500 million, FDIC-insured industrial bank based in Salt Lake City, Utah, called EnerBank. EnerBank makes home ~~improvement loans nationwide through referrals from home remodeling contractors who have no~~ other connection to the bank or CMS. This year, EnerBank will make more than $600 million in consumer loans to households nationwide for home-improvement projects that will support thousands of contractors and the manufacturers that provide materials for the jobs. EnerBank does not engage in proprietary trading and it does not sponsor or invest in private equity funds.

Question 1:

Because of its ownership interest in EnerBank, CMS Energy would be considered a "banking entity" under the proposed Volcker Rule. Furthermore, an investor that owns as little as five percent of CMS Energy could also become subject to the Volcker Rule. This could create a significant disincentive for institutional investors to invest in CMS Energy. We would like to know whether the regulators who have proposed the Volcker Rule are aware of the problem outlined above, and if so, could it be addressed in revisions to the proposed rule?

Question 2:

The proposed Volcker Rule appears to apply to commercial companies that own a thrift or an industrial loan company, as well as all of the companies in which these covered entities may have a significant investment that makes the recipient of the investment an "affiliate." While the Volcker Rule was designed to limit risks at insured depositories so that banks wouldn't be using government insured deposit funds to gamble through proprietary trading or fund investing, it appears that it will also cover all sorts of industrial and commercial companies that are in some way affiliated with a depository. Do the regulators believe that non-financial companies should be subject to the same restrictions as financial entities? What kind of enforcement and examination regime would regulators impose on non-financial entities that are required to comply with the Volcker Rule because of their affiliation with a financial entity?

CLO: #20
CCS: 12-1462
RECVD: 2/24/12

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 29, 2012

The Honorable Spencer Bachus
Chairman
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the January 18, 2012, hearing before the Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

Response to Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Chairman Bachus:

Section 1

1. Section 619(b)(2) of the Dodd-Frank Act itself divides authority for developing and adopting regulations to implement its prohibitions and restrictions between the Federal Reserve, the OCC, FDIC, SEC, and CFTC based on the type of entities for which each agency is explicitly charged or is the primary financial regulatory agency. The statute also requires these agencies, in developing and issuing implementing rules, to consult and coordinate with each other for the purposes of assuring that such rules are comparable and to provide for consistent application and implementation. Under the statutory framework, the CFTC is the primary federal regulatory agency with respect to a swap dealer and the SEC is the primary financial regulatory agency with respect to a security-based swap dealer; the Federal Reserve is explicitly charged with issuing regulations with respect to companies that control an insured depository institution, including bank holding companies. The OCC, Federal Reserve, and FDIC must jointly issue rules to implement section 619 with respect to insured depository institutions.

To enhance uniformity in both rules that implement section 619 and administration of the requirements of section 619, the Federal Reserve, OCC, FDIC, SEC and CFTC have been regularly consulting with each other in the development of rules and policies that implement section 619. The rule proposed by the agencies to implement section 619 contemplates that firms will develop and adopt a single, enterprise-wide compliance program and that the agencies would strive for uniform enforcement of section 619. We are carefully considering the public comments received on these points and will take those comments into account in crafting a final rule to implement section 619.

Section 2

1. Section 619 of the Dodd-Frank Act generally prohibits banking entities from engaging in proprietary trading for the purpose of profiting from short-term price movements, and from acquiring or retaining interests in, or having certain relationships with, hedge funds and private equity funds. In each case the statute explicitly provides certain exemptions from these prohibitions, as well as limitations on permitted activities.

Appropriate and effective implementation of the Act is a high priority for the Federal Reserve. As you note, the Federal Reserve, the OCC, the FDIC, SEC, and CFTC have issued proposed rulemakings to implement section 619; as part of those rulemakings, the agencies met with many interested representatives of the public, including banking firms, trade associations and consumer advocates, and provided an extended period of time for the public to submit comment to the agencies regarding the proposal. The agencies have received over 17,000 comments addressing a wide variety of aspects of the proposal, including each of the issues raised in your questions. The agencies are carefully reviewing those comments and considering the suggestions and issues they raise in light of the statutory restrictions and provisions. We will carefully consider the issues raised by your questions as we continue to review all comments submitted in implementing these important provisions.

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Chairman Bachus:

Section 1

1. Congress enacted the Volcker Rule as a provision of the Bank Holding Company (BHC) Act and the Federal Reserve is generally vested with the exclusive authority to implement the provisions of the BHC Act and is given broad rulemaking, examination, enforcement and supervisory powers by that legislation. The legislative history to the Dodd-Frank Act indicates that the Board should "coordinate with other Federal and state regulators of subsidiaries of [a] holding company, to the fullest extent possible, to avoid duplication of examination activities, reporting requirements, and requests for information".

The witnesses gave seemingly conflicting statements about the supervisory and enforcement framework for Volcker. Chairman Gensler noted his authority to supervise swap dealers; Governor Tarullo noted that the Fed has "primary" authority and other regulators have "backup" authority. What does this explanation mean? Which agency will have examiners ensuring compliance at the Swap Dealer or Security-based Swap Dealer; the Federal Reserve, the SEC or the CFTC? Why would the Federal Reserve not be responsible for comprehensive compliance and inform enforcement as the primary regulator? What policy objective is being achieved by having multiple agencies supervise and enforce, since having multiple regulators technically responsible for examination and enforcement, no regulator would be clearly responsible or accountable for compliance?

Section 2

1. Since the "intent" of a trader cannot be determined, regulators have proposed seventeen metrics to deploy to gauge whether an institution is hiding proprietary trading within a market making desk. Since the proposed rule consistently notes that the quantitative measurements are designed for identifying trading activity that warrants additional scrutiny, why do the metrics not at the same time make evident that the activity tested is complying with the rule? What purpose are the metrics intended to serve?

2. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding why the proposal's market making-related activity assumes that markets themselves are highly liquid and open to a wide array of end users when market making is in fact a highly nuanced process of trying to assess the demand for an instrument.

3. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding how the proposal's hedging restrictions, which require all hedges to conform to an ambiguous, undefined concept of "reasonable correlation," would restrict

the ability of market makers to be able to cost-effectively hedge the fixed income securities they hold in inventory, including on a portfolio basis.

4. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding the lack of sufficient guidance on market makers in derivatives as it relates to a banking entity's entering into a transaction in response to customer demand and hedging the related exposure.

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6. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding how the proposal's prohibited proprietary trading presumption is inconsistent with explicit congressional intent to allow useful principal activity.

7. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding why the proposal takes a transaction-by-transaction approach to principal trading when such analysis does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio.

8. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding how the five Agencies will coordinate interpretation, examination and enforcement of the Volcker Rule regulations.

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10. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012,

regarding why the proposal provides no consistency as to the types of municipal securities that are exempt from the proprietary trading prohibition under the Volcker Rule.

11. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why the proposal distinguishes between municipal securities based on the type of issuer, which would be inappropriate since different issuers may offer securities that offer the same credit exposure to investors.

12. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why tender option bonds would be captured in the definition of "covered fund" under the proposal when there is no evidence in the legislative history of the Volcker Rule suggesting that Congress intended tender option bond transactions to be included in the scope of the Volcker Rule.

13. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why the proposal does not exclude issuers of asset-backed securities from the definition of "covered funds" despite the Financial Stability Oversight Council's findings that Congress did not intend for the Volcker Rule restrictions to apply to the sale or securitization of loans.

14. Please address how your agency will solve the problem raised in the American Council of Life Insurers comment letter dated January 24, 2012, regarding why insurance company investment activities that are permitted activities under current law and the proposed regulations are subject to reporting and record keeping requirements and compliance monitoring in Subpart D.

15. Please address how your agency will solve the problems raised in the AllianceBernstein comment letter dated November 16, 2011, regarding how the market making activities described in the proposal fail to take into account unregulated over-the-counter market making activities that covered banking entitles provide to such markets.

16. Please address how your agency will solve the problem raised in the AllianceBernstein comment letter dated November 16, 2011, regarding how the market making exemption appears to be predicated on the incorrect assumption that there is a perfect hedge for all securities and that all risks can be hedged for any given holding period for any position.

17. Please address how your agency will solve the problems raised in the Bank of Japan and Financial Services Agency Government of Japan comment letter dated December 28, 2011, regarding how the proposed restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds will raise operational and transactional costs of trading in Japanese Government Bonds.

18. Please address how your agency will solve the problems raised by the Canadian Banks comment letter dated January 19, 2012, regarding how the Volcker Rule, as enacted, excludes funds registered for public sale in the U.S. under the Investment Company Act of 1940 yet the proposal fails to provide a similar exclusion for Canadian Public Funds from the proposed definition of "covered fund" which violates Canada's rights under the North American Free Trade Agreement.

19. Please address how your agency will solve the problems raised by Capital One Financial Corporation, Fifth Third Bancorp, and Regions Financial Corporation comment letter dated November 29, 2011, over how a narrowly construed insured depository institution exemption that does not extend to many of the swaps that banks and their customers consider to be core banking services could push even the smallest registered bank dealers over the Volcker Rule's $1 billion threshold which would result in additional burdensome record keeping and compliance requirements that may cause small dealers to exit the market.

20. Please address how your agency will solve the problems raised by the U.S. Chamber of Commerce Center for Capital Markets Competitiveness comment letter dated December 15, 2011, regarding how the proposed rule should be considered an economically significant rulemaking.

21. Please address how your agency will solve the problem raised the U.S. Chamber of Commerce Center for Capital Markets Competitiveness comment letter dated December 15, 2011, regarding why the definition of exempt state and municipal securities is narrower under the Volcker Rule provisions of the Dodd-Frank Act than under the Securities and Exchange Act of 1934 which will subject municipal securities issued by municipalities and authorities to Volcker Rule provisions.

22. Please address how your agency will solve the problem raised by the Citigroup Global Markets comment letter dated January 27, 2012, regarding how the government obligations exemption will be consistently implemented when obligations of "agencies" of States and their political subdivisions are exempted, but each municipal jurisdiction applies its own definition of political subdivision to its issuer entities.

23. Please address how your agency will solve the problem raised by the Citigroup Global Markets comment letter dated January 27, 2012, regarding the proposed rule's failure to expressly exempt tender option bond programs from its restrictions on covered fund activities and how covered transactions with covered funds will have a significant adverse effect on the municipal securities market.

24. Please address how your agency will solve the problem raised in the comment letters from Rep. Anna Eshoo dated December 13, 2011,; Rep. Michael Honda dated December 20, 2011,; Rep. Zoe Lofgren dated December 23, 2011,; Rep. David Schweikert dated December 16, 2011,; and Sen. Kay Hagan dated January 13, 2012, regarding how

venture capital funds should not be covered by the Volcker Rule and how the Volcker Rule, as enacted, consistently used the specific term "private equity fund" - not the more general term "investment advisor" as it relates to venture capital funds.

25. Please address how your agency will solve the problem raised in the comment letter from Sen. Kay Hagan dated January 13, 2012, regarding how the proposed regulations could inadequately clarify the treatment of certain investments made by insurers and why the rule does not conform to Section 619's directive to accommodate the "business of insurance" and includes investments in covered funds within the exemption for insurers.

26. Please address how your agency will solve the problem raised by the Income Research and Management comment letter dated January 20, 2012, regarding how the proposed regulations outlining how market making banking entities can generate revenue compel market makers to trade on an agency basis rather than a principal basis and how the domestic corporate and securitized (i.e. commercial, residential, and asset-backed mortgage securities) credit markets are too large and heterogeneous to be served appropriately primarily by an agency trading based model.

27. Please address how your agency will solve the problem raised by the Investment Industry Association of Canada comment letter dated December 21, 2011, regarding the reasoning behind the extraterritorial application of the proposed Volcker Rule when there is nothing in the statutory text of the Volcker Rule or legislative history to suggest that Congress intended the Agencies to depart from their long-standing approach to apply U.S. banking and securities law to cross-border transactions.

28. Please address how your agency will solve the problem raised by the Municipal Securities Rulemaking Board comment letter dated January 31, 2012, regarding the need to broaden the "governmental obligations" exemption from the proposed rule's restriction on proprietary trading to include all "municipal securities" as defined in the Exchange Act in order to avoid a bifurcation of the municipal securities market that brings no additional benefit to the safety and soundness of the banking system.

29. Please address how your agency will solve the problem raised by the Municipal Securities Rulemaking Board comment letter dated January 31, 2012, regarding how most municipal market participants consider a primary function of market making to be the generation of liquidity in the market by taking securities into inventory, and that a dealer may not always be able to demonstrate compliance with the requirement of the market maker exception, with respect to the covered financial position, as designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.

30. Please address how your agency will solve the problem raised by the Norinchukin Bank comment letter dated January 25, 2012, that by applying the Volcker Rule to any transactions that take place outside of the U.S. based only on the fact that foreign banks

have U.S.-based offices seems like an extraterritorial application which deviates from one of the main objectives of the Dodd-Frank Act of containing systemic risks.

31. Please address how your agency will solve the problems raised by U.K. Chancellor of the Exchequer George Osborne's comment letter dated January 23, 2012, regarding how the proposed regulations would appear to make it more difficult and costlier to provide market-making services in non-U.S. sovereign markets.

32. Please address how your agency will solve the problems raised by the Standish Mellon Asset Management comment letter dated January 19, 2012, regarding how the proposed prohibited principal trading could result in dealers being hesitant to transact in secondary cash bonds because of extraordinary compliance requirements and the lack of clarity surrounding the rules.

CLO: #18
CCS: 12-1460
RECVD: 2/24/12

Congressman Spencer Bachus
Questions for the Record
Subcommittee on Financial Institutions and Consumer Credit and
Subcommittee on Capital Markets and Government Sponsored Enterprises
Joint Hearing entitled "Examining the Impact of the Volcker Rule on
Markets, Businesses, Investors and Job Creation"
Wednesday, January 18, 2012

Questions for the Federal Reserve, SEC and CFTC

1. Congress enacted the Volcker Rule as a provision of the Bank Holding Company (BHC) Act and the Federal Reserve is generally vested with the exclusive authority to implement the provisions of the BHC Act and is given broad rulemaking, examination, enforcement and supervisory powers by that legislation. The legislative history to the Dodd Frank Act indicates that the Board should "coordinate with other Federal and state regulators of subsidiaries of [a] holding company, to the fullest extent possible, to avoid duplication of examination activities, reporting requirements, and requests for information".

   The witnesses gave seemingly conflicting statements about the supervisory and enforcement framework for Volcker. Chairman Gensler noted his authority to supervise Swap Dealers; Governor Tarullo noted that the Fed has "primary" authority and other regulators have "backup" authority. What does this explanation mean? Which agency will have examiners ensuring compliance at the Swap Dealer or Security-Based Swap Dealer: the Federal Reserve, the SEC or the CFTC? Why would the Federal Reserve not be responsible for comprehensive compliance and uniform enforcement as the primary regulator? What policy objective is being achieved by having multiple agencies supervise and enforce, since having multiple regulators technically responsible for examination and enforcement, no regulator would be clearly responsible or accountable for compliance?

Questions for the Federal Reserve, SEC, CFTC, FDIC and OCC

1. Since the "intent" of a trader cannot be determined, regulators have proposed seventeen metrics to deploy to gauge whether an institution is hiding proprietary trading within a market making desk. Since the proposed rule consistently notes that the quantitative measurements are designed for identifying trading activity that warrants additional scrutiny, why do the metrics not at the same time make evident that the activity tested is complying with the rule? What purpose are the metrics intended to serve?

2. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding why the proposal's market making-related activity assumes that markets themselves are highly liquid and open to a wide array of end users when market making is in fact a highly nuanced process of trying to assess the demand for an instrument.

3. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding how the proposal's hedging restrictions, which require all hedges to conform to an

ambiguous, undefined concept of "reasonable correlation," would restrict the ability of market makers to be able to cost-effectively hedge the fixed income securities they hold in inventory, including on a portfolio basis.

4. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding the lack of sufficient guidance on market makers in derivatives as it relates to a banking entity's entering into a transaction in response to customer demand and hedging the related exposure.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

April 20, 2012

The Honorable Carolyn McCarthy
U.S. House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the February 1, 2012, hearing before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for Kevin M. Bertsch, Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Representative McCarthy:</u>

The legislation requires regulatory agencies to develop and apply uniform definitions and reporting requirements for non-performing loans. Ensuring that standards work for both small and large financial institutions, while also giving the agencies flexibility to continue to address unique situations of smaller institutions is vital.

Do you feel uniform standards for non-performing loans are achievable, or are there alternative ways to provide for consistency of the loan classification process?

For many years, the banking agencies have utilized uniform classification definitions for key asset types, including commercial loans, retail loans, and investment securities. In addition, as set forth in interagency Call Report instructions, the agencies have long relied on U.S. GAAP to guide bank financial reporting on asset categories that are often included in definitions of "nonperforming," such as nonaccrual loans, loans past due 90 days or more, and troubled debt restructurings. From time to time, the agencies have also issued supplemental interagency guidance to enhance the consistency with which classification definitions are being applied for specific asset types, addressing, for example, classification of commercial real estate loan workouts in 2009. We believe that uniform regulatory standards for non-performing loans are achievable. At the Federal Reserve, we have taken steps to promote consistency by ensuring that examiners are well-trained on classification and financial reporting requirements, supporting examiners with staff that have accounting expertise and can respond to questions about appropriate accounting treatment as needed, and reviewing selected examination reports and work-papers to ensure consistency with existing guidance.

CLO: #30
CCS: 12-1622
RECVD: 3/8/12

Questions for the Record
Financial Institutions Subcommittee Hearing
"HR 3461- The Financial Institutions Examination Fairness and Reform Act"
February 1, 2012

Rep. Carolyn McCarthy (NY-4)

Panel 1- to all the witnesses:

The legislation requires regulatory agencies to develop and apply uniform definitions and reporting requirements for non-performing loans. Ensuring that standards work for both small and large financial institutions, while also giving the agencies flexibility to continue to address unique situations of smaller institutions is vital.

- Do you feel uniform standards for non-performing loans are achievable, or are there alternative ways to provide for consistency of the loan classification process?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

April 20, 2012

The Honorable Lynn Westmoreland
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 1, 2012, hearing before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for Kevin M. Bertsch, Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Representative Westmoreland:

How many examiners have been disciplined since 2008? How many were disciplined for not fully utilizing standard agency guidance for examination procedures?

How many examiners have had employment terminated since 2008 as a result of poor performance?

The Federal Reserve conducts its supervisory activities through its twelve Federal Reserve Banks across the country. Supervision is guided by policies and procedures established by the Board, but is conducted day-to-day by the Reserve Banks and their examiners. The performance of examiners is overseen and managed by officials of the Federal Reserve Banks.

In order to ensure consistent application of agency guidance, Federal Reserve examiners complete a comprehensive training program that includes course work, on-the-job training, and testing prior to becoming a commissioned examiner. This comprehensive training program takes approximately three years to complete and combines on-the-job training with the development of competencies through course work in primary areas of examination focus, including credit, operations, market, and management risk. Candidates must successfully complete two standardized and validated proficiency exams that test knowledge of concepts related to managing an institution and an overall understanding of other specialty areas. Typical classes include Banking and Supervision Elements, Credit Risk Analysis School, Financial Analysis and Risk Management, Principles of Asset Liability Management, Bank Management, and Examination Management.

In addition, Federal Reserve examiners receive continuing professional development to maintain and augment their skills. To provide examiners with training on content that is relevant to the current business environment, the Federal Reserve has developed an online Learning Center. The Learning Center provides examiners in the field with access to online training on the latest supervisory and regulatory guidance and emerging issues. Once delivered, the hour-long webcasts, called Rapid Response, are available to all Federal Reserve staff on demand. To date, more than 250 topics have been presented. In addition to Board guidance and policy, topics include Credit Analysis, Consumer Compliance, Operational Risk, Banking and Financial Environment, and Failed Bank Case Studies.

Based on the individual performance planning process, the Federal Reserve also supports other individual professional development needs. This may include the pursuit and maintenance of industry certifications, attendance at advanced skill training courses, peer forums, or participation in skill affinity groups.

In addition, Federal Reserve examiners are subject to a comprehensive performance management system. This includes annual performance planning that defines key objectives, deliverables, and development plans; regular performance feedback; and an annual appraisal. If a Federal Reserve examiner fails to meet the requirements of the position, the examiner is subject to a disciplinary process that could result in termination if the employee fails to correct performance problems. Depending on the severity of the issue, and whether it is a recurring one, a manager or supervisor may begin the disciplinary process at an advanced stage, up to and including termination. Further, management may deny or postpone merit increases for examiners on disciplinary status.

In regard to issues raised by bankers and other members of the public about examiner performance with the Federal Reserve Board's Ombudsman's office, the Ombudsman investigates the issues, and, if facts warrant, refers performance matters to the Reserve Banks for appropriate action within the existing performance management system.

Questions Submitted by Representative Westmoreland
Hearing: "H.R. 3461: the Financial Institutions Examination Fairness and Reform Act"
February 1, 2012

For all witnesses on Panel 1:

- How many examiners have been disciplined since 2008? How many were disciplined for not fully utilizing standard agency guidance for examination procedures?

- How many examiners have had employment terminated since 2008 as a result of poor performance?

CLO: **#29**
CCS: **12-**1621
RECVD: 3/9/12

CLO: **#41**
CCS: **12-**2496
RECVD: 3/20/12

March 26, 2012

Senator Tim Johnson
Chairman, Committee on Banking, Housing and Urban Affairs
United States Senate
Washington DC 20210-6075

Dear Chairman Johnson:

Enclosed please find my answers to the questions for the record that your office sent me on March 23. I'd like to thank you again for giving me the opportunity to appear before your committee.

Sincerely,

Jeremy Stein

Jeremy Stein

<u>Questions for Dr. Jeremy C. Stein, of Massachusetts, to be a Member of the Board of Governors of the Federal Reserve System, from Senator Moran:</u>

Q1: The regime that limits credit exposures in Europe is generally not comparable to the regime established in the Federal Reserve's proposed rule to implement Sections 165 and 166 of Dodd-Frank. Since the Federal Reserve's proposal currently contains significant differences and is generally more onerous than the European Union's Capital Requirements Directive, are you at all concerned that U.S. institutions will have a competitive disadvantage with their European peers?

A: The financial crisis has made clear the need to better understand and control single-counterparty concentrations at systemically important financial institutions (SIFIs), and to reduce inter-SIFI interconnectedness. At the same time, as the Federal Reserve and other regulators move forward with the implementation of Dodd-Frank, it will be important to make every effort to harmonize the rules for SIFIs internationally, to the extent that this can be done consistently with safety and soundness considerations, and with the intent of the statute itself. In the specific case of large exposure rules, it should be noted that the Basel Committee is currently exploring whether it makes sense to pursue international harmonization of these rules. This would be one way to reduce any potential adverse competitive effects of the Fed's single-counterparty credit limit rules on US banking firms relative to foreign banking organizations. It should also be noted that the Fed's single-counterparty credit limits only apply to bank holding companies with more than $50B in total assets. Accordingly, they do not apply to community banks or even medium-sized regional banks.

Q2: Similar to the "Volcker Rule", U.S. Treasuries are exempted from the Federal Reserve's rules on counterparty credit limits while foreign high-grade sovereigns are not. Can you make the case that this is an appropriate distinction? What should the Federal Reserve be doing to understand how this would impact American firms and markets?

A: The exemption of U.S. Treasuries, but not foreign sovereign debt, is not specific to the Federal Reserve's rules on counterparty credit limits. Rather, it is a more general feature of other principal lending restrictions to which U.S. banking firms are subject. Other examples include national bank lending limits (Office of the Comptroller of the Currency), affiliate transaction limits (Fed's Regulation W), and insider lending limits (Fed's Regulation O). So the treatment in this particular case is arguably consistent with a significant body of precedent, and serves to harmonize the rules along this one dimension. The Federal Reserve has sought comment on its proposal on the treatment of sovereign exposures, and on the quantitative impact of the proposal on U.S. banking firms. The Fed should carefully consider any comments it receives on this issue as it crafts a final version of the rule.

Questions for Mr. Jerome H. Powell, of Maryland, to be a Member of the Board of Governors of the Federal Reserve System, from Senator Moran:

1. The regime that limits credit exposures in Europe is generally not comparable to the regime established in the Federal Reserve's proposed rule to implement Sections 165 and 166 of Dodd-Frank. Since the Federal Reserve's proposal currently contains significant differences and is generally more onerous than the European Union's Capital Requirements Directive, are you at all concerned that U.S. institutions will have a competitive disadvantage with their European peers?

Answer:

Section 165 of Dodd-Frank requires the Board to establish enhanced prudential standards for those institutions that are covered, including concentration limits under Section 165(e). In carrying out this obligation, it is important that the Board avoid unnecessary negative competitive effects.

The December 2011 Notice of Proposed Rulemaking (the "NPR") is open for comment through the end of April 2012. In order to better inform decisions regarding a final rule, the NPR specifically invites comment on its quantitative impact. As the Board reviews comments on the NPR and moves toward development of a final rule, it is important that it avoid hampering the competitiveness of U.S. institutions, provided always that it remain faithful to the language of the statute.

It is also appropriate for the Board to seek international harmonization of large exposure rules. The NPR states that Basel Committee on Banking Supervision is considering such a harmonized approach, and that the Board may amend the proposed rule to make it consistent with such an approach.

Section 165(b)(2) also requires the Board to apply enhanced prudential standards, including concentration limits, to qualifying foreign banking organizations that it supervises, while giving "due regard to the principle of national treatment and equality of competitive opportunity." The Board has not yet issued regulations under this authority.

2. Similar to the "Volcker Rule", U.S. Treasuries are exempted from the Federal Reserve's rules on counterparty credit limits while foreign high-grade sovereigns are not. Can you make the case that this is an appropriate distinction? What should the Federal Reserve be doing to understand how this would impact American firms and markets?

Answer:

The proposed rule exempts U.S. Treasuries but not state and local government debt or foreign sovereign debt. My understanding is that the exemption of Treasuries was done in part to harmonize the rule with several other federal lending restrictions that apply to U.S. banks. The NPR specifically seeks comments on the scope of this exemption and the Board's decisions on a final rule should be informed by such comments.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

June 27, 2012

The Honorable Blaine Luetkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 29, 2012, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Luetkemeyer:</u>

1. The Dodd-Frank Act sets $50 billion as an arbitrary cut-off for insured depositories that will be subject to more stringent prudential standards under section 165 of the Act. However, for purposes of implementing those more rigorous prudential standards, the language also grants the Board of Governors and the FSOC the discretion to differentiate among the so-called systemically important banks according to a range of risk-related factors. Size, complexity, financial activities and riskiness might be among those factors the Board of Governors could choose to look at when drafting the implementing regulations. Congress recognized that institutions below the $50 billion threshold do not present the same risks to the overall economy. A one-size-fits-all approach would appear to be unnecessary and inappropriate given the broad discretion Congress granted to your organization, particularly in the area of additional capital requirements. Does the Board of Governors plan to tier treatment among those institutions subject section 165 and, if so, how?

On December 20, 2011, the Board of Governors of the Federal Reserve System ("Board") invited public comment on a package of proposed rules to implement sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") for nonbank financial companies that the Financial Stability Oversight Council has designated for supervision by the Board and bank holding companies with consolidated assets of $50 billion or more (collectively "covered companies"). *<u>See</u>* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; Proposed Rule, 77 Fed. Reg. 593 (Jan. 5, 2012). The package includes proposals for risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, stress testing, risk-management requirements, and an early remediation regime. The Board's proposal generally includes standards that are calibrated to take account of a covered company's capital structure, risk profile, complexity, activities, size, and any other appropriate risk-related factors.

The public comment period on the proposed rules closed on April 30, 2012, and the Board received nearly 100 comment letters from individuals, trade and financial industry groups, community groups, and financial institutions. Many commenters provided views on how the Board could further tailor application of the proposed standards to covered companies based on their systemic footprint and risk characteristics. The Board is currently reviewing comments received on the proposal carefully, and will take the views expressed by commenters into consideration as it works to develop final rules to implement sections 165 and 166 of the Dodd-Frank Act.

2. Regardless of how you score seigniorage, and which agency- the Treasury Department or the Federal Reserve- collects those profits, don't you agree that a dollar coin, which lasts over 30 years, will be cheaper for the US to maintain than a dollar bill, which last 2—3 years? Why should the Federal Reserve be able to count the seigniorage of paper currency, while the Treasury only gets to count the seigniorage of coins? Shouldn't the Treasury Department be able to count the seigniorage for both paper currency and coin?

The most recent GAO study, completed in February 2012, states that the cost of producing sufficient coins to replace all one dollar notes is never fully recovered during the 30-year analysis and that all savings are attributable to increased seigniorage income. One dollar coins last about six times longer than one dollar notes, and they cost approximately six times more to produce. One dollar notes have an estimated life of 56 months while one dollar coins have an estimated life of 30 years. One dollar notes cost approximately five cents to produce while one dollar coins cost about 30 cents to produce. Overall, since more than 1 one dollar coin is required to replace 1 one dollar note, the production costs of the one dollar coins needed to replace the one dollar notes would exceed the production costs of continuing to supply the economy with one dollar notes. In addition, the GAO's study did not address the broader societal costs to consumers, retailers and other businesses, and state and local governments of a transition to one dollar coins. Nor did the analysis address the counterfeiting risks associated with a large-scale replacement of the one dollar note with a one dollar coin. These additional costs and risks should be considered before making any policy recommendations to eliminate the one dollar note.

We believe it is important to recognize that the seigniorage earnings from currency and coin are essentially a transfer from the holders of these forms of money to the government. Both the U.S. Mint and the Federal Reserve transfer their seigniorage earnings in excess of the operating costs of their organizations to the Treasury's general fund.

Questions for the Record from
Rep. Blaine Luetkemeyer (MO-9)
Committee on Financial Services, U.S. House of Representatives

Hearing held on February 29, 2012, entitled
"Full Committee hearing to receive the testimony of Ben Bernanke, Chairman of the Federal Reserve Board of Governors, on the conduct of monetary policy and the state of the economy"

1. The Dodd-Frank Act sets $50 billion as an arbitrary cut-off for insured depositories that will be subject to more stringent prudential standards under section 165 of the Act. However, for purposes of implementing those more rigorous prudential standards, the language also grants the Board of Governors and the FSOC the discretion to differentiate among the so-called systemically important banks according to a range of risk-related factors. Size, complexity, financial activities and riskiness might be among those factors the Board of Governors could choose to look at when drafting the implementing regulations. Congress recognized that institutions below the $50 billion threshold do not present the same risks to the overall economy. A one-size-fits-all approach would appear to be unnecessary and inappropriate given the broad discretion Congress granted to your organization, particularly in the area of additional capital requirements. Does the Board of Governors plan to tier treatment among those institutions subject section 165 and, if so, how?

2. Regardless of how you score seigniorage, and which agency – the Treasury Department or the Federal Reserve – collects those profits, don't you agree that a dollar coin, which lasts over 30 years, will be cheaper for the US to maintain than a dollar bill, which last 2—3 years? Why should the Federal Reserve be able to count the seigniorage of paper currency, while the Treasury only gets to count the seigniorage of coins? Shouldn't the Treasury Department be able to count the seigniorage for both paper currency and coin?

CLO:	**#B - 44**
CCS:	**12-** 2320
RECVD:	4/2/12

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

May 24, 2012

The Honorable Spencer Bachus
Chairman
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the February 29, 2012, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Chairman Bachus:

- **Section 165 of the Dodd-Frank Act requires that the Federal Reserve establish prudential standards for the largest banking institutions that are more stringent than those that apply to smaller banks. In doing so, the Board may differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Board deems appropriate. Congress included this provision to give you the flexibility to differentiate between the largest and most complex bank holding companies, and those with more traditional activities that nevertheless exceed $50 billion in assets.**

    - **Has the Board established a way to tailor its application of enhanced prudential standards based on the riskiness or complexity of a company's activities? Will the Board establish a tiered approach to enhanced standards, with increasingly stringent standards or capital surcharges being applied to the most complex institutions?**

On December 20, 2011, the Board of Governors of the Federal Reserve System ("Board") invited public comment on a package of proposed rules to implement sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") for nonbank financial companies that the Financial Stability Oversight Council has designated for supervision by the Board and bank holding companies with consolidated assets of $50 billion or more (collectively "covered companies"). See Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; Proposed Rule, 77 Fed. Reg. 593 (Jan. 5, 2012). The package includes proposals for risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, stress testing, risk-management requirements, and an early remediation regime. The Board's proposal generally includes standards that are calibrated to take account of a covered company's capital structure, risk profile, complexity, activities, size, and any other appropriate risk-related factors.

The public comment period on the proposed rules closed on April 30, 2012, and the Board received nearly 100 comment letters from individuals, trade and financial industry groups, community groups, and financial institutions. Many commenters provided views on how the Board could further tailor application of the proposed standards to covered companies based on their systemic footprint and risk characteristics. The Board is currently reviewing comments received on the proposal carefully, and will take the views expressed by commenters into consideration as it works to develop final rules to implement sections 165 and 166 of the Dodd-Frank Act.

- **Has the FSOC recommended that the Board use a tiered approach in applying enhanced standards?**

Section 115 of the Dodd-Frank Act provides that the Financial Stability Oversight Council ("Council") may make recommendations to the Board concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to covered companies. 12 U.S.C. 5325(a)(1). The Board consulted with the Council, including by providing periodic updates to members of the Council and their staff on the development of the proposal the Board issued in December 2011. The proposal reflects comments provided to the Board as a part of this consultation process.

Chairman Spencer Bachus
Full Committee Hearing
Humphrey Hawkins
February 29, 2012
Questions for the Record

- Section 165 of the Dodd-Frank Act requires that the Federal Reserve establish prudential standards for the largest banking institutions that are more stringent than those that apply to smaller banks. In doing so, the Board may differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Board deems appropriate. Congress included this provision to give you the flexibility to differentiate between the largest and most complex bank holding companies, and those with more traditional activities that nevertheless exceed $50 billion in assets.

    - Has the Board established a way to tailor its application of enhanced prudential standards based on the riskiness or complexity of a company's activities? Will the Board establish a tiered approach to enhanced standards, with increasingly stringent standards or capital surcharges being applied to the most complex institutions?

    - Has the FSOC recommended that the Board use a tiered approach in applying enhanced standards?

CLO:	**#B-42**
CCS:	**12-** 2315
RECVD:	**04/02/12**

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SANDRA F. BRAUNSTEIN
DIRECTOR
DIVISION OF CONSUMER
AND COMMUNITY AFFAIRS

July 13, 2012

The Honorable Mark Kirk
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are the responses to your submitted questions following the March 29, 2012 hearing before the Committee on Banking, Housing, and Urban Affairs. These responses are answered jointly by me and Mr. Kenneth C. Montgomery, First Vice President and Chief Operating Officer with the Federal Reserve Bank of Boston.

A copy has also been forwarded to the Committee for inclusion in the hearing record. Please let me know if I can be of further assistance.

Sincerely,

Enclosure

FEDERAL RESERVE
BANK OF BOSTON™

600 ATLANTIC AVENUE • BOSTON MA 02210
WWW.BOSTONFED.ORG

KENNETH C. MONTGOMERY
FIRST VICE PRESIDENT AND
CHIEF OPERATING OFFICER

KENNETH.MONTGOMERY@BOS.FRB.ORG
PHONE: 617.973.2826
FAX: 617.973.5903

July 13, 2012

The Honorable Mark Kirk
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses, answered jointly with Ms. Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, to the written questions you submitted following the March 29, 2012, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Kenneth Montgomery

Enclosure

"Developing the Framework for Safe and Efficient Mobile Payments"
March 29, 2012

Questions for Ms. Sandra F. Braunstein, Director, Board of Governors of the Federal Reserve System, and Mr. Kenneth C. Montgomery, First Vice President and Chief Operating Officer, Federal Reserve Bank of Boston from Senator Kirk:

1. Now that the federal government will be participating in the Automated Clearing House to distribute government benefits like social security, growth trends for electronic payments should accelerate at an even faster pace going forward than the double-digit increases we have seen for the past few years. Please describe your perspective of role the Federal Reserve should play in regulating and facilitating electronic payments in the post-Dodd/Frank world, with an emphasis on how the Federal Reserve can contribute to maximizing the economic benefits of new technology.

Federal government benefits have for decades been provided through automated clearing house (ACH), or "direct deposit," payments to beneficiaries' accounts at depository institutions, and for many years the vast majority of benefit payments have been made in this manner, rather than by check. Making the payments electronically is generally less expensive, faster, and more secure than making them by check. For example, delivery of paper checks to benefit recipients may be delayed, and the checks, once received, may be lost, misplaced, or stolen.

In December 2010, the U.S. Treasury issued a rule to increase further the usage of electronic payments for the disbursement of government benefits. The rule requires anyone applying for benefits on or after May 2011 to receive all payments electronically via direct deposit to a deposit account at a depository institution or via a prepaid card. Treasury has contracted with a commercial bank to make Direct Express® Debit MasterCard® prepaid card accounts available to recipients who will not be receiving benefits via direct deposit; these cards can be used like other debit cards, and funds that recipients receive through the card are FDIC insured. There is no cost to sign up for the card and no monthly fee, although there are fees for some optional transactions (such as making more than one ATM withdrawal in a single month). The Direct Express® card enables benefit recipients who do not have bank accounts to avoid fees associated with cashing benefit checks. Recipients currently receiving benefits via checks will be required to switch to an electronic payment method by March 2013.

Also in December 2010, the U.S. Treasury issued a rule establishing requirements that apply to the delivery of Federal payments to prepaid cards other than the Direct Express® card. Under the rule, a prepaid card is eligible to receive Federal payments only if the card account is Federally insured, the card is not attached to a line of credit or loan agreement under which repayment from the account is triggered upon delivery of the Federal payments, and the issuer of the card provides the cardholder with all of the consumer protections that apply to a payroll card account under Regulation E (12 CFR part 1005).

With respect to benefits that are received on a Direct Express® card or prepaid card meeting Treasury's requirements, Regulation E (12 CFR part 1005), which implements the Electronic Fund Transfer Act of 1978 (EFTA), limits a recipient's liability for unauthorized electronic fund transfers out of the recipient's benefit account (e.g., if the card is lost or stolen). The Dodd-Frank Act transferred the Board's rule-writing authority with respect to most consumer protection laws, including most of the EFTA, to the Consumer Financial Protection Bureau. Under Regulation E, cardholders who dispute a transaction within 2 business days of learning of the loss or theft of their card cannot be held liable for more than $50. Those who dispute a charge within 60 days of an account statement reflecting the unauthorized transfer cannot be held liable for more than $500. Finally, the regulation provides consumers with specific error-resolution rights in the case of an unauthorized transaction.

The nation's retail payment system is becoming increasingly electronic, largely reflecting consumer preferences. The Federal Reserve continues to promote the safety and efficiency of the nation's payments system through the Reserve Banks' role as providers of payment services and the Board's regulatory role. In addition, the Federal Reserve will work cooperatively with the private sector to identify and remove barriers to innovation and efficiency. And, finally, when appropriate, the Federal Reserve will act as a catalyst to greater efficiency, safety, and accessibility within the payments system.

2. Sweden, the first European country to circulate bank note currency in 1661, is at the forefront of the move to a cashless economy. Its aggressive move to electronic transactions has resulted in a dramatic drop in robberies of banks and securities trucks and shrinkage of the "tax gap." Has the Federal Reserve quantified the costs reductions and economic benefit derived from migrating to mobile/web payments?

The cost reductions and economic benefits derived generally from migrating paper-based payments to electronic payments have been supported by theoretical analysis and some empirical verification. For instance, the Federal Reserve Bank of Philadelphia issued a 2003 working paper showing that the shift from paper-based payments to electronic payments and from branch offices to ATMs may result in an annual costs savings of 1 percent of the gross domestic product.[1] Over a ten-year period, the Federal Reserve has reduced the cost of per-item processing by one third through the electronic clearing of paper checks.

For mobile payments specifically, the benefits in relation to costs are uncertain. The United States has a well-developed and efficient payments system and enabling mobile payments requires investments by the consumers' banks, merchants, and others. Research, however, also suggests that the long-term benefits to society of having a convenient, effective mobile wallet with complementary services that go beyond mobile payments (for instance, the ability to receive targeted ads and promotions and to monitor and manage account balances from any location) could be significant.

In terms of the example of Sweden's move to a "cashless economy," it may be helpful to provide some perspective from Sweden's central bank, the Riksbank. The Riksbank reports that cash and cards are the dominant payment methods used in Sweden today at the point of sale. The

[1] Cost Savings from Electronic Payments and ATMS in Europe, August 2003, Working Paper No. 03-16, at http://www.frbatlanta.org/filelegacydocs/epconf_humphrey.pdf.

Riksbank data show that cash usage has decreased since the 1950s, but that trend has been driven by an increase in card-based payments; neither e-money nor mobile payments are yet well established in Sweden. In addition, the decline in bank robberies in recent years has been driven primarily by changes in technology and operations. Specifically, the amount of cash in the bank offices has been reduced and replaced by deposit machines and automated teller machines. Also, the shrinkage of the tax gap has been affected by recent legislation that requires companies to have certified cash registers and to offer customers a receipt, which makes cheating on cash accounting much more difficult. Carriers have taken actions to increase safety, including GPS systems in cars and cash bags, improved ink security systems in vehicle safes and cash bags, personnel training, and stricter screening of cash transporters. Despite these actions, armored carrier robberies have increased. The Riksbank believes that the cash usage will continue to decrease but that cash nevertheless will continue to be a prominent means of payment for the foreseeable future. The impact of new methods of payment, such as mobile payments, on the future demand for cash in Sweden is uncertain.

3. The "Consumers and Mobile Financial Services" report issued by the Board of Governors in March 2012 concludes that the consumers' doubts about the security of mobile financial transactions impede the growth of this new technology. What concrete recommendation would you make to improve mobile security for financial stakeholders as well as consumers? At the same time, what steps should be taken to assure that privacy rights are protected? Please identify all stakeholders that need to be considered, and all regulatory agencies that will be involved.

It is important that multiple stakeholders involved in a mobile payment transaction share responsibility for ensuring mobile payment security and protecting consumer privacy rights. Stakeholders include mobile carriers that sell and enable mobile phones for payments and oversee the handset and chip manufacturers' security requirements, financial institutions that issue debit and credit cards and/or hold consumer bank accounts that are accessed from the mobile wallets, card networks (debit, credit and prepaid), mobile solution providers, merchants, and consumers. This nascent market would benefit from mobile stakeholders jointly developing technological standards and guidelines that support different mobile payment technologies and alternatives to prevent attacks on mobile payment data and facilitate the development and implementation of consistent, integrated security measures. For example, mobile stakeholders should collaborate to develop an effective mobile payments security program that applies appropriate security measures and tools. Such a program could –

- Include a simple customer security toolkit showing consumers how to protect their mobile devices, mobile wallets, and payments data by using anti-virus software to ensure the applications downloaded are safe from viruses and malware; creating passwords for login and mobile wallet access; loading software that enables the phone to be remotely wiped, locked, or deactivated if lost or stolen; and detecting and reporting fraud or other security breaches.

- Recommend implementation of appropriate security tools for different mobile technologies, including the use of end-to-end encryption for any mobile payment transaction stored on the phone, remotely on a file server, and when data are in transit over the wireless network to protect consumer personal data (bank account and card numbers and passwords).

- Create a certification process and standard procedures to safely set-up mobile phones and wallets, including certifying vendor applications before they are loaded into mobile wallets and certifying wallets before they are put into the secure container in the phone. Certification and testing will help to ensure that data processed are encrypted and safely stored, and that applications are virus and malware free.

From a privacy perspective, mobile stakeholders should pursue jointly developing best practices that identify, standardize, and build controls that protect consumer data on mobile phones and address transparency and choice. Smartphones enable mobile payment apps to capture a broad range of user information automatically, including a consumer's geolocation, phone number, contact list, call logs, unique ids, and other data stored on the device. In addition to protecting against security breaches, industry could develop business practices for using and sharing this data, within applicable statutory and regulatory requirements. As initial steps, it could be helpful to review the Federal Trade Commission (FTC), Mobile Marketing Association (MMA), and other privacy guidelines developed to help protect consumer privacy in the mobile space, with emphasis on transparency, disclosures, consumer choice, and education.[2] It also could be helpful to inventory best practices in the United States and globally to ensure that they include strong privacy protections that encompass the entire mobile stakeholder community and address transparency, consumer education, and consumer choice. Consumers should understand their rights and obligations when they make mobile payments, especially with multiple parties involved in a mobile transaction. Mobile payment companies also should give consumers the ability to restrict using or sharing any information that is not necessary to complete a transaction.

Further analysis of existing laws may be needed to ensure that consumers are adequately protected. A legal framework exists to address the payment activities of insured depository institutions--collectively, "banks." This framework includes consumer protection statutes, such as the Gramm-Leach Bliley Act's privacy provisions, the Electronic Fund Transfer Act (EFTA), and the Truth in Lending Act, as well as the bank supervisory process. To the extent that nonbanks are involved, whether and the degree to which federal or state statutes and rules are applicable depends on the nonbank's role in the transaction and the specific provisions of the particular statute or rule. Due to the different types of service providers (bank and nonbank) and the wide variety of payment arrangements that are in place and under development, a number of

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2 In May 2012, the FTC issued a report on *Protecting Consumer Privacy in an Era of Rapid Change, which* identified best practices for businesses to protect consumer privacy and give them greater control over the collection and use of their personal data and urged mobile providers to work toward improved privacy protections, including disclosures. In December 2011, the MMA published its *Mobile Application Privacy Policy Framework,* which addressed privacy issues and data processes of many, but not all, mobile applications.

regulators may have authority over various aspects of mobile payment transaction, including the federal bank regulators, the Consumer Financial Protection Bureau, the Federal Trade Commission, the Federal Communications Commission, the Treasury Department's Financial Crimes Enforcement Network, and state agencies. However, given the fast-paced nature of changes in this area and the potential for significant improvements in consumer financial services through mobile payments, further fact-finding would aid that analysis and would be helpful to ensure that any legislative or regulatory proposals do not stifle the very innovations that would benefit consumers overall.

It is important that mobile payment stakeholders and public agencies take steps to develop coordinated programs for consumer education and awareness related to securing mobile payments and protecting consumer privacy. For example, the Federal Reserve Bank of Boston Payments staff will continue to work with mobile payment stakeholders through the Mobile Payments Industry Workgroup to help facilitate such security and privacy initiatives.[3]

4. In its 2011 Annual Report of Competitive Market Conditions, the FCC cited forecasts that more than half the nation will use smart phones to conduct numerous banking transactions by 2015; among consumers between the age of 18 and 35, over three-quarters of them will bank by mobile device. Do you agree with the FCC projections?

Smartphone usage is increasing rapidly in the United States. The Board's recent *Consumers and Mobile Financial Services* survey found that just under 40 percent of Americans between the ages of 18 and 35 were smartphone users in December of 2011. Smartphone users are much more likely to use mobile banking than other mobile phone users: among those consumers between the ages of 18 and 35, 56 percent of smartphone users had used mobile banking in the past 12 months compared to 11 percent of non-smartphone users.[4] As more and more consumers have smartphones and the number of financial institutions offering mobile banking and mobile payment services increase, it is reasonable to assume that the proportion of the population that use these services will also increase. However, although Federal Reserve and industry data can help us understand directional trends, it is more difficult to project the specific future penetration rate for these mobile financial services.

5. According to surveys within the "Consumers and Mobile Financial Services" report, the eleven percent of the adult population classified as "underbanked" are more dependent on mobile services than the general population; almost two-thirds of "underbanked" pay bills with their mobile phones to pay bills, compared to less than half of all mobile phone users. In the final words of this report, "The prevalence of mobile phone access among minorities, low-income individuals, and younger generations creates the possibility of using mobile

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[3] The Mobile Payments Industry Workgroup represents major mobile payment stakeholders, including mobile carriers, banks, card networks, payment processors, Internet payment providers, mobile chip manufacturers, mobile solution providers, merchants, and mobile and payment trade associations.

[4] Pursuant to the data collected in the Board of Governors of the Federal Reserve System *Consumers and Mobile Financial Services* survey.

technology to expand financial inclusion." Since 23 of the top 25 banks offer mobile banking, should we modify regulation of community development and investment initiatives to include expansion of mobile services, accompanied by security protocols and consumer awareness programs?

The manner in which traditionally underbanked consumers may be accessing mobile financial services is an interesting aspect of the report. Because the technology and business models are so new and still evolving, it is unclear to what extent mobile services may ultimately complement, augment, or supplant more traditional means of delivering financial services to consumers, including consumers without banking relationships and those who are banked but also use alternative financial services. The Federal Reserve will continue to monitor this aspect of the marketplace. Given the still-evolving nature of the technology, it may be too soon to consider statutory or regulatory changes. Changes such as those you suggest may be warranted in the future if they would be effective to expand financial inclusion through the offerings of mobile products and services.

CLO: #42
CCS: 12-2574
RECVD: 4/20/12

Senator Mark Kirk
"Developing the Framework for Safe and Efficient Mobile Payments"
March 29, 2012
Questions for the Record

All questions are for both Ms. Braunstein and Mr. Montgomery.

1) Now that the federal government will be participating in the Automated Clearing House to distribute government benefits like social security, growth trends for electronic payments should accelerate at an even faster pace going forward than the double-digit increases we have seen for the past few years. Please describe your perspective of role the Federal Reserve should play in regulating and facilitating electronic payments in the post-Dodd/Frank world, with an emphasis on how the Federal Reserve can contribute to maximizing the economic benefits of new technology.

2) Sweden, the first European country to circulate bank note currency in 1661, is at the forefront of the move to a cashless economy. Its aggressive move to electronic transactions has resulted in a dramatic drop in robberies of banks and securities trucks and shrinkage of the "tax gap." Has the Federal Reserve quantified the costs reductions and economic benefit derived from migrating to mobile/web payments?

3) The "Consumers and Mobile Financial Services" report issued by the Board of Governors in March 2012 concludes that the consumers' doubts about the security of mobile financial transactions impede the growth of this new technology. What concrete recommendation would you make to improve mobile security for financial stakeholders as well as consumers? At the same time, what steps should be taken to assure that privacy rights are protected? Please identify all stakeholders that need to be considered, and all regulatory agencies that will be involved.

4) In its 2011 Annual Report of Competitive Market Conditions, the FCC cited forecasts that more than half the nation will use smart phones to conduct numerous banking transactions by 2015; among consumers between the age of 18 and 35, over three-quarters of them will bank by mobile device. Do you agree with the FCC projections?

5) According to surveys within the "Consumers and Mobile Financial Services" report, the eleven percent of the adult population classified as

"underbanked" are more dependent on mobile services than the general population; almost two-thirds of "underbanked" pay bills with their mobile phones to pay bills, compared to less than half of all mobile phone users. In the final words of this report, "The prevalence of mobile phone access among minorities, low-income individuals, and younger generations creates the possibility of using mobile technology to expand financial inclusion." Since 23 of the top 25 banks offer mobile banking, should we modify regulation of community development and investment initiatives to include expansion of mobile services, accompanied by security protocols and consumer awareness programs?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 23, 2012

The Honorable Ron Paul
Chairman
Subcommittee on Domestic
Monetary Policy and Technology
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the March 27, 2012, hearing before the House Financial Services Subcommittee on Domestic Monetary Policy and Technology. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Steven B. Kamin

Steven B. Kamin
Director, Division of International Finance

Enclosure

Questions for Mr. Steven B. Kamin, Director of the Division of International Finance, Board of Governors of the Federal Reserve System, from Chairman Ron Paul:

1. Has the Federal Reserve provided any other assistance either financial or technical in nature, aside from the central bank liquidity swap lines, to help mitigate the financial crisis in Europe? If so, please provide a thorough list and explanation of such assistance.

The Federal Reserve has no programs in place other than the central bank liquidity swaps that involve financial institutions in Europe. I would note that the main purpose of the swap lines is to protect financial markets in the United States from disruptions in foreign markets and to help support the flow of credit to U.S. households and businesses.

We have of course been in continual contact with our European counterparts and have closely monitored the situation, with an eye toward minimizing the potential spillovers to the U.S. economy.

2. Does the Federal Reserve have the ability and authority to provide financial assistance to Europe, aside from the central bank liquidity swap lines? If so, under what statute(s) does the Federal Reserve have such authority and what form(s) could such assistance take?

As noted above, the Federal Reserve has no programs in place that involve financial institutions in Europe other than the central bank liquidity swaps, and participates in these swaps in order to protect U.S. financial markets and maintain the flow of credit in the U.S. economy. The Federal Reserve operates its swap lines under the authority of Section 14 of the Federal Reserve Act, which permits the Federal Reserve Banks to conduct operations in foreign exchange and to open and maintain accounts in foreign currency with foreign central banks. Any other action taken in response to the situation in Europe would be the decision of the Federal Reserve Board or the FOMC and would be taken in accordance with relevant statutes.

3. The International Monetary Fund (IMF) is not permitted to accept funds directly from the Federal Reserve. Notwithstanding the restraint on the IMF, does the Federal Reserve have the authority to provide funding directly to the IMF? If so, please cite the legal statute(s).

No, the Federal Reserve System would be prohibited by statute from extending credit to the Fund without Congressional approval.

The Bretton Woods Agreements Act (BWA) reserves for Congress the ability to authorize certain actions to be taken on behalf of the United States with respect to the IMF. Under the Act, "[u]nless Congress by law authorizes such action, neither the President nor any person or agency shall on behalf of the United States. . .make any loan to the Fund. . .". For purposes of the BWA, a reserve bank would likely be considered a "person" and may be considered an "agency", to the extent that it would be acting at the request of the Board or the FOMC.

4. What would the ramifications be to the Federal Reserve if the ECB is unable to repay the dollars it has borrowed? Does the Federal Reserve have a contingency plan in the event the ECB does not repay the dollars? If so, what is this plan?

The dollars involved in our swaps with the ECB are not borrowed, they are swapped in exchange for euros provided by the ECB. The ECB is bound by contract to return any dollars it draws from the swap line, and we believe it will uphold its obligation in every instance. Our expectation that the ECB will repay us the dollars we have swapped for euros is based on the financial strength of that institution and its history of prudent decision-making: the Federal Reserve has a long track record of conducting successful operations not only with the ECB, but also with the national central banks of the euro area countries. As shareholders of the ECB, the national central banks – and their national governments behind them – would be expected to further backstop the ECB's obligations.

5. Payment transactions in the Eurozone are settled using the TARGET 2 system, a settlement system owned and operated by the Eurosystem, which is comprised of the 17 national central banks of the European monetary Union and the ECB. Under TARGET 2, the various national central banks accumulate assets and liabilities amongst themselves.

a. Is there a credit risk between the various national central banks of Europe as a result of the TARGET system?

The TARGET2 system settles domestic and cross-border interbank payments in the euro area by crediting and debiting banks' reserve accounts at their respective national central banks. Any accumulation of assets and liabilities in the TARGET2 system by the various national central banks are claims on and liabilities to the ECB, not one another. The ECB and euro-area national central banks control for credit risk in their operations with monetary and financial institutions by applying haircuts in valuing the collateral they receive and by requiring their counterparties to adjust the marketable assets they post as collateral as the prices of those assets change.

b. If so, under what circumstances could a national central bank incur a write-down or loss on its Target 2 assets?

In the event that there is a credit loss despite these precautions, then according to Eurosystem rules, capital losses are allocated according to the respective capital shares of the national central banks in the Eurosystem, not according to TARGET2 balances.

c. If such losses could occur, how does the Federal Reserve assess credit risk to the Federal Reserve's loans to the ECB?

The credit standing of the ECB is of the highest caliber, it has a very strong financial position, and we continue to view our swap lines with the ECB as safe. TARGET2 losses would not diminish either the effectiveness or the safety of the Federal Reserve's swap operations with the ECB.

FEDERAL RESERVE BANK *of* NEW YORK

33 LIBERTY STREET, NEW YORK, NY 10045-0001

WILLIAM C. DUDLEY
PRESIDENT

July 11, 2012

BY E-MAIL

The Honorable Ron Paul
Chairman
Subcommittee on Domestic Monetary Policy and Technology
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Re: Hearing Entitled "Federal Reserve Aid to the Eurozone: Its impact on the U.S. and the dollar," March 27, 2012

Dear Chairman Paul:

I respectfully submit the following responses to questions you posed in a letter dated April 27, 2012. I understand that these responses will be included in the record for the above-captioned hearing.

Question 1:

The Federal Reserve receives no appropriations from Congress and is completely dependent on funding itself through its own operations. During your testimony you stated that the Federal Reserve made a $4 billion profit from the central bank liquidity swap arrangements during 2008 and 2009. Considering that the Federal Reserve's annual operating budget is roughly $4 billion, and money is fungible, could it be said that the Fed is funded by foreign central banks rather than through returns on its portfolio of Treasuries?

Response:

While the Federal Reserve's current operating budget and the profit to date on our liquidity swaps are roughly the same, it would not be accurate to say that the Federal Reserve is funded by foreign central banks. Profits on the liquidity swaps did not come in the regular course of the Federal Reserve's operations, and, unlike income derived from our portfolio of government securities, are not a typical source of revenue for the Federal Reserve System.

Question 2:

With respect to the swap lines with the European Central Bank (ECB), you stated during the hearing that, "We think we are very well secured in those transactions. We fully anticipate to be fully repaid." You also stated that you "don't have enough information to assess the quality of the ECB balance sheet."

- *a.* ***How does the Federal Reserve consider the ECB swap transactions well secured if the Fed does not assess the condition of the ECB's balance sheet?***
- *b.* ***Why would the Fed lend dollars to a bank without assessing the balance sheet and financial position of the bank, especially when the sole purpose of lending those dollars is for them to be re-lent to unstable banks in exchange for collateral of questionable value?***
- *c.* ***Does the fact that the Fed has not assessed the ECB's balance sheet and that the ECB has been lending dollars to unstable banks for collateral of questionable quality belie the Fed's assertion that the ECB is a safe counterparty?***

Response:

As I stated in my testimony, we believe that these swap transactions are secure. First, at the initiation of each transaction, the Federal Reserve takes ownership of foreign currency that it holds for the duration of the trade. This provides an important safeguard: if a central bank failed to repay us, we could sell the currency into the market for dollars, which would limit the consequences to the Fed's balance sheet and to the taxpayer of a failure to repay.

Second, fluctuations in exchange or interest rates between initiation and maturity do not alter the contractual repayment amounts. At the end of each swap transaction, the Federal Reserve gets back all the dollars it provided plus a fee.

Third, the Federal Reserve must agree to any request to draw on the swap lines. We are in frequent contact with our counterparts at each foreign central bank regarding developments abroad. If we became uncomfortable with our exposure at any time, we could stop further swap transactions with the central bank (or central banks) in question.

Fourth, with respect to the ECB, the Federal Reserve has a long track record of conducting successful operations not only with the ECB itself, but also with the national central banks of the euro area countries. Those national central banks – and their national governments behind them – are shareholders in the ECB and would be expected to backstop the ECB's obligations in the highly unlikely event that the ECB failed to repay us.

Question 3:

> ***Has the Federal Reserve provided any other assistance either financial or technical in nature, aside from the central bank liquidity swap lines, to help mitigate the financial crisis in Europe? If so, please provide a thorough list and explanation of such assistance.***

Response:

I respectfully refer you to the response to this question provided by Steven Kamin, Director of the Division of International Finance at the Federal Reserve Board of Governors, and my co-panelist at the March 27th hearing.

Question 4:

> ***Does the Federal Reserve have the ability and authority to provide financial assistance to Europe, aside from the central bank liquidity swap lines? If so, under what statute(s) does the Federal Reserve have such authority and what form(s) could such assistance take?***

Response:

The Federal Reserve derives its authority exclusively from the Federal Reserve Act, and all of our operations and actions are conducted pursuant to that statute.

The Federal Open Market Committee (FOMC) established central bank liquidity swap arrangements with five foreign central banks, including the ECB, between 2007 and 2008 and reauthorized them in successive votes from May 2010 through the present. The current authorization runs through February 1, 2013. I am not aware of any additional plans or intentions within the Federal Reserve to provide financial assistance to European central banks or governments.

Question 5:

> ***The International Monetary Fund (IMF) is not permitted to accept funds directly from the Federal Reserve. Notwithstanding the restraint on the IMF, does the Federal Reserve have the authority to provide funding directly to the IMF? If so, please cite the legal statute(s).***

Response:

I respectfully refer you to the response to this question provided by Steven Kamin, Director of the Division of International Finance at the Federal Reserve Board of Governors, and my co-panelist at the March 27th hearing.

Question 6:

What would the ramifications be to the Federal Reserve if the ECB is unable to repay the dollars it has borrowed? Does the Federal Reserve have a contingency plan in the event the ECB does not repay the dollars? If so, what is this plan?

Response:

The dollars involved in our swaps with the ECB are not borrowed; they are swapped in exchange for euros provided by the ECB. The ECB is bound by contract to return any dollars it draws from the swap line, and we believe it will uphold its obligation in every instance. Our expectation that the ECB will repay us the dollars we have swapped for euros is based on the financial strength of that institution and its shareholders – the national central banks of the euro area countries. As mentioned above, the Federal Reserve has a long history of conducting successful operations with the ECB and with the national central banks of the euro area countries.

Question 7:

Payment transactions in the Eurozone are settled using the TARGET 2 system, a settlement system owned and operated by the Eurosystem, which is comprised of the 17 national central banks of the European monetary union and the ECB. Under TARGET 2, the various national central banks accumulate assets and liabilities amongst themselves.

a. Is there a credit risk between the various national central banks of Europe as a result of the TARGET system?
b. If so, under what circumstances could a national central bank incur a write-down or loss on its TARGET 2 assets?
c. If such losses could occur, how does the Federal Reserve assess credit risk to the Federal Reserve's loans to the ECB?

Response:

I respectfully refer you to the response to this question provided by Steven Kamin, Director of the Division of International Finance at the Federal Reserve Board of Governors, and my co-panelist at the March 27th hearing.

Respectfully yours,

William C. Dudley

William C. Dudley
President

CLO: #49
CCS: 12-3048
RECVD: 4/27/12

Questions for the Record from Chairman Ron Paul (TX-14)
Subcommittee on Domestic Monetary Policy and Technology
Committee on Financial Services
U.S. House of Representatives

Hearing held on March 27, 2012, entitled
"Federal Reserve Aid to the Eurozone: Its Impact on the U.S. and the Dollar"
Witness: Steven B. Kamin, Director, Division of International Finance
Board of Governors of the Federal Reserve System

1. Has the Federal Reserve provided any other assistance either financial or technical in nature, aside from the central bank liquidity swap lines, to help mitigate the financial crisis in Europe? If so, please provide a thorough list and explanation of such assistance.

2. Does the Federal Reserve have the ability and authority to provide financial assistance to Europe, aside from the central bank liquidity swap lines? If so, under what statute(s) does the Federal Reserve have such authority and what form(s) could such assistance take?

3. The International Monetary Fund (IMF) is not permitted to accept funds directly from the Federal Reserve. Notwithstanding the restraint on the IMF, does the Federal Reserve have the authority to provide funding directly to the IMF? If so, please cite the legal statute(s).

4. What would the ramifications be to the Federal Reserve if the ECB is unable to repay the dollars it has borrowed? Does the Federal Reserve have a contingency plan in the event the ECB does not repay the dollars? If so, what is this plan?

5. Payment transactions in the Eurozone are settled using the TARGET 2 system, a settlement system owned and operated by the Eurosystem, which is comprised of the 17 national central banks of the European monetary union and the ECB. Under TARGET 2, the various national central banks accumulate assets and liabilities amongst themselves.

    a. Is there a credit risk between the various national central banks of Europe as a result of the TARGET system?
    b. If so, under what circumstances could a national central bank incur a write-down or loss on its TARGET 2 assets?
    c. If such losses could occur, how does the Federal Reserve assess credit risk to the Federal Reserve's loans to the ECB?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

July 16, 2012

The Honorable Jim DeMint
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the June 7, 2012, hearing before the Joint Economic Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator DeMint:</u>

1. Is the U.S. at greater risk now of a recession than at any other time over the past three years?

On June 20th, Federal Open Market Committee (FOMC or Committee) participants released an updated set of economic projections. While committee participants generally marked down their projections for economic growth, most still see the economy as expanding at a moderate pace over coming quarters before then picking up gradually (the most pessimistic projections for real GDP growth were 1.6 percent in 2012 and 2.2 percent in 2013). That said, most participants see the balance of risks as weighted mainly toward slower growth and higher unemployment; in particular, strains in global financial markets continue to pose significant downside risks to the recovery and to further improvement in labor market conditions.

2. In the spirit of transparency, I would like to ask you about the Federal Reserve's disaster preparedness if interest rates on U.S. debt spike quickly as they have in many European nations.

a. Is the Federal Reserve prepared for a spike in U.S. borrowing costs?
b. What actions might the Federal Reserve take if interest rates on debt spike?

It is important to initially establish the underlying explanation for a higher-than-anticipated level of Treasury yields. If the spike in yields is a result of unexpectedly strong growth in economic activity, this would be a welcome development and the Federal Reserve would act appropriately to ensure that its mandate of maximum employment in a context of stable prices was met. Moreover, in this case, the negative effects of higher interest costs on the federal budget would be substantially more than offset by the effects of increased tax revenues and reduced spending for income-support programs.

In contrast, if the spike in interest rates were the result of a loss of confidence on the part of financial market participants in the ability of the government to manage its fiscal policy--as we have seen in a number of countries recently--there is little that the Federal Reserve could do to counteract rising interest rates. This potentially severe adverse development is why, in my testimony and on many other occasions, I have urged fiscal policymakers to put in place as soon as possible a credible long-term budget plan that would both put fiscal policy on a sustainable trajectory and avoid undue risk in the near term to the pace of the recovery. Such a plan would help keep long-term interest rates low and improve household and business confidence, thereby providing support to the near-term recovery.

c. If the U.S. were suddenly to face 10-year borrowing rates of 5 percent, 8 percent, or 10 percent, do you think the U.S. could sustain its debt path? What is the breaking point between sustainability and unsustainability?

As the Congressional Budget Office (CBO) recently reported, the federal budget already is on an unsustainable path if recent fiscal policies are continued. (This is the extended alternative fiscal scenario presented in the CBO's The 2012 Long-Term Budget Outlook, June 2012.) The CBO's projection assumed that nominal 10-year Treasury rates would rise to about 5 percent in the longer run, close to their historical average over the past four decades. If interest rates rose quickly and sharply to higher levels because of concerns about the ability of fiscal policymakers to control the federal budget then federal government debt would rise even faster than the unsustainable increases estimated in the CBO's long-term projection.

d. Has the Federal Reserve considered the benefits and consequences of the U.S. printing its way out of debt if interest rates rise to extreme levels?

The Federal Reserve is strongly committed to its dual mandate of maximum employment and price stability. Any action to boost inflation in response to elevated levels of federal debt would only lead to further increases in interest rates and add to the nation's problems.

3. What would be the impact on banks engaged in interest rate swaps if rates were to rise to 8%? Are the large banks adequately capitalized to handle such a change?

Regulatory guidance (SR 96-13, SR 10-1, and SR12-2) emphasizes the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related to the interest rate risk ("IRR") exposures of institutions. The regulators expect all institutions to manage their IRR exposures using processes and systems commensurate with their earnings and capital levels, complexity, business model, risk profiled, and scope of operations. Specifically, regulators expect institutions to:

- Regularly assess a range of alternative future interest rate scenarios, including meaningful interest rate shocks, to identify the inherent risk. Scenarios should be severe but plausible, in light of the existing level of rates and interest rate cycle.

- Communicate IRR tolerances so that the board of directors and senior management clearly understand the institution's risk tolerance limits and approach to managing the impact of IRR on earnings and capital adequacy. The tolerances should be explicit, and address the potential impact of changing interest rates on earnings and capital from a short-term and long-term perspective.

- The Federal Reserve recently completed our second annual Comprehensive Capital Analysis and Review (CCAR). In the CCAR, the Federal Reserve assessed the internal capital planning processes of the 19 largest bank holding companies and evaluated their capital adequacy under a very severe hypothetical stress scenario that included a peak unemployment rate of 13 percent, a 50 percent drop in equity prices, and a further 21 percent decline in housing prices.

- Interest rate shocks were included in this assessment, but not to the degree of a 400 percent increase in rates to 8 percent.

- That stated, for the largest bank holding companies (BHCs), which engage in dealer activities and make markets trading interest rate derivatives, their interest rate risk profiles are generally not as directionally sensitive as regional and community banks. In other words, certain changes in the *shape* of the yield curve, not just the absolute level, are more likely to result in outsized losses at the largest BHCs than parallel shifts of the curve up or down. Such changes associated with macroeconomic stress were used in the CCAR hypothetical stress scenario.

- Note, trading activity in interest rate OTC derivatives does generate counterparty credit risk. In scenarios where there are extreme moves in underlying risk factors--such as rates moving to 8 percent--counterparty credit risk exposures could increase significantly. In CCAR, such exposures were stressed in the hypothetical scenario. In addition, counterparty credit risk exposures are regularly assessed and monitored in the supervisory process for the largest BHCs.

4. Whereas fiscal stimulus has a measurable cost, people seem to view monetary stimulus as a free lunch. Is monetary stimulus free, and if not, what are its costs and who will bear them?

While monetary policy does not have direct costs for U.S. taxpayers analogous to those associated with fiscal policy, there certainly are important costs and risks in conducting monetary policy that the FOMC considers in its deliberations. The Federal Reserve conducts monetary policy to foster its statutory mandate to promote maximum employment and stable prices. In reaching its decisions, the Committee carefully reviews the outlook for economic growth and inflation, and it adjusts the stance of policy as appropriate to foster its statutory goals of maximum employment and stable prices. However, the economic outlook is always uncertain and there are many potential costs and risks in conducting policy. For example, the FOMC could maintain a stance of policy that turns out to have been too tight. In this case, output could fall below potential, unemployment could rise, and inflation could fall persistently below levels that the Committee judges to be consistent with price stability. Alternatively, the FOMC could also maintain a stance of policy that provides too much accommodation for too long. In that scenario, output could move above potential and inflation could move persistently above mandate-consistent levels. The costs associated with either of these scenarios would be greatly compounded if households and businesses came to question the Federal Reserve's willingness and ability to achieve price stability in the long-run. In that case, long-term inflation expectations could become unanchored and the Federal Reserve could find it very difficult to achieve its statutory mandate.

As the Committee noted in its recent statement, economic growth is expected to remain moderate over coming quarters and then to pick up very gradually. Consequently, the Committee anticipates that the unemployment rate will decline only slowly toward levels that it judges to be consistent with its dual mandate. Furthermore, strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee anticipates that inflation over the medium term will run at or below the rate that it judges most consistent with its dual mandate. Moreover, long-term inflation expectations have remained stable. Against this backdrop, the Committee has judged that it is appropriate to maintain a highly accommodative stance of monetary policy.

5. In an effort to promote maximum employment do you think that the Federal Reserve's policies have compromised stable prices?

The Federal Reserve's accommodative policy actions have not compromised price stability. Since the onset of the recession, consumer prices--as measured by the price index for personal consumption expenditures--have risen at an average annual rate of 1 3/4 percent--a bit below the 2 percent rate of inflation that the Committee has indicated that it judges most consistent with its statutory mandate. After increasing earlier this year as crude oil and gasoline prices rose, inflation has declined more recently as those prices have fallen back. Meanwhile, longer-term inflation expectations have remained stable. Over the medium term, as reflected in the Committee's Summary of Economic Projections, the Committee anticipates that inflation will run at or below the rate that it judges most consistent with its dual mandate.[1] Private-sector forecasts of inflation over the medium term are broadly consistent with those of the Committee participants.

6. What changes will you have to see in the economy to allow interest rates to rise?

The Federal Open Market Committee has indicated in its recent statements that it currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014. As the economic recovery continues, the Committee eventually will need to make monetary policy less accommodative in order to ensure that the economy expands at a sustainable pace and to prevent inflation from persistently exceeding its longer-run objective. In determining the appropriate time to increase its target for the federal funds rate, the Committee will consider a range of factors, including actual and projected rates of resource utilization, the medium-term outlook for inflation, and the risks to the achievement of the Committee's objectives.

7. FOMC participants have cited numerous times the downside economic risks associated with uncertainty over U.S. fiscal policy and uncertainty regarding regulatory policies. Do you believe that fiscal policy uncertainty is materially affecting business and household behavior and that fiscal policy uncertainty is a risk to economic growth, as FOMC meeting participants repeatedly identify?

Heightened uncertainty both about the economic outlook and about fiscal policy may be leading firms to be more reluctant to hire and invest along with making households less willing to buy big ticket items. Improved economic conditions should help reduce this uncertainty, but policymakers should also seek to reduce the uncertainty about fiscal policy. As I have stated on

[1] The Committee's most recent projections collected at the time of its June meeting can be found at http://www.federalreserve.gov/monetarypolicy/fomcprojtabl20120620.htm

many occasions, a key task for fiscal policymakers should be to put in place a credible long-term budget plan that would both put fiscal policy on a sustainable trajectory and avoid undue risk in the near term to the pace of the recovery. Doing so earlier rather than later would not only reduce uncertainty, hold down interest rates, and help maintain the U.S. government's credibility in financial markets, but it would also ultimately be less disruptive by avoiding abrupt shifts in policy and by giving those affected by budget changes more time to adapt.

8. Dr. Lawrence Summers, former economic advisor to President Obama, recently argued in a Washington Post article that the government should increase its debt – especially long-term debt – in order to lock in low rates and that the Fed should refrain from quantitative easing and operation twist type policies. Do you agree with this argument?

The Federal Open Market Committee's large scale asset purchases and maturity extension program have been designed to stimulate the economy by putting downward pressure on longer-term interest rates, thereby making financial conditions more accommodative. Dr. Summers notes that large scale asset purchases may be appropriate, but that there may be limits on the extent to which lower long-term rates can induce more private spending. He also raises the concern that very low rates could encourage speculative activity. As noted in the minutes of the FOMC meetings, these issues have been discussed by the FOMC. On balance, the Committee has judged that the effects of asset purchases in putting downward pressure on long-term interest rates and in easing financial conditions more broadly has been helpful in supporting the economic recovery and fostering the FOMC's statutory mandate of maximum employment and stable prices. Of course, monetary policy is not a panacea for all of the nation's economic difficulties. Indeed, Dr. Summers also argued that increased government spending financed by low-cost long-term debt could be helpful in boosting the economy. Of course, appropriate policies for spending and government borrowing are complicated and are the responsibility of Congress and the administration. In my view, to best support the economy, fiscal policy needs to be set on a sustainable path over the medium term by putting in place a credible longer-run budget plan, while avoiding near-term fiscal risks to the recovery.

9. An economist at the Center on Budget and Policy Priorities recently argued that the economy could handle the pain if Congress delays fiscal decisions until the beginning of next year. Would you consider a deferral of impending fiscal decisions into next year to be a low-risk strategy, or would this be a gamble that financial markets, businesses, and households can weather mounting fiscal uncertainty without significant economic consequence?

A key goal for fiscal policymakers should be to put in place a credible longer-term plan for placing the federal budget on a sustainable trajectory while avoiding undue risk in the near-term to the pace of the recovery. The policies now written into law that create the so-called fiscal cliff do not meet both of these objectives because they would put the still-fragile recovery at risk. The economic consequences of failing to avert the full implications of the fiscal cliff are highly uncertain, but it is clear that those consequences would be unwelcome. Fiscal policymakers should work on a credible plan that would support the performance of the economy in both the near term and the long term by setting the federal budget on a sustainable path while giving attention to the growth-related implications of the spending and tax choices that they make.

10. The IMF has said that, in order for SDRs to play a more meaningful role as a reserve asset to reduce global imbalances, the volume of SDRs would have to be expanded. Currently, SDRs account for a little less than 4% of global reserves. The IMF has suggested increasing annual allocations of SDRs to 13% of global reserves by the 2020s.

a. What do you think the IMF's motive is in increasing SDRs reserves?

The IMF does not make annual allocations of SDRs. SDR allocations have occurred three times: in the early 1970s, in the late 1970s, and in 2009.

Under the IMF Articles of Agreement, the IMF membership can decide to make a general allocation of SDRs with an 85 percent majority vote if the Board of Governors finds that the conditions set forth in the Articles regarding a long term global need to supplement existing reserve assets have been met:

> ...the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.

The IMF reviews the need for an SDR allocation every five years, prior to the beginning of a so-called "basic period." At the time of the last review in mid-2011, there was no consensus among the IMF membership on the need for an allocation of SDRs during the 10th basic period, which commenced on January 1, 2012.

b. Do you see a problem with allowing countries to have greater access to credit reserves by the increase of SDRs?

The Secretary of the Treasury has primary responsibility for international economic policy, including policies regarding the IMF. SDR allocations raise a range of issues relating to the functioning of the international monetary system. A potential problem that has been discussed is whether an increase in SDRs could be inflationary. However, that does not appear to be a serious risk, especially in regard to the U.S. economy, especially as any new SDR allocation would likely be a very small fraction of the global money supply.

11. A Citigroup analysis recently said that U.S. and European regulators are essentially forcing banks to buy government debt and allowing them not to count government bond holdings against their capital reserve requirements in order to create a steady market for government bonds and to keep the yields low. Do you think that this could make the debt crisis worse by obscuring the real cost of borrowing?

Financial institutions need liquidity to manage their daily operations and to withstand periods of acute funding stress without reliance on central bank liquidity support. Robust liquidity risk management and liquidity buffers are especially important because a liquidity shortfall at a single institution can have system-wide repercussions. Amongst non-cash assets, debt issued by highly-rated governments in developed economies is viewed as the most monetizeable in adverse states of the world.

Joint Economic Committee
Republicans
Representative Kevin Brady *Vice Chairman*
Senator Jim DeMint *Senior Republican Senator*

CLO: **#B - 67**
CCS: **12-** 3713
RECVD: 6/13/12

June 12, 2012

Chairman Bernanke:

I would like to thank you for your recent testimony before the Joint Economic Committee on June 7th, 2012. As a follow up to your testimony, I would like to submit the following questions for the record. I look forward to your response to what I consider important questions about the state of our economy.

Sincerely,

Jim DeMint

Senator Jim DeMint

1. Is the U.S. at greater risk now of a recession than at any other time over the past three years?

2. In the spirit of transparency, I would like to ask you about the Federal Reserve's current disaster preparedness if interest rates on U.S. debt spike quickly as they have in many European nations.
    a. Is the Federal Reserve prepared for a spike in U.S. borrowing costs?
    b. What actions might the Federal Reserve take if interest rates on U.S. debt spike?
    c. If the U.S. were suddenly to face 10-year borrowing rates of 5%, 8%, or 10%, do you think the U.S could sustain its debt path? What is the breaking point between sustainability and unsustainability?
    d. Has the Federal Reserve considered the benefits and consequences of the U.S. printing its way out of debt if interest rates rise to extreme levels?

3. What would be the impact on banks engaged in interest rate swaps if rates were to rise to 8%? Are the large banks adequately capitalized to handle such a change?

4. Whereas fiscal stimulus has a measurable cost, people seem to view monetary stimulus as a free lunch. Is monetary stimulus free, and if not, what are its costs and who will bear them?

5. In an effort to promote maximum employment do you think that the Federal Reserve's policies have compromised stable prices?

6. What changes will you have to see in the economy to allow interest rates to rise?

7. FOMC participants have cited numerous times the downside economic risks associated with uncertainty over U.S. fiscal policy and uncertainty regarding regulatory policies. Do you believe that fiscal policy uncertainty is materially affecting business and household behavior and that fiscal policy uncertainty is a risk to economic growth, as FOMC meeting participants repeatedly identify?

8. Dr. Lawrence Summers, former economic advisor to President Obama, recently argued in a Washington Post article that the government should increase its debt – especially long-term debt – in order to lock in low rates and that the Fed should refrain from quantitative easing and operation twist type policies. Do you agree with this argument?

9. An economist at the Center on Budget and Policy Priorities recently argued that the economy could handle the pain if Congress delays fiscal decisions until the beginning of next year. Would you consider a deferral of impending fiscal decisions into next year to be a low-risk strategy, or would this be a gamble that financial markets, businesses, and households can weather mounting fiscal uncertainty without significant economic consequence?

10. The IMF has said that, in order for SDRs to play a more meaningful role as a reserve asset to reduce global imbalances, the volume of SDRs would have to be expanded. Currently, SDRs

account for a little less than 4% of global reserves. The IMF has suggested increasing annual allocations of SDRs to 13% of global reserves by the 2020s.

a. What do you think the IMF's motive is in increasing SDRs reserves?
b. Do you see a problem with allowing countries to have greater access to credit reserves by the increase of SDRs?

11. A Citigroup analysis recently said that US and European regulators are essentially forcing banks to buy government debt and allowing them not to count government bond holdings against their capital reserve requirements in order to create a steady market for government bonds and to keep the yields low. Do you think that this could make the debt crisis worse by obscuring the real cost of borrowing?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

July 16, 2012

The Honorable Mick Mulvaney
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the June 7, 2012, hearing before the Joint Economic Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Mulvaney:

In response to Rep. Mulvaney's questions, Chairman Bernanke noted interest-rate swaps are less risky than pre-crisis Collateralized Debt Obligations and Credit Default Swaps because they are fairly straightforward and are largely used for hedging purposes. However, he added that "over-the-counter derivatives can be dangerous."

1. Based on the Chairman's statement that interest rate swaps are largely used to hedge, what data does the Federal Reserve use to distinguish how much trading activity in the interest rate swaps market is related to hedging risk versus taking speculative positions?

Data from the Bank for International Settlements (BIS) as of December 2011 indicate that the global gross notional amount of interest rate swaps outstanding stood at roughly $402 trillion. Regulatory reporting data for the same period indicate that the gross notional outstanding amount of interest rate swaps of U.S. insured commercial banks stood at roughly $136 trillion. Of these swaps, roughly $87 trillion are short term, i.e., a maturity of less than one year. Interest rate swaps are commonly used by banks and other financial and non-financial entities to hedge risks arising from fixed and variable interest payments.

2. If interest rate swaps are largely used for hedging, what is the source of the possible danger that the Chairman believes over-the-counter derivatives present?

Aside from interest rate risk, swaps are subject to counterparty risk. Specifically, swaps are subject to the risk that the counterparty that has promised to make a number of contractual payments may default on that obligation. Moreover, the default event may occur at a time when the required payment is significant, thus resulting in a substantial loss. Over-the-counter derivatives must be subject to rigorous and continuous risk management to guard against counterparty as well as market risks that are inherent in such contracts.

3. Some market experts have stated the interest-rate swaps market can impact the yield curve on U.S. Treasuries.

Can the interest rate swaps market impact the yield on U.S. Treasuries? If so, how can it affect the U.S. Treasuries market?

The interest rate swaps market is very active, and arbitrage across fixed income markets generally implies that swap rates and rates on fixed-income instruments, including Treasuries, tend to move together. These co-movements reflect common economic factors--such as expectations and uncertainties about future economic and financial conditions--and common technical factors--such as mortgage-duration-related hedging activities.

In some cases, however, idiosyncratic supply and demand factors specific to the swaps market may not pass through significantly to Treasury yields. For example, in the period between mid-September and mid-November 2008, the 30-year swap rate declined more than 45 basis points while the 30-year Treasury yield edged up a few basis points, leaving the 30-year swap spread sharply narrower. Market participants reportedly attributed this development to increased needs by pension funds and insurance companies to receive fixed rates in the interest rate swaps market in order to extend the durations of their asset portfolios following significant equity market losses that caused the duration of their asset holdings to shorten.

That said, a significant disruption in the interest rate swaps market could have significant repercussions for the Treasury market and other fixed income markets. For example, a disruption in the swaps market could impair the ability of many investors to properly manage interest rate risk. In that event, investors might tend to pull back from risk taking, which could put upward pressure on the yields on many fixed-income instruments, including longer-term Treasury securities. On the other hand, any upward pressure on Treasury yields in this scenario might be damped if investors who previously relied on the swaps market for interest rate risks management began to rely more heavily on Treasury markets for this purpose.

U.S. interest rate swaps are derivative assets whose payments depend upon fluctuations in the U.S. Treasury yield curve. Typically, the value of derivatives are considered to depend on the underlying value of the reference asset, e.g., the U.S. yield curve, but not vice versa. This "frictionless" view of market dynamics, however, is likely an oversimplification in reality. Demand for and the supply of U.S. Treasury securities that are required to settle certain interest rate derivatives may have an effect on U.S. Treasury prices and yields at different points in time. These effects, though they may be significant at times, are not thought to have a persistent effect on the value of U.S. Treasury securities.

4. According to the Office of the Comptroller of the Currency's Fourth Quarter 2011 Derivatives Trading Activity Report, the total credit exposure to risk-based capital ratio imposed by derivatives traded for the top five banks is 316%. Chairman Bernanke noted the importance of having as much interest rate swap activity trade through a central counterparty as possible (which the Federal Reserve is currently working to promote), adopting higher capital standards for banks (in the form of Basel III), and imposing adequate margin requirements for OTC transactions. Currently, Basel II puts a 0% standard risk weight on financial institutions' holdings of debt issues by domestic and foreign sovereigns with credit ratings of AA- or higher. This incentivizes financial institutions to hold sovereign debt rated AA- or higher on their balance sheets.

Does the risk weight methodology on sovereign debt rated AA- or higher indirectly affect trading activity on the OTC derivatives market? If so, then how does it impact a financial institution's total credit exposure to risk based capital ratio, especially as it relates to the institution's ability to meet its OTC derivatives obligations when responding to market shocks (e.g. an abrupt rise in interest rates)?

OTC derivative obligations are typically settled in cash. According to the 2012 ISDA Margin Survey, between 80 and 85 percent of all collateral received and posted on OTC derivative transactions is in the form of cash and U.S. Treasury securities.[1] Between five and fifteen percent of all collateral received and posted, however, is in the form of non-U.S government securities. When these securities are accepted, they are typically subject to a haircut that reduces the recognized value of the collateral relative to the face value of the security. The haircut applied on such securities that are accepted for discount window loans ranges between five and fifteen percent, which is broadly suggestive of haircuts that would be applied by private market participants.[2] Accordingly, non-U.S. government securities may be used at a modest discount to satisfy OTC derivative obligations.

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[1] The 2012 ISDA Margin survey can be found at: http://www2.isda.org/functional-areas/research/surveys/margin-surveys/

[2] Collateral haircuts that are applied to discount window loans can be found at: http://www.frbdiscountwindow.org/discountmargins.cfm?hdrID=21?genid=22&desc=Collateral%20Margins%20Table&url=discountmargins.cfm?hdrID=21

MICK MULVANEY
5TH DISTRICT, SOUTH CAROLINA

1004 LONGWORTH HOB
WASHINGTON, D.C. 20515
(202) 225-5501
FAX (202) 225-0464

1456 EBENEZER RD
ROCK HILL, SC
(803) 327-1114
FAX (803) 327-4330

Congress of the United States
House of Representatives

COMMITTEE ON BUDGET

JOINT ECONOMIC COMMITTEE

COMMITTEE ON SMALL BUSINESS
CHAIRMAN OF
SUBCOMMITTEE ON
CONTRACTING AND WORKFORCE

June 14, 2012

CLO: #B - 68
CCS: 12- 3758
RECVD: 6/14/12

The Honorable Ben S. Bernanke
Chairman
Board of Governors
The Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Dr. Bernanke:

Thank you for your testimony on the Economic Outlook to the Joint Economic Committee on Thursday, June 7. The insight you provide is widely considered to be among the highest caliber, and I enjoy having the opportunity to work together to confront the economic challenges facing our nation.

As you know, time constraints often leave many questions unasked. I appreciate your willingness to work with the Committee to allow these questions to be presented within a reasonable timeframe after the hearing. Enclosed are additional questions I have regarding the topic we discussed. Your thoughtful comments on these can help inform the public debate surrounding our financial system.

Thank you in advance for your consideration, and I look forward to working together in the days ahead.

Best regards,

Mick Mulvaney
Member of Congress

Questions for the Record
Joint Economic Committee
Hearing on the Economic Outlook
U.S. Representative Mick Mulvaney (SC-05)
June 7, 2012

In response to Rep. Mulvaney's questions, Chairman Bernanke noted interest-rate swaps are less risky than pre-crisis Collateralized Debt Obligations and Credit Default Swaps because they are fairly straightforward and are largely used for hedging purposes. However, he added that "over-the-counter derivatives can be dangerous."

Q1: Based on the Chairman's statement that interest-rate swaps are largely used to hedge, what data does the Federal Reserve use to distinguish how much trading activity in the interest-rate swaps market is related to hedging risk versus taking speculative positions?

Q2: If interest rate swaps are largely used for hedging, what is the source of the possible danger that the Chairman believes that over-the-counter derivatives present?

Some market experts have stated the interest-rate swaps market can impact the yield curve on U.S. Treasuries.

Q3: Can the interest-rate swaps market impact the yield curve on U.S. Treasuries? If so, how can it affect the U.S. Treasuries market?

According to the Office of the Comptroller of the Currency's Fourth Quarter 2011 Derivatives Trading Activity Report, the total credit exposure to risk-based capital ratio imposed by derivatives traded for the top five banks is 316%. Chairman Bernanke noted the importance of having as much interest rate swap activity trade through a central counterparty as possible (which the Federal Reserve is currently working to promote), adopting higher capital standards for banks (in the form of Basel III), and imposing adequate margin requirements for OTC transactions. Currently, Basel II puts a 0% standard risk weight on financial institutions' holdings of debt issued by domestic and foreign sovereigns with credit ratings of AA- or higher. This incentivizes financial institutions to hold sovereign debt rated AA- or higher on their balance sheets.

Q4: Does the risk weight methodology on sovereign debt rated AA- or higher indirectly affect trading activity in the OTC derivatives market? If so, then how does it impact a financial institution's total credit exposure to risk-based capital ratio, especially as it relates to the institution's ability to meet its OTC derivatives obligations when responding to market shocks (e.g. abrupt rise in interest rates)?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 30, 2012

The Honorable Shelley Moore Capito
Chairman
Subcommittee on Financial Institutions
and Consumer Credit
House of Representatives
Washington, D.C. 20515

Dear Madam Chair:

Enclosed are my responses to the written questions you submitted following the May 16, 2012, hearing before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michael S. Gibson
Director
Banking Supervision and Regulation

Enclosures

Questions for Dr. Michael S. Gibson, Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, from Chairman Capito:

1. Is it the Board's intention to significantly narrow the value of the thrift charter by subjecting SLHCs to BHC rules–and if not, can you describe the factors that are important in distinguishing the regulatory treatment of SLHCs and BHCs?

Congress transferred authority for the supervision of SLHCs from the Office of Thrift Supervision to the Federal Reserve effective on July 21, 2011. In preparing for that responsibility, the Board conducted extensive outreach with SLHCs to learn about their structure activities and practices. The Board also carried over existing Office of Thrift Supervision rules with respect to the activities of SLHCs and made no changes to the scope of permissible real estate activities for SLHCs.[1]

In addition, the Board has sought to tailor its supervisory approach to the characteristics of SLHCs. Federal Reserve supervision of SLHCs has, as an initial matter, focused on risk management practices,[2] and, as required under the Home Owners' Loan Act ("HOLA"), involves regular consultations with state insurance commissioners, the SEC, and other functional regulators.[3]

The Board's supervision of SLHCs also recognizes that different supervisory programs applied to SLHCs and BHCs prior to July 2011. During the current first round of inspections of SLHCs, Federal Reserve examiners are becoming acquainted with each SLHC's management and are seeking to fully understand the organization's operations and business model. Examiners are discussing the Board's supervisory expectations and rating system with SLHC management, but are not issuing final Federal Reserve ratings.[4]

Because regulatory capital requirements (including specific minimums) were not applied to SLHCs at the holding company level prior to July 2011, the Board currently is using both a qualitative and quantitative approach to evaluating capital at SLHCs. To be clear, the Board currently is not using the regulatory ratios used for BHCs to evaluate capital of SLHCs. Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act") provides that depository institution holding companies must meet consolidated minimum capital requirements that are at least as stringent as those applied to insured depository institutions. Consistent with section 171, the Board recently sought comment on a proposed rule implementing such consolidated minimum capital requirements for SLHCs (available at http://www.federalreserve.gov/newsevents/press).

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[1] 12 CFR 238.52(a)(i) and 238.53(b)(4) – (8).
[2] This approach is described in Attachment B to SR letter 11-11. For your reference, SR letter 11-11 and its attachments are appended to this response.
[3] 12 U.S.C. § 1467a(b)(4)(C).
[4] The Board's approach to the first round of SLHC inspections is discussed more fully in SR letter 11-11.

2. Regarding insurance companies, it is well-established that the risk-based capital standards utilized to regulate insurance companies and banks are starkly different—and is like comparing apples to oranges. Can you detail the benefits, if any, of applying incongruent bank-based capital standards (e.g., Basel) to insurance-based SLHCs, how this would work in practice, and how the benefits outweigh the costs?

It has long been the Board's general practice to apply consistent consolidated minimum capital requirements to all bank holding companies with $500 million or more in total consolidated assets, including bank holding companies that control functionally regulated subsidiary insurance companies. This approach helps to ensure the safety and soundness of each bank holding company and a level playing field across bank holding companies. The Board does not, however, apply its capital standards to an insurance company subsidiary of a bank holding company. Instead, the Board relies for the insurance company subsidiary on the capital requirements established by the appropriate state insurance regulator.

The Board is required under section 171 of the Act to apply to all bank holding companies and savings and loan holding companies minimum risk-based and leverage capital requirements that are not less than the minimum capital requirements applicable to insured depository institutions. However, the Board has recognized that some insurance company assets and activities are not permissible for banks and so has proposed tailored capital requirements that take account of these differences consistent with section 171 of the Act.

For example, the Board recently sought public comment on proposed revisions to its regulatory capital requirements that included a specific capital treatment for certain lower-risk assets, such as non-guaranteed separate accounts, that are commonly held by insurance companies but not by depository institutions. In contrast, the Board proposed identical treatment under its capital rules with respect to assets that are commonly held by both insurance companies and banks, such as bonds and other extensions of credit.

3. Do you support and advocate establishing distinct regulatory standards governing insurance-based SLHCs that more accurately reflect the insurance business model over the BHC model?

Please see response to question 4.

4. Although all of us are familiar with AIG, how many insurers today are engaged in the types of financial engineering activities that caused AIG's collapse? Is the AIG-experience justification for imposing bank-centric holding company requirements upon companies engaged only in traditional insurance activities?

Approximately 27 SLHCs primarily engage in insurance activities ("ISLHCs"). As explained in SR letter 11-11 (July 21, 2011), the Board is using the first cycle of SLHC inspections to learn more about the particular operations of each ISLHC. Supervisory assessments are currently being conducted at each ISLHC and its subsidiaries to more fully understand the activity make up of each ISLHC and determine if any activities pose safety and soundness concerns.

In April 2011, the Board stated its intention, to the greatest extent possible taking into account any unique characteristics of SLHCs and the requirements of HOLA, to assess the condition, performance, and activities of SLHCs on a consolidated basis in a manner that is consistent with the Board's risk-based approach regarding bank holding company supervision. State insurance regulators currently supervise insurance companies only on an individual entity basis. The Board's consolidated supervisory program is applied in a risk-focused manner and supervisory activities (such as, continuous monitoring, discovery reviews, and testing) vary across portfolios of institutions based on size, complexity, and risk. Board and Reserve Bank staffs are working to create supervisory plans that specifically address the risks associated with the activities of ISLHCs.

In its recent proposal that would revise regulatory capital requirements, the Board emphasized the importance of using a uniform approach to capital requirements for all depository institution holding companies in order to mitigate potential competitive equity issues, limit opportunities for regulatory arbitrage, and facilitate comparable treatment of similar risks.

5. Regarding the Collins Amendment, do you believe it makes sense to apply bank-oriented Basel risk-based capital (RBC) and leverage requirements to insurance companies? Does the Fed believe it has the discretion to use insurance-based measures of RBC and leverage-so long as the Fed determines these insurance measures satisfy the minimum floor requirements of the Collins Amendment?

As indicated in the response to question 2, the Board is required under section 171 of the Act to apply minimum risk-based and leverage capital requirements, on a consolidated basis, to bank holding companies and savings and loan holding companies that are not less than the minimum capital requirements applicable to insured depository institutions. The Board expects also to consider insurance-based measures of an insurance company's capital to evaluate capital as a supplemental measure of capital adequacy and to assess the risk of the insurance company subsidiary as it relates to the consolidated structure.

BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

DIVISION OF CONSUMER AND
COMMUNITY AFFAIRS

SR 11-11

CA 11-5

July 21, 2011

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK AND TO SAVINGS AND LOAN HOLDING COMPANIES SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Supervision of Savings and Loan Holding Companies (SLHCs)

Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (Dodd-Frank Act) transfers to the Board of Governors of the Federal Reserve System (Board) the supervisory functions of the Office of Thrift Supervision (OTS) related to SLHCs and their nondepository subsidiaries beginning on July 21, 2011. The Dodd-Frank Act also provides that all regulations, guidelines, and other advisory materials issued by the OTS on or before the transfer date with respect to SLHCs and their nondepository subsidiaries will be enforceable until modified, terminated, set aside, or superseded. As a result of this change in law, approximately 430 SLHCs will be transferring to Board supervision on July 21, 2011.

The Board has approved a notice that will be published in the Federal Register shortly which outlines the OTS regulations that the Board intends to continue to enforce after the transfer date.[2] As discussed in that notice, the Board will publish an interim final rule that effectuates the transition of regulations as soon as practicable.

This letter describes the supervisory approach the Board will use during the first supervisory cycle[3] for SLHCs. As discussed in a notice of intent issued by the Board and published in the Federal Register in April 2011 (notice of intent), the Board believes that it is important that any company that owns and operates a depository institution be held to appropriate standards of capitalization, liquidity, and risk management consistent with the

[1] Pub. L. 111-203, July 21, 2010; 124 Stat. 1376. See Section 312, Powers and Duties Transferred.

[2] See Federal Reserve Board press release, "Federal Reserve seeks comment on notice outlining regulations previously issued by the Office of Thrift Supervision," July 21, 2011.

[3] For purposes of this letter, the first supervisory cycle for an SLHC is the period of time between July 21, 2011, and the close of the first required inspection.

principles of safety and soundness.[4] The Board also believes that it is important that such companies be held to appropriate standards consistent with principles of consumer compliance risk management, including where nondepository subsidiaries are engaged in activities involving consumer financial products or services.

As a result, it is the Board's intention, to the greatest extent possible taking into account any unique characteristics of SLHCs and the requirements of the Home Owner's Loan Act (HOLA), to assess the condition, performance, and activities of SLHCs on a consolidated basis in a manner that is consistent with the Board's established risk-based approach regarding bank holding company (BHC) supervision. As with BHCs, the Board's objective will be to ensure that an SLHC and its nondepository subsidiaries are effectively supervised and can serve as a source of strength for, and do not threaten the soundness of, its subsidiary depository institution(s).

However, the Board is aware that it will take time for Federal Reserve supervisory staff to better understand an SLHC's operations and business model. The Board also is aware that SLHC management may need a period of time to make operational changes in response to the Federal Reserve's supervisory expectations, if necessary. The first cycle of SLHC inspections therefore will be instructive to both the Federal Reserve and SLHC management in terms of practical issues that arise in the supervision of an SLHC, particularly in the supervision of an SLHC that engages primarily in commercial, insurance, or broker-dealer activities.

As discussed in the notice of intent, the Board generally intends to transition SLHCs into the Board's designated supervisory portfolios of holding companies with similar characteristics and risk profiles. SLHCs that engage in significant commercial, insurance, and broker-dealer activities may be included in separate supervisory portfolios. The frequency and scope of supervisory activities for holding companies is discussed in detail in section 5000 of the Federal Reserve's *Bank Holding Company Supervision Manual* and in Board Supervision and Regulation (SR) letter 02-1, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less." For specific information about the supervisory approach during the first supervisory cycle for holding companies of varying size and complexity, see Attachments A and B of this letter.

Additionally, the notice of intent stated that the Board anticipated transitioning SLHCs to the Board's "RFI/C(D)" rating system (commonly referred to as "RFI").[5] The Board will issue a notice shortly outlining application of the RFI rating system to SLHCs and any modifications that the Board believes are necessary to accommodate SLHCs. That notice will provide the public with an additional opportunity to comment and will provide for a transition period before Federal Reserve examiners will assign final RFI ratings.

First-Cycle Inspections

The Federal Reserve plans to use the first inspections to learn more about the unique operational features of SLHCs and how its holding company supervision framework can most effectively be implemented at these companies. Accordingly, the focus of inspection activities during the first supervisory cycle will be on gaining an understanding of the structure and

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[4] See 76 FR 22662.

[5] See SR letter 04-18, "Bank Holding Company Rating System," and 69 FR 70444.

operations of each SLHC. Depending on the size and activities of the SLHC, Federal Reserve supervisory staff should use the first supervisory cycle to develop an understanding of the SLHC's business profile; prepare an institutional overview, risk assessment, and supervisory plan; and begin initial discovery reviews and assessments. A discovery review is an inspection activity designed to improve the Federal Reserve's understanding of a particular business activity or control process. For a larger and more complex company, the Reserve Bank will use a continuous monitoring program to supervise the SLHC.

In addition, during the first supervisory cycle, Federal Reserve supervisory staff should assess whether an SLHC conducts its operations in a safe and sound manner and in compliance with applicable laws and regulations, as well as whether an SLHC, its subsidiary depository institution(s), and nondepository subsidiaries are in compliance with any enforcement actions, applications commitments, or other supervisory directives (including citations in previous examinations or inspections). If Federal Reserve supervisory staff concludes that an SLHC is not conducting its operations in a safe and sound manner; is in violation of applicable law or regulations; or is not complying with any outstanding enforcement action, commitment, or supervisory directive, or if the primary regulator of a subsidiary savings association has determined that it is not in satisfactory condition, appropriate action should be taken against the SLHC, including possible formal or informal enforcement action.

As noted above, the Board understands that it will take time to acquaint SLHCs with the Board's supervisory policies and approach. To help facilitate this transition, examiners will be using this first supervisory cycle to inform SLHCs how their operations compare to the Board's supervisory expectations. As a result, the Board will not be issuing final RFI ratings to SLHCs during the first supervisory cycle.

Instead, during the first supervisory cycle, the Federal Reserve will be issuing an "indicative rating" that indicates to the SLHC how it would be rated if the RFI rating system was formally applied. Similar to a traditional inspection, the findings accompanying the indicative rating should include a detailed description of deficiencies that need to be addressed by management and/or the board of directors. Deficiencies that are correctable in the normal course of business; do not pose an immediate threat to the safety and soundness of the organization; or do not represent a violation of applicable law or regulation or failure to comply with any outstanding enforcement action, commitment, or supervisory directive generally should not result in formal or informal enforcement actions.

When communicating inspection findings, examiners should use standard Federal Reserve terminology to differentiate among matters requiring immediate attention (MRIAs), matters requiring attention (MRAs), and observations.[6] Examiners should discuss with management practices that are not consistent with the safety-and-soundness or consumer compliance risk management principles that are applied to BHCs to understand the business reasons for such practices and any controls surrounding the practices in question. When MRIAs and/or MRAs have been identified and communicated to the SLHC in a report of inspection, examiners should work with the SLHC to establish a plan and appropriate timetable for SLHC management to address these matters within a reasonable period. In determining the appropriate timetable for addressing deficiencies, examiners should refer to the priorities outlined in SR 08-1/CA 08-1 and should consider the nature, scope, complexity, and risk of the deficiency.

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[6] See SR letter 08-1/CA letter 08-1, "Communication of Examination/Inspection Findings" (SR 08-1/CA 08-1).

Supervision staff at the Board will review MRIAs and MRAs periodically to ensure appropriate prioritization and consistent treatment across SLHCs.

Applicable Law, Regulations, and Guidance

The main governing statute for SLHCs is HOLA. Other statutes apply to both SLHCs and BHCs, such as the Change in Bank Control Act and the Management Interlocks Act. As noted above, the Board intends to issue an interim final rule that will codify all the rules that apply to SLHCs. Although the Board anticipates conforming certain portions of the OTS rules to those currently found in the Board's Regulation Y, Regulation Y will not apply to SLHCs. Although SLHCs are similar to BHCs, SLHCs are not subject to the Bank Holding Company Act. In particular, SLHCs may engage in a wider array of activities than those permissible for BHCs and may have concentrations in real estate lending that are not typical for BHCs. Moreover, unlike BHCs, SLHCs are currently not subject to regulatory consolidated capital requirements, nor have they previously been subject to a formal source-of-strength doctrine. Guidance for assessing the capital adequacy of SLHCs is included in this letter as Attachment C.

As discussed above, the Dodd-Frank Act transfers all supervisory guidance applicable to SLHCs to the Board on the transfer date. Both the Board's and the OTS's supervisory guidance is largely based on principles of safety and soundness. Accordingly, the majority of Board guidance for BHCs should be equally relevant for the operations of SLHCs. The Board currently is reviewing OTS guidance and, as a general matter, has found that much of it is similar to that of the Board or was issued on an interagency basis.[7] During the first supervisory cycle, examiners should evaluate an SLHC using the same safety-and-soundness and consumer compliance risk management principles that are applied to a BHC.

The principles to be applied during the first supervisory cycle are largely set forth in the following documents:

- SR letter 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies"
- SR letter 08-9/CA letter 08-12, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations"
- SR letter 08-1/CA letter 08-1, "Communication of Examination/Inspection Findings"
- SR letter 04-18, "Bank Holding Company Rating System"
- SR letter 02-1, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less"
- SR letter 99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles"
- SR letter 99-15, "Risk-Focused Supervision of Large Complex Banking Organizations"
- SR letter 97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions"

[7] The Board intends to publish more detailed information about the application of supervisory guidance to SLHCs at a later date.

- Federal Reserve *Bank Holding Company Supervision Manual*:
    - Section 2010 (supervision of subsidiaries)
    - Section 2020 (intercompany transactions)
    - Section 4010 (parent company financial factors)
    - Section 4060 (consolidated earnings)
    - Section 4070 (BHC rating system)
    - Section 5000 (BHC inspection program)

SLHCs preparing for Federal Reserve inspections may find it helpful to become familiar with this guidance, in addition to the interim final rules setting forth regulations for SLHCs.

The Board will continue to review the OTS guidance to determine whether and how best to integrate it into the Board's supervisory system. If examiners have questions about the applicability of a particular safety and soundness or consumer compliance risk management principle, they should consult with Board staff.

Communication and Coordination

The Board understands that the transition to supervision of an SLHC by a new federal agency presents challenges for both the supervised institution and the agency. To address these challenges, the Federal Reserve has designated staff at each Reserve Bank to review, on an ongoing basis, the Federal Reserve's conduct of first-cycle inspections of SLHCs. Board staff will coordinate with those staff to periodically review inspection practices, promote a consistent supervisory approach across SLHCs, and clarify the application of policies and guidance for examiners and SLHCs as necessary.

Contacts

For questions regarding this guidance, please contact Kevin Bertsch, Associate Director, at (202) 452-5265, T. Kirk Odegard, Assistant Director, Policy Implementation & Effectiveness, at (202) 530-6225, or Michael Sexton, Assistant Director, Domestic Banking Acquisitions & Activities, at (202) 452-3009, in the Division of Banking Supervision and Regulation; or Suzanne Killian, Assistant Director, at (202) 452-2090, or Phyllis Harwell, Manager, LFI/LBO and Consumer Complaints, (202) 452-3658, in the Division of Consumer and Community Affairs. In addition, questions may be sent via the Board's public website.[8]

Patrick M. Parkinson
Director
Division of Banking Supervision
and Regulation

Sandra F. Braunstein
Director
Division of Consumer
and Community Affairs

Cross-References:

- SR letter 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies"
- SR letter 08-9/CA letter 08-12, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations"
- SR letter 08-1 / CA letter 08-1, "Communication of Examination/Inspection Findings"
- SR letter 04-18, "Bank Holding Company Rating System"
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- SR letter 99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles"
- SR letter 99-15, "Risk-Focused Supervision of Large Complex Banking Organizations"
- SR letter 97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions"

Attachments:

A. *First-Cycle Inspection of SLHCs Engaged Primarily in Depository Institution Activities*
B. *First-Cycle Inspection of Insurance SLHCs, Broker-Dealer SLHCs, and Commercial SLHCs*
C. *Assessing Capital Planning and Sufficiency*

[8] See http://www.federalreserve.gov/feedback.cfm.

CLO: #63
CCS: 12-3922
RECVD: 6/21/12

Questions for the Record from Chairman Shelley Moore Capito
May 16, 2012
Subcommittee on Financial Institutions
and Consumer Credit
Hearing entitled "The Impact of the Dodd-Frank Act: What It Means to be a Systemically Important Financial Institution"

Questions for FRB:

1) Is it the Board's intention to significantly narrow the value of the thrift charter by subjecting SLHCs to BHC rules—and if not, can you describe the factors that are important in distinguishing the regulatory treatment of SLHCs and BHCs?

2) Regarding insurance companies, it is well-established that the risk-based capital standards utilized to regulate insurance companies and banks are starkly different—and is like comparing apples to oranges. Can you detail the benefits, if any, of applying incongruent bank-based capital standards (e.g., Basel) to insurance-based SLHCs, how this would work in practice, and how the benefits outweigh the costs?

3) Do you support and advocate establishing distinct regulatory standards governing insurance-based SLHCs that more accurately reflect the insurance business model over the BHC model?

4) Although all of us are familiar with AIG, how many insurers today are engaged in the types of financial engineering activities that caused AIG's collapse? Is the AIG-experience justification for imposing bank-centric holding company requirements upon companies engaged only in traditional insurance activities?

5) Regarding the Collins Amendment, do you believe it makes sense to apply bank-oriented Basel risk-based capital (RBC) and leverage requirements to insurance companies? Does the Fed believe it has the discretion to use insurance-based measures of RBC and leverage--so long as the Fed determines these insurance measures satisfy the minimum floor requirements of the Collins Amendment?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

July 25, 2012

Honorable Bill Posey
United States House of Representatives
120 Cannon House Office Building
Washington, DC 20515

Dear Congressman Posey:

This is in response to your letter dated June 14, and the questions you asked at the May 17, 2012, hearing before the House Committees on Financial Services regarding the enforcement practices of the Federal banking agencies and the Securities and Exchange Commission. Specifically, you requested the number of criminal cases the Federal banking agencies have pursued since the financial crises of 2008 or, as an alternative, the number of cases the agencies referred to the Department of Justice. In addition, you asked for information about the penalties we have assessed and our efforts to investigate the compensation committees of the institutions we supervise.

As I mentioned in my written statement, the enforcement authority of the Federal Reserve and the other banking agencies is different in significant respects from that of other federal agencies. Importantly, Congress has not provided the Federal Reserve and the other bank regulatory agencies with the authority to seek criminal penalties for violations of law. This does not mean, however, that potential criminal violations are left unabated. Federal banking regulators have long had regulations in place that require the banking institutions they supervise to file suspicious activity reports (SARs) with the government identifying transactions involving possible violations of law or regulation.[1] Criminal investigators at the Department of Justice and authorized criminal prosecutors have direct access to the data system that holds these SARs.

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[1] See 12 C.F.R. §§ 208.62, 211.5(k), 211.24(f) and 225.4(f) (Federal Reserve); 12 § C.F.R. 21.11 (OCC); 12 C.F.R. § 353.3 (FDIC); 12 C.F.R. § 563.180 (OTS); and 12 C.F.R. § 748.1 (NCUA).

The Federal Reserve supervises more than 5,000 bank holding companies, 825 state-chartered banks that are members of the Federal Reserve System (state member banks), and effective one year after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 430 savings and loan holding companies. Since the financial crises of 2008, these institutions have filed more than 124,000 SARs involving suspected criminal activity where the transaction at issue involved either an insider, was in excess of $200,000, or resulted in a material impact on the institution. Where circumstances warrant, we have independently referred possible misconduct to the Department of Justice or other federal law enforcement authorities. When requested by the Department of Justice or other federal law enforcement authorities, the Federal Reserve provides support to criminal investigative authorities in connection with investigations that are initiated as a result of these SARs consistent with applicable legal restrictions. However, the decision to file criminal charges in a particular case is fully within the discretion of the Department of Justice or other federal agency with the authority to press criminal charges.

As the events of the financial crisis demonstrate, incentive compensation practices throughout a firm can incent employees to undertake imprudent risks that can significantly and adversely affect the risk profile of the firm. To help address this, in June 2010, the Federal Reserve initiated a targeted horizontal review of the compensation practices of the 25 largest, most complex banking organizations. The Federal Reserve also initiated a review of incentive compensation practices at regional, community, and other banking organizations as part of the regular, risk-focused examination process. A description of the results of the horizontal review of the largest banking organizations was published in a white paper by the Federal Reserve in October 2011. Deficiencies noted during the exam process will be factored into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions or take other actions.

In 2009, the Federal Reserve also issued guidance that sets clear expectations for banking organizations concerning their incentive compensation arrangements and related risk-management, control, and governance processes.[2] For example, we expect that banking organizations will establish incentive compensation arrangements that do not encourage employees to expose their

[2] Guidance on Sound Incentive Compensation Policies, 25 Fed. Reg. 122 (June 25, 2010) (proposed on October 22, 2009).

organizations to imprudent risks. In addition, incentive compensation arrangements should be compatible with, and not undermine, the organization's other controls and risk-management processes. Moreover, each institution's board of directors or, in appropriate circumstances, its compensation committee, is expected to review and approve the key elements of the firm's incentive compensation arrangements, conduct after-the-fact evaluations of how well the firm's incentive compensation arrangements have achieved their objectives, and understand and evaluate the internal controls and risk-management processes related to compensation.

The Federal Reserve in appropriate circumstances may take enforcement action against a banking organization to address misaligned incentive compensation practices. Such an action may require the organization to develop and promptly implement a plan to correct deficiencies in its incentive compensation arrangements or related processes. For example, in July 2011, the Federal Reserve entered into a consent cease and desist order and assessed an $85 million civil money penalty against Wells Fargo & Company and Wells Fargo Financial to address, among other things, allegations that the compensation practices of Wells Fargo Financial improperly incented employees to steer potential prime borrowers into more costly subprime loans or to falsely inflate the income of mortgage applicants. The $85 million civil money penalty was, at the time, the largest penalty the Federal Reserve had assessed in a consumer-protection enforcement action and was the first formal enforcement action taken by a federal bank regulatory agency to address alleged steering of borrowers into high-cost, subprime loans. The enforcement action also requires Wells Fargo to submit an acceptable plan to modify its incentive compensation practices and performance programs for mortgage lending personnel in order to encourage personnel to avoid fraudulent, deceptive or unfair conduct.

I hope this information is helpful.

Sincerely,

Scott G. Alvarez

CLO:	**#65**
CCS:	**12-** 4044
RECVD:	6/22/12

Questions for the Record
Representative Bill Posey
June 13, 2012

Full Committee Hearing: "Examining the Settlement Practices of U.S. Financial Regulators"
May 17, 2012

The following questions should be posed to the following witnesses on Panel I: Mr. Alvarez of the Federal Reserve; Mr. Osterman of the Federal Deposit Insurance Corporation; Mr. Stipano of the Office of the Comptroller of the Currency

Please provide the following data on your agency's settlement practices:

1. Number of criminal prosecutions pursued
2. Number of convictions arising from those prosecutions
3. Number and amount of stipulated settlements (and the total amount of damages to which the settlements pertain
4. Number of compensation committees examined for impropriety

Should your agency lack the authority to pursue criminal prosecutions, please tell me what referrals related to the questions posed above your agency has given to the Department of Justice and the outcome of those referrals.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

October 9, 2012

The Honorable Blaine Luetkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the June 19, 2012, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Scott G. Alvarez

Enclosure

Questions for Mr. Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System, from Representative Luetkemeyer:

1. Are you making any recommendations on investing in European government bonds?

See response for question 2.

2. Are you classifying investments in European government bonds?

The Federal Reserve does not make investment recommendations on European government bonds or any other type of instrument. The Federal Reserve and the other banking regulatory agencies continuously monitor developments in country risk and their possible effect on regulated institutions. Agency staff regularly coordinate on an inter-agency basis their reviews of the transfer and country risk of countries to which U.S. regulated institutions have exposure, including the appropriate treatment and reserve requirements for sovereign and commercial exposures in default. As part of this review, the agencies assess all pertinent quantitative factors, such as debt burden as percent of GDP, balance of payment, current account measures and many other measures, as well as qualitative factors, such as a sovereign obligor's commitment to internationally sponsored repayment plans.

CLO: **#81**
CCS: **12-**4600
RECVD: 7/20/12

Questions for the Record from
Rep. Blaine Luetkemeyer (MO-9)
Committee on Financial Services, U.S. House of Representatives

Hearing held on June 19, 2012, entitled
"Examining Bank Supervision and Risk Management in Light of JPMorgan Chase's Trading Loss"

Questions for Panel One

1. Are you making any recommendations on investing in European government bonds?

2. Are you classifying investments in European government bonds?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

February 7, 2013

The Honorable Spencer Bachus
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the June 19, 2012, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Scott G. Alvarez

Enclosure

<u>Questions for Mr. Scott Alvarez, General Council, Board of Governors of the Federal Reserve System, from Representative Spencer Bachus:</u>

1. One of the things about the JPMorgan loss that I can't figure out is which regulator is responsible for what. The OCC regulated JPMorgan's national bank, where the Chief Investment Office was located. But the Federal Reserve regulated the holding company. What, specifically, did the Federal Reserve do in supervising the holding company that could have prevented a sudden loss like this from happening? In particular, what responsibility did the New York Federal Reserve Bank have for supervising JPMorgan? Given the multiplicity of regulators that have some responsibility for JPMorgan, wouldn't it have been better had we consolidated regulators in the Dodd-Frank Act? Or do you believe that the fragmented structure we had before and decided to keep really works?

Our financial regulatory system relies on a variety of federal and state supervisors to execute particular supervisory and examination responsibilities for certain parts of a firm. This multi-agency approach was intended to allow the separate focus on different activities within financial conglomerates and to make use of different skills at different agencies throughout the government. It was also designed to provide for the consistent regulation of firms engaged in regulated activity regardless of their affiliation with an insured depository institution.

As the regulator and supervisor of bank holding companies, the Federal Reserve's role in this statutory arrangement is typically that of consolidated regulator and supervisor of the parent holding company. Accordingly, our supervisory program for such firms generally takes a broad view of the activities, risks, and management of the consolidated firm, with a particular focus on the capital adequacy, governance, and risk-management practices and competencies of the firm as a whole. However, many of the principal business activities of the largest financial firms are conducted through the functionally regulated subsidiaries of those firms, such as insured depository institutions, broker-dealers, and insurance companies.

In the specific case of JPMorgan Chase & Co. (JPMorgan), the Federal Reserve is the supervisor of JPMC (the holding company), the Office of the Comptroller of the Currency (OCC) is the supervisor of JPMorgan's national bank, and the Securities and Exchange Commission is the supervisor of JPMC's U.S. securities broker/dealer. By law, the Federal Reserve must defer to the fullest extent possible on examinations conducted by these other U.S. regulators that supervise various parts of the bank holding company. Operations outside the United States, such as JPMorgan's securities broker/dealer chartered and operating in London, are also subject to supervision by other authorities, such as the UK Financial Services Authority.

In response to the significant trading losses that were announced earlier this year by JPMorgan as a result of trading operations at the London branch of its national bank, the Federal Reserve--in its capacity as consolidated supervisor of the bank holding company--is working with the OCC, the regulator of the national bank, to review the firm's response and remedial actions. In particular, the Federal Reserve has been assisting in the oversight of JPMorgan's efforts to manage and de-risk the portfolio in question. We also have been working with the OCC and Federal Deposit Insurance Corporation (FDIC) to identify the changes in risk measurement, management and governance that will be necessary to improve risk-control practices surrounding the firm's trading activities across the organization and to address the trading strategies that led to these losses.

The Federal Reserve has a history of working cooperatively with other federal and state regulators. Together, the Federal Reserve and other functional regulators work to discharge the supervisory and examination responsibility given to each agency for particular parts of a large financial firm in a way that maximizes the expertise and resources of each agency and best ensures the safety and soundness of the consolidated firm and each of its constituent parts.

2. Several presidents of the regional Federal Reserve Banks as well as at least one prominent former regulator have called for breaking up those institutions that have become known as "Too Big to Fail." The Dodd-Frank Act did not do that; in fact, the institutions that were "Too Big to Fail" before the financial crisis are even bigger now than they were then. Should these institutions be broken up into smaller units so they can be more effectively supervised and so their failure wouldn't jeopardize the financial system? Is it the intention of the Federal Reserve to break up or shrink these institutions using its authority to set enhanced prudential standards under the Dodd-Frank Act for those institutions designated by the Financial Stability Oversight Council for regulation by the Federal Reserve?

A major objective of the Dodd-Frank Act is to mitigate the threats to financial stability posed by the too-big-to-fail problem. The too-big-to-fail problem is a pernicious one that has a number of substantial harmful effects. Critically, it reduces the incentives of shareholders, creditors, and counterparties of such firms to discipline excessive risk-taking. And it produces competitive distortions by enabling firms with large systemic footprints to fund themselves more cheaply than other firms because of the perception that these large firms will not be allowed to fail. This competitive distortion is not only unfair to smaller firms and damaging to competition today, but it also spurs further growth by the largest firms and more consolidation and concentration in the financial industry.

The Dodd-Frank Act takes a two-pronged approach in addressing the too-big-to-fail problem. The first prong empowers the Federal Reserve to reduce the probability of failure of a large, complex financial firm through tougher prudential regulation and supervision, including enhanced risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, stress testing, an early remediation regime, and activities restrictions. Ending the perception that some firms are too-big-to-fail also requires allowing a large, complex financial firm to fail if it cannot meet its obligations--and to do so without inflicting serious damage on the broader financial system. Importantly, the Dodd-Frank Act provides a mechanism for the FDIC, the Federal Reserve and the Treasury to jointly place any large financial firm that is in distress into liquidation. In addition the Dodd-Frank Act empowers the Federal Reserve and the FDIC to require large firms to conduct annual resolution planning. In particular, the Federal Reserve is working with the FDIC to require large, complex financial firms to better prepare for their own resolution by adopting so-called living wills.

In addition to stricter regulation and supervision of large, complex financial firms, the Dodd-Frank Act places new checks on the growth by acquisition of our major financial firms. It expands current restraints on acquisitions by bank holding companies to include a broader range of acquired firms (not just banks) and a broader range of liabilities (not just deposits). This expansion reflects a financial system that has changed in important ways since 1994, when the Congress first adopted concentration limits for banks and bank holding companies. The act also imposes new restrictions on the capital markets activities of banking firms--restrictions that will disproportionately affect the structure and profitability of the largest banking firms. For example, the so-called Volcker rule will restrict the ability of banking firms to engage in proprietary trading of securities and derivatives and to invest in or sponsor private investment funds.

The Federal Reserve's goal in designing enhanced prudential standards for large bank holding companies is to produce a well-integrated set of rules that meaningfully reduces the probability of failure of our largest, most complex financial firms and that minimizes the losses to the financial system and the economy if such a firm should fail. In doing so, we aim to require these firms to take into account the costs that they impose on the broader financial system, soak up the implicit subsidy these firms enjoy due to market perceptions of their systemic importance, and give these firms regulatory incentives to shrink their systemic footprint.

3. Jamie Dimon has used words like "sloppy," "stupid" and "bad judgment" to describe his firm's actions in this matter. Yet it is also the case that due to JPMorgan's "fortress balance sheet," the losses are eminently manageable, and do not in way jeopardize the firm's solvency or pose any threat to taxpayers. Are there lessons there for financial regulation? Does it seem to be the case that if an institution is well capitalized, most of what is in the Dodd-Frank Act that is intended to make the system safer is unnecessary, and if an institution is poorly capitalized, much of what is in the Dodd-Frank act is irrelevant?

Among the core objectives of the Dodd-Frank Act are enhancing regulators' ability to monitor and address threats to financial stability, strengthening both the prudential oversight (including capital regulation) and resolvability of large, complex financial firms, and improving the capacity of financial markets and infrastructures to absorb shocks. Achieving each of these objectives is important to enhancing the safety and soundness of the financial system.

The trading losses at JPMorgan have served to remind us of the fundamental importance of capital regulation in our prudential oversight of the largest banking firms. Although the risk-management failures that led to JPMorgan's recent trading losses are a cause for significant supervisory concern, it is important to note that these losses, though large in absolute dollar terms, are not a threat to the safety and soundness of the firm. Every dollar of these losses will be borne by JPMorgan's shareholders, and not by depositors or taxpayers, a result that is a function of the substantial amounts of high-quality capital that JPMorgan holds.

While robust bank capital requirements alone cannot ensure the safety and soundness of the largest banking firms, and indeed should be buttressed by other effective regulatory tools, they are central to good financial regulation because they ensure that capital is available to absorb all kinds of losses, unanticipated as well as anticipated. For precisely this reason, the Federal Reserve and other federal banking regulators continue to take important steps to strengthen bank capital regulation, especially for the largest, most complex firms.

4. Why do you believe that the best way to avoid future bailouts of financial institutions is by requiring higher capital cushions? How do you ensure that the capital requirements are commensurate with the risks posed by that institution to itself as well to the financial system more broadly?

While robust bank capital requirements alone cannot ensure the safety and soundness of our financial system, they are central to good financial regulation precisely because capital is available to absorb all kinds of potential losses and make taxpayer-funded bailouts less likely. Ensuring the capital adequacy of financial firms requires both improvement of the traditional, firm-based approach to capital regulation and the creation of a more systemic, or macroprudential, component of capital regulation.

With respect to improving the traditional approach to capital regulation, the Federal Reserve's work has principally involved the development of stronger regulatory capital standards in cooperation with other supervisors in the Basel Committee on Banking Supervision. This work includes the Basel 2.5 reforms that strengthened the market-risk capital requirements of Basel II. This work also includes the Basel III reforms, which improve the quality of regulatory capital, increase the quantity of required minimum regulatory capital, require banks to maintain a capital conservation buffer and, for the first time internationally, introduce a minimum leverage ratio. The Federal Reserve and other U.S. banking agencies recently issued final regulations to implement Basel 2.5 in the United States and proposed regulations to implement Basel III. (See 77 Federal Register 53060, August 30, 2012; 77 Federal Register 52792, August 30, 2012; 77 Federal Register 52888, August 30, 2012; and 77 Federal Register 52978, August 30, 2012.)

The recent financial crisis also made clear that the existing international regulatory capital framework was not sufficiently responsive to macroprudential concerns, such as the threat to financial stability posed by systemically important financial institutions. Accordingly, in Basel Committee deliberations, the Federal Reserve advocated for capital surcharges on the world's largest, most interconnected banking organizations based on their global systemic importance. Last year, an international agreement was reached on a framework for such surcharges, to be implemented during the same 2016-2019 transition period for the capital conservation buffers in Basel III. This initiative is consistent with the Federal Reserve's obligation under section 165 of the Dodd-Frank Act to impose more stringent capital standards on systemically important financial institutions, including the requirement that these additional standards be graduated based on the systemic footprint of the institution.

Both the Dodd-Frank Act provision and the Basel framework are motivated by the fact that the failure of a systemically important firm would have dramatically greater negative consequences on the financial system and the economy than the failure of other firms. Stricter capital requirements on systemically important firms should also help offset any funding advantage these firms derive from any remaining perceived status as too-big-to-fail and provide an incentive for such firms to reduce their systemic footprint.

The Federal Reserve has also sought to enhance the resiliency of the capital position of banking organizations through the development of firm-specific stress testing and capital planning requirements. These supervisory tools serve two related functions. They make capital regulation more forward-looking by testing whether firms would have enough capital to remain viable financial intermediaries if in an adverse macroeconomic scenario. They also contribute to the macroprudential dimension of supervision by enabling simultaneous examination of the risks faced by all large financial institutions during the hypothetical adverse economic scenario.

The Dodd-Frank Act also requires stress-testing requirements, which has been implemented through a final rule (77 Federal Register 62378, October 12, 2012). Pursuant to the rule, the Federal Reserve conducts annual stress tests on all bank holding companies with $50 billion or more in assets to determine whether they have the capital needed to absorb losses in hypothetical baseline, adverse, and severely adverse economic conditions. In addition, the rule requires that these companies and certain other regulated financial firms with assets between $10 billion and $50 billion to conduct internal stress tests. The Federal Reserve must publish a summary of results of the supervisory stress tests and issue regulations requiring firms to publish a summary of the company-run stress tests. Firm-specific capital planning has also become an important supervisory tool. In November 2011, the Federal Reserve issued a new regulation requiring large banking organizations to submit an annual capital plan. This tool serves multiple purposes. First, it provides a regular, structured, and comparative way to promote and assess the capacity of large bank holding companies to understand and manage their capital positions. Second, it provides supervisors with an opportunity to evaluate any capital distribution plans against the backdrop of the firm's overall capital position, a matter of considerable importance given the significant distributions that some firms made in 2007 even as the financial crisis gathered momentum. Third, at least for the next few years, it will provide a regular assessment of whether large bank holding companies will readily meet the Basel 2.5 and Basel III capital requirements as they take effect in the United States.

A stress test is a critical part of the annual capital plan review. But, as these three different purposes indicate, the capital plan review is about more than using a stress test to determine whether a firm's capital distribution plans are consistent with remaining a viable financial intermediary in adverse economic conditions. As indicated during our capital plan reviews in both 2011 and 2012, the Federal Reserve may object to a capital plan because of significant deficiencies in a firm's capital planning process, as well as because one or more relevant capital ratios would fall below required levels under the assumptions of stress and planned capital distributions. Likewise, the stress test is relevant not only for its role in the capital planning process. As noted earlier, it also serves other important purposes, not least of which is increased transparency of both bank holding company balance sheets and the supervisory process of the Federal Reserve.

5. There is an obvious trade-off between safety and economic growth. Higher capital standards may mean safer banks, but the price is that there will be less credit and that credit will be more expensive. Can you tell us the price we will pay for Basel III? How much more capital will banks need to meet the new standards? Have we sacrificed economic growth in the name of safety?

The Board and other agencies recently sought comment on proposed revisions to the banking agencies' capital rules that would, among other things, incorporate new international standards established by Basel III. (See 77 Federal Register 52792, August 30, 2012; 77 Federal Register 52888, August 30, 2012; and 77 Federal Register 52978, August 30, 2012, collectively, the "NPRs"). The proposed revisions would result in capital requirements that better reflect banking organizations' risk profiles and, combined with other requirements of the Dodd-Frank Act, should enhance their ability to continue to function as financial intermediaries particularly during stressful periods. Over the medium- and long-term, this should improve the overall resiliency of the banking system and increase economic growth. It is expected that a more stable financial system will result in lower long-term costs of credit for consumers and small businesses and a more consistent supply of credit to consumers and small businesses.

Based on the analysis conducted by the Board and our international colleagues, stronger capital requirements could help reduce the likelihood of banking crises while yielding positive net economic benefits. Moreover, this analysis found that the requirements would only have a modest negative impact on the gross domestic product of member countries, and that any such negative impact could be significantly mitigated by phasing in the proposed requirements over time.[1]

The Board along with the other banking agencies considered the potential impact of the proposed requirements on banking organizations using regulatory reporting data, supplemented by certain assumptions where data needed to calculate the capital requirements was not reported (the Board's analyses, related assumptions, and descriptions of methodologies used for the analyses are included as Attachment B). The general conclusion of the Board as well as the other agencies was that the vast majority of banking organizations, including community banks, already would meet the proposed minimum requirements on a fully phased-in basis and would also have capital sufficient to exceed the proposed capital buffer threshold for restrictions on capital distributions and certain discretionary payments to executive officers.

In addition, the Board and the other banking agencies sought public comment on the proposed requirements in the NPRs to better understand their potential costs and benefits. The agencies asked several specific questions in the NPRs about potential costs related to the proposals, and

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[1] *See* "An assessment of the long-term economic impact of stronger capital and liquidity requirements" (August 2010), available at http://www.bis.org/publ/bcbs173.pdf. (Attachment A).

are considering all comments carefully. During the comment period, the agencies also participated in various outreach efforts, such as engaging community banking organizations and trade associations, among others, to better understand industry participants' concerns about the NPRs and to gather information on their potential effects. These efforts have provided valuable additional information to assist the agencies as they determine how to proceed with the proposed rulemakings. The comment period on the NPRs ended on October 22, 2012, and more than 1,000 public comments have been submitted to the banking agencies.

The Board believes that an appropriately structured, robust and comprehensive regulatory capital framework will be essential to increasing the resiliency of U.S. banking organizations and the financial system. As the Board and the other banking agencies work toward this goal, all the comments received on the proposed changes to the U.S. regulatory framework will be carefully considered.

6. Has the Fed discovered any of the governance, risk management or control weaknesses that characterized JP Morgan's Chief Investment Office in any other parts of the holding company?

JPMorgan Chase has admitted that it did not have appropriate risk management processes in place to monitor the risk of trading activities in its CIO. The Federal Reserve is working with JPMorgan Chase and the OCC to address these risk management failures and ensure that JPMorgan has appropriate risk management for its trading activities across the organization. Confidential information regarding examinations of bank holding companies, such as JPMorgan Chase, are protected by law.

7. In your view, do the types of synthetic derivatives used by JPMorgan Chase's Chief Investment Office in this case serve any beneficial purpose from a safety and soundness standpoint? Or should they just be banned?

Credit derivatives can be used by regulated financial institutions to hedge existing exposures, to create new exposures, or to make two-way markets for other derivatives users such as asset managers (thus earning a "bid-ask spread"). Thus, credit derivatives can serve the purpose of allowing a bank to manage its exposure to clients as well as to service clients. However, these transactions entail significant embedded leverage and can involve imperfectly offsetting long and short positions in similar – but not perfectly correlated – reference assets. Derivatives trading therefore must occur within a well-controlled environment in order to ensure that risk is appropriately measured and that positions do not grow too large in size.

8. The fact that the Federal Reserve and the OCC have over a hundred examiners combined on-site at JPMorgan Chase and yet failed to appreciate the risks being undertaken by the firm's Chief Investment Office has caused some to question the wisdom of having regulators "embedded" at our nation's largest financial firms. Under this view, those examiners are at such high risk of becoming "captured" by the firms whose offices they report to every day that we would actually be better off if they performed their duties

off-site. What is your view? Is it time for a fundamental rethinking of some of our basic assumptions about how best to supervise our nation's largest financial institutions?

In order to supervise these large banks, supervisors must spend significant amounts of time at the firms interacting with firm personnel. However, Federal Reserve examiners should also regularly spend time off site interacting with management as well as peers responsible for supervising other institutions. We will continue to evaluate and explore the optimal balance.

9. Press reports suggest that JPMorgan Chase's peer institutions were less aggressive in their strategies for investing the huge "excess deposits" that have built up on their balance sheets due to the Fed's highly accommodative monetary policy, choosing to invest those funds largely in Treasuries and other forms of government-guaranteed debt rather than the more speculative instruments that Chase's Chief Investment Office traded. Is that an accurate characterization? Should we be worried that there are other "London Whale"-type trades at other large financial institutions yet to be uncovered, or is that fear largely unfounded?

Based on the work undertaken since the risk management failures at CIO surfaced, the Federal Reserve has no reason to believe that similar outsized positions exists elsewhere. However, this incident highlights the challenge that supervisors face in monitoring evolving risk profiles when a bank's internal risk reporting and risk limits are deficient, rendering the firm itself unable to identify and escalate emerging risks and vulnerabilities.

10. Martin Wolf has asked the following question that I now ask you: "Suppose there were no lenders of last resort, no government deposit insurance, no government regulation of financial intermediaries, and no government bailouts. Would the financial world be more or less dangerous than it is?"

Those were the conditions prior to the establishment of the Federal Reserve System, which was founded to help offset the cyclical panics that followed highs in the business cycle. They were also largely the conditions that existed at the time of the financial crisis that became the Great Depression. The creation of a lender of last resort, federal deposit insurance, regulation of financial intermediaries and, now, a framework for placing into resolution any systemically important firm in distress were all intended to reduce the likelihood and depth of future financial crises, which, history has demonstrated, impose high costs on broad numbers of consumers, households and businesses small and big.

The recent trading losses at JPMorgan Chase have also served to remind us of the fundamental importance of capital regulation in our prudential oversight of the largest financial firms. While robust bank capital requirements cannot alone ensure the safety and soundness of the financial system, they are central to appropriate financial regulation precisely because a company with adequate capital will be able to absorb a variety of losses, including those that are unanticipated.

CLO: #80
CCS: 12-4599
RECVD: 7/20/12

Questions for the Record from Congressman Bachus

Mr. Scott Alvarez, General Counsel, Federal Reserve

- One of the things about the JPMorgan loss that I can't figure out is which regulator is responsible for what. The OCC regulated JPMorgan's national bank, where the Chief Investment Office was located. But the Federal Reserve regulated the holding company. What, specifically, did the Federal Reserve do in supervising the holding company that could have prevented a sudden loss like this from happening? In particular, what responsibility did the New York Federal Reserve Bank have for supervising JPMorgan? Given the multiplicity of regulators that have some responsibility for JPMorgan, wouldn't it have been better had we consolidated regulators in the Dodd-Frank Act? Or do you believe that the fragmented structure we had before and decided to keep really works?

- Several presidents of the regional Federal Reserve Banks as well as at least one prominent former regulator have called for breaking up those institutions that have become known as "Too Big to Fail." The Dodd-Frank Act did not do that; in fact, the institutions that were "Too Big to Fail" before the financial crisis are even bigger now than they were then. Should these institutions be broken up into smaller units so they can be more effectively supervised and so their failure wouldn't jeopardize the financial system? Is it the intention of the Federal Reserve to break up or shrink these institutions using its authority to set enhanced prudential standards under the Dodd-Frank Act for those institutions designated by the Financial Stability Oversight Council for regulation by the Federal Reserve?

- Jamie Dimon has used words like "sloppy," "stupid" and "bad judgment" to describe his firm's actions in this matter. Yet it is also the case that due to JPMorgan's "fortress balance sheet," the losses are eminently manageable, and do not in way jeopardize the firm's solvency or pose any threat to taxpayers. Are there lessons there for financial regulation? Does it seem to be the case that if an institution is well capitalized, most of what is in the Dodd-Frank Act that is intended to make the system safer is unnecessary, and if an institution is poorly capitalized, much of what is in the Dodd-Frank act is irrelevant?

- Why do you believe that the best way to avoid future bailouts of financial institutions is by requiring higher capital cushions? How do you ensure that the capital requirements are commensurate with the risks posed by that institution to itself as well to the financial system more broadly?

- There is an obvious trade-off between safety and economic growth. Higher capital standards may mean safer banks, but the price is that there will be less credit and that credit will be more expensive. Can you tell us the price we will pay for Basel III? How much more capital will banks need to meet the new standards? Have we sacrificed economic growth in the name of safety?

- Has the Fed discovered any of the governance, risk management or control weaknesses that characterized JP Morgan's Chief Investment Office in any other parts of the holding company?

- In your view, do the types of synthetic derivatives used by JPMorgan Chase's Chief Investment Office in this case serve any beneficial purpose from a safety and soundness standpoint? Or should they just be banned?

- The fact that the Federal Reserve and the OCC have over a hundred examiners combined on-site at JPMorgan Chase and yet failed to appreciate the risks being undertaken by the firm's Chief Investment Office has caused some to question the wisdom of having regulators "embedded" at our nation's largest financial firms. Under this view, those examiners are at such high risk of becoming "captured" by the firms whose offices they report to every day that we would actually be better off if they performed their duties off-site. What is your view? Is it time for a fundamental rethinking of some of our basic assumptions about how best to supervise our nation's largest financial institutions?

- Press reports suggest that JPMorgan Chase's peer institutions were less aggressive in their strategies for investing the huge "excess deposits" that have built up on their balance sheets due to the Fed's highly accommodative monetary policy, choosing to invest those funds largely in Treasuries and other forms of government-guaranteed debt rather than the more speculative instruments that Chase's Chief Investment Office traded. Is that an accurate characterization? Should we be worried that there are other "London Whale"-type trades at other large financial institutions yet to be uncovered, or is that fear largely unfounded?

- Martin Wolf has asked the following question that I now ask you: "Suppose there were no lenders of last resort, no government deposit insurance, no government regulation of financial intermediaries, and no government bailouts. Would the financial world be more or less dangerous than it is?"

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

December 13, 2012

The Honorable Ron Paul
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the July 18, 2012, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Paul:

1. What items constitute the "Other Federal Reserve assets" line item in Table 1 of the weekly Federal Reserve Statistical Release H.4.1 Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks? Please provide as detailed a categorized list as possible?

"Other Federal Reserve assets" ("other assets") include assets denominated in foreign currencies; premiums paid on securities bought; accrued interest on other accounts receivable; Reserve Bank premises and operating equipment less allowances for depreciation; and, until recently, float-related as-of adjustments.[1] Until January 2009, "other assets" also included the currency swaps with other central banks. For reference, the Board of Governors' Credit and Liquidity Programs and the Balance Sheet public website presents a summary of the H.4.1 statistical release with an interactive guide (http://www.federalreserve.gov/monetarypolicy/bst_fedsbalancesheet.htm).

2. The "Other Federal Reserve assets" line item increased from approximately $40 billion in early 2009 to roughly $100 billion in early 2010, remaining at that level throughout 2010. What were the causes for the increase in the "Other Federal Reserve assets" line items over the 2009-2010 period?

You noted that between 2009 and early 2010, "other assets" increased. Indeed, between January 28, 2009, and the present, "other assets" have increased by roughly $150 billion. The increase primarily reflects an increase in unamortized premiums on securities held in the Federal Reserve's System Open Market Account portfolio. The Federal Reserve purchases securities in the open market at market-determined prices. The market price of a security can be expressed as the face value of that security plus a premium or a discount, depending on whether the market price of the security is above or below the face value on the date of purchase. On the H.4.1 statistical release, we report the face value of the securities, and the premium or discount at the time of purchase is separately reported under "other assets." This accounting treatment has been in place for decades.

Since early 2009, the Federal Reserve has engaged in large-scale asset purchases in an effort to ease overall financial conditions and to provide support for the economic recovery. Because the market prices of most of the securities that were purchased were greater than the face value of those securities, "other assets" have increased reflecting the accumulation of premiums as our holdings of securities have increased.[2]

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[1] As one part of an effort to simplify the administration of reserve requirements and thereby reduce burden on the banking sector, the Federal Reserve eliminated as-of adjustments on July 12, 2012. Additional information about reserves simplifications can be found at http://www.federalreserve.gov/newsevents/press/other/20120405a.htm

[2] The Federal Reserve publishes the details of all of its securities holdings on the public website of the Federal Reserve Bank of New York (http://www.newyorkfed.org/markets/soma/sysopen_accholdings.html).

3. The "Other Federal Reserve assets" line item has nearly doubled since early 2011, increasing from roughly $100 billion to almost $200 billion. What is (are) the cause(s) for this increase in the "Other Federal Reserve assets" line item?

Please see the response to question 2.

4. Is the increase in the line item "Other Federal Reserve assets" related in any way to the dollar swap lines with foreign central banks or to other assistance to foreign central banks, commercial banks, or governments?

The central bank liquidity swaps that the Federal Reserve has with other central banks have been reported separately since January 2009. As a result, the increase in "other assets" since then is not related to those swaps, nor is it related to assistance to foreign institutions.

5. The central bank liquidity swap lines when first drawn upon in 2007 were published in the H.4.1 release with the "Other Federal Reserve assets" line item before being broken out into a separate line item in early 2009. Are there some specific facilities, asset types, or other categories that could be given their own line item now that the "Other Federal Reserve assets" line items had grown so large?

Although the security premiums at the date of purchase are largely a technical accounting item, we are considering whether to report the premiums on securities separately from other items included in the "other assets" category.

CLO:	**#B - 101**
CCS:	**12-5593**
RECVD:	8/22/12

Questions for the Record from Congressman Ron Paul (TX-14)

Hearing held July 18, 2012 to receive the testimony of the Federal Reserve Board of Governors on monetary policy and the state of the economy.

The Honorable Ben S. Bernanke
Chairman, Board of Governors of the Federal Reserve System

1. What items constitute the "Other Federal Reserve assets" line item in Table 1 of the weekly Federal Reserve Statistical Release H.4.1 Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks? Please provide as detailed a categorized list as possible.

2. The "Other Federal Reserve assets" line item increased from approximately $40 billion in early 2009 to roughly $100 billion in early 2010, remaining at that level throughout 2010. What were the causes for the increase in the "Other Federal Reserve assets" line item over the 2009-2010 period?

3. The "Other Federal Reserve assets" line item has nearly doubled since early 2011, increasing from roughly $100 billion to almost $200 billion. What is (are) the cause(s) for this increase in the "Other Federal Reserve assets" line item?

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CLO: #B - 102
CCS: 12-5594
RECVD: 8/22/12

Questions for the Record
Representative Bill Posey
August 3, 2012

Full Committee Hearing "Monetary Policy and the State of the Economy"
July 18, 2012

The following questions should be posed to Federal Reserve Chairman Bernanke:

On May 17, 2012, the Federal Reserve's General Counsel, Mr. Scott Alvarez, testified before our committee about the settlement practices of U.S. financial regulators. This is an issue in which I have great interest because I believe that the practice of reaching settlements with wrong doers—often without requiring them to admit or deny guilt—fails to serve as a deterrent to bad behavior. The failure of the federal government to criminally prosecute bad actors for their bad behavior simply leaves open the likelihood of repeated financial wrongdoing.

During the May hearing, I asked the Federal Reserve, among other regulators, to provide me with data on your agency's enforcement action settlements entered into as a result of wrongdoing related to the financial crisis. I simply wanted to know the number of criminal prosecutions pursued, the number of convictions arising from the prosecutions, the number and amount of stipulated settlements, and the number of compensation committees examined for impropriety. I asked your agency to provide that information to me within a week. Nearly two and a half months later, I received an inadequate response with very little substance. I find it disturbing that U.S. regulators frequently rely on settlement practices, but fail to keep adequate records on these settlements.

Fast forward to today, and we have an investment bank, Barclay's Capital, entering into a $450 million settlement with U.S. and U.K. regulators for intentionally manipulating the Libor rate to advantage their business operations and to make the bank look healthier than it was. Barclay's is not being forced to admit or deny guilt in this settlement. It will simply write a check and its worries will go away. No doubt, through its manipulation of Libor, Barclays has cheated Floridians out of money, affecting their cost of living, retirement, and investments.

I would like to know what the Federal Reserve's role will be in investigating and resolving this matter. What involvement do you see the Federal Reserve having in the Department of Justice's pursuit of criminal charges against Barclay's employees? How will the Federal Reserve help assess the impact this manipulation has had on Floridians and Americans all across the country? Does the Federal Reserve have a plan in place to more closely monitoring banks' Libor submissions or any guidelines in place to allow regulators to more quickly raise red flags if certain submissions appear to be out of the norm? Will the Federal Reserve encourage the President's Working Group on Capital Markets to closely look into the manipulation?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

August 27, 2012

The Honorable Joseph I. Lieberman
Chairman
Committee on Homeland Security
and Governmental Affairs
United States Senate
Washington, D.C. 20510

The Honorable Susan M. Collins
Ranking Member
Committee on Homeland Security
and Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Senators:

On June 29, 2012, the Government Accountability Office ("GAO") issued a report titled "FORECLOSURE REVIEW: Opportunities Exist to Further Enhance Borrower Outreach Efforts," (GAO-12-776). This report included three recommendations addressed to the Federal Reserve Board ("Board") and the Office of the Comptroller of the Currency ("OCC"). The purpose of this letter is to provide additional information about actions that the Board has taken in response to these recommendations.

The goal of the Independent Foreclosure Review ("IFR") process is to remediate borrowers determined by an independent consultant to have been financially harmed from improper foreclosure actions in 2009 and 2010. The Board, working closely with the OCC, has taken extensive steps to ensure that borrowers who suffered financial injury are identified and appropriately compensated for financial injury they suffered as a result of errors, misrepresentations, or other deficiencies in the foreclosure process. We appreciate the GAO's recommendations as we work to implement an outreach process. As part of our ongoing efforts to solicit the greatest possible participation in the IFR process, the Board has responded fully to two of the three GAO recommendations, and, within weeks, will have completed its efforts to fully respond to the third. In addition, the Board recently extended the deadline to submit a Request for Review form for an additional three months, to December 31, 2012.

The GAO's first recommendation is to enhance the readability of the Request for Review form on the IFR website, suggesting a plain language guide to the questions as one solution. A plain language guide is now available to borrowers in English and Spanish on the IFR website. In addition, the Board and OCC developed a webinar earlier this year as a guide for housing counselors to better advise borrowers on completing the form, which continues to serve as a helpful resource tool. The webinar and associated materials are available in English and Spanish on the Board's website. Housing counseling agencies approved by the U.S. Department of Housing and Urban Development are among those using the webinar materials to offer training sessions to borrowers interested in submitting a Request for Review form. We have also recently redesigned our website to allow for easier navigation.

The GAO's second recommendation is that the Board and OCC require servicers to include a range of potential remediation amounts or categories in public communication materials. On June 21, 2012, the Board and the OCC released guidance to be used in determining the compensation or other remedies that borrowers will receive for financial injury identified during the IFR. The Board and OCC also developed a Frequently Asked Questions ("FAQs") document to accompany the guidance and further explain the remediation process and the injury categories. These materials are available in English and Spanish on the IFR website and on the Board's website, along with a quick summary guide to further assist borrowers in understanding the guidance. The new guidance and FAQs were reviewed in detail with, and incorporated feedback from, consumer groups before being made available to the public.

The GAO's third recommendation is that the Board and OCC require the servicers to analyze the borrower population potentially eligible for the IFR, looking at both borrowers who have responded to existing outreach opportunities as well as those who have not, focusing on factors such as MSA, zip code, servicer, and borrower characteristics as a way of improving outreach to borrowers. The Board and the OCC have met with servicers and their consultants a number of times in the past weeks in order to look for ways to improve our outreach generally and to address this GAO recommendation in particular.

On July 30, 2012, the Board and OCC participated in a meeting of the counseling intermediaries funded by servicers to provide IFR-related outreach to borrowers. A purpose of the meeting was to review and look for ways to improve existing outreach activities. The Board followed this up by holding a meeting on August 6, 2012, with national intermediaries, including community advocates and other non profit groups who serve borrower populations potentially eligible for the IFR to seek their participation in outreach activities. To further heighten awareness, several of the Federal Reserve Banks have held outreach events and participated in activities in their districts.

On August 15, 2012, the Board and OCC convened a meeting of servicers, independent consultants, media firms and community-based organizations with experience in outreach to diverse borrower populations. At the meeting, the media firms and community-based organizations presented ideas on ways to increase awareness about and encourage participation in the IFR. With the benefit of the ideas shared during the meeting, the Board and OCC instructed the servicers to develop new outreach strategies. The servicers were also directed to conduct targeted analyses to identify underrepresented borrowers potentially eligible for a foreclosure review. For the targeted analyses, the Board and OCC required the servicers to analyze their own IFR data with overlays to the 2010 Census data to identify gaps in coverage by factors such as income, race, ethnicity, language use and foreclosure rates at the MSA, county and census-tract levels, and identify trends, such as low response rates by geography and borrower characteristics. The Board is finalizing its analysis of the IFR data on mailings and responses at the county level to aid local outreach efforts. We plan to make information concerning the Board's analysis publicly available in the coming weeks by posting it on the Board's website. Using this information, coupled with feedback from media firms and community stakeholders, including the ideas presented at the August 15 meeting, the Board and OCC are requiring the servicers to revise their outreach plans to respond to any gaps and needs for additional outreach.

The Board continues to be committed to providing potentially harmed borrowers with a review process that is both accessible and impartial. Along with the OCC, we continue to receive valuable input from community groups, housing counseling organizations and other interested stakeholders on ways to heighten awareness, encourage participation, and improve the borrower experience in the IFR process. We believe the actions we have taken independently, and those we have taken in response to the GAO's recommendations, are important steps towards increasing awareness about the IFR process and the opportunities that borrowers have to participate in this extensive effort.

Sincerely,

cc: The Honorable Tim Johnson
The Honorable Richard Shelby

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

August 27, 2012

The Honorable Darrell E. Issa
Chairman
Committee on Oversight
and Government Reform
House of Representatives
Washington, D.C. 20515

The Honorable Elijah E. Cummings
Ranking Member
Committee on Oversight
and Government Reform
House of Representatives
Washington, D.C. 20515

Dear Congressmen:

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The Honorable Darrell E. Issa
The Honorable Elijah E. Cummings
Page Three

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Sincerely,

cc: The Honorable Spencer Bachus
The Honorable Barney Frank

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

October 2, 2012

The Honorable Mike Enzi
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the February 7, 2012, hearing before the Senate Budget Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Enzi:</u>

1. We can both agree on the importance of reducing the federal deficit. The GAO reported in 2011 that by replacing the \$1 note with a \$1 coin, the government could save at least \$5.5 billion over 30 years. Using Federal Reserve methodology in its 1990, 1993, and 1995 Reports, GAO calculated annual savings of \$318 million, \$395 million and \$456 million.

In addition, in 2000 GAO estimated savings of \$522 million per year, which projects to nearly \$16 billion in savings over 30 years. GAO also noted in a 1995 report that Federal Reserve Board of Governor Edward W. Kelley, Jr. testified before the House Banking and Financial Services Committee that the Reserve Model estimated \$460 - \$467 million per year in government savings by replacing \$1 notes with \$1 coins. In its latest, March 2011 Report, GAO stated: "We have previously recommended to the Congress replacement of the \$1 note with a \$1 coin and, in view of the ongoing significant estimated federal deficit, continue to support this prior recommendation." Do you support the GAO's recommendation that we move from a one dollar note to a one dollar coin?

The GAO has produced two recent reports on the issue of replacing \$1 notes with \$1 coins. The first report was published in March 2011 and the second in February 2012. Both rely on similar data, with the second report incorporating data on important efficiency improvements in the processing of notes. Most importantly, the second report clearly separates the GAO's estimates of the real resource costs of replacing \$1 notes with \$1 coins from estimates of the seigniorage revenue that might flow to the government from mandating use of the \$1 coin.[1]

Overall, the GAO found that the real resource costs of producing sufficient \$1 coins to replace all \$1 notes are never fully recovered during the 30-year period of analysis in its studies and that the net benefits to the government are attributable to increased seigniorage revenue from mandating use of the \$1 coin. This result flows from the fact that although coins are expected to last longer than notes, the coins are estimated to cost six times more to produce. In addition, the GAO's estimate of increased seigniorage from use of the \$1 coin flows from an assumption that coins would need to replace notes at a ratio of greater that 1-to-1. This replacement ratio, based on the experiences of Canada and the United Kingdom in the 1980s, presumably results from characteristics of coins such as weight and bulk that make holding and carrying coins a less efficient payment option for some purposes and leads consumers and businesses to store unwanted coins in informal inventories. Analytically, the closer the replacement ratio is to 1-to-1, the lower the amount of seigniorage revenue available to offset the real resource costs of producing the coins. Since seigniorage is crucial to these calculations, it is also important to recognize that the use of electronic payments has been growing rapidly and creates significant uncertainty about the long-term estimates of seigniorage. Other important issues involve

[1] A 2004 GAO report clarified that seigniorage from coins is not counted in tallies of the U.S. budget deficit or surplus, and is not counted or scored by the Congressional Budget Office or the Office of Management and Budget for purposes of determining the budgetary effects of legislation.

changes in processing $1 notes since the 1990s that have substantially increased their average life as well as concerns that counterfeiting $1 coins could increase if they are in widespread use.[2]

2. I am told that the Federal Reserve Board acknowledged the existence of an analysis by Board staff entitled "One Dollar Note vs. One Dollar Coin: A Cost-Benefit Analysis", conducted in late 2008 or early 2009. It is my understanding that the report estimated annual savings of $800 million to $900 million from using $1 coins instead of $1 notes – which in turn projects out to as much as $27 billion in savings over 30 years. I believe that study, as written in 2008/2009, would be very helpful to this committee as we look for ways to reduce the federal deficit, and would be particularly helpful in concert with the five GAO reports on this issue. Will you please share a copy of the study with me?

In the latter half of 2008 and early 2009, the Board staff began a research study of the broader societal costs and benefits of changing the use of $1 notes and $1 coins. Initial work was undertaken by junior staff. However, because of other pressing matters at the time, that initial work was not reviewed, refined, or approved by senior management. As a consequence, no final study or analysis resulted from that effort.

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[2] For example, the United Kingdom is faced with a counterfeit £1 coin that the public is largely unable to authenticate.

Michael B. Enzi

Questions for the Record
From Senator Mike Enzi
For Chairman of the Federal Reserve, Ben Bernanke
The Outlook for Monetary and Fiscal Policy
February 7, 2012
Senate Budget Committee

Question #1: We can both agree on the importance of reducing the federal deficit. The GAO reported in 2011 that by replacing the $1 note with a $1 coin, the government could save at least $5.5 billion over 30 years. Using Federal Reserve methodology in its 1990, 1993, and 1995 Reports, GAO calculated annual savings of $318 million, $395 million, and $456 million, respectively.

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CLO: #B - 111
CCS: 12-6367
RECVD: 9/18/12

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

May 21, 2013

The Honorable Carolyn Maloney
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the February 27, 2013, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Maloney:

1. Close to 450,000 files were reviewed by the independent consultants in connection with the independent foreclosure review. Please indicate how many of those files were of New York Residents.

The Independent Foreclosure Review ("IFR") required by the regulators' enforcement orders against the major mortgage loan servicers included a borrower outreach procedure that allowed borrowers who were in foreclosure during 2009 and 2010 at the covered servicers to submit a request to have their foreclosure reviewed by an independent consultant. As of December 31, 2012, the deadline for submission of requests for review, about 500,000 borrowers out of the total eligible population of over 4.2 million had submitted requests for review. In addition, at Federal Reserve-regulated servicers, approximately 60,000 files were slated for review as part of the separate review of certain types of borrower files by independent consultants that was part of the IFR – the "look-back." Data for the files slated for review as part of the "look-back" was not maintained on a state-by-state basis.

As you know, the IFR ceased at the 13 servicers participating in the agreement in principle announced by the Federal Reserve and Office of the Comptroller of the Currency ("OCC") in January. As a result of the agreement, each of those 4.2 million borrowers will receive some direct compensation and may benefit from additional assistance that we are requiring from the servicers, including all eligible borrowers from New York, regardless of whether their file would be reviewed as part of the IFR.

2. There are still 4 million borrowers who were in foreclosure between 2009 and 2010. With an $8 billion settlement, how far do you believe it will go? Will the payment match the harm?

With the OCC taking the lead, we undertook strong enforcement actions in 2011 to help the millions of affected borrowers in foreclosure during 2009 and 2010 and to correct mortgage servicing deficiencies. Our goals were, and continue to be, to require the major lenders and servicers to correct their foreclosure practices and maintain practices that ensure that no consumer is wrongfully foreclosed upon or wrongfully denied access to available loan modification programs, and to assist borrowers subject to improperly administered foreclosure practices. Our enforcement actions required the servicers to immediately correct foreclosure practices. When it became clear that the reviews of individual files to identify injured borrowers required by our enforcement actions – the IFR – would significantly delay getting remediation to borrowers, the OCC and the Federal Reserve, after consulting consumer groups, chose to change course with respect to that requirement of our enforcement actions. Although none of the available options were ideal, we accepted the agreement, which provides some immediate assistance to all in-scope borrowers, because that approach will result in money being paid to more borrowers in a shorter time frame than would have occurred if the file reviews had continued. This approach also preserved the rights of borrowers to obtain full remediation for any injury.

3. Who gave the order that no money would be paid to borrowers while close to $2 billion in fees was generated?

The process of carefully reconstructing and reviewing the hundreds of thousands of files to ensure consistent treatment took the servicers and independent consultants substantial time and required significant resources. As the IFR proceeded, it became clear that the process of identifying injured borrowers and determining the type and amount of remediation due them was proceeding much too slowly, largely due to this complex and labor-intensive process. The regulators, after consulting with community groups, chose to change course. Although none of the available options were ideal, we accepted the agreements to pay all in-scope borrowers and provide other foreclosure prevention assistance because that approach will result in money being paid to more borrowers in a shorter time frame than would have occurred if the file reviews had continued.

4. We have been told that there was agreement that institutions would not compensate injured borrowers until all institutions were ready to do so.

a. Were you aware of this agreement?

Please see response for 4 (c).

b. Do you believe it was appropriate to allow the process to be conducted in that manner?

Please see response for 4 (c).

c. Wouldn't it have been more effective to compensate borrowers where harm was found and documented rather than wait for the entire process to be completed?

We are not aware of any such agreement and, in fact, encouraged institutions subject to the Federal Reserve's jurisdiction to make payments to borrowers as soon as practicable. The IFR required the identification of injured borrowers by the independent consultants and then the submission by the servicer of an acceptable plan to provide remediation to those borrowers. Processes were being developed to assure that all borrowers who suffered similar financial injuries were treated consistently in the remediation they received. The Federal Reserve contemplated that, once an institution's remediation plan was completed, we would have required the servicer to carry out the remediation without regard to whether other institutions were ready to provide remediation.

5. Please shed some light on the decision to halt the independent review. Were there specific reports from the IC's that led you to believe you weren't going to find what you expected to find?

As noted above, as the IFR proceeded, it became clear that the process of identifying injured borrowers and determining the type and amount of remediation due them was proceeding much too slowly, largely due to its complex and labor-intensive nature. The regulators, after consulting with community groups, chose to change course. Although none of the available options were ideal, we accepted the agreements to pay all in-scope borrowers and provide other foreclosure prevention assistance because that approach will result in money being paid to more borrowers in a shorter time frame than would have occurred if the file reviews had continued.

6. Do you believe that injured borrowers will be rightly compensated for the financial harm they suffered?

Please see response to question 2.

7. How have practices at the institutions that you supervise changed since the consent orders were signed?

The provisions of the Federal Reserve's mortgage servicing-related Consent Orders required servicers to fix what was broken to ensure a fair and orderly mortgage servicing process going forward, and the Federal Reserve continues to expect servicers to fully correct these practices and policies. In the time since issuing our orders, progress has been made in implementing better controls, and improving systems and processes designed to ensure the errors leading to our enforcement actions do not recur. The Federal Reserve is examining servicers to monitor and test these improvements and examiners will continue to work to ensure complete compliance with the Federal Reserve's enforcement actions and to verify the corrective actions taken by the servicers. In addition we are coordinating very closely with the Consumer Financial Protection Bureau ("CFPB") on the implementation of standards that help improve mortgage servicing across the industry.

8. Please provide information about how the fee structures between the IC's and the financial institutions were determined and what role the Federal Reserve played in that determination, as well as whether the resulting total had any impact on the final figure that was agreed to on January 7.

The independent consultants were retained by the servicers and work for the servicers, subject to the oversight of the Federal Reserve and OCC. Accordingly, the fee arrangements between the independent consultants and the servicers were negotiated by those parties. Consistent with our standard practice, the Federal Reserve did not participate in those negotiations. The Federal Reserve reviewed each consultant to a servicer we regulate to ensure that the consultant would not be reviewing any work product that the consultant had previously provided to the servicer and to ensure that the consultant would be able to review borrower files without influence by the servicer that retained them.

9. There have been concerns expressed that outreach efforts to borrowers by lenders about available restitution and a suggestion that efforts were inadequate. Specifically, I would like to know what efforts will be made to contact the 5% of the 4.2 million borrowers who were not reached with the initial mailing?

Serviceable addresses exist for the vast majority of the in-scope population as many borrowers have existing relationships with the servicers or their addresses have been identified through other means. The regulators have required substantial efforts to locate current addresses for the remaining borrowers. These efforts included several rounds of address searches using the national change of address database and third-party consumer databases, which contain information from sources such as credit bureaus, public records/registrations, utilities, phone number databases, and similar sources, to determine borrowers' most likely current address. Borrowers can continue to update contact information with Rust Consulting, Inc. ("Rust"), the IFR Administrator and paying agent under the agreement in principle, by calling 1-888-952-9105. Finally, the paying agent will also take additional steps to identify current addresses for borrowers eligible for payment under the payment agreement. There are no additional steps that eligible borrowers will need to take to receive payment under the payment agreement.

10. While the settlement is national in scope, no state was impacted as severely as New York with robo-signing, document forgeries and other foreclosure abuses; which has been well documented. Accordingly, I hope you will be able to inform me how cases of New York borrowers will be reviewed and administered?

As a result of the payment agreement, approximately 4.2 million "in-scope" borrowers at the 13 participating servicers, including all eligible borrowers from New York State, will receive some monetary compensation. On April 12, 2013, payments began to these borrowers. Payments will range from $300 to $125,000 plus equity. As of May 20, 2013, more than 2.4 million checks have been cashed or deposited totaling more than $2.2 billion dollars.

11. Finally, I am hoping you can let me know the criteria that will be used to determine how much each individual borrower will be eligible to receive. While I support your desire to move forward and offer restitution to injured borrowers, I am hopeful that will be done in a methodical manner.

As noted in the answer to question 10, on April 12, 2013, payments under the payment agreement began to the 4.2 million borrowers and as of May 20, 2013, more than 2.4 million checks have been cashed or deposited totaling more than $2.2 billion dollars. Payments will range from $300 to $125,000 plus equity. In order to determine the individual payment amounts, borrowers were categorized according to the stage of their foreclosure process and the type of possible servicer error. Regulators then determined amounts for each category using the financial remediation matrix published in June 2012 as a guide, incorporating input from consumer groups. The Federal Reserve has published the payment amounts and the number of people in each category on its website at http://www.federalreserve.gov/consumerinfo/independent-foreclosure-review-payment-agreement.htm.

12. Since signing the consent order, how many borrowers in New York state have had their files reviewed, and what were the results of those reviews?

The Federal Reserve has made available on our website data on the number of borrowers who have submitted a request to have their mortgage reviewed by an independent consultant as part of the IFR. As noted above, the payment agreement replaces the IFR at the 13 participating servicers with a broader framework that allows all borrowers covered by the agreement – whether or not their file was slated for review as part of the IFR – to receive compensation significantly more quickly than under the IFR. As a result of the recent agreement, servicers must provide monetary compensation to all borrowers within the scope of the original enforcement actions; borrower files will no longer be subject to individual review as part of this process.

13. What efforts have been made to find borrowers that have not yet been contacted or those who have not responded to mail or telephone attempts, and how many of those are estimated to live in New York?

Please see response to question 9. The Federal Reserve does not have data on a state-by-state basis on the number of in-scope borrowers who were not able to be contacted in connection with the IFR.

14. What assurances will borrowers have that any information they provide to servicers will not be used in the foreclosure process?

The Federal Reserve and the OCC have directed servicers to use contact or personal information provided in connection with the IFR *only* for purposes relating to the IFR process. The privacy policy governing the IFR, which remains in effect following the payment agreement, is available online on the IndependentForeclosureReview.com website under the privacy policy section.

15. What assurances will New York state borrowers have under the new settlement that they will not be dual tracked with a foreclosure proceeding while the claim is being pursued?

While the payment agreement with the participating servicers itself does not automatically forestall or prevent foreclosure actions from continuing, the Consent Orders entered into by the servicers expressly address efforts to prevent dual tracking, for example, by requiring servicers to improve coordination between their foreclosure activities and their loss mitigation efforts in order to prevent unnecessary foreclosures and keep borrowers in their homes whenever possible. In addition, the Federal Reserve and the OCC have issued guidance to the servicers subject to the Consent Orders directing a review before foreclosure sales for all pending foreclosures. These reviews also help prevent avoidable foreclosures by ensuring that foreclosure-prevention alternatives are considered and foreclosure standards are met. In addition, the federal banking agencies have been working closely with the CFPB to develop national mortgage servicing industry standards that limit a servicer's ability to dual track borrowers. Such industry standards were issued in January by the CFPB and become effective in January 2014. The Federal Reserve is committed to enforcement of our Consent Orders and of these standards.

CLO:	**#B - 19**
CCS:	**13-1251**
RECVD:	**3/1/13**

Semi Annual Testimony Before Congress of
Federal Reserve Board of Governors Chairman Ben Bernanke
February 27, 2013
Questions for the Record

Independent Foreclosure Review

1. Close to 450,000 files were reviewed by the independent consultants in connection with the independent foreclosure review. Please indicate how many of those files were of New York Residents.
2. There are still 4 million borrowers who were in foreclosure between 2009 and 2010. With an $8 billion settlement, how far do you believe it will go? Will the payment match the harm?
3. Who gave the order that no money would be paid to borrowers while close to $2 billion in fees was generated?
4. We have been told that there was agreement that institutions would not compensate injured borrowers until all institutions were ready to do so.
    a. Were you aware of this agreement?
    b. Do you believe it was appropriate to allow the process to be conducted in that manner?
    c. Wouldn't it have been more effective to compensate borrowers where harm was found and documented rather than wait for the entire process to be completed?
5. Please shed some light on the decision to halt the independent review. Were there specific reports from the IC's that led you to believe you weren't going to find what you expected to find?
6. Do you believe that injured borrowers will be rightly compensated for the financial harm they suffered?
7. How have practices at the institutions that you supervise changed since the consent orders were signed?
8. Please provide information about how the fee structures between the IC's and the financial institutions were determined and what role the Federal Reserve played in that determination, as well as whether the resulting total had any impact on the final figure that was agreed to on January 7.
9. There have been concerns expressed that outreach efforts to borrowers by lenders about available restitution and a suggestion that efforts were inadequate. Specifically, I would like to know what efforts will be made to contact the 5% of the 4.2 million borrowers who were not reached with the initial mailing?
10. While the settlement is national in scope, no state was impacted as severely as New York with robo-signing, document forgeries and other foreclosure abuses; which has been well

documented. Accordingly, I hope you will be able to inform me how cases of New York borrowers will be reviewed and administered?

11. Finally, I am hoping you can let me know the criteria that will be used to determine how much each individual borrower will be eligible to receive. While I support your desire to move forward and offer restitution to injured borrowers, I am hopeful that will be done in a methodical manner.
12. Since signing the consent order, how many borrowers in New York state have had their files reviewed, and what were the results of those reviews?
13. What efforts have been made to find borrowers that have not yet been contacted or those who have not responded to mail or telephone attempts, and how many of those are estimated to live in New York?
14. What assurances will borrowers have that any information they provide to servicers will not be used in the foreclosure process?
15. What assurances will New York state borrowers have under the new settlement that they will not be dual tracked with a foreclosure proceeding while the claim is being pursued?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

July 17, 2013

The Honorable Ed Royce
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 27, 2013, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Royce:

Entitlements and Long-Term Fiscal Concerns

1. During the recent hearings in the House in Senate, Mr. Chairman, you heard a number of concerns expressed regarding our fiscal position and the national debt. You repeatedly stated that we need to make changes in the long-run or long-term. My question, Mr. Chairman, is when does the long-run end? Or to use your words from the Senate hearing, when do we get to "the point where the debt really begins to explode?" Would you agree it is mathematically impossible to keep tax revenue at its historical average and not address entitlements without an explosion of deficits?

Fiscal policymakers confront daunting challenges, and the economy's performance will depend importantly on the choices that are made about the course of fiscal policy. I believe that fiscal policymakers should keep three objectives in mind as they face these decisions. First, to promote economic growth and stability, the federal budget must be put on a sustainable long-run path that first stabilizes the ratio of federal debt to GDP, and, given the current elevated level of debt, eventually places that ratio on a downward trajectory. Second, as fiscal policymakers address the urgent issue of longer-run fiscal sustainability, they should avoid unnecessarily impeding the current economic recovery. Third, policymakers should make these policy adjustments with an eye toward tax and spending policies that increase incentives to work and save, encourage investments in workforce skills, advance private capital formation, promote research and development, and provide necessary and productive public infrastructure.

Under current CBO projections, the ratio of federal debt to GDP remains near current levels over the next five years and then begins to rise over the final five years of the projection, and based on their longer term outlook, debt mounts rapidly after 2023 owing to the effects of population aging and the continued rise in health care costs. In CBO's scenario, taxes are near their long-term average and non-interest outlays rise well above their long-run average and thus deficits widen. It is critical that policymakers address these long run imbalances between spending and taxes by lowering the trajectory for outlays, raising taxes above their long-run average, or some combination of the two. A credible fiscal plan that addresses these longer-run challenges could help keep longer-term interest rates low and boost household and business confidence, thereby supporting economic growth today.

Contradictory Impact of Quantitative Easing (QE) on Growth

2. Chairman Bernanke; despite the Federal Reserve's $3 Trillion -and growing- balance sheet today, isn't the real effect of quantitative easing at this point in our economic cycle, after the crisis, contradictory with respect to real growth and job creation, despite an accommodative monetary policy?

The Federal Reserve and many other central banks around the world are expanding their balance sheets to the favor of government, housing finance, and big banks, yet growth is marginal and jobs aren't being created fast enough by new ventures and small businesses.

Isn't the impact of QE to reallocate credit to the government and housing without expanding it in other parts of the private sector where it is needed? Is the central bank's traditional transmission mechanism broken and having a negative impact, instead of its intended beneficial impact? If it isn't broken after four years of unprecedented monetary policy accommodation, then why is growth so low and job creation not growing faster?

The U.S. economy continues to face headwinds; these include not only the tax increases and cuts in government spending enacted earlier this year, but also still-tight credit conditions for many small businesses and for households that have less-than-pristine credit records. While monetary policy cannot fully offset these headwinds, there is substantial evidence that the Federal Reserve's monetary policy--including its purchases of longer-term securities--have reduced interest rates, helped improve financial conditions more broadly, and contributed to growth of economic activity and employment. Low interest rates have boosted private demand for goods and services, giving businesses a reason to expand production and create jobs. Low mortgage rates are helping to strengthen the housing market, contributing to rising sales and construction of new homes, and to increased employment of construction workers, many of whom work for small businesses. Low interest rates also have contributed to rising home prices, putting more homeowners in a position to refinance and benefit from lower mortgage payments. Low rates for car loans have spurred sales of motor vehicles and thus raised employment in the U.S. auto industry. While the purpose of our monetary policy is to promote maximum employment and price stability, it also has helped improve the health of the banking system; the combination of a stronger banking system and a stronger economy has increased the amount of credit flowing to American households and businesses, helping to support the economic recovery.

<u>Ad Hoc Monetary Policy</u>

3. Mr. Chairman, businesses and investors are increasingly interested in when the Fed will begin to raise rates. Which indicator is relevant for these businesses and investors today? Is it through mid-2015 as announced last September and reflected in the FOMC's forward guidance? Is it as long as unemployment is above 6.5% (and inflation below 2.5%) as announced in December? Or should investors be focused on the rule Fed Vice Chairman Janet Yellen believes should be followed in normal times, which suggests rates should begin to rise before 2015?

In its most recent statement, the Federal Open Market Committee indicated that the current exceptionally low level of short-term interest rates will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. As you note, this quantitative approach to describing its policy outlook replaced the date-based guidance that the Committee had employed until last fall. Under the date-based guidance, the Committee had indicated that it anticipated that economic conditions would warrant exceptionally low levels of interest rates at least through mid-2015. It is worth noting, however, that the Committee, in its December statement indicated that the new quantitative thresholds were consistent with the earlier date-based guidance. With regard to the economic indicators that would be relevant for businesses and households in evaluating the likely stance of monetary policy going forward, the Committee has indicated that in addition to the unemployment and inflation rates, it considers other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments.

<u>TBTF fixed globally?</u>

4. Last week, Governor Tarullo presented a paper at Cornell law school on the international cooperation in financial regulation, which arguably is a good thing given the global impact of financial crises in modern times. Yet, how can we say we have solved the policy of "too big to fail"–TBTF) and are enhancing financial stability, especially if there is no binding mechanism in place today for the cross-border resolution of large failing, globally active banks or means for cross-border dispute resolution? The Financial Stability Board's recommended principles from 2012 are nice to have, but have no legally binding impact on the United States or any other G20 nation.

David Wright, the Secretary General of IOSCO, late last year, reviewed the case for a binding international agreement or treaty – such as we have in other policy areas like trade (WTO), health (WHO), or airplane safety – for things like the cross-border resolution of large failing global banks. Until we have some kind of treaty or agreement in place, even if limited to cross-border resolution and dispute settlement, how can we convincingly say that we truly have ended TBTF under either the bankruptcy code or Dodd-Frank and thereby enhanced financial stability?

The Dodd-Frank Act provides a number of tools that did not exist prior to the recent financial crisis to address the too-big-to-fail problem. These include:

- providing for an orderly resolution process for systemically significant non-bank financial institutions;
- requiring living wills to help guide institutions and regulators to improve resolvability of significant financial firms;
- requiring enhanced prudential supervision and capital requirements for large, systemically significant financial firms;
- bringing previously unregulated, systemically-important financial entities under the regulatory umbrella;
- providing a new financial sector concentration limit and giving the Fed new authority to consider financial stability in merger and acquisition proposals by banking firms; and,
- central clearing of derivatives to help reduce interconnectedness.

Although these new statutory tools are in various stages of regulatory implementation, the Fed has already strengthened its oversight of large, complex banking firms and has worked with these firms to materially improve their capital adequacy and capital planning through our 2009 SCAP exercise and our annual CCAR exercise since 2011. We have also now released our proposals to implement enhanced prudential standards for large U.S. and foreign banking firms and FSOC-designated nonbank firms. The proposed rules, which increase in stringency with the systemic footprint of the covered company, would provide incentives for covered companies to reduce their systemic footprint and require covered companies to internalize the external costs that their failure or distress would impose on the broader financial system.

In addition, I note that the FDIC's orderly liquidation powers are effective today and their core regulatory implementation architecture is in place. More work remains to be done around the world to maximize the prospects for an orderly SIFI resolution, but the basic framework is in place in the United States.

We have made significant progress towards eliminating too big to fail, and ratings actions taken over the past two years by Moody's with respect to our largest banking firms are a reflection of the progress we have made on that front. More work remains to be done, but eliminating too big to fail is a core objective as we implement Dodd Frank and Basel 3 reforms.

Too Much Leverage, Not Enough Capital Formation and Investment

5. Mr. Chairman, we have a monetary policy (QE) that encourages borrowing by the government and housing industry especially based on the Federal Reserve's purchases on its balance sheet, and at the same time we have a fiscal policy in this country, through the national budget and both corporate and individual tax codes, that also rewards leverage (by credits and other tax expenditures for borrowing) and penalizes capital formation and investment.

What do we need to do with respect to both monetary policy and fiscal policy to achieve a better balance, where capital formation and wealth generation for investment aren't penalized and borrowing isn't rewarded as much as it has been historically? On both fronts, how [do] we get from where we are today – too highly leveraged a nation – to a more responsible position where capital formation and investment in growth and jobs is rewarded and not penalized (or demonized)?

The financial crisis, the deep recession that followed, and the subsequent slow recovery has presented substantial challenges for monetary and fiscal policy. For monetary policy, the primary challenge has been to accommodate exceptionally weak aggregate demand--which has caused employment to fall to an unacceptable level--and stave off an unwelcome disinflation in an environment where the equilibrium real rate of interest has been historically low. In striving to meet this challenge, the Federal Open Market Committee (FOMC) first lowered the target federal funds rate to its effective lower bound in late 2008, then began communicating its intention of holding the federal funds rate at an exceptionally low level as long as macroeconomic conditions warrant. It also initiated substantial purchases of longer-term government securities to put further downward pressure on market interest rates. These monetary policy actions were needed to provide much-needed support to aggregate demand and to keep overall price inflation from falling too far below the FOMC's longer-run objective of 2 percent per year. In part because of monetary policy, U.S. macroeconomic performance and labor market conditions have continued to improve gradually, and overall economic activity and employment appears likely to continue rising this year and, according to the central tendency forecasts produced by the FOMC in March, is expected to accelerate over the next two years.

Fiscal policy, at all levels of government, also has been and continues to be an important determinant of the pace of economic growth. Federal fiscal policy, taking into account discretionary actions and so-called automatic stabilizers, was, on net, quite expansionary during the recession and early in the recovery. Although near-term fiscal restraint has increased, much less has been done to address the federal government's longer-term fiscal imbalances, which, in large part, reflect the effects of the projected aging of our population and anticipated increases in health care costs, along with mounting debt service payments. To promote economic growth and stability in the longer term, it will be essential for fiscal policymakers to put the federal budget on a sustainable long-run path. Importantly, the objectives of effectively addressing longer-term fiscal imbalances and of minimizing the near-term fiscal headwinds facing the economic recovery are not incompatible. To achieve both goals simultaneously, the Congress and the Administration could consider replacing some of the near-term fiscal restraint currently in law with policies that reduce the federal deficit more gradually in the near term but more substantially in the longer run.

Housing Prices

6. How do you evaluate the role the Federal Reserve has been playing to provide liquidity to the housing market? Some observers suggest that the increase in house prices against normal seasonal patterns may be building to another house price bubble down the road. Those who believe in a stock valuation model of discounted cash flows approach to house prices suggest that the inevitable normalization of rates will deflate house prices as a result and thus the current valuation gains are illusory. What do you think the result of the normalization of rates will be for equity in homes?

Recent purchases of agency mortgage-backed securities are one way through which the Federal Reserve has sought to provide support to the housing market. These purchases have contributed to historically low mortgage interest rates in recent years, which have increased housing affordability for homeowners eligible for new mortgages. The Federal Reserve's actions may have contributed to the recent increases in house prices, although this connection is not well-established and will be a topic of much research in the years to come. Concerns that recent increases in house prices are the beginnings of "another housing bubble" ought to be tempered by the fact that mortgage credit is tight for all but the highest credit quality households and aggregate mortgage debt outstanding continues to contract.

As you note, standard pricing models support the notion that rising interest rates will put pressure on house prices. The magnitude of the effect is difficult to gauge because of uncertainty over how much rates will rise and because the precise relationship between house prices and interest rates is not well-established. Many economic models suggest that rising interest rates will lead to a deceleration in the pace of house price growth but should not derail the recovery in housing markets. Indeed, expectations for a housing market recovery may be justified by relatively low price-to-rent ratios as well as by strong pent-up housing demand.

Cost and Benefits of Dodd-Frank Rules

7. Mr. Chairman, what is the impact of the 400 new Dodd-Frank rules on economic growth and job creation? Is the net impact positive or negative in your view?

If no one - including the Federal Reserve - has attempted to do it, shouldn't some organization take a hard, independent, and objective look at the impact on our financial system and our economy? Wouldn't some kind of methodical, regular economic impact assessment of these new rules be a good thing to know?

Many of the Dodd-frank Act provisions are still in the early stages of implementation making it difficult to accurately assess the impact of the Act at this point.

Overall, we expect a safer financial system to contribute to higher levels of economic activity and employment, on average. Most importantly, it is clear that distress within the financial system can lead to notable contractions in economic activity and employment, and regulatory reform, by reducing the probability of such severe financial strains, should lead to higher levels of economic activity and employment. Indeed, analyses of portions of the revised regulatory framework – while falling short of a comprehensive analysis of all reforms associated with Dodd-Frank and related efforts – suggest such benefits from reform.

That said, it is difficult to envision an effort to assess the macroeconomic effects of the combined set of reforms. Economic models of the macroeconomy typically do not contain the type of detailed modeling of the financial system needed to provide such a systematic assessment and detailed data are not available regarding many of the macroeconomic effects. In our implementation efforts, we consider the economic impact of proposed changes, and engage with our fellow regulatory agencies, private-sector groups, consumer advocacy organizations, and the broader public to gain as full an understanding as possible of how implementation of Dodd-Frank reforms will affect the economy.

Financial Stability Defined

8. Mr. Chairman, in the Federal Reserve's new role as the chief regulator for financial stability purposes under Dodd-Frank, you have issued or will issue new rules that hinge on the importance of financial stability without really defining what we mean – in Dodd-Frank for example – by the "financial stability of the United States."

The Office of Financial Research (OFR) defined "financial stability" in its first annual report as: "Financial stability' means that the financial system is operating sufficiently to provide its basic functions for the economy even under stress." Is that definition subscribed to by the Federal Reserve, yes or no?

If not, what is yours, and what are the implications for new policies like the FSOC designation of nonbank financial institutions as systemically important or the enhanced prudential standards in Dodd-Frank Sec. 165, which are still pending? Wouldn't you agree that we all need to agree on some basic definitions and their implications, not only for financial regulation but also their potential impact on the real economy? Please elaborate.

In its final rule on nonbank designations, the Council said it will consider a "threat to the financial stability of the United States" to exist if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." The Federal Reserve considers this the relevant standard for designations.

FSOC Process

9. Please update us on how the FSOC and the Fed through your representation on the FSOC is approaching the analysis of firms being considered for nonbank SIFI designation.

Are different metrics being applied in the evaluation of different business models? Are those metrics being applied in a consistent manner across all business models (i.e. asset managers, insurers, broker dealers, etc)?

What do you generally believe the timeframe is for the first nonbank SIFI designations to occur?

Will designations occur before prudential standards are established for nonbank SIFIs? If so, designated firms would face uncertainty, why not wait for rules to be in place before designations are made?

In September of last year, the GAO issued a report that contained specific recommendations to strengthen the accountability and transparency of FSOC and OFR's decisions and activities as well as to enhance collaboration among FSOC members and with external stakeholders. I ask that you submit a statement for the record that details the progress made with respect to each of the recommendations.

The report also suggested working to rationalize rulemakings and using professional and technical advisors including state regulators, industry experts and academics to assist FSOC. What has been done in this regard?

In considering which nonbank financial firms should be assessed for potential designation as systemically important, the Council is using a combination of quantitative and qualitative metrics that facilitate comparative analysis across firms while also considering the unique factors specific to a firm and its industry. In laying out this approach, the Council issued a final rule and interpretive guidance that describes a three-stage process leading to a proposed determination. The first stage applies uniform quantitative thresholds, the second stage analyses identified firms based primarily on existing public and regulatory information, using industry- and company-specific quantitative and qualitative information, and the third stage entails contacting nonbank financial companies that merit further review to collect firm-specific information that was not available in the second stage.

The Council has made significant progress in its designation work since finalizing its rule and guidance -- particularly by advancing an initial set of companies to the third and final stage of the designations process starting in September of last year. The Council staff are currently undertaking a detailed analysis of each company, and providing the companies opportunities to provide information regarding their businesses and operations. It is critically important that we take the time to get the analysis right, and staff is moving as quickly as possible in doing so.

Various rulemakings under Dodd-Frank are being conducted by the regulators at the same time as the Council's designations process. The Council's ongoing collaboration with regulators, including the Federal Reserve, will foster consistency between the designations process and those rules. The Council does not believe it is necessary or appropriate to postpone the evaluation of companies for potential designation until these other regulatory actions are completed. These rulemakings are not essential to the Council's consideration of whether a nonbank financial company could pose a threat to U.S. financial stability.

Regarding the GAO report, in November 2012, the Council and the OFR jointly provided a response to Congress and the GAO with a description of the actions planned and taken in response to each of the recommendations in the report. Since the GAO issued its report, the Council and the OFR have further leveraged outside expertise in several ways. Most notably, in November 2012, Treasury announced the members of a new Financial Research Advisory Committee, which will work with the OFR to develop and employ best practices for data management, data standards, and research methodologies. The committee is made up of 30 distinguished professionals in economics, finance, financial services, data management, risk management, and information technology. Members include two Nobel laureates in economics; leaders in business and nonprofit fields; and prominent researchers at major universities and think tanks. The committee held its inaugural meeting in December 2012 in Washington, D.C., and has been active through subcommittees that are focused on research, data, technology, risk management, and other issues. In addition, through the OFR's ongoing work and symposia, the Council is able to draw on the insights and expertise of various industry experts and academics on cutting edge systemic risk and financial stability analyses and methods.

Section 165 Rules for Foreign Banks with US Operations

10. In your open meeting to propose the Section 165 rules for foreign banks with U.S. operations, the Federal Reserve staff indicated that there was little chance of retaliation against U.S. firms based on this proposal. Recently in a speech, EU Commissioner Barnier seemed to articulate a strong contradictory view.

a. Do you still feel there is little chance of similar constraints being put on U.S. firms in foreign markets?

The Board is carefully considering the potential that its action might affect the environment for U.S. banking organizations operating overseas. U.S. banking organizations already operate in a number of overseas markets that apply Basel risk-based capital requirements to their local commercial banking and investment banking activities. In addition, the U.K., which is host to substantial operations of U.S. banking organizations, applies local liquidity standards to commercial banking and investment banking subsidiaries of non-U.K. banks operating in their market.

b. Will you take in to account this possibility of retaliation when considering changes to the rule?

Please see previous response.

c. Congress at different times has established express statutory authority for the Fed to supervise bank holding companies and also intermediate holding companies for the financial activities of commercial firms. Can you please identify the express statutory authority for establishing the intermediate holding company structure for foreign banks?

Title I of the Dodd-Frank Act requires the Board to impose enhanced prudential standards on banking organizations, including foreign banking organizations, with $50 billion or more in total consolidated assets. Section 165 contains certain required standards and also gives the Board authority to adopt additional standards it considers appropriate.[1] Section 168 grants the Board specific rulemaking authority to implement subtitles A and C of Title I of the Dodd-Frank Act. The Board also is authorized by the Bank Holding Company Act, the Federal Deposit Insurance Act, and the International Banking Act to ensure that bank holding companies and foreign banking organizations operating in the United States conduct their operations in a safe and sound manner. The proposal would adopt the U.S. intermediate holding company requirement as an additional standard in furtherance of the stated objective of section 165 to "mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure of ongoing activities, of large, interconnected financial institutions."[2] The U.S. intermediate holding company requirement would apply risk-based capital requirements, leverage limits, and liquidity requirements on the foreign banking organization's U.S. bank and

[1] 12 U.S.C. § 5365(b).
[2] 12 U.S.C. § 5365(a)(1).

nonbank subsidiaries on a consistent, comprehensive, and consolidated basis in a manner similar to those applied to U.S. banking organizations.

CLO: #B - 33
CCS: 13- 1504
RECVD: 3|13|13

Rep. Ed Royce (CA-39)
FC Hearing: "Monetary Policy and the State of the Economy"
Questions for the Record
2.26.13

Entitlements and Long-Term Fiscal Concerns

During the recent hearings in the House in Senate, Mr. Chairman, you heard a number of concerns expressed regarding our fiscal position and the national debt. You repeatedly stated that we need to make changes in the long-run or long-term. My question, Mr. Chairman, is when does the long-run end? Or to use your words from the Senate hearing, when do we get to "the point where the debt really begins to explode?" Would you agree it is mathematically impossible to keep tax revenue at its historical average and not address entitlements without an explosion of deficits?

Contradictory Impact of Quantitative Easing (QE) on Growth

Chairman Bernanke, despite the Federal Reserve's $3 Trillion – and growing - balance sheet today, isn't the real effect of quantitative easing at this point in our economic cycle, after the crisis, contradictory with respect to real growth and job creation, despite an accommodative monetary policy?

The Federal Reserve and many other central banks around the world are expanding their balance sheets to the favor of government, housing finance, and big banks, yet growth is marginal and jobs aren't being created fast enough by new ventures and small businesses. Isn't the impact of QE to reallocate credit to the government and housing without expanding it in other parts of the private sector where it is needed? Is the central bank's traditional transmission mechanism broken and having a negative impact, instead of its intended beneficial impact? If it isn't broken after four years of unprecedented monetary policy accommodation, then why is growth so low and job creation not growing faster?

Ad Hoc Monetary Policy

Mr. Chairman, businesses and investors are increasingly interested in when the Fed will begin to raise rates. Which indicator is relevant for these businesses and investors today? Is it through mid-2015 as announced last September and reflected in the FOMC's forward guidance? Is it as long as unemployment is above 6.5% (and inflation below 2.5%) as announced in December? Or should investors be focused on the rule Fed Vice Chairman Janet Yellen believes should be followed in normal times, which suggests rates should begin to rise before 2015?

TBTF fixed globally?

Last week, Governor Tarullo presented a paper at Cornell law school on the international cooperation in financial regulation, which arguably is a good thing given the global impact of financial crises in modern times. Yet, how can we say we have solved the policy of "too big to fail" – TBTF) and are enhancing financial stability, especially if there is no binding mechanism in place today for the cross-border resolution of large failing, globally active banks or means for cross-border dispute resolution? The Financial Stability Board's recommended principles from 2012 are nice to have, but have no legally binding impact on the United States or any other G20 nation.

David Wright, the Secretary General of IOSCO, late last year, reviewed the case for a binding international agreement or treaty - such as we have in other policy areas like trade (WTO), health (WHO), or airplane safety – for things like the cross-border resolution of large failing global banks. Until we have some kind of treaty or agreement in place, even if limited to cross-border resolution and dispute settlement, how can we convincingly say that we truly have ended TBTF under either the bankruptcy code or Dodd-Frank and thereby enhanced financial stability?

Too Much Leverage, Not Enough Capital Formation and Investment

Mr. Chairman, we have a monetary policy (QE) that encourages borrowing by the government and housing industry especially based on the Federal Reserve's purchases on its balance sheet, and at the same time we have a fiscal policy in this country, through the national budget and both corporate and individual tax codes, that also rewards leverage (by credits and other tax expenditures for borrowing) and penalizes capital formation and investment.

What do we need to do with respect to both monetary policy and fiscal policy to achieve a better balance, where capital formation and wealth generation for investment aren't penalized and borrowing isn't rewarded as much as it has been historically? On both fronts, how to we get from where we are today – too highly leveraged a nation – to a more responsible position where capital formation and investment in growth and jobs is rewarded and not penalized (or demonized)?

Housing Prices

How do you evaluate the role the Federal Reserve has been playing to provide liquidity to the housing market? Some observers suggest that the increase in house prices against normal seasonal patterns may be building to another house price bubble down the road. Those who believe in a stock valuation model of discounted cash flows approach to house prices suggest that the inevitable normalization of rates will deflate house prices as a result and thus the current valuation gains are illusory. What do you think the result of the normalization of rates will be for equity in homes?

Cost and Benefits of Dodd-Frank Rules

Mr. Chairman, what is the impact of the 400 new Dodd-Frank rules on economic growth and job creation? Is the net impact positive or negative in your view?

If no one - including the Federal Reserve - has attempted to do it, shouldn't some organization take a hard, independent, and objective look at the impact on our financial system and our economy? Wouldn't some kind of methodical, regular economic impact assessment of these new rules be a good thing to know?

Financial Stability Defined

Mr. Chairman, in the Federal Reserve's new role as the chief regulator for financial stability purposes under Dodd-Frank, you have issued or will issue new rules that hinge on the importance of financial stability without really defining what we mean – in Dodd-Frank for example – by the "financial stability of the United States."

The Office of Financial Research (OFR) defined "financial stability" in its first annual report as: "Financial stability' means that the financial system is operating sufficiently to provide its basic functions for the economy even under stress." Is that definition subscribed to by the Federal Reserve, yes or no?

If not, what is yours, and what are the implications for new policies like the FSOC designation of nonbank financial institutions as systemically important or the enhanced prudential standards in Dodd-Frank Sec. 165, which are still pending? Wouldn't you agree that we all need to agree on some basic definitions and their implications, not only for financial regulation but also their potential impact on the real economy? Please elaborate.

FSOC Process

Please update us on how the FSOC and the Fed through your representation on the FSOC is approaching the analysis of firms being considered for nonbank SIFI designation.

Are different metrics being applied in the evaluation of different business models? Are those metrics being applied in a consistent manner across all business models (i.e. asset managers, insurers, broker dealers, etc)?

What do you generally believe the timeframe is for the first nonbank SIFI designations to occur?

Will designations occur before prudential standards are established for nonbank SIFIs? If so, designated firms would face uncertainty, why not wait for rules to be in place before designations are made?

In September of last year, the GAO issued a report that contained specific recommendations to strengthen the accountability and transparency of FSOC and OFR's decisions and activities as well as to enhance collaboration among FSOC members and with external stakeholders. I ask that you submit a statement for the record that details the progress made with respect to each of the recommendations.

The report also suggested working to rationalize rulemakings and using professional and technical advisors including state regulators, industry experts and academics to assist FSOC. What has been done in this regard?

Section 165 Rules for Foreign Banks with US Operations

In your open meeting to propose the Section 165 rules for foreign banks with U.S. operations, the Federal Reserve staff indicated that there was little chance of retaliation against U.S. firms based on this proposal. Recently in a speech, EU Commissioner Barnier seemed to articulate a strong contradictory view.

a. Do you still feel there is little chance of similar constraints being put on U.S. firms in foreign markets?
b. Will you take in to account this possibility of retaliation when considering changes to the rule?

Congress at different times has established express statutory authority for the Fed to supervise bank holding companies and also intermediate holding companies for the financial activities of commercial firms. Can you please identify the express statutory authority for establishing the intermediate holding company structure for foreign banks?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

June 21, 2013

The Honorable Mick Mulvaney
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 27, 2013, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Mulvaney:

1. The Congressional Budget Office (CBO) projections of future interest rates published in their report titled "CBO Budget and Economic Outlook Fiscal Years 2013-2023" in tables B-1 and B-2 are displayed below. Are the Federal Reserve's projections for future interest rates for similar products and time frames consistent with CBO's projections? If the Federal Reserve does not agree with the CBO projections, please provide your projections, explain the reasons for the difference of opinion, and articulate why the Federal Reserve believes its numbers are a better gauge of future interest rates.

Finally, how will the CBO projected interest rates, and if different, the Federal Reserve's projected interest rates, affect or alter the Federal Reserve's exit strategy? What are the impacts to the economy of the exit strategy using these projected rates?

The CBO projections of interest rates published in their report titled "CBO Budget and Economic Outlook Fiscal Years 2013-2023" in tables B-1 and B-2 are as follows:

Projections by calendar year:

10-year Treasury note: 2012: 1.8% 2013: 2.1% 2014: 2.7% 2015: 3.5% 2016: 4.3% 2017: 5.0% 2018: 5.2% 2019: 5.2% 2020: 5.2% 2021: 5.2% 2022: 5.2% 2023: 5.2%

3-month Treasury bill: 2012: .1% 2013: .1% 2014: .2% 2015: .2% 2016: 1.5% 2017: 3.4% 2018: 4.0% 2019: 4.0% 2020: 4.0% 2021: 4.0% 2022:4.0% 2023: 4.0%

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3-month Treasury bill: 2012: .1% 2013: .1% 2014: .1% 2015: .2% 2016: 1.0% 2017: 2.9% 2018: 4.0% 2019: 4.0% 2020: 4.0% 2021: 4.0% 2022: 4.0% 2023: 4.0%

The Federal Reserve does not publish official forecasts of interest rates, in part because the level of rates now and in the future is influenced by Federal Reserve policy actions that have not yet been decided upon. That said, FOMC participants--the seven Federal Reserve Board governors and 12 Reserve Bank presidents--prepare individual economic projections four times each year. As part of those projections, FOMC participants project a path for the federal funds rate based on their own evaluation of the economic outlook and judgment regarding the appropriate path of monetary policy. That information is published as an addendum to the FOMC minutes. The most recent projections were prepared for the June FOMC meeting and are available at [http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20130619.pdf]. Although the individual projections vary, the central tendency of these projections for the path of the federal funds rate is qualitatively similar to the path shown above for the CBO projections of the three-month bill rate. In particular, most FOMC participants expect the funds rate to remain quite low through 2015.

The trajectory for the path of short-term interest rates has implications for longer-term yields. Specifically, longer-term yields will tend to move higher as investors perceive that the date after which the FOMC is expected to begin raising short-term rates is drawing closer. This effect is evident in the CBO projections for the ten-year Treasury yield; it begins to move higher in 2013 and 2014 even though the CBO projects the three-month bill rate to remain quite low throughout 2015. In addition to this effect operating through expectations regarding short-term rates, the normalization of the size of the Federal Reserve's balance sheet should put some additional upward pressure on long-term rates by raising the term premiums embedded in yields on long-term securities.

In short, in most economic forecasts, short and long-term rates rise gradually over time as the economy continues to recover. A discussion of this and related issues is included in a recent speech by Chairman Bernanke entitled "Long-Term Interest Rates" and available at http://www.federalreserve.gov/newsevents/speech/bernanke20130301a.htm.

2. In the Subcommittee on Monetary Policy and Trade hearing entitled "Near-Zero Rate, Near-Zero Effect? Is 'Unconventional' Monetary Policy Really Working?" on March 5, 2013, two witnesses, Dr. Joseph Gagnon and Mr. David Malpass, expressed conflicting views on the Federal Reserve's ability to influence short-term interest rates during its exit from quantitative easing because of a lack of short-term Treasury bills. Dr. Gagnon argued that the Federal Reserve could enter into repurchase agreements on its long-term securities and have the same effect as selling Treasury bills. Mr. Malpass responded that this would not be a viable option because the market for repurchase agreements could not sustain the magnitude of repurchase agreements the Fed would need to manipulate the short-term interest rate. Does the Fed have the practical ability to manipulate short term interest rates through repurchase agreements, and what would be the implication to the repo market if the Federal Reserve engaged in this activity? Does the increasing size of the Federal Reserve balance sheet reduce the efficacy of using repurchase agreements to affect short-term interest rates?

As discussed in the minutes of its June 2011 meeting, the FOMC will rely primarily on changes in the FOMC's target federal funds rate to remove policy accommodation at the appropriate time. During the normalization process, adjustments in the interest rate on excess reserves and to the level of reserves in the banking system will be used to bring the funds rate toward its target.

The Federal Reserve has developed tools, including term deposits and reverse repurchase agreements (RPs), that could be used to drain reserves at the appropriate time if necessary. By issuing term deposits and reverse RPs, the Federal Reserve will be able to reduce the quantity of reserves in the banking system as needed.

Such draining tools may also have a secondary effect by directly putting upward pressure on money market rates. For example, conducting three-month term reverse RP operations will drain reserves and put upward pressure on the overnight federal funds rate, but such operations will also put some upward pressure on the three-month term RP rate. The extent of the latter effect is difficult to gauge, but would also work in the general direction of tightening financial conditions.

The Federal Reserve can also drain reserves and tighten financial conditions by selling assets, if necessary. In short, the FOMC is confident that it has the tools necessary to withdraw policy accommodation at the appropriate time.

3. Chairman Bernanke, in your testimony before the Committee on Financial Services on February 7, 2013, you said "Federal Reserve analysis shows that remittances to the Treasury could be quite low for a time in some scenarios, particularly if interest rates were to rise quickly." In fact, a chart in the January 2013 Federal Reserve staff report referenced in your testimony shows that remittances drop to zero as interest rates rise when the Federal Reserve continues to make asset purchases to expand its balance sheet through 2013, a program it has already begun. What it doesn't show, however, is how much the Federal Reserve is losing as interest rates rise. In each of the scenarios explored in your staff report, and at the current pace of purchasing $85 billion per month of securities over 2013, what is the expected profit or loss from your unconventional policy measures? In your response, please distinguish between the profit or loss from interest paid on reserves and the profit or loss from balance sheet assets. Also, please provide an update of how much you have made from quantitative easing to date, how much you expect to make, and how much you estimate that you will lose as interest rates rise at the end of unwinding the Fed's balance sheet.

The Federal Reserve has a dual mandate of fostering price stability and maximum employment, and the large-scale asset purchases have been undertaken in pursuit of that mandate. Any profits or losses from the policy are incidental to the ultimate goals of policy. Indeed, a more rapidly growing economy benefits the fiscal position of the federal government substantially more--through reduced expenditures on unemployment benefits and increased tax receipts--than any variation in the Federal Reserve Board's earnings.

From 2009 through 2012, the Federal Reserve remitted almost $300 billion to the U.S. Treasury, an average of over $70 billion per year. Prior to the financial crisis, the Federal Reserve would typically remit between $20 and $25 billion to the Treasury per year.

The staff working paper projects--under a variety of assumptions--how the Federal Reserve's income might evolve over coming years. That analysis includes both the possibility of realized losses from asset sales as well as the expense of paying interest on reserve balances. In the scenarios analyzed, when assessing the effects on Federal Reserve earnings over the entire period of asset purchases, the average annual remittances to the Treasury exceeds the typical annual remittances prior to the crisis. That averaging combines periods when remittances are substantially above historical averages, as they have been since 2009, with periods when remittances fall, perhaps to zero. http://www.federalreserve.gov/pubs/feds/2013/201301/index.html

CLO: #B - 31
CCS: 13- 1503
RECVD: 3/13/13

Questions for the record

Rep. Mick Mulvaney

February 27, 2013

Monetary Policy and the State of the Economy

To: Chairman Ben Bernanke

1)

The Congressional Budget Office (CBO) projections of future interest rates published in their report titled "CBO Budget and Economic Outlook Fiscal Years 2013-2023"in tables B-1 and B-2 are displayed below. Are the Federal Reserve's projections for future interest rates for similar products and time frames consistent with the CBO's projections? If the Federal Reserve does not agree with the CBO projections, please provide your projections, explain the reasons for the difference of opinion, and articulate reasons why the Federal Reserve believes its numbers are a better gauge of future interest rates.

Finally, how will the CBO projected interest rates, and if different, the Federal Reserve's projected interest rates, affect or alter the Federal Reserve's exit strategy? What are the impacts to the economy of the exit strategy using these projected rates?

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3)

Chairman Bernanke, in your testimony before the Committee on Financial Services on February 7, 2013, you said "Federal Reserve analysis shows that remittances to the Treasury could be quite low for a time in some scenarios, particularly if interest rates were to rise quickly." In fact, a chart in the January 2013 Federal Reserve staff report referenced in your testimony shows that remittances drop to zero as interest rates rise when the Federal Reserve continues to make asset purchases to expand its balance sheet through 2013, a program it has already begun. What it doesn't show, however, is how much the Federal Reserve is losing as interest rates rise. In each of the scenarios explored in your staff report, and at the current pace of purchasing $85 billion per month of securities over 2013, what is the expected profit or loss from your unconventional policy measures? In your response, please distinguish between the profit or loss from interest paid on reserves and the profit or loss from balance sheet assets. Also, please provide an update of how much you have made from quantitative easing to date, how much you expect to make, and how much you estimate that you will lose as interest rates rise at the end of unwinding the Fed's balance sheet.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

July 11, 2013

The Honorable Steve Stivers
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 27, 2013, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Stivers:</u>

1. With all of the recent discussion centering on systemic risk and "Too Big to Fail," do you believe U.S. regional banks are a systemic risk?

The Dodd-Frank Act ("DFA") identified all bank holding companies with assets in excess of $50 billion as firms that need to be subject to enhanced prudential standards. In implementing the requirements of the DFA, the Federal Reserve has proposed the establishment of enhanced prudential standards for this entire population of firms, but has proposed to gradate application of the enhanced prudential standards so that the firms with a greater systemic footprint face more stringent standards. While regional banks are important contributors to economic growth and development within certain geographic areas, the risks to broader financial stability posed by U.S. regional banking firms are materially less than the financial stability risks posed by the largest and most complex U.S. banking firms.

2. Do you believe the $50 billion asset threshold is the right proxy for determining systemic risk?

a. Wouldn't the 11-point Test in Title 1 of the Dodd-Frank Act for non-bank systemically important financial institutions (SIFIs) be a better way to determine bank SIFIs?

Determining whether a financial institution poses systemic risk requires a complex assessment. In designating a nonbank financial company as systemically important, the Dodd-Frank Act requires the Financial Stability Oversight Council ("FSOC") to consider: (1) the extent of the company's leverage; (2) the extent and nature of the company's off-balance-sheet exposures; (3) the extent and nature of the transactions and relationships between the company and other significant nonbank financial companies and significant bank holding companies; (4) the importance of the company as a source of credit for households, business, and State and local governments and as a source of liquidity for the U.S. financial system; (5) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of the company would have on the availability of credit in such communities; (6) the extent to which assets are managed rather than owned by the company; (7) the nature, scope, size, scale, concentration, interconnectedness, and mix of activities of the company; (8) the degree to which the company is already regulated; (9) the amount and nature of the company's financial assets; (10) the amount and types of liabilities of the company; and (11) any other risk-related factors that the FSOC deems appropriate.

By contrast, Title I of the Dodd-Frank Act requires the Board to apply enhanced prudential standards to any bank holding company with total consolidated assets of $50 billion or more. Because bank holding companies with only $50 billion in consolidated assets may not pose systemic risk, the Board expects to use the authority it has under Dodd-Frank to tailor the application of the enhanced prudential standards based on systemic risk-related factors such as a firm's capital structure, riskiness, complexity, financial activities, and size.

b. What are your thoughts on a proposed framework for defining SIFIs through factors as detailed in a 2009 study by the Cleveland Federal Reserve (attached)?

The proposed framework would define a systemically important financial institution in terms of its size; whether its failure would transmit distress to other financial firms; whether its condition is highly correlated with that of other financial firms; and whether it is a dominant participant in key financial markets or activities. While somewhat more general than the list of considerations the FSOC is required to take into account under Title I of the Dodd-Frank Act, the proposed framework would likely require an assessment of many of the same issues. It is also noteworthy that the financial firms designated as systemically important by FSOC will be disclosed in its Annual Report, which is consistent with one of the 2009 study recommendations.

3. There are recent concerns that the administrative burden from some of the newly written rules stemming from the Dodd-Frank Act is going to have a substantial impact on regional and community banks that are not systemically important. How do we ensure that we don't harm these traditional institutions in our efforts to protect the economy from those that are truly systemically important?

The Federal Reserve recognizes that regional and community banks play a critical role in the U.S. economy and, accordingly, has taken a number of steps to reduce the regulatory burden on those institutions. For example, the Board has established a subcommittee to focus on supervisory approaches to community and regional banks to help ensure that their views on the supervisory process are considered. A primary goal of the subcommittee is to ensure that the development of supervisory guidance is informed by an understanding of the unique characteristics of community and regional banks and consideration of the potential for excessive burden and adverse effects on lending. As an additional example, the Board created the Community Depository Institutions Advisory Council ("CDIAC") to provide input on the economy, lending conditions, and other issues of interest to community banks. Members include representatives of banks, thrift institutions, and credit unions serving on local advisory councils at the 12 Federal Reserve Banks. One member of each of the Reserve Bank councils is selected to serve on the CDIAC, which meets twice a year with the Board. These and other forms of outreach are an important means of helping to strike the right balance between promoting safety and soundness throughout the banking system and keeping compliance costs for smaller banks as low as possible.

With respect to the changes we will see in the financial regulatory architecture as a result of the Dodd-Frank Act and the recent implementation of the Basel III capital framework, it is important to emphasize that these reforms are principally directed at our largest, most complex financial firms, including nonbanks. Many of the requirements arising from the new Basel III rules--which establish an integrated regulatory capital framework designed to ensure that U.S. banking organizations maintain strong capital positions--will not apply to smaller banks. In fact, most of the significant changes from the proposed capital rules that were made in the final version of the rules were in response to concerns expressed by smaller banks. For example, the new rules maintain current practices on risk weighting residential mortgages and provide community banking organizations the option of maintaining existing standards on the regulatory capital treatment of accumulated other comprehensive income and pre-existing trust preferred securities. Our aim with these changes was to reduce the burden and complexity of the rules for community banks while preserving the benefit of more rigorous capital standards. Indeed, most banking organizations with less than $10 billion in assets already meet the higher capital standards, and the new rules will help preserve the benefits of stronger capital positions these banks have built since the financial crisis.

Community banking organizations also will not be subject to the Federal Reserve's additional enhanced prudential standards that larger banking firms face or will face, such as capital plans, stress testing, resolution plans, single-counterparty credit limits, and capital surcharges. Furthermore, most of the major systemic risk and prudential provisions of the Dodd-Frank Act--such as the Volcker Rule, derivatives push-out, derivatives central clearing requirements, and the Collins amendment--will have a far smaller impact on community banks than on large banking firms. In focusing on the largest, most complex financial firms, the Dodd-Frank Act reforms aim to require those firms to account for the costs they impose on the broader financial system and soak up the implicit subsidy these firms enjoy due to market perceptions of their systemic importance, ultimately creating a more level playing field for financial institutions of all sizes.

4. What is the legal authority for the Federal Reserve to use Quantitative Easing?

As you know, the Federal Reserve is charged by Congress with promoting the goals of maximum employment, stable prices and moderate long-term interest rates. See 12 U.S.C. § 225(a). The Federal Reserve works to accomplish these monetary policy goals in part through the conduct of open market operations authorized under section 14 of the Federal Reserve Act. See 12 U.S.C. § 355. Quantitative Easing is the popular term used to refer to the Federal Open Market Committee's program for providing monetary policy accommodation to the economy by purchasing and holding longer-term Treasury securities and mortgage backed securities guaranteed by the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

Section 14 of the Federal Reserve Act specifically authorizes the Federal Reserve to purchase and sell obligations of or guaranteed by the United States or any agency of the United States, such as Ginnie Mae, Fannie Mae and Freddie Mac. Purchases of these securities should put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative. These financial developments, in turn, should help to strengthen the economic recovery and to ensure that inflation, over time, is at the rate most consistent with the mandate from the Congress.

CLO: #B - 34
CCS: 13-1505
RECVD: 3/13/13

Questions for the Record

House Committee on Financial Services
Full Committee Hearing - "Monetary Policy and the State of the Economy"
February 27, 2013

Mr. Bernanke, please respond in writing to the following questions, as I did not have an opportunity to discuss these issues with you during your recent testimony before the House Committee on Financial Services:

1. With all of the recent discussion centering on systemic risk and "Too Big to Fail," do you believe U.S. regional banks are a systemic risk?
2. Do you believe the $50 billion asset threshold is the right proxy for determining systemic risk?
    a. Wouldn't the 11-point Test in Title 1 of the Dodd-Frank Act for non-bank systemically important financial institutions (SIFIs) be a better way to determine bank SIFIs?
    b. What are your thoughts on a proposed framework for defining SIFIs through factors as detailed in a 2009 study by the Cleveland Federal Reserve (attached)?
3. There are recent concerns that the administrative burden from some of the newly written rules stemming from the Dodd-Frank Act is going to have a substantial impact on regional and community banks that are not systemically important. How do we ensure that we don't harm these traditional institutions in our efforts to protect the economy from those that are truly systemically important?
4. What is the legal authority for the Federal Reserve to use Quantitative Easing?

Thank you in advance for responding to these questions. I eagerly anticipate your response.

Sincerely,

STEVE STIVERS
Member of Congress

Encl.

FEDERAL RESERVE BANK OF CLEVELAND

POLICY DISCUSSION PAPERS

On Systemically Important Financial Institutions and Progressive Systemic Mitigation

By James B. Thomson

POLICY DISCUSSION PAPER NUMBER 27 AUGUST 2009

On Systemically Important Financial Institutions and Progressive Systemic Mitigation

By James B. Thomson

One of the most important issues in the regulatory reform debate is that of systemically important financial institutions. This paper proposes a framework for identifying and supervising such institutions; the framework is designed to remove the advantages they derive from becoming systemically important and to give them more time-consistent incentives. It defines criteria for classifying firms as systemically important: size (the classic doctrine of too big to let fail) and the four C's of systemic importance (contagion, concentration, correlation, and conditions); it also discusses the concept of progressive systemic mitigation.

James B. Thomson is a vice president in the Office of Policy Analysis of the Federal Reserve Bank of Cleveland. The author thanks the regulatory reform workgroup at the Federal Reserve Bank of Cleveland (Jean Burson, Emre Ergungor, Mark Greenlee, Joe Haubrich, Paul Kaboth, Dan Littman, Stephen Ong, and Andy Watts) for their thoughtful contributions to this work, as well as Ed Kane, Bill Osterberg, Mark Sniderman, and Walker Todd for their insightful comments and suggestions.

POLICY DISCUSSION PAPERS

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Introduction

Central banks increasingly define financial stability as a key mission, second only to monetary policy. Achieving financial stability involves promoting time-consistent incentives for financial firms and other market participants. Getting the incentives right requires supervisors to deal with systemic risk and, in particular, systemically important financial institutions. Establishing a financial stability supervisor alone will not achieve stability; it is also crucial to deal proactively with systemically important financial institutions. To do so, it is necessary to have a workable definition of "systemically important."

On one level, the definition is fairly simple. A firm is considered systemically important if its failure would have economically significant spillover effects which, if left unchecked, could destabilize the financial system and have a negative impact on the real economy. This definition is unsatisfactory because it provides little guidance in practice. What we need is a workable definition of "systemically important." However, because a variety of factors could make a firm systemically important, a one-size-fits-all definition would not be very useful.

What can be gained from putting parameters around the term? Delineating the factors that might make a financial institution systemically important is the first step towards managing the risk arising from it. Understanding why a firm might be systemically important is necessary to establish measures that reduce the number of such firms and to develop procedures for resolving the insolvency of systemically important firms at the lowest total cost (including the long-run cost) to the economy.

This paper aims to establish a set of criteria for designating financial firms as systemically important. First, the sources of systemic risk are identified by considering how a financial institution becomes systemically important. Regarding systemic importance as a continuum rather than a binary distinction, we then investigate the usefulness of establishing categories of systemic importance and the trade-off between a manageable definition and the number of categories used to classify financial institutions. Next we discuss the establishment of a list of systemically important financial institutions, weigh the merits of making such a list public, and offer criteria for categorizing institutions. We close with conclusions and policy recommendations.

Defining Systemically Important Financial Institutions

The purpose of creating a practical definition of systemic importance is to enable supervisors to discipline systemically important financial institutions. Understanding the nature and causes of systemic importance is the foundation for creating regulations, supervisory policies, and infrastructure that will rein in the associated systemic risk; in some cases, doing so sufficiently mitigates an institution's potential systemic impact so that it would no longer be considered systemically important. Because any two firms could be deemed systemically important for unrelated reasons, a one-size-fits-all designation such as "too big to fail" is inadequate.[1] Consequently, the approach taken here is to propose a means of classifying systemically important financial institutions (SIFIs).

1. The first incarnation of the philosophy of "too big to let fail," dates back to the FDIC bailout of the Continental Illinois Bank and Trust Company of Chicago in 1984. For a discussion of the failure and rescue of Continental Illinois, see Irwin Sprague, 1986, *Bailout: An Insider's Account of Bank Failures and Rescues*, N.Y.: Basic Books.

Size

The simplest—and potentially most flawed—way to classify SIFIs is a size threshold, whether it be asset-based, activity-based, or both. Ideally, a size-based classification should have a flow of funds/ credit intermediation aspect. For instance, a bank with 5 percent of assets nationwide that holds a portfolio made up largely of government and agency securities is likely to have less serious systemic implications than a comparable bank with a portfolio of commercial and industrial loans. After all, the bank holding mostly low-risk, marketable securities will be less likely to fail—and will suffer fewer losses if it does fail—than the bank holding more opaque, riskier commercial and industrial loans. Off-balance-sheet activities might also need to be accounted for. Credit substitutes, such as letters of credit and lines of credit, are rightfully included in financial firms' credit-intermediation activities. Moreover, it is important to define SIFIs in a way that minimizes unintended consequences, such as reducing market discipline on firms added to the SIFI list.

Size alone is not an adequate criterion. Although the size threshold could certainly be set low enough to capture most of the firms that are systemically important for other reasons, the majority would not be systemically important. Including these firms would put too heavy a burden on them: One objective of defining systemically important institutions is to allow differential regulatory taxes across types. Efficiency and equity concerns therefore require more flexible definitions. The definitions presented here will be based on four factors other than size which, individually or collectively, can make a financial institution systemically important. These are the four C's of systemic importance: contagion, correlation, concentration, and conditions (context).

As a starting point for a size-based definition, a financial firm would be considered systemically important if it accounts for at least 10 percent of the activities or assets of a principal financial sector or financial market or 5 percent of total financial market activities or assets.[2] Using current financial-sector designations as a guide, a SIFI would satisfy any of the following criteria.[3]

- The consolidated entity holds 10 percent or more of nationwide banking assets
  - Or has 5 percent of nationwide banking assets and 15 percent or more of loans.
- After converting off-balance-sheet activities into balance-sheet equivalents, the consolidated entity holds 10 percent or more of nationwide banking assets.
  - Off-balance-sheet items would include, for instance, items from schedule RC-L from the FFIEC Reports of Income and Condition and HC-L from the Federal Reserve Y9 reports; structured investment vehicles and other loan special purpose entities used to remove assets from the firm's balance sheet for regulatory capital purposes; and assets sold or securitized.
  - It might be prudent to apply the adjusted-asset test only to financial institutions that hold more than 5 percent of U.S. banking assets.
- The consolidated entity accounts for 10 percent of the total number or total value of life insurance products (whole and universal life policies and annuities) nationwide.
- The consolidated entity accounts for 15 percent of the total number or total value of all

2. These standards could be established on a book or fair-market basis. Ideally, SIFI thresholds would be determined using fair-value accounting when possible.

3. These are examples of possible thresholds. However, any proposed system of thresholds must be vetted and, if possible, established (and periodically updated) on the basis of empirical studies.

insurance products (whole and universal life policies, property and casualty policies, annuities, etc.) nationwide.

- A nonbank financial institution (other than a traditional insurance company) such as an investment bank might be considered systemically important if
  - Its total asset holdings would rank it as one of the 10 largest banks in the country
    - Its total assets would rank it in the top 20 largest banks and its adjusted total assets (accounting for off-balance sheet activities) would rank it in the top 10 largest banks
  - It accounted for more than 20 percent of securities underwritten (averaged over the previous five years).

Contagion

The two classic cases of contagion as a source of systemic importance are Herstatt Bank and Continental Illinois, both in 1984. Although Herstatt was a relatively small institution, its closing had the potential to disrupt the international payments system and imposed nontrivial losses on its counterparties. As discussed in Todd and Thomson (1991), the stated rationale for the FDIC bailout of all Continental Illinois's creditors was the threat that losses would be transmitted to some 2,300 community banks that had correspondent-banking relationships with Continental.[4] Most recently, the justification for the Federal Reserve of New York's assisted acquisition of Bear Stearns by JPMorgan Chase appears to have been concerns about contagion; in this case, the source of contagion was the potential of loss transmission through the credit-default-swaps market. In principle, the ability to put parameters around contagion as source of systemic importance should enable effective treatments to mitigate contagion.

A financial institution would be considered systemically important if its failure could result in

- Substantial capital impairment of institutions accounting for a combined 30 percent of the assets of the financial system
- The locking up or material impairment of essential payments systems (domestic or international)
- The collapse or freezing up of one or more important financial markets.

A substantial impairment of a payments system or market would be one that is large or long enough to affect real economic activity.[5]

Correlation

Correlation, as a source of systemic importance, is also known as the "too many to fail" problem. Penati and Protopapadakis show how correlated risk exposure contributed to the overexposure of large U.S. banks to borrowers in developing countries.[6] There are two important aspects of correlation risk. First are the institutions' incentives to take on risks that are highly correlated with other institutions because policymakers are less likely to close an institution if many other institutions would become decapitalized at the same time. This is consistent with the casual observation of herding behavior in the financial system which, in the most recent episode, took the form of finan-

4. Walker F. Todd and James B. Thomson, 1991, "An Insider's View of the Political Economy of the Too Big to Let Fail Doctrine." In *Public Budgeting and Financial Management: An International Journal*, 3:547–617.

5. It is important to define the parameters of a material or substantial disruption of the payments system carefully; studies are needed to establish these.

6. See Alessandro Penati and Aris Protopapadakis, 1988, "The Effect of Implicit Deposit Insurance on Banks' Portfolio Choices with an Application to International Overexposure," *Journal of Monetary Economics*, 21: 107–26. For a discussion of the too many to fail problem, see Janet Mitchell, 1988, "Strategic Creditor Passivity, Regulation, and Bank Bailouts," CEPR discussion paper no. 1780.

cial institutions overexposing themselves to subprime mortgages, mortgage-backed securities, and related mortgage-derivative securities. Second is the potential for largely uncorrelated risk exposures to become highly correlated in periods of financial stress. Andrew Lo calls this phenomenon "phase-locking behavior."[7] This means that a group of institutions that would not typically pose a systemic threat might, in certain economic or financial-market conditions, become systemically important. This second form of correlation-driven systemic importance is actually an example of condition- or context-driven systemic importance.

The too-many-to-fail problem is a bit more difficult because it requires that a group or subset of institutions be classified as jointly systemic. As in the case of contagion, putting parameters around correlated risk exposure (including determining what level of correlation across portfolios poses a systemic threat), is the first step towards developing and implementing regulatory treatments. Classifying institutions as systemically important because of correlated risks will mean developing and estimating risk models, using stress testing and scenario analysis, and establishing a set of fundamental risk exposures that financial institutions' portfolios can be mapped into. Fortunately, some large financial institutions are doing this type of risk modeling and scenario analysis for looking at their own risk profile: their work provides a good foundation for other to work from. Moreover, academic economists have begun thinking about modeling macro-financial risks in the economy, a step towards modeling and quantifying correlated-risk exposure.[8]

What levels of correlated risks would give rise to systemic concerns? Thresholds that would make groups of institutions systemically important include

- The probability that an economic or financial shock would decapitalize institutions accounting, in aggregate, for 35 percent of financial system assets or 20 percent of banking assets
- Potential for economic/financial shock to decapitalize institutions accounting, in aggregate, for 15 percent of financial system assets or 10 percent of banking assets, and for nationwide shares amounting to
  - 50 percent of wholesale or retail payments, or
  - 35 percent of a major credit activity,[9] or
  - 50 percent of securities processing or 30 percent of securities underwriting (five-year average), or
  - 20 percent of the total number or total value of life insurance products (universal and whole life policies and annuities), or
  - 30 percent of the total number or total value of insurance products (whole and universal life policies, property and casualty policies, annuities, etc.).

Concentration

Dominant firms' presence in key financial markets or activities can give rise to systemic importance if the failure of one of these firms could materially disrupt or lock up the market. Concentration has two important aspects: the size of the firm's activities relative to the contestability of the mar-

7. See Andrew W. Lo, 2008, *Hedge Funds: An Analytic Perspective*. Princeton, NJ: Princeton University Press.

8. See for example, Dale F. Gray, Robert C. Merton, and Zvi Bodie, 2006, "A New Framework for Analyzing and Managing Macrofinancial Risks of an Economy," NBER Working Paper no. 12637, October. Available at <http://www.nber.org/papers/w12637>.

9. Fairly broad definitions of credit activities should be used: For instance, the categories might include commercial credit, housing finance, small-business credit, agricultural credit, and consumer credit. Moreover, it is necessary to establish a threshold for categorizing a credit activity as major.

ket. That is, concentration is less likely to make a financial institution systemically important if, other things being equal, the activities of a distressed institution can easily be assumed by a new entrant into the market or by the expansion of an incumbent firm's activities. Hence, it is logical to adjust concentration thresholds to account for contestability.

A financial institution is systemically important if its failure could materially disrupt a financial market or payments system, causing economically significant spillover effects that impede the functioning of broader financial markets and/or the real economy. Thresholds for concentration that would render a financial institution systemically important include any firm (on a consolidated basis) that

- Clears and settles more than 25 percent of trades in a key financial market.
- Processes more than 25 percent of the daily volume of an essential payments system.
- Is responsible for more than 30 percent of an important credit activity.

Conditions/Context

In certain states of nature or some macro-financial conditions, closure policy may not be independent of these conditions. In other words, regulators are reluctant to allow the official failure (closure) of a distressed financial institution under particular economic or financial market conditions if its solvency could have been resolved under more normal conditions. Hence, conditions/context are sources of systemic importance. For instance, Haubrich notes that the New York Fed's reluctance to allow the failure of Long-Term Capital Management resulted largely from the fragility of financial markets at that time—due to the Southeast Asian currency crises and the Russian default.[10] This might explain, in part, why LTCM was treated as systemically important and Amaranth (which was more than twice as big) was not. Another example would be intervention to prevent the bankruptcy of Bear Stearns by merging it (with assistance) into JPMorgan Chase in early 2008, whereas Drexel Burnham Lambert was allowed to enter bankruptcy in early 1990. Firms that might be made systemically important by conditions/context are probably the most difficult to identify in advance. Certainly, stress testing and scenario analysis will be needed to identify them. As discussed above, during periods of financial market distress, phase-locking behavior can cause what would otherwise be slightly correlated risk exposures to become highly correlated. As a result, a group of institutions that would not pose a systemic threat under normal economic or financial-market conditions become systemically important.

Two sets of criteria must be established to classify firms that are systemically important because of context. First is the probability that economic or financial conditions will materialize that produce the state of nature where a firm or group of firms becomes systemically important. Second are the thresholds for systemic importance, which presumably would be based on those used to classify SIFIs according to contagion, concentration, and correlation during normal market conditions; which thresholds are applied would depend on which type of systemic importance the conditions produce.

10. See Joseph G. Haubrich, 2007, "Some Lessons on the Rescue of Long-Term Capital Management," Federal Reserve Bank of Cleveland, *Policy Discussion Paper*. No. 19, April.

Establishing SIFI Categories

One way to classify systemically important financial institutions was suggested in the Geneva report:[11] Institutions may be systemic on their own, as part of group, or in a particular context (or state of the economy). Under this classification scheme, there would likely be four or five categories of institutions: Category four would consist of large—but not overly complex—regional financial institutions; category five would consist of community financial institutions. Institutions could migrate between categories as their activities and risks evolve.

Constructing categories permits application of the modern tax principles of horizontal and vertical equity in regulating FISIs. Within each category, every financial institution would be subject to equivalent regulatory treatment and intensity of supervision. Of course, because two institutions could fall under the same category for different reasons, the exact forms of their regulatory taxes would logically differ. In this case, equitable treatment consists of the same degree of regulatory interference (level of regulatory taxes), although the forms of regulation may not be exactly the same. As you move up the categories, firms would be subject to increased levels of regulatory interference and supervisory attention—that is, progressive systemic mitigation—analogous to the prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991.

Increased regulatory taxes and supervisory scrutiny for higher categories can be justified in terms of economic efficiency and equity. For instance, economic efficiency dictates that regulatory taxes increase to the point where the cost of the last increment of these taxes equals the benefit of imposing them. It is likely that the cost of complying with additional regulations is inversely related to an institution's size and complexity, while the benefits from additional regulation are directly related. Hence, as institutions become larger and more complex, increased regulation and more intensive supervision may be consistent with economic efficiency. Furthermore, to the extent that the wedge between the private and social costs of failure is related to an institution's size and complexity, economic efficiency demands graduated sets of regulatory taxes, which are designed to internalize the externalities.

There are equally compelling arguments for progressively intensive or intrusive regulatory treatments on the grounds of equity as you move up the systemic category ladder. One such is the "level playing field" argument: To the extent that systemic importance confers competitive advantages on an institution, equity concerns would dictate a system of graduated regulatory taxes to remove (or at least minimize) the advantages of being (or becoming) systemically important.

Of the five categories, only three would contain financial institutions that are considered systemically important. The rationale for a five-category system is that it allows for more consistent application of regulatory taxes and supervisory oversight across categories, following the notion that differential supervision and regulation can level the playing field by mitigating the advantages financial institutions derive from systemic importance.[12] The categories would likely be defined as follows:

11. Markus Brunnermeier, Andrew Crocket, Charles Goodhart, Avinash D. Persaud, and Hyun Shin, "Fundamental Principles of Financial Regulation," 2009. Geneva Reports on the World Economy, 11.

12. Another rationale for systemic categories is that the degree to which markets can or would be allowed to discipline systemic institutions differs across categories, with higher categories containing financial institutions where market discipline is less likely to be effective (or those that are allowed to operate unfettered).

Category 1

Financial institutions that would be considered SIFIs on the basis of size alone (the classic too big to let fail category) or to concentration (the firm is a dominant player in an economically significant financial market or activity)

Category 2

Financial institutions that are systemically important because of interconnectedness (interbank or inter-firm exposure, also known as contagion)

Category 3

Financial institutions that are systemically important as a group because of correlated risk exposures (the too many to fail problem). Also included in category 3 would be financial institutions that are systemically important because of conditions or context.

Category 4

Large financial institutions that are not systemically important but whose failure could have economically significant implications for regional economies. This category would include large regional banking companies and large insurance companies.

Category 5

Financial institutions not included in the other categories, consisting primarily of community financial institutions.

Under the philosophy of progressive systemic mitigation, institutions in category 5 would be subject to a basic level of safety-and-soundness regulation and supervisory oversight. No special reporting requirements, targeted risk exams, or other treatments would be necessary.[13] Category 4 institutions would not face any special capital surcharges or activity restrictions that might apply in categories 1–3, but they would be subject to additional reporting requirements and expected to implement risk management systems and more sophisticated risk controls than category 5 institutions. Moreover, category 4 institutions would be subject to more vigorous supervision than those in category 5.[14]

At a minimum, category 3 institutions should be subject to periodic stress tests and be required to have contingency plans in place. Regulatory agencies need to conduct routine scenario analysis and simulations to ascertain the financial system's vulnerability to a correlated-risk event and establish the appropriate regulatory treatment. Such treatment might include actions like portfolio limits, add-on capital requirements, and loss reserves tied to the activities driving the correlated risks. Scenario analysis and risk simulations would be used as part of contingency plans for handling correlated risk events. Stress tests, scenario analysis, risk simulations, and contingency plans would also be part of the operational regulatory system for dealing with institutions that are rendered systemically important by conditions or context.

Progressive systemic mitigation implies that the treatments adopted for category 3 institutions should also be applied to those in categories 1 and 2. For category 2 institutions, it is necessary to

13. These institutions would remain subject to consumer regulation.

14. Recently, Federal Reserve Bank of Cleveland President Sandra Pianalto outlined a new regulatory scheme, "tiered parity," in which financial firms would be separated into three classes or tiers based upon their complexity. As in the present proposal, the regulatory treatment of a firm would be determined according to the tier it is assigned to (with equal regulatory treatment of firms within a tier). To go from the five-category progressive systemic mitigation scheme to the three tiers of the tiered-parity scheme, you simply combine categories 4 and 5 into tier 3 and categories 2 and 3 into tier 2. Category 1 of progressive systemic mitigation is essentially the same as tier 1 of the Cleveland Fed's tiered-parity proposal. For a description of tiered parity, see Sandra Pianalto, "Steps toward a New Financial Regulatory Architecture," Ohio Banker's Day address, April 1, 2009, available at <http://www.clevelandfed.org/For_the_Public/News_and_Media/Speeches/2009/Pianalto_20090401.cfm>.

establish regulatory reporting requirements that allow for inter-bank/inter-firm exposures, direct and indirect, to be tracked and measured. In addition, limits on direct and indirect exposure to counterparties should be instituted, along with specific reserves and add-on capital charges designed to limit contagion across firms. For category 1 institutions, two more types of regulatory treatment need to be added to those faced by category 2 institutions. First, market discipline should be enhanced through mandatory debt-structure requirements, which could include a mandatory subordinated debt requirement and/or reverse convertible debentures.[15] Moreover, a system of double indemnity for shareholders in category 1 institutions could be an effective device for providing socially compatible incentives for those institutions.[16]

This is only a partial set of remedies that might be applied progressively to financial institutions in each category. Naturally, the exact regulatory treatments and the nature of the increased supervisory attention would need additional study. After all, as a system of regulatory taxes, progressive systemic mitigation is subject to the regulatory dialectic. Consequently, it is important to understand the unintended consequences of whatever treatments are adopted.[17] Such an understanding will help reduce the deadweight losses of the regulatory regime and increase regulators' ability to respond dynamically to an evolving financial system.

Transparency versus Constructive Ambiguity: Should the List of SIFIs Be Public?

How much information is made public (details about SIFIs, criteria for inclusion in the categories, and the associated regulatory treatment) depends on several factors: the extent to which the supervisory regime utilizes market discipline; whether inclusion on the list has unintended certification effects (or, alternatively, whether ambiguity reduces the credibility of implicit government guarantees); and the degree to which markets can reliably indentify the financial institutions that populate the categories.[18] The more information is released—that is, the closer the regime is to full disclosure—the more side issues must be addressed. For instance, how will an institution's inclusion in—or removal from—the list of SIFIs or the promotion (demotion) to a higher (lower) category be communicated? Will there be watch lists of SIFIs that are under consideration for change in status? Would the names of firms that are systemically important because of context/conditions be made public and, if so, what additional information (such as risk models, scenario analysis, and simulations) should be provided?

The choice of disclosure regime would seem to be between transparency (publication of the list of firms in each category) and some version of constructive ambiguity, where selected information is released. The term "constructive ambiguity" has been attributed to former Secretary of State Henry Kissinger;[19] in a diplomatic context, it refers to the use of ambiguous statements as part of a negotiating strategy. However, in the context of central banking and financial markets, the term refers to a policy of using ambiguous statements to signal intent while retaining policy flexibility. In the context of the federal financial safety net, many have argued for a policy of

15. For a discussion of mandatory subordinated debt requirements, see Rong Fan, Joseph G. Haubrich, Peter Ritchken, and James B. Thomson, 2003, "Getting the Most Out of a Mandatory Subordinated Debt Requirement," *Journal of Financial Services Research*, 24:2/3, 149–79; Reverse convertible debentures are discussed in Mark J. Flannery, "No Pain, No Gain? Effecting Market Discipline via 'Reverse Convertible Debentures'" (November 2002). Available at <http://ssrn.com/abstract=352762 or DOI: 10.2139/ssrn.352762>.

16. See Edward J. Kane, 1987, "No Room for Weak Links in the Chain of Deposit Insurance Reform," *Journal of Financial Services Research*, 1:77–111.

17. For a discussion of the regulatory dialectic, see Edward J. Kane, 1977, "Good Intentions and Unintended Evil: The Case against Selective Credit Allocation," *Journal of Money, Credit, and Banking*, 9:1, 55–69.

18. For an analysis of how markets discover regulatory information, see Allen Berger, Sally M. Davies, and Mark J. Flannery, 2000, "Comparing Market and Supervisory Assessments of Bank Performance: Who Knows What When?" *Journal of Money, Credit, and Banking*, 32:3, 641–67.

19. <http://en.wikipedia.org/wiki/Constructive_ambiguity>.

constructive ambiguity to limit expansion of the federal financial safety net.[20] The notion here is that if market participants are uncertain whether their claim on a financial institution will be guaranteed, they will exert more risk discipline on the firm. In this context, constructive ambiguity is a regulatory tactic for limiting the extent to which de facto government guarantees are extended to the liabilities of the firms that regulators consider systemically important. Uncertainty about whether a firm is considered systemically important and which category it belongs to in the progressive systemic mitigation regime may, at the margin, exert stronger market discipline on institutions than if the list of SIFIs were made public.

For a number of reasons, a policy of supervisory transparency is superior to constructive ambiguity for our purposes. First, constructive ambiguity, broadly viewed, is a competitor of the progressive systemic mitigation regime proposed in this paper. Constructive ambiguity is a supervisory policy aimed at reducing the agency problems associated with firms' systemic importance by creating uncertainty about which firms and creditors might be rescued if a firm fails. Progressive systemic mitigation is an explicit set of regulations and supervisory policies designed to reduce (if not eliminate) the advantages of being systemically important. Under its rules, the social costs of systemic importance would be internalized by the institution and its stakeholders. Second, to the extent that SIFIs would be subject to specific sets of regulatory treatments, it is unlikely that there would be much value in continuing the policy of constructive ambiguity in the proposed progressive systemic mitigation system. After all, markets will probably be able to surmise which firms are on the SIFI list by observing differences in capital structure, balance sheet entries (including footnotes), and intensity of regulatory scrutiny. Finally, the benefit of constructive ambiguity in avoiding an SIFI certification effect that might result from publishing a list of SIFI firms would only affect a small number of firms at the margin. The efficiency gains of avoiding the certification effect on these marginally systemic firms is likely to be swamped by efficiency losses associated with withholding information from the market. Hence, the list of SIFIs, including categories and criteria for inclusion, should be made public, along with a watch list of financial institutions whose SIFI status might change.

An effective system of supervisory transparency entails more than simply disclosing information; it must also include producing information and disseminating it in a useful form.[21] A case in point is the argument for requiring credit rating organizations to disclose information, such as probabilities of default and loss given default, upon which a rating is based.[22] In the supervisory transparency regime, this means that all information used to assign institutions to an SIFI category—including supervisory risk models and their results—should be disclosed. [23] Furthermore, stress tests of SIFIs, along with contingency plans for handling the financial distress of one or more large financial institutions, should be implemented and disclosed.

20. For a discussion of constructive ambiguity as a tool for limiting conjectural government guarantees of bank creditors, see Frederic S. Mishkin, 1999, "Financial Consolidation: Dangers and Opportunities," *Journal of Banking and Finance* 23:2–4, 675–91. For a discussion of constructive ambiguity in the context of lender-of-last-resort policies, see Marvin Goodfriend and Jeffrey M. Lacker, 1991, "Limited Commitment and Central Bank Lending," Federal Reserve Bank of Richmond, *Economic Quarterly*, 85:4, 1–27.

21. For an example of useful information, see the recommendations of the 2001 Working Group on Public Disclosure, which suggests that supervisors release information (such as data about risk exposure) that provides a consistent view of a bank's risk management approach. See Board of Governors of the Federal Reserve System, 2001, SR 01-6: Enhancement to Public Disclosure, Division of Banking Supervision, April.

22. See Charles W. Calomiris, 2008, "The Subprime Turmoil: What's Old, What's New, and What's Next," presentation at the Federal Reserve Bank of Kansas City's symposium, "Maintaining Stability in a Changing Financial System," August 21–22.

23. In cases where releasing a piece of information could result in the disclosure of confidential business information, suppression of the information should be predicated on a careful cost-benefit analysis, which weighs the financial institution's private interests against the benefits to society.

Conclusions and Policy Recommendations

The legacy of economic and financial crises is a post-crisis regime characterized by increased government interference in markets. However, simply increasing the amount of formal regulation and the degree of supervisory oversight and interference is not necessarily the best path forward. Financial market reforms must deal in the least-cost way with the fundamental issues that contributed to the current crisis. One of the most important issues that regulators, legislators, and other policymakers must face is that of systemically important financial institutions.

We propose the study and subsequent adoption of a financial-market supervisory infrastructure in which SIFIs are identified, categorized according to the nature or source of their systemic importance, and subjected to specific regulatory treatments that address the risk these firms impose. The ultimate objective of progressive systemic mitigation is to improve economic efficiency by promoting socially compatible risk incentives for SIFIs and to increase fairness in the financial system by leveling the playing field; the means of achieving this are reducing or removing, through regulatory taxes, the advantages of being systemically important.

Specific regulatory treatments to deal with the four C's of systemic importance (contagion, correlation, concentration, and context/conditions) must be carefully studied before they are adopted. These regulatory treatments might include (but are not limited to) capital surcharges, special reserves, mandatory subordinated debt and/or reverse capital debentures, inter-firm exposure limits, and increased regulatory reporting requirements. Moreover, banking supervisors should be required to conduct periodic systemic risk analyses, stress tests, and other simulations as part of a contingency planning process that would improve regulators' ability to deal in a least-cost manner (combined short- and long-term costs) with the failure of one or more SIFIs. Finally, the information disclosure regime must be addressed when implementing the new supervisory architecture. We argue for full transparency, which includes publishing the list of SIFIs, presumably on a quarterly basis; the criteria for inclusion in an SIFI category; and specific regulatory treatments. In addition, financial institutions whose systemic status may be upgraded or downgraded should be included on a published watch list.

One issue we have not dealt with here is the need to establish a credible resolution process for SIFIs. This, of course, involves careful consideration of the types of resolution authority needed, the funding source for operating any such authority, and the related infrastructure. While a credible resolution process should involve addressing contingency plans as part of the supervisory regime, we leave discussion of the type and form of resolution authority to a companion paper.

papers

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

July11, 2013

The Honorable Mike Johanns
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed is my response to the written question you submitted following the February 26, 2013, hearing before the Senate Banking Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Question for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Johanns:</u>

1. Mr. Chairman, as you know, numerous Senators have weighed in with the Board of Governors that, in enacting Dodd-Frank, Congress intended to utilize state-risk based capital rules governing capital for insurance-based SLHCs. As you have heard in your recent appearances before the House Financial Services and Senate Banking Committees, many of us remain deeply troubled by the Federal Reserve's insistence in applying bank centric standards to such companies. In particular, Senator Collins has written to you pointing out that "it was not Congress' intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime." In your recent appearance before the House Financial Services Committee, however, you indicated the Board of Governors was constrained by the Collins Amendment in addressing the insurance-banking distinction.

Given that the statute does not preclude utilizing insurance capital standards to satisfy minimum capital requirements that are equivalent to Basel standards, and that congressional intent is now clear on permitting the use of such insurance standards, will the Board continue to insist that the Collins Amendment mandates the use of bank-centric standards for insurance-based SLHCs and grants the Board no flexibility or discretion in this area? If so, could you provide the legal rationale as to why the Board of Governors believes it has no such flexibility and discretion?

Section 171 of the Dodd-Frank Act, by its terms, requires the appropriate federal banking agencies to establish minimum capital requirements for bank holding companies (BHCs) and savings and loan holding companies (SLHCs) that "shall not be less than" "nor quantitatively lower than" the generally applicable capital requirements for insured depository institutions. Section 171 does not contain an exception from these requirements for an insurance company that is a BHC or an SLHC, or for a BHC or an SLHC that controls an insurance company.

To allow the Board an additional opportunity to consider prudent approaches to establish capital requirements for SLHCs that engage substantially in insurance activities within the requirements of the terms of section 171, the Board, on July 2, 2013, determined to defer application of the new Basel III capital framework to SLHCs with significant insurance activities (i.e. those with more than 25 percent of their assets derived from insurance underwriting activities other than credit insurance) and to SLHCs that are themselves state regulated insurance companies. After considering the concerns raised by commenters regarding the proposed application of the proposed regulatory capital rules to SLHCs with significant insurance activities, the Board concluded that it would be appropriate to take additional time to evaluate the appropriate capital requirements for these companies in light of their business models and risks. Among other issues, commenters argued that the final capital rules should take into account insurance company liabilities and asset-liability matching practices, the risks associated with separate accounts, the interaction of consolidated capital requirements with the capital requirements of state insurance regulators, and differences in accounting practices for banks and insurance companies. The Board is carefully considering these issues in determining how to move forward in developing a capital framework for these SLHCs, consistent with section 171 of the Dodd-Frank Act.

CLO: #B - 23
CCS: 13-1389
RECVD: 3/6/13

Questions for the Record

Senator Mike Johanns

2.21.13 Senate Banking Committee hearing

"Semiannual Monetary Policy Report to the Congress"

Question for Federal Reserve Chairman Bernanke

1. Mr. Chairman, as you know, numerous Senators have weighed in with the Board of Governors that, in enacting Dodd-Frank, Congress intended to utilize state-risk based capital rules governing capital for insurance-based SLHCs. As you have heard in your recent appearances before the House Financial Services and Senate Banking Committees, many of us remain deeply troubled by the Federal Reserve's insistence in applying bank-centric standards to such companies. In particular, Senator Collins has written to you pointing out that "it was not Congress' intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime." In your recent appearance before the House Financial Services Committee, however, you indicated the Board of Governors was constrained by the Collins Amendment in addressing the insurance-banking distinction.

   Given that the statute does not preclude utilizing insurance capital standards to satisfy minimum capital requirements that are equivalent to Basel standards, and that congressional intent is now clear on permitting the use of such insurance standards, will the Board continue to insist that the Collins Amendment mandates the use of bank-centric standards for insurance-based SLHCs and grants the Board no flexibility or discretion in this area? If so, could you provide the legal rationale as to why the Board of Governors believes it has no such flexibility and discretion?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

November 25, 2013

The Honorable Patrick McHenry
Chairman
Subcommittee on Oversight
and Investigations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the April 16, 2013, hearing before the Subcommittee on Oversight and Investigations. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System, from Chairman McHenry:</u>

1. (To Mr. Alvarez): The Federal Reserve can only order asset divestures if it determines that less drastic restrictions on the company's activities are inadequate to mitigate the threat the company poses. In your opinion, must the Federal Reserve actually order the company to adopt the less drastic restrictions before it can "determine" that those measures are inadequate? Or are there circumstances in which the Federal Reserve may make the necessary "determination" without having first imposed the other measures?

Section 121 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) authorizes the Federal Reserve Board (Board), with the consent of the Financial Stability Oversight Council (FSOC), to take certain enumerated actions if the Board determines that a large bank holding company or a nonbank financial company supervised by the Board poses a grave threat to U.S. financial stability. In particular, the Board may limit the ability of the company to grow through mergers or acquisitions, restrict the ability of the company to offer certain financial products, require the termination of certain activities, or impose conditions on the manner in which the company conducts one or more activities.

Section 121 authorizes the Board to require the company to sell or otherwise transfer assets to unaffiliated entities under certain circumstances. This authority requires a finding that the firm poses a grave threat to U.S. financial stability. Before taking this action, section 121 also requires the Board to determine that the enumerated actions, including limiting mergers and acquisitions, restricting products, terminating or limiting activities, and imposing conditions on the manner in which activities are conducted, are inadequate to mitigate the threat to U.S. financial stability. Any action the Board proposes to take under section 121 is subject to an affirmative vote of 2/3 of the voting members of the FSOC. In addition, section 121 grants the company a right to notice and a hearing before any mitigatory action is taken pursuant to that section. Any action taken under section 121 would be made after careful consideration of the facts and circumstances of the grave threat posed by a particular company.

2. (To Messrs. Alvarez, Osterman, and Wigand): Section 165(d)(4) of the Dodd-Frank Act appears to refer to two concepts for purposes of determining whether a living will is deficient: "credibility" and "facilitating an orderly resolution under bankruptcy." In your opinion, is there a distinction between those terms? If so, please explain the meaning of each term.

Section 165(d)(4) of the Dodd-Frank Act provides that if the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) jointly determine that a living will is "not credible" or "would not facilitate an orderly resolution under title 11, United States Code" they must notify the filer of plan of the deficiencies in the plan. Neither of the quoted terms is further defined in the statute.

The plain language of Section 165(d)(4) and its use of the word "or" suggests two evaluations. The concept of "not credible" appears to require an assessment of the specific assumptions and conclusions of the plan while the "would not facilitate" concept appears to focus on whether the plan and its informational content would be helpful in a proceeding under title 11 of the Bankruptcy Code.

3. (To Messrs. Alvarez and Osterman): Does Section 165(d)(5) require the Federal Reserve and the FDIC to impose restrictions or heightened standards and/or divestitures after a company fails to timely submit an acceptable living will, or is that decision purely discretionary?

If a company fails to resubmit an acceptable living will, section 165(d)(5)(A) provides that the Federal Reserve Board and the FDIC may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies the filing company.

If requirements are imposed pursuant to section 165(d)(5)(A) and the company fails to submit a satisfactory plan within two years of the imposition of the requirements, section 165(d)(5)(B) provides that the Federal Reserve Board and the FDIC, in consultation with the Financial Stability Oversight Council, may jointly require the company to divest certain identified assets or operations. The use of the term "may" in section 165(d)(5)(A) and (B) suggests that the Federal Reserve and the FDIC have discretion over whether to impose the more stringent requirements identified in the section.

4. (To Mr. Alvarez): Does a financial company have a right to judicial review of an action by the Federal Reserve and the FSOC under Section 121? If so, what would be the standard of review?

Section 121 requires the Board, in consultation with the FSOC, to provide a company written notice that it is being considered for mitigatory action. The company would then have an opportunity to request a hearing to contest the proposed action. The Board is required to notify the company of the final decision of the Board and the FSOC within 60 days of the hearing or of the notice of consideration of mitigatory action if a hearing is not requested.

Section 121 does not expressly provide for judicial review of a final decision of the Board and the FSOC. However, a company subject to an action under section 121 may be able to avail itself of the procedures set forth in the Administrative Procedure Act (APA), which provides that "final agency action for which there is no other adequate remedy in a court is subject to judicial review."[1] Agency action includes an agency order or sanction.[2] The APA also provides that a reviewing court may set side agency action that is found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.[3]

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[1] See section 704 of the APA; 5 U.S.C. § 704.
[2] See section 551(13) of the APA; 5 U.S.C. § 551(13).
[3] See section 706(2)(A) of the APA; 5 U.S.C. § 706(2)(A).

5. (To Messrs. Alvarez and Osterman): Does a financial company have a right to judicial review of an action by the Federal Reserve and the FDIC under Section 165(d)(5)? If so, what would be the standard of review?

Section 165(d)(5) does not expressly provide for judicial review of a final decision of the Board and the FDIC. However, a company subject to an action under section 165(d)(5) may be able to avail itself of the procedures set forth in the Administrative Procedure Act (APA), which provides that "final agency action for which there is no other adequate remedy in a court is subject to judicial review."[4] Agency action includes an agency order or sanction.[5] The APA also provides that a reviewing court may set aside agency action that is found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.[6]

6. (a) (To Mr. Alvarez): In response to a question by Mr. Duffy asking whether "you've seen this petition by Public Citizen, yes?" the following exchange occurred:

Mr. Alvarez: I don't know. I know...

Mr. Duffy: You haven't seen a petition that has been made...

Mr. Alvarez: I've seen (inaudible)

Mr. Duffy: ...with regard to Public Citizen and regard to a very large bank-U.S. Bank. I'm sorry, U.S. Bank-Bank of America?

Mr. Alvarez: I have not.

Mr. Duffy: You haven't seen that? Do you-have you guys responded to any petitions that have been filed under Section 121?

Mr. Alvarez: No, we have not.

(Source: Congressional Quarterly Transcript at p. 33.)

Question:

Is the foregoing a materially accurate transcription of your testimony? If not, please state why not.

(b) On February 10, 2012, the Federal Reserve mailed a letter on your letterhead and under your signature to Mr. David Arkush of the public interest advocacy group Public Citizen. The Federal Reserve's letter was in response to a petition made by Public Citizen

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[4] See section 704 of the APA; 5 U.S.C. § 704.
[5] See section 551(13) of the APA; 5 U.S.C. § 551(13).
[6] See section 706(2)(A) of the APA; 5 U.S.C. § 706(2)(A).

advocating that the Federal Reserve use its authority under Section 121 to mitigate risks posed by the Bank of America Corporation. In part, the letter states that "[t]he Federal Reserve takes seriously its responsibilities under the DFA [Dodd-Frank Act], and will carefully consider all the information available to it, including public comments, confidential supervisory information, and other information, in determining the actions it may take under the statute."

Did you sign the February 10, 2012 letter to Mr. Arkush?

Please clarify or otherwise supplement your above-recounted testimony.

On February 10, 2012, on behalf of Chairman Bernanke, I responded to two letters each dated January 25, 2012, sent to Chairman Bernanke by Mr. Arkush on behalf of Public Citizen. Mr. Arkush advocated that the Board and FSOC use the authorities in the Dodd-Frank Act to mitigate the risks to financial stability that Mr. Arkush asserted are posed by the Bank of America Corporation (BAC) and other large and complex financial institutions. Mr. Arkush suggested that the Board and the FSOC invoke the authority in section 121 of DFA to reform BAC into one or more smaller institutions. My response letter acknowledges receipt of Mr. Arkush's letters, but provided no analysis or review of those letters.

At the time of my testimony, which was over one year later, I did not remember that one of the letters was styled as a petition regarding BAC. I apologize for my failure of memory. As noted in the response to Mr. Arkush, the Board appreciates receiving the views of interested parties, such as Public Citizen, on issues of concern regarding the banking organizations it supervises, and welcomes further public input. In implementing its various statutory authorities under the Dodd-Frank Act, the Board considers all of the information available to it, including public comments.

7. (To Mr. Alvarez): The public interest advocacy group, Public Citizen, has interpreted Section 121 of the Dodd-Frank Act to permit the Federal Reserve to require mitigatory action "well in advance of financial distress at an institution that poses a grave threat to U.S. financial stability." Public Citizen argued that Congress intended Section 121 to be used substantially before an institution actually becomes distressed because Section 121 does not contain a mechanism to order a company to take mitigatory action on an emergency basis. In addition, it argued that the "early" use of Section 121 is appropriate in light of the Dodd-Frank Act's larger structure, because absent divestitures or other mitigatory action the FDIC may not be able to successfully resolve an institution that actually becomes distressed using the Dodd-Frank Act's orderly liquidation authority.

Thus, Public Citizen argued that the Federal Reserve and the FSOC were legally able to use their authority under Section 121 in the case of the Bank of America Corporation because the institution was "structurally unsound" even though it was not in "immediate danger." In Public Citizen's view, Bank of America posed a "grave threat" within the meaning of the Dodd-Frank Act because it was large in size and was highly interconnected

to other financial institutions, and because its size made it hard to manage and gave rise to an expectation in the marketplace of government-funded bailouts should Bank of America become insolvent in the future (thus creating moral hazard). In addition, Public Citizen argued that Bank of America was in a distressed financial condition because, among other factors, its stock price had decreased 90% since 2007; its share price was much lower than its stated tangible book value; spreads for credit default swaps on Bank of America had risen to relatively high levels; and its long-term economic condition was not favorable due to declines in income, litigation exposure, capitalization pressures, and exposure to the European financial crisis.

Question:

Based on the above facts, does Bank of America constitute a "grave threat" within the meaning of Section 121?

Mitigating the threat to financial stability posed by systemically important financial companies is a core objective of the financial regulatory community. A great deal of progress has been made by the FSOC and the financial regulatory agencies, including the Board in implementing the Dodd-Frank Act, several provisions of which were intended to mitigate the threat to financial stability posed by systemically important financial companies.

The Board has already taken a number of steps to improve the quantity and quality of capital held by large banking organizations, including by increasing the minimum risk-based and leverage capital requirements on the largest and most complex banking organizations, and implementing an annual stress test of those capital levels (CCAR). The Dodd-Frank Act also provides a number of important tools for addressing the potential threats that could be posed by systemically important financial companies to U.S. financial stability, including enhanced prudential standards for bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by the FSOC for Board supervision, an orderly resolution authority for large financial firms, living wills, stress testing, and central clearing and margin requirements for derivatives, among other provisions. The Board is actively working to implement these tools with the other Federal banking agencies, as appropriate. In addition, section 121 of the Dodd-Frank Act authorizes the Board, with consent of two-thirds of the voting members of the FSOC, to take certain steps if the Board determines that a large bank holding company or a nonbank financial company supervised by the Board poses a grave threat to the financial stability of the United States.

The Board and other U.S. regulators are now in the process of implementing these reforms. While much progress has been made by the Board and the other financial regulatory agencies in implementing the Dodd-Frank Act reforms designed to address and reduce threats to U.S. financial stability, identifying and addressing risks that emerge or develop as our dynamic system and economy evolve is an ongoing process. The Board and the financial regulatory agencies will continue to monitor emerging systemic threats and risks to U.S. financial stability and deploy the tools available to the agencies designed to mitigate those threats, as appropriate, and endeavor to reduce the probability of failure of systemically important financial firms, implement procedures to resolve these firms in an orderly manner, and strengthen the financial system. A decision whether a particular banking organization poses a grave threat to financial stability is reserved by statute to the Board and the FSOC.

CLO: #42
CCS: 13-2673
RECVD: 5/02/13

Chairman McHenry
Questions for the Record
April 16, 2013 Oversight and Investigations Subcommittee Hearing
"Who is Too Big to Fail: Does Dodd-Frank Authorize the Government to Break-Up Financial Institutions?"

(To Mr. Alvarez): The Federal Reserve can only order asset divestures if it determines that less drastic restrictions on the company's activities are inadequate to mitigate the threat the company poses. In your opinion, must the Federal Reserve actually order the company to adopt the less drastic restrictions before it can "determine" that those measures are inadequate? Or are there circumstances in which the Federal Reserve may make the necessary "determination" without having first imposed the other measures?

(To Messrs. Alvarez, Osterman, and Wigand): Section 165(d)(4) of the Dodd-Frank Act appears to refer to two concepts for purposes of determining whether a living will is deficient: "credibility" and "facilitating an orderly resolution under bankruptcy." In your opinion, is there a distinction between those terms? If so, please explain the meaning of each term.

(To Messrs. Alvarez and Osterman): Does Section 165(d)(5) require the Federal Reserve and the FDIC to impose restrictions or heightened standards and/or divestitures after a company fails to timely submit an acceptable living will, or is that decision purely discretionary?

(To Mr. Alvarez): Does a financial company have a right to judicial review of an action by the Federal Reserve and the FSOC under Section 121? If so, what would be the standard of review?

(To Messrs. Alvarez and Osterman): Does a financial company have a right to judicial review of an action by the Federal Reserve and the FDIC under Section 165(d)(5)? If so, what would be the standard of review?

(To Mr. Wigand): In response to a question from Chairman McHenry asking whether the Federal Reserve and the FDIC considered a firm's liquidity when reviewing a resolution plan submitted under Section 165(d), the following exchange occurred:

Mr. Wigand: Yes, [liquidity] certainly would be a factor. Absolutely.

. . .

Mr. McHenry: Ok. So being resolved in the Bankruptcy Code and [the] requirement within the living will [there] has to be some capacity for liquidity support as they're unwound under the Bankruptcy Code or resolved.

Mr. Wigand: More — more specifically what is required is for the firm to outline how they will handle the liquidity management of the bankruptcy process. So specifically, you know, I — we — we aren't asking the firms to specifically identify where that liquidity support will be drawn from.

But it's a liquidity analysis to indicate how the firm can unwind itself or go through the bankruptcy process without posing systemic consequences.

Source: Congressional Quarterly Transcript at p. 50.

Questions:

Is the foregoing a materially accurate transcription of your testimony? If not, please state why not.

If the foregoing is materially accurate, please state the reasons why the FDIC does not "ask[] the firms to specifically identify where that liquidity support will be draw[n] from." In answering this question, please state the reasons why, in the FDIC's view, the FDIC is able to determine that a living will is credible and would facilitate an orderly resolution of the company under the Bankruptcy Code in the absence of information that identifies the sources from which a company would receive liquidity support.

Please detail how companies otherwise substantiate their liquidity management plans.

(To Mr. Alvarez): In response to a question by Mr. Duffy asking whether "you've seen this petition by Public Citizen, yes?" the following exchange occurred:

Mr. Alvarez: I don't know. I know . . .

Mr. Duffy: You haven't seen a petition that has been made . . .

Mr. Alvarez: I've seen (inaudible)

Mr. Duffy: . . . with regard to Public Citizen and regard to a very large bank — U.S. Bank. I'm sorry, U.S. Bank — Bank of America?

Mr. Alvarez: I have not.

Mr. Duffy: You haven't seen that? Do you — have you guys responded to any petitions that have been filed under Section 121?

Mr. Alvarez: No, we have not.

Source: Congressional Quarterly Transcript at p. 33.

Question:

Is the foregoing a materially accurate transcription of your testimony? If not, please state why not.

On February 10, 2012, the Federal Reserve mailed a letter on your letterhead and under your signature to Mr. David Arkush of the public interest advocacy group Public Citizen. The Federal Reserve's letter was in response to a petition made by Public Citizen advocating that the Federal Reserve use its authority under Section 121 to mitigate risks posed by the Bank of America Corporation. In part, the letter states that "[t]he Federal Reserve takes seriously its responsibilities under the DFA [Dodd-Frank Act], and will carefully consider all the information available to it, including public comments, confidential supervisory information, and other information, in determining the actions it may take under the statute."

Questions:

Did you sign the February 10, 2012 letter to Mr. Arkush?

Please clarify or otherwise supplement your above-recounted testimony.

(To Mr. Alvarez): The public interest advocacy group, Public Citizen, has interpreted Section 121 of the Dodd-Frank Act to permit the Federal Reserve to require mitigatory action "well in advance of financial distress at an institution that poses a grave threat to U.S. financial stability." Public Citizen argued that Congress intended Section 121 to be used substantially before an institution actually becomes distressed because Section 121 does not contain a mechanism to order a company to take mitigatory action on an emergency basis. In addition, it argued that the "early" use of Section 121 is appropriate in light of the Dodd-Frank Act's larger structure, because absent divestitures or other mitigatory action the FDIC may not be able to successfully resolve an institution that actually becomes distressed using the Dodd-Frank Act's orderly liquidation authority.

Thus, Public Citizen argued that the Federal Reserve and the FSOC were legally able to use their authority under Section 121 in the case of the Bank of America Corporation because the institution was "structurally unsound" even though it was not in "immediate danger." In Public Citizen's view, Bank of America posed a "grave threat" within the meaning of the Dodd-Frank Act because it was large in size and was highly interconnected to other financial institutions, and because its size made it hard to manage and gave rise to an expectation in the marketplace of government-funded bailouts should Bank of America become insolvent in the future (thus creating moral hazard). In addition, Public Citizen argued that Bank of America was in a distressed financial condition because, among other factors, its stock price had decreased 90% since 2007; its share price was much lower than its stated tangible book value; spreads for credit default swaps on Bank of America had risen to relatively high levels; and its long-term economic condition was not favorable due to declines in income, litigation exposure, capitalization pressures, and exposure to the European financial crisis.

Question:

Based on the above facts, does Bank of America constitute a "grave threat" within the meaning of Section 121?

STEVE STIVERS
15TH DISTRICT, OHIO

FINANCIAL SERVICES COMMITTEE

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Congress of the United States

2013 MAY 29 AM 8:38

House of Representatives

RECEIVED
OFFICE OF THE CHAIRMAN

May 23, 2013

The Honorable Ben Bernanke
Chairman
Board of Governors of Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

CLO: #B - 58
CCS: 13-3151
RECVD: 5/29/13

Dear Chairman Bernanke:

On February 27, 2013, you testified before the House Committee on Financial Services, in a hearing entitled "Monetary Policy and the State of the Economy." Unfortunately, I did not have an opportunity to discuss my concerns with you regarding systemic risk and quantitative easing.

In lieu of that opportunity, I submitted questions for the record with the anticipation that you would respond to my concerns in writing. However, I have not received a response to these questions.

I remain optimistic that you will be able to address these concerns with expediency. I have attached my original submission for the record to this letter, and look forward to your response.

Sincerely,

STEVE STIVERS
Member of Congress

Encl.

WASHINGTON OFFICE:
1022 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
PH: (202) 225-2015
FAX: (202) 225-3529

CENTRAL OHIO DISTRICT OFFICE:
3790 MUNICIPAL WAY
HILLIARD, OH 43026
PH: (614) 771-4968
FAX: (614) 771-3990

SOUTHEAST OHIO DISTRICT OFFICE:
123 S. BROAD STREET, SUITE 235
LANCASTER, OH 43130
PH: (740) 654-2654
FAX: (740) 654-2482

SOUTHWEST OHIO DISTRICT OFFICE:
69 N. SOUTH STREET, SUITE 178
WILMINGTON, OH 45177
PH: (937) 283-7049
FAX: (937) 283-7052

Questions for the Record

House Committee on Financial Services
Full Committee Hearing - "Monetary Policy and the State of the Economy"
February 27, 2013

Mr. Bernanke, please respond in writing to the following questions, as I did not have an opportunity to discuss these issues with you during your recent testimony before the House Committee on Financial Services:

1. With all of the recent discussion centering on systemic risk and "Too Big to Fail," do you believe U.S. regional banks are a systemic risk?
2. Do you believe the $50 billion asset threshold is the right proxy for determining systemic risk?
   a. Wouldn't the 11-point Test in Title 1 of the Dodd-Frank Act for non-bank systemically important financial institutions (SIFIs) be a better way to determine bank SIFIs?
   b. What are your thoughts on a proposed framework for defining SIFIs through factors as detailed in a 2009 study by the Cleveland Federal Reserve (attached)?
3. There are recent concerns that the administrative burden from some of the newly written rules stemming from the Dodd-Frank Act is going to have a substantial impact on regional and community banks that are not systemically important. How do we ensure that we don't harm these traditional institutions in our efforts to protect the economy from those that are truly systemically important?
4. What is the legal authority for the Federal Reserve to use Quantitative Easing?

Thank you in advance for responding to these questions. I eagerly anticipate your response.

Sincerely,

STEVE STIVERS
Member of Congress

Encl.

FEDERAL RESERVE BANK OF CLEVELAND

POLICY DISCUSSION PAPERS

On Systemically Important Financial Institutions and Progressive Systemic Mitigation

By James B. Thomson

POLICY DISCUSSION PAPER NUMBER 27 AUGUST 2009

On Systemically Important Financial Institutions and Progressive Systemic Mitigation

By James B. Thomson

One of the most important issues in the regulatory reform debate is that of systemically important financial institutions. This paper proposes a framework for identifying and supervising such institutions; the framework is designed to remove the advantages they derive from becoming systemically important and to give them more time-consistent incentives. It defines criteria for classifying firms as systemically important: size (the classic doctrine of too big to let fail) and the four C's of systemic importance (contagion, concentration, correlation, and conditions); it also discusses the concept of progressive systemic mitigation.

James B. Thomson is a vice president in the Office of Policy Analysis of the Federal Reserve Bank of Cleveland. The author thanks the regulatory reform workgroup at the Federal Reserve Bank of Cleveland (Jean Burson, Emre Ergungor, Mark Greenlee, Joe Haubrich, Paul Kaboth, Dan Littman, Stephen Ong, and Andy Watts) for their thoughtful contributions to this work, as well as Ed Kane, Bill Osterberg, Mark Sniderman, and Walker Todd for their insightful comments and suggestions.

Policy Discussion Papers are published by the Research Department of the Federal Reserve Bank of Cleveland. To receive copies or to be placed on the mailing list, e-mail your request to 4dsubscriptions@clev.frb.org or fax it to 216-579-3050. Please send your questions comments, and suggestions to us at editor@clev.frb.org.

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ISSN 1528-4344

Introduction

Central banks increasingly define financial stability as a key mission, second only to monetary policy. Achieving financial stability involves promoting time-consistent incentives for financial firms and other market participants. Getting the incentives right requires supervisors to deal with systemic risk and, in particular, systemically important financial institutions. Establishing a financial-stability supervisor alone will not achieve stability; it is also crucial to deal proactively with systemically important financial institutions. To do so, it is necessary to have a workable definition of "systemically important."

On one level, the definition is fairly simple. A firm is considered systemically important if its failure would have economically significant spillover effects which, if left unchecked, could destabilize the financial system and have a negative impact on the real economy. This definition is unsatisfactory because it provides little guidance in practice. What we need is a workable definition of "systemically important." However, because a variety of factors could make a firm systemically important, a one-size-fits-all definition would not be very useful.

What can be gained from putting parameters around the term? Delineating the factors that might make a financial institution systemically important is the first step towards managing the risk arising from it. Understanding why a firm might be systemically important is necessary to establish measures that reduce the number of such firms and to develop procedures for resolving the insolvency of systemically important firms at the lowest total cost (including the long-run cost) to the economy.

This paper aims to establish a set of criteria for designating financial firms as systemically important. First, the sources of systemic risk are identified by considering how a financial institution becomes systemically important. Regarding systemic importance as a continuum rather than a binary distinction, we then investigate the usefulness of establishing categories of systemic importance and the trade-off between a manageable definition and the number of categories used to classify financial institutions. Next we discuss the establishment of a list of systemically important financial institutions, weigh the merits of making such a list public, and offer criteria for categorizing institutions. We close with conclusions and policy recommendations.

Defining Systemically Important Financial Institutions

The purpose of creating a practical definition of systemic importance is to enable supervisors to discipline systemically important financial institutions. Understanding the nature and causes of systemic importance is the foundation for creating regulations, supervisory policies, and infrastructure that will rein in the associated systemic risk; in some cases, doing so sufficiently mitigates an institution's potential systemic impact so that it would no longer be considered systemically important. Because any two firms could be deemed systemically important for unrelated reasons, a one-size-fits-all designation such as "too big to fail" is inadequate.[1] Consequently, the approach taken here is to propose a means of classifying systemically important financial institutions (SIFIs).

1. The first incarnation of the philosophy of "too big to let fail," dates back to the FDIC bailout of the Continental Illinois Bank and Trust Company of Chicago in 1984. For a discussion of the failure and rescue of Continental Illinois, see Irwin Sprague, 1986, *Bailout: An Insider's Account of Bank Failures and Rescues*, N.Y.: Basic Books.

Size

The simplest—and potentially most flawed—way to classify SIFIs is a size threshold, whether it be asset-based, activity-based, or both. Ideally, a size-based classification should have a flow of funds/credit intermediation aspect. For instance, a bank with 5 percent of assets nationwide that holds a portfolio made up largely of government and agency securities is likely to have less serious systemic implications than a comparable bank with a portfolio of commercial and industrial loans. After all, the bank holding mostly low-risk, marketable securities will be less likely to fail—and will suffer fewer losses if it does fail—than the bank holding more opaque, riskier commercial and industrial loans. Off-balance-sheet activities might also need to be accounted for. Credit substitutes, such as letters of credit and lines of credit, are rightfully included in financial firms' credit-intermediation activities. Moreover, it is important to define SIFIs in a way that minimizes unintended consequences, such as reducing market discipline on firms added to the SIFI list.

Size alone is not an adequate criterion. Although the size threshold could certainly be set low enough to capture most of the firms that are systemically important for other reasons, the majority would not be systemically important. Including these firms would put too heavy a burden on them: One objective of defining systemically important institutions is to allow differential regulatory taxes across types. Efficiency and equity concerns therefore require more flexible definitions. The definitions presented here will be based on four factors other than size which, individually or collectively, can make a financial institution systemically important. These are the four C's of systemic importance: contagion, correlation, concentration, and conditions (context).

As a starting point for a size-based definition, a financial firm would be considered systemically important if it accounts for at least 10 percent of the activities or assets of a principal financial sector or financial market or 5 percent of total financial market activities or assets.[2] Using current financial-sector designations as a guide, a SIFI would satisfy any of the following criteria.[3]

- The consolidated entity holds 10 percent or more of nationwide banking assets
  - Or has 5 percent of nationwide banking assets and 15 percent or more of loans.
- After converting off-balance-sheet activities into balance-sheet equivalents, the consolidated entity holds 10 percent or more of nationwide banking assets.
  - Off-balance-sheet items would include, for instance, items from schedule RC-L from the FFIEC Reports of Income and Condition and HC-L from the Federal Reserve Y9 reports; structured investment vehicles and other loan special purpose entities used to remove assets from the firm's balance sheet for regulatory capital purposes; and assets sold or securitized.
  - It might be prudent to apply the adjusted-asset test only to financial institutions that hold more than 5 percent of U.S. banking assets.
- The consolidated entity accounts for 10 percent of the total number or total value of life insurance products (whole and universal life policies and annuities) nationwide.
- The consolidated entity accounts for 15 percent of the total number or total value of all

2. These standards could be established on a book or fair-market basis. Ideally, SIFI thresholds would be determined using fair-value accounting when possible.

3. These are examples of possible thresholds. However, any proposed system of thresholds must be vetted and, if possible, established (and periodically updated) on the basis of empirical studies.

insurance products (whole and universal life policies, property and casualty policies, annuities, etc.) nationwide.

- A nonbank financial institution (other than a traditional insurance company) such as an investment bank might be considered systemically important if
  - Its total asset holdings would rank it as one of the 10 largest banks in the country
    - Its total assets would rank it in the top 20 largest banks and its adjusted total assets (accounting for off-balance sheet activities) would rank it in the top 10 largest banks
  - It accounted for more than 20 percent of securities underwritten (averaged over the previous five years).

Contagion

The two classic cases of contagion as a source of systemic importance are Herstatt Bank and Continental Illinois, both in 1984. Although Herstatt was a relatively small institution, its closing had the potential to disrupt the international payments system and imposed nontrivial losses on its counterparties. As discussed in Todd and Thomson (1991), the stated rationale for the FDIC bailout of all Continental Illinois's creditors was the threat that losses would be transmitted to some 2,300 community banks that had correspondent-banking relationships with Continental.[4] Most recently, the justification for the Federal Reserve of New York's assisted acquisition of Bear Stearns by JPMorgan Chase appears to have been concerns about contagion; in this case, the source of contagion was the potential of loss transmission through the credit-default-swaps market. In principle, the ability to put parameters around contagion as source of systemic importance should enable effective treatments to mitigate contagion.

A financial institution would be considered systemically important if its failure could result in

- Substantial capital impairment of institutions accounting for a combined 30 percent of the assets of the financial system
- The locking up or material impairment of essential payments systems (domestic or international)
- The collapse or freezing up of one or more important financial markets.

A substantial impairment of a payments system or market would be one that is large or long enough to affect real economic activity.[5]

Correlation

Correlation, as a source of systemic importance, is also known as the "too many to fail" problem. Penati and Protopapadakis show how correlated risk exposure contributed to the overexposure of large U.S. banks to borrowers in developing countries.[6] There are two important aspects of correlation risk. First are the institutions' incentives to take on risks that are highly correlated with other institutions because policymakers are less likely to close an institution if many other institutions would become decapitalized at the same time. This is consistent with the casual observation of herding behavior in the financial system which, in the most recent episode, took the form of finan-

4. Walker F. Todd and James B. Thomson, 1991, "An Insider's View of the Political Economy of the Too Big to Let Fail Doctrine." In *Public Budgeting and Financial Management: An International Journal*, 3:547–617.

5. It is important to define the parameters of a material or substantial disruption of the payments system carefully; studies are needed to establish these.

6. See Alessandro Penati and Aris Protopapadakis, 1988, "The Effect of Implicit Deposit Insurance on Banks' Portfolio Choices with an Application to International Overexposure," *Journal of Monetary Economics*, 21: 107–26. For a discussion of the too many to fail problem, see Janet Mitchell, 1988, "Strategic Creditor Passivity, Regulation, and Bank Bailouts," CEPR discussion paper no. 1780.

cial institutions overexposing themselves to subprime mortgages, mortgage-backed securities, and related mortgage-derivative securities. Second is the potential for largely uncorrelated risk exposures to become highly correlated in periods of financial stress. Andrew Lo calls this phenomenon "phase-locking behavior."[7] This means that a group of institutions that would not typically pose a systemic threat might, in certain economic or financial-market conditions, become systemically important. This second form of correlation-driven systemic importance is actually an example of condition- or context-driven systemic importance.

The too-many-to-fail problem is a bit more difficult because it requires that a group or subset of institutions be classified as jointly systemic. As in the case of contagion, putting parameters around correlated risk exposure (including determining what level of correlation across portfolios poses a systemic threat), is the first step towards developing and implementing regulatory treatments. Classifying institutions as systemically important because of correlated risks will mean developing and estimating risk models, using stress testing and scenario analysis, and establishing a set of fundamental risk exposures that financial institutions' portfolios can be mapped into. Fortunately, some large financial institutions are doing this type of risk modeling and scenario analysis for looking at their own risk profile: their work provides a good foundation for other to work from. Moreover, academic economists have begun thinking about modeling macro-financial risks in the economy, a step towards modeling and quantifying correlated-risk exposure.[8]

What levels of correlated risks would give rise to systemic concerns? Thresholds that would make groups of institutions systemically important include

- The probability that an economic or financial shock would decapitalize institutions accounting, in aggregate, for 35 percent of financial system assets or 20 percent of banking assets
- Potential for economic/financial shock to decapitalize institutions accounting, in aggregate, for 15 percent of financial system assets or 10 percent of banking assets, and for nationwide shares amounting to
  - 50 percent of wholesale or retail payments, or
  - 35 percent of a major credit activity,[9] or
  - 50 percent of securities processing or 30 percent of securities underwriting (five-year average), or
  - 20 percent of the total number or total value of life insurance products (universal and whole life policies and annuities), or
  - 30 percent of the total number or total value of insurance products (whole and universal life policies, property and casualty policies, annuities, etc.).

Concentration

Dominant firms' presence in key financial markets or activities can give rise to systemic importance if the failure of one of these firms could materially disrupt or lock up the market. Concentration has two important aspects: the size of the firm's activities relative to the contestability of the mar-

7. See Andrew W. Lo, 2008, *Hedge Funds: An Analytic Perspective*. Princeton, NJ: Princeton University Press.

8. See for example, Dale F. Gray, Robert C. Merton, and Zvi Bodie, 2006, "A New Framework for Analyzing and Managing Macrofinancial Risks of an Economy," NBER Working Paper no. 12637, October. Available at <http://www.nber.org/papers/w12637>.

9. Fairly broad definitions of credit activities should be used: For instance, the categories might include commercial credit, housing finance, small-business credit, agricultural credit, and consumer credit. Moreover, it is necessary to establish a threshold for categorizing a credit activity as major.

ket. That is, concentration is less likely to make a financial institution systemically important if, other things being equal, the activities of a distressed institution can easily be assumed by a new entrant into the market or by the expansion of an incumbent firm's activities. Hence, it is logical to adjust concentration thresholds to account for contestability.

A financial institution is systemically important if its failure could materially disrupt a financial market or payments system, causing economically significant spillover effects that impede the functioning of broader financial markets and/or the real economy. Thresholds for concentration that would render a financial institution systemically important include any firm (on a consolidated basis) that

- Clears and settles more than 25 percent of trades in a key financial market.
- Processes more than 25 percent of the daily volume of an essential payments system.
- Is responsible for more than 30 percent of an important credit activity.

Conditions/Context

In certain states of nature or some macro-financial conditions, closure policy may not be independent of these conditions. In other words, regulators are reluctant to allow the official failure (closure) of a distressed financial institution under particular economic or financial market conditions if its solvency could have been resolved under more normal conditions. Hence, conditions/context are sources of systemic importance. For instance, Haubrich notes that the New York Fed's reluctance to allow the failure of Long-Term Capital Management resulted largely from the fragility of financial markets at that time—due to the Southeast Asian currency crises and the Russian default.[10] This might explain, in part, why LTCM was treated as systemically important and Amaranth (which was more than twice as big) was not. Another example would be intervention to prevent the bankruptcy of Bear Stearns by merging it (with assistance) into JPMorgan Chase in early 2008, whereas Drexel Burnham Lambert was allowed to enter bankruptcy in early 1990. Firms that might be made systemically important by conditions/context are probably the most difficult to identify in advance. Certainly, stress testing and scenario analysis will be needed to identify them. As discussed above, during periods of financial market distress, phase-locking behavior can cause what would otherwise be slightly correlated risk exposures to become highly correlated. As a result, a group of institutions that would not pose a systemic threat under normal economic or financial-market conditions become systemically important.

Two sets of criteria must be established to classify firms that are systemically important because of context. First is the probability that economic or financial conditions will materialize that produce the state of nature where a firm or group of firms becomes systemically important. Second are the thresholds for systemic importance, which presumably would be based on those used to classify SIFIs according to contagion, concentration, and correlation during normal market conditions; which thresholds are applied would depend on which type of systemic importance the conditions produce.

10. See Joseph G. Haubrich, 2007, "Some Lessons on the Rescue of Long-Term Capital Management," Federal Reserve Bank of Cleveland, *Policy Discussion Paper*. No. 19, April.

Establishing SIFI Categories

One way to classify systemically important financial institutions was suggested in the Geneva report: [11] Institutions may be systemic on their own, as part of group, or in a particular context (or state of the economy). Under this classification scheme, there would likely be four or five categories of institutions: Category four would consist of large—but not overly complex—regional financial institutions; category five would consist of community financial institutions. Institutions could migrate between categories as their activities and risks evolve.

Constructing categories permits application of the modern tax principles of horizontal and vertical equity in regulating FISIs. Within each category, every financial institution would be subject to equivalent regulatory treatment and intensity of supervision. Of course, because two institutions could fall under the same category for different reasons, the exact forms of their regulatory taxes would logically differ. In this case, equitable treatment consists of the same degree of regulatory interference (level of regulatory taxes), although the forms of regulation may not be exactly the same. As you move up the categories, firms would be subject to increased levels of regulatory interference and supervisory attention—that is, progressive systemic mitigation—analogous to the prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991.

Increased regulatory taxes and supervisory scrutiny for higher categories can be justified in terms of economic efficiency and equity. For instance, economic efficiency dictates that regulatory taxes increase to the point where the cost of the last increment of these taxes equals the benefit of imposing them. It is likely that the cost of complying with additional regulations is inversely related to an institution's size and complexity, while the benefits from additional regulation are directly related. Hence, as institutions become larger and more complex, increased regulation and more intensive supervision may be consistent with economic efficiency. Furthermore, to the extent that the wedge between the private and social costs of failure is related to an institution's size and complexity, economic efficiency demands graduated sets of regulatory taxes, which are designed to internalize the externalities.

There are equally compelling arguments for progressively intensive or intrusive regulatory treatments on the grounds of equity as you move up the systemic category ladder. One such is the "level playing field" argument: To the extent that systemic importance confers competitive advantages on an institution, equity concerns would dictate a system of graduated regulatory taxes to remove (or at least minimize) the advantages of being (or becoming) systemically important.

Of the five categories, only three would contain financial institutions that are considered systemically important. The rationale for a five-category system is that it allows for more consistent application of regulatory taxes and supervisory oversight across categories, following the notion that differential supervision and regulation can level the playing field by mitigating the advantages financial institutions derive from systemic importance.[12] The categories would likely be defined as follows:

11. Markus Brunnermeier, Andrew Crocket, Charles Goodhart, Avinash D. Persaud, and Hyun Shin, "Fundamental Principles of Financial Regulation," 2009. Geneva Reports on the World Economy, 11.

12. Another rationale for systemic categories is that the degree to which markets can or would be allowed to discipline systemic institutions differs across categories, with higher categories containing financial institutions where market discipline is less likely to be effective (or those that are allowed to operate unfettered).

Category 1

Financial institutions that would be considered SIFIs on the basis of size alone (the classic too big to let fail category) or to concentration (the firm is a dominant player in an economically significant financial market or activity)

Category 2

Financial institutions that are systemically important because of interconnectedness (interbank or inter-firm exposure, also known as contagion)

Category 3

Financial institutions that are systemically important as a group because of correlated risk exposures (the too many to fail problem). Also included in category 3 would be financial institutions that are systemically important because of conditions or context

Category 4

Large financial institutions that are not systemically important but whose failure could have economically significant implications for regional economies. This category would include large regional banking companies and large insurance companies.

Category 5

Financial institutions not included in the other categories, consisting primarily of community financial institutions.

Under the philosophy of progressive systemic mitigation, institutions in category 5 would be subject to a basic level of safety-and-soundness regulation and supervisory oversight. No special reporting requirements, targeted risk exams, or other treatments would be necessary.[13] Category 4 institutions would not face any special capital surcharges or activity restrictions that might apply in categories 1–3, but they would be subject to additional reporting requirements and expected to implement risk management systems and more sophisticated risk controls than category 5 institutions. Moreover, category 4 institutions would be subject to more vigorous supervision than those in category 5.[14]

At a minimum, category 3 institutions should be subject to periodic stress tests and be required to have contingency plans in place. Regulatory agencies need to conduct routine scenario analysis and simulations to ascertain the financial system's vulnerability to a correlated-risk event and establish the appropriate regulatory treatment. Such treatment might include actions like portfolio limits, add-on capital requirements, and loss reserves tied to the activities driving the correlated risks. Scenario analysis and risk simulations would be used as part of contingency plans for handling correlated risk events. Stress tests, scenario analysis, risk simulations, and contingency plans would also be part of the operational regulatory system for dealing with institutions that are rendered systemically important by conditions or context.

Progressive systemic mitigation implies that the treatments adopted for category 3 institutions should also be applied to those in categories 1 and 2. For category 2 institutions, it is necessary to

13. These institutions would remain subject to consumer regulation.

14. Recently, Federal Reserve Bank of Cleveland President Sandra Pianalto outlined a new regulatory scheme, "tiered parity," in which financial firms would be separated into three classes or tiers based upon their complexity. As in the present proposal, the regulatory treatment of a firm would be determined according to the tier it is assigned to (with equal regulatory treatment of firms within a tier). To go from the five-category progressive systemic mitigation scheme to the three tiers of the tiered-parity scheme, you simply combine categories 4 and 5 into tier 3 and categories 2 and 3 into tier 2. Category 1 of progressive systemic mitigation is essentially the same as tier 1 of the Cleveland Fed's tiered-parity proposal. For a description of tiered parity, see Sandra Pianalto, "Steps toward a New Financial Regulatory Architecture," Ohio Banker's Day address, April 1, 2009, available at <http://www.clevelandfed.org/For_the_Public/News_and_Media/Speeches/2009/Pianalto_20090401.cfm>.

establish regulatory reporting requirements that allow for inter-bank/inter-firm exposures, direct and indirect, to be tracked and measured. In addition, limits on direct and indirect exposure to counterparties should be instituted, along with specific reserves and add-on capital charges designed to limit contagion across firms. For category 1 institutions, two more types of regulatory treatment need to be added to those faced by category 2 institutions. First, market discipline should be enhanced through mandatory debt-structure requirements, which could include a mandatory subordinated debt requirement and/or reverse convertible debentures.[15] Moreover, a system of double indemnity for shareholders in category 1 institutions could be an effective device for providing socially compatible incentives for those institutions.[16]

This is only a partial set of remedies that might be applied progressively to financial institutions in each category. Naturally, the exact regulatory treatments and the nature of the increased supervisory attention would need additional study. After all, as a system of regulatory taxes, progressive systemic mitigation is subject to the regulatory dialectic. Consequently, it is important to understand the unintended consequences of whatever treatments are adopted.[17] Such an understanding will help reduce the deadweight losses of the regulatory regime and increase regulators' ability to respond dynamically to an evolving financial system.

Transparency versus Constructive Ambiguity: Should the List of SIFIs Be Public?

How much information is made public (details about SIFIs, criteria for inclusion in the categories, and the associated regulatory treatment) depends on several factors: the extent to which the supervisory regime utilizes market discipline; whether inclusion on the list has unintended certification effects (or, alternatively, whether ambiguity reduces the credibility of implicit government guarantees); and the degree to which markets can reliably indentify the financial institutions that populate the categories.[18] The more information is released—that is, the closer the regime is to full disclosure—the more side issues must be addressed. For instance, how will an institution's inclusion in—or removal from—the list of SIFIs or the promotion (demotion) to a higher (lower) category be communicated? Will there be watch lists of SIFIs that are under consideration for change in status? Would the names of firms that are systemically important because of context/conditions be made public and, if so, what additional information (such as risk models, scenario analysis, and simulations) should be provided?

The choice of disclosure regime would seem to be between transparency (publication of the list of firms in each category) and some version of constructive ambiguity, where selected information is released. The term "constructive ambiguity" has been attributed to former Secretary of State Henry Kissinger;[19] in a diplomatic context, it refers to the use of ambiguous statements as part of a negotiating strategy. However, in the context of central banking and financial markets, the term refers to a policy of using ambiguous statements to signal intent while retaining policy flexibility. In the context of the federal financial safety net, many have argued for a policy of

15. For a discussion of mandatory subordinated debt requirements, see Rong Fan, Joseph G. Haubrich, Peter Ritchken, and James B. Thomson, 2003, "Getting the Most Out of a Mandatory Subordinated Debt Requirement," *Journal of Financial Services Research*, 24:2/3, 149–79; Reverse convertible debentures are discussed in Mark J. Flannery, "No Pain, No Gain? Effecting Market Discipline via 'Reverse Convertible Debentures'" (November 2002). Available at <http://ssrn.com/abstract=352762 or DOI: 10.2139/ssrn.352762>.

16. See Edward J. Kane, 1987, "No Room for Weak Links in the Chain of Deposit Insurance Reform," *Journal of Financial Services Research*, 1:77–111.

17. For a discussion of the regulatory dialectic, see Edward J. Kane, 1977, "Good Intentions and Unintended Evil: The Case against Selective Credit Allocation," *Journal of Money, Credit, and Banking*, 9:1, 55–69.

18. For an analysis of how markets discover regulatory information, see Allen Berger, Sally M. Davies, and Mark J. Flannery, 2000, "Comparing Market and Supervisory Assessments of Bank Performance: Who Knows What When?" *Journal of Money, Credit, and Banking*, 32:3, 641–67.

19. <http://en.wikipedia.org/wiki/Constructive_ambiguity>.

constructive ambiguity to limit expansion of the federal financial safety net.[20] The notion here is that if market participants are uncertain whether their claim on a financial institution will be guaranteed, they will exert more risk discipline on the firm. In this context, constructive ambiguity is a regulatory tactic for limiting the extent to which de facto government guarantees are extended to the liabilities of the firms that regulators consider systemically important. Uncertainty about whether a firm is considered systemically important and which category it belongs to in the progressive systemic mitigation regime may, at the margin, exert stronger market discipline on institutions than if the list of SIFIs were made public.

For a number of reasons, a policy of supervisory transparency is superior to constructive ambiguity for our purposes. First, constructive ambiguity, broadly viewed, is a competitor of the progressive systemic mitigation regime proposed in this paper. Constructive ambiguity is a supervisory policy aimed at reducing the agency problems associated with firms' systemic importance by creating uncertainty about which firms and creditors might be rescued if a firm fails. Progressive systemic mitigation is an explicit set of regulations and supervisory policies designed to reduce (if not eliminate) the advantages of being systemically important. Under its rules, the social costs of systemic importance would be internalized by the institution and its stakeholders. Second, to the extent that SIFIs would be subject to specific sets of regulatory treatments, it is unlikely that there would be much value in continuing the policy of constructive ambiguity in the proposed progressive systemic mitigation system. After all, markets will probably be able to surmise which firms are on the SIFI list by observing differences in capital structure, balance sheet entries (including footnotes), and intensity of regulatory scrutiny. Finally, the benefit of constructive ambiguity in avoiding an SIFI certification effect that might result from publishing a list of SIFI firms would only affect a small number of firms at the margin. The efficiency gains of avoiding the certification effect on these marginally systemic firms is likely to be swamped by efficiency losses associated with withholding information from the market. Hence, the list of SIFIs, including categories and criteria for inclusion, should be made public, along with a watch list of financial institutions whose SIFI status might change.

An effective system of supervisory transparency entails more than simply disclosing information; it must also include producing information and disseminating it in a useful form.[21] A case in point is the argument for requiring credit rating organizations to disclose information, such as probabilities of default and loss given default, upon which a rating is based.[22] In the supervisory transparency regime, this means that all information used to assign institutions to an SIFI category—including supervisory risk models and their results—should be disclosed. [23] Furthermore, stress tests of SIFIs, along with contingency plans for handling the financial distress of one or more large financial institutions, should be implemented and disclosed.

20. For a discussion of constructive ambiguity as a tool for limiting conjectural government guarantees of bank creditors, see Frederic S. Mishkin, 1999, "Financial Consolidation: Dangers and Opportunities," *Journal of Banking and Finance* 23:2–4, 675–91. For a discussion of constructive ambiguity in the context of lender-of-last-resort policies, see Marvin Goodfriend and Jeffrey M. Lacker, 1991, "Limited Commitment and Central Bank Lending," Federal Reserve Bank of Richmond, *Economic Quarterly*, 85:4, 1–27.

21. For an example of useful information, see the recommendations of the 2001 Working Group on Public Disclosure, which suggests that supervisors release information (such as data about risk exposure) that provides a consistent view of a bank's risk management approach. See Board of Governors of the Federal Reserve System, 2001, SR 01-6: Enhancement to Public Disclosure. Division of Banking Supervision, April.

22. See Charles W. Calomiris, 2008, "The Subprime Turmoil: What's Old, What's New, and What's Next," presentation at the Federal Reserve Bank of Kansas City's symposium, "Maintaining Stability in a Changing Financial System," August 21–22.

23. In cases where releasing a piece of information could result in the disclosure of confidential business information, suppression of the information should be predicated on a careful cost-benefit analysis, which weighs the financial institution's private interests against the benefits to society.

Conclusions and Policy Recommendations

The legacy of economic and financial crises is a post-crisis regime characterized by increased government interference in markets. However, simply increasing the amount of formal regulation and the degree of supervisory oversight and interference is not necessarily the best path forward. Financial market reforms must deal in the least-cost way with the fundamental issues that contributed to the current crisis. One of the most important issues that regulators, legislators, and other policymakers must face is that of systemically important financial institutions.

We propose the study and subsequent adoption of a financial-market supervisory infrastructure in which SIFIs are identified, categorized according to the nature or source of their systemic importance, and subjected to specific regulatory treatments that address the risk these firms impose. The ultimate objective of progressive systemic mitigation is to improve economic efficiency by promoting socially compatible risk incentives for SIFIs and to increase fairness in the financial system by leveling the playing field; the means of achieving this are reducing or removing, through regulatory taxes, the advantages of being systemically important.

Specific regulatory treatments to deal with the four C's of systemic importance (contagion, correlation, concentration, and context/conditions) must be carefully studied before they are adopted. These regulatory treatments might include (but are not limited to) capital surcharges, special reserves, mandatory subordinated debt and/or reverse capital debentures, inter-firm exposure limits, and increased regulatory reporting requirements. Moreover, banking supervisors should be required to conduct periodic systemic risk analyses, stress tests, and other simulations as part of a contingency planning process that would improve regulators' ability to deal in a least-cost manner (combined short- and long-term costs) with the failure of one or more SIFIs. Finally, the information disclosure regime must be addressed when implementing the new supervisory architecture. We argue for full transparency, which includes publishing the list of SIFIs, presumably on a quarterly basis; the criteria for inclusion in an SIFI category; and specific regulatory treatments. In addition, financial institutions whose systemic status may be upgraded or downgraded should be included on a published watch list.

One issue we have not dealt with here is the need to establish a credible resolution process for SIFIs. This, of course, involves careful consideration of the types of resolution authority needed, the funding source for operating any such authority, and the related infrastructure. While a credible resolution process should involve addressing contingency plans as part of the supervisory regime, we leave discussion of the type and form of resolution authority to a companion paper.

papers

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BEN S. BERNANKE
CHAIRMAN

October 29, 2013

The Honorable Mick Mulvaney
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the July 17, 2013, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Mulvaney:

1. Mr. Chairman, when you appeared before the Committee, we discussed the possibility of an environment where remittances from the Federal Reserve cease for an extended period of time. You stated that such an environment "won't affect our ability to do monetary policy." However, I also asked how such a circumstance would affect day-to-day operations. Specifically, I asked about where the money would come from to run the Federal Reserve if the combined earnings were negative for an extended period of time. In response to my question, you stated that it comes "from the balance sheet."

If the Federal Reserve's balance sheet is not providing enough combined earnings to cover all its expenses, including any amount needed to equate surplus to capital paid-in, how does the Federal Reserve pay its bills? I understand the accounting principles behind the use of deferred assets, but in a net negative cash flow position, where does the money actually come from to pay the Federal Reserve's obligations?

From an accounting perspective, the Federal Reserve pays its obligations by crediting the accounts that depository institutions hold at the Reserve Banks. The Federal Reserve would continue to meet its obligations in this manner, even in a scenario in which a Reserve Banks' earnings were insufficient to provide for the costs of operations, payments of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. In such a case, remittances to the Treasury would be suspended and a deferred asset would be recorded that represented the amount of net earnings the Reserve Bank would need to realize before remittances to the Treasury resumed. The deferred asset would be reduced in periods when Federal Reserve earnings exceeded expenses. It is important to note that an outcome in which the Federal Reserve would need to book a deferred asset as a result of negative net earnings is highly unlikely. Prior to the crisis, the Federal Reserve regularly generated net earnings of about $25 billion per year. With the expansion of the Federal Reserve's balance sheet over recent years, Federal Reserve remittances to the U.S. Treasury have increased sharply. Last year alone, the Federal Reserve remitted $82 billion to the U.S. Treasury. Moreover, the CBO projects that cumulative Federal Reserve remittances over the period 2013-2023 will amount to about $510 billion, an average annual pace well above pre-crisis norms, and also that projected Federal earnings will substantially exceed projected expenses in each year.[1]

2. What are the components (sources of cash) of the combined earnings of the Federal Reserve? What are the components of its expenses and other obligations (uses of cash)?

The components of the Federal Reserve's combined earnings and expenses are presented in the annual audited financial statements, which are available at http://www.federalreserve.gov/monetarypolicy/bst_fedfinancials.htm. Information regarding sources and uses for cash are provided in, or may be derived from, the audited combined statements of condition, income, changes in capital, and accompanying notes to the financial statements.

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[1] See "Updated Budget Projections: Fiscal Years 2013 to 2023" released by the CBO in May 2013.

Most of the combined earnings of the Federal Reserve come from interest earnings on securities held in the System Open Market Account (SOMA). As the Federal Reserve's balance sheet has expanded in recent years, the income derived from the balance sheet has also grown, with the interest earnings on SOMA holdings remaining the primary source of combined earnings, accounting for more than 90 percent of total net income. During the period from 2008-2012, the Reserve Banks remitted approximately 95 percent of their net income to the U.S. Treasury.

The Federal Reserve's expenses and cash outflows are small relative to total earnings. The primary components of Federal Reserve expenses are interest expense paid on the account balances that depository institutions hold at Reserve Banks and operating expenses incurred to fulfill the Federal Reserve's mission. Interest on depository institutions' account balances has been paid since October 2008, but this expense category has remained at relatively low levels because the interest rate paid on these balances has been at 1/4 percentage points since December 2008. Interest expense paid on depository institutions' account balances and Reserve Bank operating expenses have amounted to about 10 percent of Reserve Banks' net earnings for the year ended December 31, 2012. The interest expense category will increase at some point when the Federal Reserve begins to normalize the stance of monetary policy. However, the CBO projects that Federal Reserve expenses will remain modest relative to its earnings over the coming years.

Questions for the Record submitted by Rep. Mick Mulvaney (R-SC)
Committee on Financial Services
Hearing on "Monetary Policy and the State of the Economy"
Witness: The Honorable Ben Bernanke, Chairman of the Board of the Federal Reserve
Hearing Date: July 17, 2013

Question #1: Mr. Chairman, when you appeared before the Committee, we discussed the possibility of an environment where remittances from the Federal Reserve cease for an extended period of time. You stated that such an environment "won't affect our ability to do monetary policy." However, I also asked how such a circumstance would affect day-to-day operations. Specifically, I asked about where the money would come from to run the Federal Reserve if the combined earnings were negative for an extended period of time. In response to my question, you stated that it comes "from the balance sheet."

If the Federal Reserve's balance sheet is not providing enough combined earnings to cover all its expenses, including any amount needed to equate surplus to capital paid-in, how does the Federal Reserve pay its bills? I understand the accounting principles behind the use of deferred assets, but in a net negative cash flow position, where does the money actually come from to pay the Federal Reserve's obligations?

Question #2: What are the components (sources of cash) of the combined earnings of the Federal Reserve? What are the components of its expenses and other obligations (uses of cash)?

CLO: #B - 87
CCS: 13- 4740
RECVD: 8/12/13

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

September 20, 2013

The Honorable Robert Pittenger
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the July 17, 2013, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Pittenger:

1. **When was the last time the Fed used Reg[ulation] D for monetary policy?**

2. **How many times has the Fed used Reg[ulation] D for monetary policy?**

3. **Can you provide a justification for retaining Reg[ulation] D?**

4. **What methods of managing monetary policy does the Fed have, other than Reg[ulation] D?**

5. **If Congress were to eliminate the six limit transfer under Reg[ulation] D, what concerns would the Fed raise?**

Response to questions 1-5

The Federal Reserve Act (FRA) directs the Federal Reserve to conduct monetary policy to foster a dual mandate of maximum employment and price stability and provides the Federal Reserve with the authority to utilize a range of tools to achieve that mandate. One important tool provided for in the FRA is reserve requirements.

Reserve requirements provide a stable and predictable demand for reserve balances. In implementing monetary policy, the Federal Reserve then adjusts the supply of reserve balances so as to maintain the level of the federal funds rate close to the target level set by the Federal Open Market Committee (FOMC). The Federal Reserve operated in this way over the last several decades before the financial crisis, and the stable demand for reserves created by reserve requirements was central to the daily implementation of monetary policy over this entire period.

Over recent years, the Federal Reserve has found it necessary to utilize nontraditional monetary policy tools to foster its macro objectives. In current circumstances, reserve balances far exceed the level of reserve requirements and the level of reserve requirements thus plays only a minor role in the daily implementation of monetary policy. However, as discussed in the minutes of the June 2011 FOMC meeting, the FOMC will eventually take steps to normalize the size and composition of the Federal Reserve's balance sheet and return to the usual mechanisms for targeting the federal funds rate.

The FRA specifies that reserve requirements can be applied only to narrow classes of liabilities of depository institutions-principally transaction accounts and nonpersonal time deposits. In order to abide by this statutory requirement, the Federal Reserve has developed precise regulatory definitions of transaction deposits and nonpersonal time deposits.

These definitions are laid out in Regulation D and include the distinctions between transaction accounts (which are subject to reserve requirements) and savings deposits (which are not subject to reserve requirements). An important element of the regulatory definition of a "savings deposit" is the six-withdrawal limit. While this limit is sometimes criticized as unnecessarily restrictive and burdensome, the Federal Reserve must have a way of defining transaction deposits and savings deposits in order to impose reserve requirements in the manner envisioned in the FRA. Absent a binding limitation on withdrawals from savings deposits, banks could provide checking and other transaction services through savings deposits rather than transaction accounts and completely avoid reserve requirements. The resulting decline in required reserves could have adverse implications for monetary policy implementation.

In 2008, the Congress granted the Federal Reserve the authority to pay interest on required and excess reserve balances held by depository institutions. As discussed in previous testimony by Federal Reserve officials and in the minutes of the April 2008 FOMC meeting, this authority could allow the Federal Reserve to conduct monetary policy without reserve requirements. The Federal Reserve will consider a range of possible operating regimes once the size and composition of the Federal Reserve's balance sheet has been normalized. While policymakers might ultimately conclude that it is desirable to reduce reserve requirements to zero, it would be premature at this stage to implement changes in statute or regulation that would limit the effectiveness of reserve requirements.

6. The Fed has made a number of regulatory changes that have facilitated transfers in some instances. Hasn't this already weakened the rule for purposes of monetary policy?

The Federal Reserve made one regulatory change in 2009 that eliminated the distinction previously drawn in Regulation D between transfers made by check or debit card, and other convenient transfers like preauthorized or automatic transfers. Prior to 2009, Regulation D limited the number of "convenient" transfers and withdrawals that could be made from savings deposits to not more than six per month. Within that limit of six per month, not more than three of the transfers or withdrawals could be made by check, debit card, or other similar order made by the depositor and payable to third parties. In 2009, the Federal Reserve eliminated the sublimit on check and debit card transfers so that all convenient transfers from savings deposits would be subject to the same numeric limit. The Federal Reserve did not, however, raise the overall limit of six per month on convenient transfers from savings deposits. The elimination of the sublimit did not weaken the Federal Reserve's capacity to distinguish between transaction accounts and saving deposit accounts for the assessment of reserve requirements because the six-per-month limitation on convenient transfers or withdrawals from saving deposit accounts provides the needed distinction.

7. How do central banks in other countries conduct monetary policy without a Re[gulation] D type of requirement?

Some central banks have been able to implement monetary policy without reserve requirements. In these countries, banks' demand for reserves often stems from the need to maintain working balances at the central bank to facilitate payments. While the Federal Reserve could consider moving to such a system at some point in the future, the unique features of the U.S. banking system raise some important questions about how such a system would operate in the United States. For example, with thousands of depository institutions managing their balances at the Federal Reserve each day to facilitate daily payments flows, the aggregate demand for reserves could be quite volatile and that, in turn, could complicate the implementation of monetary policy.

Some central banks that rely on reserve requirements to implement monetary policy may be able to avoid a limitation on savings accounts withdrawals similar to that in Regulation D if the statutory authority for reserve requirements in those countries extends to a relatively broad set of depository institution liabilities. For example, reserve requirements are an important part of the framework for monetary policy implementation for the European Central Bank (ECB). In contrast to the statutory authority for reserve requirements in the United States, the ECB is able to impose reserve requirements on very broad array of depository institution liabilities including essentially all bank deposits and debt securities. As a result, depositories are not able to avoid reserve requirements simply by shifting balances from transaction accounts to savings accounts. In the Euro area, the statutory authority for the ECB to apply reserve requirements against a very broad set of depository institution liabilities thus has the benefit of allowing for a much simpler regulatory framework for deposit reporting than in the United States.

Rep. Pittenger Questions for the Record
"Monetary Policy and the State of the Economy"
Chairman Bernanke
July 17, 2013

Specific Questions on Regulation-D:

Q) When was the last time the Fed used Reg D for monetary policy?

Q) How many times has the Fed used Reg D for monetary policy?

Q) Can you provide a justification for retaining Reg D?

Q) What methods of managing monetary policy does the Fed have, other than Reg D?

Q) If Congress were to eliminate the six limit transfer under Reg D, what concerns would the Fed raise?

Q) The Fed has made a number of regulatory changes that have facilitated transfers in some instances. Hasn't this already weakened the rule for purposes of monetary policy?

Q) How do central banks in other countries conduct monetary policy without a Red D type of requirement?

CLO: #B - 88
CCS: 13- 4741
RECVD: 8/12/13

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 4, 2014

The Honorable Blaine Luetkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 11, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

Questions for The Honorable Janet Yellen, Chair Board of Governors of the Federal Reserve System from Rep. Blaine Luetkemeyer:

1. The SIFI designation process should focus on not size alone but also the business and complexity of an institution. Do you believe that business model, complexity, global interconnectedness, and other metrics beyond size alone should be considered when making SIFI determinations?

I agree that many variables need to be considered in determining whether a firm's financial distress could damage the financial stability of the United States. Indeed, a key lesson from the financial crisis is that distress at, or the disorderly failure of, large interconnected financial institutions can have a devastating impact on the functioning of the financial system and inflict severe harm on the real economy. The externalities created by the failure of such systemically important financial institutions (SIFIs) were illustrated by the collapse of Lehman Brothers in the fall of 2008, which triggered a dramatic rise in the pricing of risk across asset markets.

Measuring the systemic importance of financial institutions is far from straightforward. In many cases, the impact of a firm's failure on the financial system as a whole is likely to be correlated with its size. But several other factors will also typically be relevant. Several academic papers, for instance, equate systemic importance with the interconnectedness of a firm's activities with the rest of the financial system, measured using either readily observed factors such as intra-financial assets and liabilities, cross-border activity, and the use of various complex financial instruments such as derivatives, or using statistical techniques to draw inferences from market price data.[1] Other relevant factors will include the extent to which the firm relies on short-term liabilities to fund illiquid assets, and the degree to which the financial intermediation services provided by the firm are relied upon by households, businesses and other parts of the financial system for which there are no ready substitutes.

It is for this reason that section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the Financial Stability Oversight Council (FSOC) to consider 10 statutory factors when assessing whether a nonbank financial company should be designated as systemically important; these include the leverage of the firm, its importance in credit provision, and many other factors potentially unrelated to a firm's size.

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[1] Among the useful efforts along these lines are a measure of "Conditional Value-at-Risk" (CoVaR) (see Tobias Adrian and Markus K. Brunnermeier (2011), "CoVaR (PDF)," Federal Reserve Bank of New York Staff Reports 348 (New York: Federal Reserve Bank of New York, September), and a measure of systemic risk based on each firm's contribution to the expected capital shortfall of the entire financial system in a crisis (see Christian T. Brownlees and Robert F. Engle (2011), "Volatility, Correlation and Tails for Systemic Risk Measurement," New York University Working Paper (New York: New York University, June). The concept behind the latter measure is also described in Viral V. Acharya, Christian Brownlees, Robert Engle, Farhang Farazmand, and Matthew Richardson (2011), "Measuring Systemic Risk," in Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance (New York: Wiley Publishers), pp. 87-119. Updated systemic risk rankings are maintained by the authors here. A helpful review of the efforts to measure systemic risk is Monica Billio, Mila Getmansky, Andrew W. Lo, and Loriana Pelizzon (2010), "Measuring Systemic Risk in the Finance and Insurance Sectors (PDF)," MIT Sloan School Working Paper 4774-10 (Cambridge, MA: MIT Sloan School of Management, March).

2. There has been very little transparency from the Federal Reserve on the details of the SIFI designation process, particularly for nonbank institutions. Will you provide the Committee with information on the methodology used to make these SIFI determinations?

The Federal Reserve Board is firmly committed to promoting transparency and accountability in connection with its activities. The FSOC is charged by Congress with designating SIFIs. The FSOC established a robust process, after seeking public notice and comment on an initial and revised proposal, for exercising its designation authority. The process contains three stages during which the FSOC screens companies for review and conducts an in-depth analysis of companies that pass the screen.

In developing this process, the FSOC sought to maximize transparency with respect to the Determination Process by providing a detailed description of (i) the profile of those nonbank financial companies likely to be evaluated by the FSOC for a potential determination, and (ii) the metrics that the FSOC intends to use when analyzing companies at various stages of the Determination Process. There are numerous opportunities during this process for a nonbank financial company to communicate with the FSOC and its staff and submit information regarding the company's activities and its potential to pose a threat to U.S. financial stability.

The FSOC applies quantitative metrics to a broad group of nonbank financial companies in determining whether a firm should be considered for designation. A nonbank financial company will be evaluated in Stage 2 of the Determination Process, if it meets both a size threshold ($50 billion in total consolidated assets) and any one of five thresholds that measure a company's interconnectedness, leverage, liquidity risk and maturity mismatch. During Stage 2, a nonbank financial company is analyzed based on a wide range of quantitative and qualitative information available to the FSOC primarily through public and regulatory sources.

A nonbank financial company that is advanced to Stage 3 receives a notice that the company is under consideration for a Proposed Determination, which also may include a request that the nonbank financial company provide information relevant to the FSOC's evaluation. In addition, the nonbank financial company is provided an opportunity to submit written materials to the FSOC. Following a Proposed Determination, a nonbank financial company is provided a written notice of the Proposed Determination, which includes an explanation of the basis of the Proposed Determination. A nonbank financial company that is subject to a Proposed Determination may request a written or oral hearing to contest the Proposed Determination. If the FSOC determines to subject a company to supervision by the Board of Governors and prudential standards, the FSOC will provide the nonbank financial company with written notice of the FSOC's final determination, including an explanation of the basis for the FSOC's decision.

In 2013, the FSOC determined that material financial distress at each of three nonbank financial companies, American International Group, Inc., General Electric Capital Corporation, and Prudential Financial, Inc., could pose a threat to U.S. financial stability and that those companies should be subject to Federal Reserve Board Supervision and enhanced prudential standards. The FSOC released the bases of its determinations, which were posted on its website. The FSOC evaluated these firms using the three-stage process.

The Federal Reserve Board recognizes the critical importance of transparency and will continue to pursue ways to promote further transparency that are consistent with the FSOC's central mission to monitor emerging threats to the financial system.

3. Under what authority does the International Association of Insurance Supervisors (IAIS) develop and implement international capital standards for Internationally Active Insurance Groups (IAIGs) who have not been named GSIIs or SIFIs? What entity will enforce those capital standards on U.S. domiciled multinational insurance groups?

In its July 2013 press release announcing the policy measures that would apply to the designated global systemically important insurers, the International Association of Insurance Supervisors (IAIS) stated that it considered a sound capital and supervisory framework for the global insurance sector more broadly to be essential for supporting financial stability, and that it planned to develop a comprehensive, group-wide supervisory and regulatory framework for internationally active insurance groups (IAIGs), including an international capital standard (ICS). State insurance supervisors, the National Association of Insurance Commissioners (NAIC), the Federal Insurance Office (FIO), and more recently, the Federal Reserve, are members of the IAIS. The business of insurance has become increasingly global in the past few decades. The decision of the IAIS to develop an ICS for IAIGs reflects that trend and has a parallel in the development of capital standards for internationally active banks by the Basel Committee on Banking Supervision (BCBS). The BCBS has been promulgating capital requirements for internationally active banks since the 1980s. The U.S. federal banking agencies, which are members of the BCBS, have long contributed to and supported the work to develop common baseline prudential standards for global banks.

Once developed by the IAIS, each national supervisor would determine the extent and manner in which any capital standards developed by the IAIS would be applied to IAIGs regulated by that national supervisor.

4. Should the IAIS develop global insurance capital standards and, if so, why? How would global insurance standards be implemented, given the different accounting standards and solvency systems across the world?

Please see response for question 3.

5. Can these international standards be implemented without compromising the state-based system of regulation in the United States? Can you guarantee that new rules will be compatible with our state-based regulatory system?

The standards under development by the IAIS are not bank-centric. Moreover, they are not contemplated to replace existing insurance risk-based capital standards at U.S. domiciled insurance legal entities within the broader firm. A goal of the international capital standard being developed by the IAIS is to achieve greater comparability of the capital requirements of IAIGs across jurisdictions at the group-wide level. This should promote financial stability, provide a more level playing field for firms and enhance supervisory cooperation and coordination by increasing the understanding of firms among group-wide and host supervisors.

It should also lead to greater confidence being placed on the group-wide supervisor's analysis by host supervisors.

Any IAIS capital standard would supplement existing legal entity risk-based capital requirements by evaluating the financial activities of the firm overall rather than by individual legal entity.

6. What insurance expertise does the Federal Reserve have? Are you actively hiring more staff with insurance expertise?

The Federal Reserve has hired staff with expertise in analyzing and supervising insurance companies to conduct inspections of insurance firms and assist in training other Federal Reserve examiners and staff on insurance issues. In addition, Federal Reserve staff consults with the FIO on issues related to our supervisory framework, including insurance capital requirements and stress testing. Federal Reserve staff also meets regularly with industry representatives, the NAIC and state insurance regulators to discuss insurance-related issues. The Federal Reserve expects to continue consultations with other regulators and standard-setters, the FSOC, the industry and the public, to further the Federal Reserve's expertise and to gain additional perspectives on the regulation and supervision of insurance companies.

Questions for the Record from
Rep. Blaine Luetkemeyer (MO-3)
Committee on Financial Services
U.S. House of Representatives

CLO: #Y - 15
CCS: 14-1439
RECVD: 2/28/14

Hearing held on February 11, 2014
"Monetary Policy and the State of the Economy"

Witness: The Honorable Janet Yellen, Chair of the Board of Governors of the Federal Reserve System

1. The SIFI designation process should focus on not size alone but also the business and complexity of an institution. Do you believe that business model, complexity, global interconnectedness, and other metrics beyond size alone should be considered when making SIFI determinations?

2. There has been very little transparency from the Federal Reserve on the details of the SIFI designation process, particularly for nonbank institutions. Will you provide the Committee with information on the methodology used to make these SIFI determinations?

3. Under what authority does the International Association of Insurance Supervisors (IAIS) develop and implement international capital standards for Internationally Active Insurance Groups (IAIGs) who have not been named GSIIs or SIFIs? What entity will enforce those capital standards on U.S. domiciled multinational insurance groups?

4. Should the IAIS develop global insurance capital standards and, if so, why? How would global insurance standards be implemented, given the different accounting standards and solvency systems across the world?

5. Can these international standards be implemented without compromising the state-based system of regulation in the United States? Can you guarantee that new rules will be compatible with our state-based regulatory system?

6. What insurance expertise does the Federal Reserve have? Are you actively hiring more staff with insurance expertise?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 2, 2014

The Honorable Kyrsten Sinema
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the February 11, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

Questions for The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Sinema:

1. In your testimony, you noted that recovery in the job market is proceeding slowly, but [t]hose out of a job for more than six months continue to make up an unusually large fraction of the unemployed. As you know, the long-term unemployed depend on extended unemployment benefits to stay afloat while they look for jobs. When Emergency Unemployment Compensation benefits expired this past December, over 12,000 families in Arizona lost crucial benefits, and failure to extend this program could cost the state's economy over $150 million in 2014 alone. But this situation is not unique to Arizona. Given the uncertain future of unemployment insurance extensions in Congress, what effect on the job market does FOMC foresee if we fail to extend relief to the long-term unemployed?

The primary effect of extended unemployment insurance (UI) benefits is to help to support the income and consumption of those who have been out of work long enough to have exhausted their regular state UI benefits. In addition, extended UI benefits can help to blunt some of the effects that long-term joblessness can have on the broader economy. In particular, because people receiving unemployment benefits tend to spend a high fraction of their income, by offsetting a portion of these individuals lost wages, extended UI benefits help to support aggregate spending.

It is also possible that extended unemployment benefits could discourage some unemployed individuals from taking jobs. However, most economists believe that this effect is relatively small, in part because only a fraction of one's previous paycheck is typically replaced by unemployment benefits. Hence, on balance, extended unemployment benefits most likely help to support the job market in a weak economy through their effects on aggregate spending.

2. In your testimony, you mentioned that last year's increase in mortgage rates has slowed recovery in the housing sector. Home prices are rebounding slowly but surely. Arizona alone has seen over a ten percent increase in home values this past year and three percent growth is projected for next year. Given that prices continue to rise, are you concerned that increasing mortgage rates could discourage home buying and cost us the critical growth we have seen in recent years?

As you suggest, the rise in home prices and mortgage rates over the past year has cut into the affordability of homes for many potential home buyers. Reflecting this development, the volume of existing home sales has dropped over the past several months. Nonetheless, to date, broader measures of economic growth have been fairly resilient in the face of slowing housing market activity. I currently expect such activity to turn up some in the coming months as macroeconomic and labor market conditions continue to improve.

3. Several American insurance companies were concurrently designated Globally Systemically Important Institutions (G-SIIs) by the international Financial Stability Board (FSB) and Systemically Important Financial Institutions (SIFIs) by domestic regulators under the Dodd-Frank Act. The Fed apparently participated in FSB deliberations, which in some cases resulted in American companies designation on the international level as

G-SIIs before they were labeled SIFIs by regulators at home. Did the Fed make any effort to forestall FSB designation until the SIFI process was complete, and do you see a problem with such international determination predating decision making by American regulators?

The International Association of Insurance Supervisors (IAIS) was established in 1994 as the international standards setting body responsible for the insurance sector. In 2013, the IAIS published a methodology for identifying global systemically important insurers (G-SIIs) and a set of policy measures that will apply to them. At the time that the IAIS formulated the G-SII methodology and policy measures, the Federal Insurance Office (FIO) (an office within the Treasury Department), the National Association of Insurance Commissioners, and state insurance regulators were members of the IAIS and participated actively in the process. The Financial Stability Board (FSB) subsequently endorsed the IAIS methodology and the policy measures and published a list of nine G-SIIs, three of which are U.S. insurance firms. The Financial Stability Oversight Council (FSOC) has designated two of the three U.S. G-SII firms for supervision by the Federal Reserve.

There is considerable overlap in membership between the FSOC and FSB. The three U.S. members of the FSB--the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission are also voting members of the FSOC. In addition, FIO and the state insurance regulators are nonvoting members that participate in the FSOC. The FSOC had done considerable work on non-bank insurance SIFIs by the time the FSB published the G-SII list. Moreover, the FSOC and its committees had been briefed several times on the progress of IAIS work on G-SII designation before the IAIS and FSB made their final decisions about G-SII designations.

International regulatory standards and designations developed by the FSB or IAIS are not legally binding. Neither the FSB, nor the IAIS, has the ability to implement requirements in any jurisdiction. Implementation in the United States would have to be pursuant to U.S. law and would have to comply with the administrative rulemaking process, including an opportunity for public comment.

4. In your confirmation hearing, you agreed that banks and insurance providers should be subject to regulations that are tailored to their unique features, rather than a one-size-fits all approach. How will you ensure that the Federal Reserve works with industry and other experts to develop an insurance-based capital framework and what is the timetable for rulemaking on this topic?

The Federal Reserve understands the challenges posed by applying the enhanced prudential standards, in particular the capital and liquidity standards, to firms primarily engaged in insurance activities. The Federal Reserve is assessing the designated insurance firms to determine how enhanced prudential standards should apply to them and the extent to which tailored application of the standards would be appropriate. Each firm will receive notice and opportunity to comment prior to a final determination of the enhanced prudential standards that the Federal Reserve will apply to the company. It is important to note the Federal Reserve's ability to tailor the enhanced capital requirements for designated insurance firms is limited by the

Collins Amendment, which requires the Federal Reserve to subject all FSOC-designated firms to capital requirements that are at least as stringent as those applicable to banks.

Questions for the Record – Committee on Financial Services

CLO: #Y - 18
CCS: 14-1441
RECVD: 2/28/14

From: Congresswoman Kyrsten Sinema

Date: February 11, 2014

Title: "Monetary Policy and the State of the Economy"

For Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System

1. In your testimony, you noted that recovery in the job market is proceeding slowly, but "[t]hose out of a job for more than six months continue to make up an unusually large fraction of the unemployed." As you know, the long-term unemployed depend on extended unemployment benefits to stay afloat while they look for jobs. When Emergency Unemployment Compensation benefits expired this past December, over 12,000 families in Arizona lost crucial benefits, and failure to extend this program could cost the state's economy over $150 million in 2014 alone. But this situation is not unique to Arizona. Given the uncertain future of unemployment insurance extensions in Congress, what effect on the job market does FOMC foresee if we fail to extend relief to the long-term unemployed?

2. In your testimony, you mentioned that last year's increase in mortgage rates has slowed recovery in the housing sector. Home prices are rebounding slowly but surely. Arizona alone has seen over a ten percent increase in home values this past year and three percent growth is projected for next year. Given that prices continue to rise, are you concerned that increasing mortgage rates could discourage home buying and cost us the critical growth we have seen in recent years?

3. Several American insurance companies were concurrently designated Globally Systemically Important Institutions (G-SIIs) by the international Financial Stability Board (FSB) and Systemically Important Financial Institutions (SIFIs) by domestic regulators under the Dodd-Frank Act. The Fed apparently participated in FSB deliberations, which in some cases resulted in American companies' designation on the international level as G-SIIs before they were labeled SIFIs by regulators at home. Did the Fed make any effort to forestall FSB designation until the SIFI process was complete, and do you see a problem with such international determination predating decision making by American regulators?

4. In your confirmation hearing, you agreed that banks and insurance providers should be subject to regulations that are tailored to their unique features, rather than a one-size-fits all approach. How will you ensure that the Federal Reserve works with industry and other experts to develop an insurance-based capital framework and what is the timetable for rulemaking on this topic?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

March 31, 2014

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the March 13, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs.

Please let me know if I can be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

Reponses from Gov. Jerome Powell to questions from Senator Warren:

1. **Each of you testified that there is still work to be done to end Too Big to Fail. Do you think that ending Too Big to Fail should be the Board of Governors of the Federal Reserve System's (Fed) top regulatory priority?**

As I mentioned in my testimony before the Committee, I believe that ending Too Big to Fail ("TBTF") is at the heart of the post-financial crisis reform program. We need a strong financial system that can play its critical role in supporting economic activity by providing credit to businesses and households, without exposing taxpayers to losses or creating incentives for excessive risk taking. Ending TBTF is a necessary step in ensuring financial stability

Ending TBTF is and will continue to be a core objective of the Federal Reserve, in coordination with the other U.S. bank regulatory agencies, the SEC, the CFTC, and international regulatory agencies. Regulators around the world have made significant progress on this front – including the Basel 3 capital and liquidity rules for large, global banks; capital surcharges for the most systemically important banking firms; and new statutory resolution regimes to handle the failure of systemically important financial firms. But we also realize that much work remains to be done to end TBTF. I am committed to continuing this critical effort.

2. **Do you think that regulators must ultimately reduce the size of the largest financial institutions to end Too Big to Fail? Do you believe it will be possible through other regulatory approaches – such as resolution authority – to convince the markets that the government will truly let a massive institution fail?**

I am committed to ending TBTF. I believe that regulatory reforms around the world since the financial crisis have produced significant progress to that end. If those reforms ultimately prove inadequate, then additional measures should be considered.

In the past few years, the Federal Reserve and other regulators have taken important actions to reduce the likelihood of a failure of a systemically important institution. Such actions include:

- Basel III capital rules, plus proposed supplementary leverage ratio and planned SIFI risk-based capital surcharges.
- Stress tests of large US banking firms
- Basel III liquidity rules
- Improvements in supervision of firms
- Derivatives transparency, central clearing, and margining

In addition, regulatory checks are in place that aim to curb the expansion of the largest financial firms. These include the 10-percent deposit cap and DFA 10-percent liability cap on BHC acquisitions, as well as the Federal Reserve's consideration of the effect on financial stability of proposed acquisitions by large banking organizations.

Further, regulators are taking many steps to make systemically important financial firms more resolvable -- through the living wills process and the development of the FDIC's preferred "single point of entry" resolution strategy. And the Federal Reserve is working with the FDIC on a minimum long-term debt requirement that would promote the resolvability of the largest, most complex U.S. banking firms.

While meaningful progress has been made, more work needs to be done, and I am committed to finishing the job. Over time, these efforts and continued use of regulatory and supervisory tools should contribute to greater market confidence that these institutions are less likely to fail and resolvable without systemic impact if they do fail.

3. **At a Banking subcommittee hearing this January, I asked four economists – Luigi Zingales from the University of Chicago, Simon Johnson from the MIT Sloan School of Management, Harvey Rosenblum from the Southern Methodist University, and Allan H. Meltzer of the Tepper School of Business – whether the Dodd-Frank Act would end Too Big to Fail when it was fully implemented. They each said it would not. Do you agree? If so, what kind of additional authority do you think the Fed needs to ensure that Too Big to Fail is ended? If not, what gives you confidence that Dodd-Frank, once fully implemented, will successfully address Too Big to Fail?**

As discussed in the prior response, the Federal Reserve and the global regulatory community have made significant progress towards eliminating TBTF in the past few years by reducing the probability of failure of large financial firms and reducing the damage to the system if a large financial firm were to fail. The rating agencies and other market participants have recognized that progress. More work remains to be done to eliminate TBTF, including work to fully implement the provisions of the Dodd-Frank Act, and we are committed to completing that work as expeditiously as possible.

If the statutory implementation and regulatory reform work in train proves to be insufficient to solve the TBTF problem, we should be willing to look at the costs and benefits of additional approaches.

4. **Congressman Cummings and I sent a letter to Chair Yellen in February urging her to revise the Fed's delegation rules so that the Fed's Board would have to vote on any settlement that included at least $1 million in payments, or that banned an individual from banking or required new management. At a hearing last month, Chair Yellen testified that it was "completely appropriate for the Board to be fully involved in important decisions," and that she "fully intend[ed]" to make sure the Board would be more involved going forward. Do you agree in principle with Chair Yellen's testimony and will you support her efforts to require Board members to vote on major settlement agreements?**

I support the principle that members of the Board should be involved in important enforcement decisions and will work with Chair Yellen on future steps for carrying out that principle.

5. **Last February, the Fed and the Office of the Comptroller of the Currency entered into what they touted as a $9.3 billion settlement with mortgage servicers accused of illegal foreclosure practices. In their joint press release accompanying the settlement, the agencies claimed they had secured $5.7 billion in relief for homeowners in the form of "credits" for what the agencies described as "assistance to borrowers such as loan modifications and forgiveness of deficiency judgments." The press release did not disclose that the manner in which the credits were calculated could allow the servicers to pay only a small fraction of that $5.7 billion, potentially reducing the direct relief to injured borrowers by billions of dollars.**

   Senator Coburn and I recently introduced the Truth in Settlements Act, which would require agencies to publicly disclose all the key details of their major settlement agreements – including the method of calculating any credits. Of course, agencies are not required to wait for congressional action to adopt such basic transparency measures. Do you think the Fed should voluntarily adopt the disclosure provisions of the Truth in Settlements Act?

The Federal Reserve is required by law to publicly disclose any written agreement that is enforceable by the agency against a regulated entity or individual and any final order in any administrative enforcement proceeding. This requirement applies to enforcement actions entered into by consent with the regulated institution or individual.

Accordingly, the amended consent orders that implemented the payment agreement with the mortgage servicers relating to illegal foreclosure practices were publicly disclosed by the Federal Reserve in February 2013 as attachments to the press release that announced the issuance of those actions. The publicly disclosed amended consent orders contain all of the enforceable provisions governing the payment agreement, including the methodology under which the servicers would obtain credit for specific foreclosure assistance activities in connection with the servicers' obligations under the amended consent order to provide such activities.

6. **For the last five years, the Fed has kept interest rates extremely low and has used asset purchases to drive rates down even further. Yet the unemployment rate still remains higher than the Fed's target for full employment. In such situations – where the Fed is struggling to fulfill its full employment mandate using monetary policy alone – should the Fed consider using its regulatory authority to attempt to boost job growth?**

The Federal Reserve carries out its responsibilities to regulate and supervise financial firms so as to help ensure the safety and soundness of regulated firms and to help protect financial stability. In doing so, the Federal Reserve adopts a macro- as well as microprudential perspective, which means, among other things, that it takes into account the potential systemic consequences of financial distress as well as the safety and soundness of individual firms.

Relaxing its supervision of regulated financial firms in an effort to support economic growth would risk greater economic volatility in the future, and could ultimately result in worse economic performance over time. That said, the Federal Reserve monitors its regulatory actions for signs that its supervision may inadvertently reduce credit availability and thereby restrain economic growth.

7. **Section 165(d) of the Dodd-Frank Act requires the Fed and the Federal Deposit Insurance Corporation (FDIC) to ensure that large financial institutions can be resolved in an orderly fashion using the conventional bankruptcy process. These institutions are required to submit "living wills" that describe how such a conventional resolution could occur. If the Fed and the FDIC find that those plans lack credibility, they may require the financial institution to divest subsidiaries, hold increased capital, reduce leverage, or take other steps to shrink or simplify the institution. To date, over 100 institutions have submitted living wills, and the Fed and the FDIC have not rejected a single plan as lacking credibility.**

   What gives you confidence that our largest financial institutions could currently be resolved through a conventional bankruptcy procedure? What criteria would you use to determine whether a resolution plan is "credible" for the purposes of Section 165(d)? Are you willing to take the actions identified in Section 165(d)(5) of Dodd-Frank – including mandating divestiture of subsidiaries – if you believe a resolution plan lacks credibility?

One of the most important goals of the Dodd-Frank Act and the regulatory community after the crisis is to end "too-big-to fail." The perception of "too-big-to-fail" is greatly mitigated when market participants understand that losses from the failure of a major financial firm would fall exclusively on shareholders and creditors. The "living wills" provision of the Dodd-Frank Act helps guide institutions and regulators to improve the resolvability in bankruptcy of large financial institutions.

The staff of the Federal Reserve and FDIC are reviewing and assessing the plans filed by the large financial firms under Section 165(d) of the Dodd-Frank Act. At this time, no decision has been reached by the Board regarding the adequacy of the plans for facilitating the resolution of the firms in bankruptcy. If confirmed, I expect to explore the adequacy of the plans and whether improvements should be made in the plans and/or the bankruptcy code to ensure that no firm is too big to fail.

Section 165(d)(5) of the Dodd-Frank Act permits the Board and FDIC to take action if a resolution plan is determined to not be credible and the institution does not correct the plan within a certain period of time. I would be willing to support any actions appropriate to ensure compliance with the law and mitigate risks to the financial stability of the United States.

8. **As a fraction of GDP, the financial sector today is about twice as large as it was in the 1970s. Despite this growth in size, researchers have found that the sector is less efficient than it once was in allocating credit for the real economy. Do you believe that there are effectively "reverse economies of scale," such that financial institutions can grow so large that they become less efficient at performing their primary function of allocating credit?**

Many fundamental changes have occurred in the financial sector and the broader economy since the 1970's. Without a doubt, one important development is the increased concentration in the financial services industry. There is not a consensus among researchers that increased concentration has a direct effect on the efficiency of credit allocation, either adverse or otherwise. However, increased concentration in the financial sector has raised a number of other pressing public policy issues, notably the concern that some institutions have grown "too big to fail."

9. **Last year, the Financial Stability Board (FSB) directed the International Association of Insurance Supervisors (IAIS) to propose global qualitative capital standards by 2016 for "internationally active insurance groups" (IAIGs) – a category that includes U.S.-based insurance companies that have not been designated as systemically important financial institutions. Ostensibly, the three U.S. representatives to the FSB – the Fed, the Securities Exchange Commission, and the Treasury Department – supported the FSB's directive to the IAIS.**

    a. **[To Powell]: As a member of the Fed at the time of the FSB's directive to the IAIS, did you agree with the Fed's decision to support (or at a minimum, not oppose) the directive?**

    Yes. In its July 2013 press release announcing the policy measures that would apply to the designated global systemically important insurers (GSIIs), the IAIS also stated that it considered a sound capital and supervisory framework for the global insurance sector more broadly to be essential for supporting financial stability and that it planned to develop a comprehensive, group-wide supervisory and regulatory framework for internationally active insurance groups (IAIGs), including a capital standard (ICS). The business of insurance has become increasingly global in the past few decades. The decision of the IAIS to develop an ICS for IAIGs reflects that trend and has a parallel in the development of capital standards for internationally active banks by the Basel Committee on Banking Supervision.

    The FSB endorsed these proposed measures by the IAIS. That endorsement was consistent with the mission of the FSB to coordinate at the international level the work of national financial authorities and international standard setting bodies, including the IAIS, and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. State insurance supervisors, the National Association of Insurance Commissioners, the Federal Insurance Office, and more recently, the Federal Reserve, are members of the IAIS.

b. **[To Fischer, Brainard, and Powell]: U.S. insurance regulation is primarily state-based and relies on state guaranty funds, whereas European insurance regulation is primarily based on capital standards and does not rely on guaranty funds. Given this difference in regulatory approach, do you think it is appropriate for U.S.-based IAIGs to be subject to a single, global capital standard for their U.S. operations?**

   A goal of the international capital standard (ICS) being developed by the IAIS is to achieve greater comparability of the capital requirements of IAIGs across jurisdictions at the group-wide level. This should promote financial stability, provide a more level playing field for firms and enhance supervisory cooperation and coordination by increasing the understanding among group-wide and host supervisors. It should also lead to greater confidence being placed on the group-wide supervisor's analysis by host supervisors. The standards under development by the IAIS are not contemplated to replace existing insurance risk-based capital standards at U.S. domiciled insurance legal entities within the broader firm. Any IAIS capital standard would supplement existing legal entity risk-based capital requirements by evaluating the financial activities of the firm overall rather than by individual legal entity.

   It is important to note that neither the FSB, nor the IAIS, has the ability to implement requirements in any jurisdiction. Implementation in the United States would have to be consistent with U.S. law and comply with the administrative rulemaking process.

   It is also important to note that the Basel Committee on Banking Supervision has been promulgating capital requirements for internationally active banks since the 1980s. The U.S. federal banking agencies, which are members of the Basel Committee, have long contributed to and supported the work of the Committee to develop common baseline prudential standards for global banks.

10. **What do you see as the proper role of the General Counsel's office in both the Fed's rulemaking process and its supervisory and enforcement processes? Does it go beyond the duties that are specifically delegated to the General Counsel's office in 12 C.F.R. § 265.6?**

The role of the Legal Division is to provide legal advice and services to the Board to meet it responsibilities in all aspects of its statutory duties, including the Board's bank supervisory and regulatory responsibilities and authority. The Legal Division also is responsible for drafting regulations and assisting the Board in analyzing legislation and drafting statutory changes affecting the Board and its work. The Legal Division provides legal support for the Board's role in developing and implementing monetary policy, employing its financial stability tools, and all aspects of the Board's operations, including the Board's procurement and personnel functions, ethics, and information disclosure. In addition, the Legal Division represents the Board in litigation in federal and state court, and pursues enforcement actions against individuals and companies over which the Board has supervisory authority.

Section 11(k) of the Federal Reserve Act permits the Board to delegate to Board members and employees functions other than those relating to rulemaking or pertaining principally to monetary and credit policies. 12 C.F.R. § 265.6 lists various authorities the Board had delegated to its staff and to the Reserve Banks. Importantly, the Board retains ultimate responsibility for all authorities it has delegated, and provided in section 265.3 that any single Board member may, on the member's own initiative, require the full Board to review a matter delegated to staff or the Reserve Banks.

11. In your view, did deregulation cause the 2008 financial crisis?

The argument that deregulation caused the financial crisis may well hold some truth. I believe that the more fundamental explanation is that the pace of innovation and change in the financial sector led over time to a situation where the existing regulatory regimes were inadequate.

Beginning in the 1970's and accelerating in the 1980's, many traditional forms of credit intermediation as practiced by commercial banks were supplemented and in some cases displaced by securities-based financing models, with mortgage securitizations and money market funds being only the most important examples. During the same period, banks and broker-dealers were increasingly organized on a global basis, with multiple legal entities in various jurisdictions. These developments brought considerable benefits, but ultimately allowed a systemic crisis that imposed enormous costs on the broader economy in 2008.

In my view, most of these key developments were not spawned directly by deregulation; rather, they reflect the failure of regulatory regimes to keep up with the pace of innovation. A number of the provisions of Dodd-Frank have been crafted to recognize this reality, and provide policymakers tools that will be sufficiently flexible over time to address new and emerging concerns as institutions and market practices evolve.

12. The Senate Permanent Subcommittee on Investigations recently released a report detailing Credit Suisse's role in aiding thousands of Americans evade their U.S. tax obligations. Credit Suisse and the Swiss government have not been cooperating with the Department of Justice's investigation. Do you think it is appropriate for the Fed to use any of its regulatory or enforcement authority under the circumstances?

Authority to enforce compliance with U.S. law is by law administered by a number of Federal agencies. For example, the Department of Justice is responsible for criminal prosecutions. The Federal Reserve has authority to take specific types of regulatory and enforcement actions against foreign banks and their U.S. operations to ensure safe and sound operations and compliance with U.S. law. These actions can include informal direction to institutions as well as formal actions such as cease and desist orders, civil money penalties, or, in serious cases, termination of U.S. officers. We consider use of this enforcement authority in appropriate circumstances within the limits imposed by law, and believe that firms of all sizes, including the largest financial firms, must be held accountable for failure to comply with the law.

With regard to Credit Suisse, I understand that firm is under investigation by the Department of Justice. It would not be appropriate to comment on an ongoing investigation or potential supervisory actions related to a specific firm.

CLO: #31
CCS: 14- 1951
RECVD: 3/21/14

Questions from Senator Warren:

1. Each of you testified that there is still work to be done to end Too Big to Fail. Do you think that ending Too Big to Fail should be the Board of Governors of the Federal Reserve System's (Fed) top regulatory priority?

2. Do you think that regulators must ultimately reduce the size of the largest financial institutions to end Too Big to Fail? Do you believe it will be possible through other regulatory approaches – such as resolution authority – to convince the markets that the government will truly let a massive institution fail?

3. At a Banking subcommittee hearing this January, I asked four economists – Luigi Zingales from the University of Chicago, Simon Johnson from the MIT Sloan School of Management, Harvey Rosenblum from the Southern Methodist University, and Allan H. Meltzer of the Tepper School of Business – whether the Dodd-Frank Act would end Too Big to Fail when it was fully implemented. They each said it would not. Do you agree? If so, what kind of additional authority do you think the Fed needs to ensure that Too Big to Fail is ended? If not, what gives you confidence that Dodd-Frank, once fully implemented, will successfully address Too Big to Fail?

4. Congressman Cummings and I sent a letter to Chair Yellen in February urging her to revise the Fed's delegation rules so that the Fed's Board would have to vote on any settlement that included at least $1 million in payments, or that banned an individual from banking or required new management. At a hearing last month, Chair Yellen testified that it was "completely appropriate for the Board to be fully involved in important decisions," and that she "fully intend[ed]" to make sure the Board would be more involved going forward. Do you agree in principle with Chair Yellen's testimony and will you support her efforts to require Board members to vote on major settlement agreements?

5. Last February, the Fed and the Office of the Comptroller of the Currency entered into what they touted as a $9.3 billion settlement with mortgage servicers accused of illegal foreclosure practices. In their joint press release accompanying the settlement, the agencies claimed they had secured $5.7 billion in relief for homeowners in the form of "credits" for what the agencies described as "assistance to borrowers such as loan modifications and forgiveness of deficiency judgments." The press release did not disclose that the manner in which the credits were calculated could allow the servicers to

pay only a small fraction of that $5.7 billion, potentially reducing the direct relief to injured borrowers by billions of dollars.

Senator Coburn and I recently introduced the Truth in Settlements Act, which would require agencies to publicly disclose all the key details of their major settlement agreements – including the method of calculating any credits. Of course, agencies are not required to wait for congressional action to adopt such basic transparency measures. Do you think the Fed should voluntarily adopt the disclosure provisions of the Truth in Settlements Act?

6. For the last five years, the Fed has kept interest rates extremely low and has used asset purchases to drive rates down even further. Yet the unemployment rate still remains higher than the Fed's target for full employment. In such situations – where the Fed is struggling to fulfill its full employment mandate using monetary policy alone – should the Fed consider using its regulatory authority to attempt to boost job growth?

7. Section 165(d) of the Dodd-Frank Act requires the Fed and the Federal Deposit Insurance Corporation (FDIC) to ensure that large financial institutions can be resolved in an orderly fashion using the conventional bankruptcy process. These institutions are required to submit "living wills" that describe how such a conventional resolution could occur. If the Fed and the FDIC find that those plans lack credibility, they may require the financial institution to divest subsidiaries, hold increased capital, reduce leverage, or take other steps to shrink or simplify the institution. To date, over 100 institutions have submitted living wills, and the Fed and the FDIC have not rejected a single plan as lacking credibility.

   What gives you confidence that our largest financial institutions could currently be resolved through a conventional bankruptcy procedure? What criteria would you use to determine whether a resolution plan is "credible" for the purposes of Section 165(d)? Are you willing to take the actions identified in Section 165(d)(5) of Dodd-Frank – including mandating divestiture of subsidiaries – if you believe a resolution plan lacks credibility?

8. As a fraction of GDP, the financial sector today is about twice as large as it was in the 1970s. Despite this growth in size, researchers have found that the sector is less efficient than it once was in allocating credit for the real economy. Do you believe that there are

effectively "reverse economies of scale," such that financial institutions can grow so large that they become less efficient at performing their primary function of allocating credit?

9. Last year, the Financial Stability Board (FSB) directed the International Association of Insurance Supervisors (IAIS) to propose global qualitative capital standards by 2016 for "internationally active insurance groups" (IAIGs) – a category that includes U.S.-based insurance companies that have not been designated as systemically important financial institutions. Ostensibly, the three U.S. representatives to the FSB – the Fed, the Securities Exchange Commission, and the Treasury Department – supported the FSB's directive to the IAIS.

    a. [To Powell]: As a member of the Fed at the time of the FSB's directive to the IAIS, did you agree with the Fed's decision to support (or at a minimum, not oppose) the directive?

    b. [To Fischer, Brainard, and Powell]: U.S. insurance regulation is primarily state-based and relies on state guaranty funds, whereas European insurance regulation is primarily based on capital standards and does not rely on guaranty funds. Given this difference in regulatory approach, do you think it is appropriate for U.S.-based IAIGs to be subject to a single, global capital standard for their U.S. operations?

10. What do you see as the proper role of the General Counsel's office in both the Fed's rulemaking process and its supervisory and enforcement processes? Does it go beyond the duties that are specifically delegated to the General Counsel's office in 12 C.F.R. § 265.6?

11. In your view, did deregulation cause the 2008 financial crisis?

12. The Senate Permanent Subcommittee on Investigations recently released a report detailing Credit Suisse's role in aiding thousands of Americans evade their U.S. tax

obligations. Credit Suisse and the Swiss government have not been cooperating with the Department of Justice's investigation. Do you think it is appropriate for the Fed to use any of its regulatory or enforcement authority under the circumstances?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

March 31, 2014

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the March 13, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs.

Please let me know if I can be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

Responses from Gov. Jerome Powell to Questions from Senator Kirk:

ISSUE: Capital Rules for Insurance Companies

1. **While many of us believe that the Dodd-Frank Act already gives the Federal Reserve the authority to distinguish between insurance companies and banks when promulgating capital standards under the Collins Amendment, the Federal Reserve has made statements publicly that it does not believe it has the statutory authority to do so. Therefore, a number of senators on this Committee introduced legislation, S. 1369 to codify and clarify that the Federal Reserve can and should make distinctions between insurance companies and banks when setting capital standards. Is it your interpretation that this authority currently exists?**

The Collins amendment requires that the Board establish consolidated minimum risk-based and leverage requirements for depository institution holding companies and nonbank financial companies designated by the FSOC that are no less than the generally applicable risk-based capital and leverage requirements that apply to insured depository institutions. If confirmed, I will continue to work with the other governors and the staff of the Federal Reserve to craft a regulatory capital regime for insurance companies and other nonbank financial companies that is strong but appropriate for the risk profile of the companies consistent with the Collins Amendment.

2. **This ability for distinction should also transfer to the Fed's ability to distinguish between insurance companies and banks for purposes of accounting practices. I have at least two insurance companies in my state that are supervised by the Fed as savings and loan holding companies. These companies are not publicly traded and do not prepare financial statements in accordance with GAAP—but rather, in accordance with GAAP-based insurance accounting known as Statutory Accounting Principles (SAP). Every person I consult tells me that SAP is the most effective and prudential way to supervise the finances of an insurance company. It is my understanding that the Federal Reserve may want to force these insurance companies that have used SAP reporting for many decades to spend hundreds of millions of dollars preparing GAAP statements—primarily because the Fed is comfortable with GAAP and understands it since it's what banks use. Is this is true? If it is true, is it simply b/c the Fed is so accustomed to bank regulation and not insurance regulation that it simply wants to make things easier for itself? Do you agree with this one-size fits all approach to regulation? Can you provide a cost benefit analysis to this as it seems to not add any additional supervisory value and only adds astronomic costs to these companies?**

One of the key differences between SAP and GAAP accounting is the financial reporting of subsidiaries; SAP does not allow for consolidation accounting. SAP accounting is prescribed by the National Association of Insurance Commissioners and is used by state insurance regulators to evaluate the financial condition and solvency of domestic insurance subsidiaries. The federal regulatory framework for depository institution holding companies, including regulatory and supervisory tools being developed and implemented under DFA, is based on protecting financial stability, protecting the safety and soundness of the consolidated holding company, and protecting the federal deposit insurance fund. I recognize the unique characteristics of insurance companies and understand the concerns raised by insurance companies that do not currently use GAAP for financial reporting. The Fed delayed the capital rulemaking for these entities in order to further study these issues, including the associated costs and benefits of requiring use of GAAP by insurance entities that do not use GAAP currently.

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March 31, 2014

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Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the March 13, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs.

Please let me know if I can be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

Responses from Gov. Jerome Powell to Questions from Ranking Member Crapo:

1. **A recent paper presented at the US Monetary Policy Forum suggests the possibility that current monetary stimulus may involve a "tradeoff between more stimulus today at the expense of a more challenging and disruptive policy exit in the future." How concerned are each of you about the exit from all this monetary stimulus of the past several years?**

As the recovery continues, the Federal Reserve will move over time to return monetary policy to a more normal stance. The pace and timing of this process will depend on developments in the economy – particularly, further progress in reducing unemployment, and inflation moving back toward the FOMC's 2% longer range target for inflation – as well as financial market developments. After such a long period of highly accommodative policy, it is important that the FOMC be as predictable and transparent as possible about the path of policy. In all likelihood, the process of normalization will take several years.

The Federal Reserve and the FOMC have a growing range of tools to manage the normalization process. The FOMC has indicated that interest rates will be the main tool used to tighten policy when economic and financial conditions warrant such a change. The FOMC has also indicated that most Committee participants do not anticipate sales of mortgage-backed securities during the normalization process.

Increasing the interest rate paid on reserve balances that depository institutions hold at the Federal Reserve Banks is also likely to be an important tool for raising the federal funds rate when doing so becomes appropriate. In addition, the FOMC has been testing a number of additional tools, including a term deposit facility, term reverse repurchase agreements, and an overnight fixed-rate reverse repurchase agreements, in order to strengthen the link between the rate paid on reserve balances and market rates. I am confident that the Federal Reserve has the tools it needs to exit over time from its highly accommodative stance of policy. While the process of exiting may not always be a smooth one, I believe that it will be manageable.

2. **I worry that the aggregate impact of the rules implementing Dodd-Frank will be immense. For some financial companies it will result in a regulatory death-by-a-thousand-cuts, with significant impact for the economy at large. If confirmed to the Board of Governors, how will each of you intend to monitor the cumulative regulatory burden on entities affected by the Fed's rulemakings?**

I agree that regulators should be careful to consider the cumulative regulatory burden on entities of regulations. The Federal Reserve considers the costs and benefits of every rule that it issues. The Federal Reserve seeks to minimize burden and the impact on the economy of regulations it issues while faithfully implementing the requirements of each statutory mandate. The Federal Reserve looks to present its proposed regulations as a package of integrated changes wherever possible to ensure that banking institutions have a good opportunity to evaluate the impact of the changes collectively. The Federal Reserve also includes explanations in the preambles to proposed regulations of the interaction between the proposal and other regulations.

Many of the regulations that are being put in place are targeted at the large banks. The Federal Reserve is working with other regulators to help ensure that its rules are properly calibrated so that smaller institutions are not faced with the same burdens as large institutions. If confirmed, I will be attentive to the costs and benefits of Federal Reserve rulemakings.

3. **As part of its QE purchases, the Fed has accumulated a significant percentage of all new federal mortgage-backed security issuances. The large nature of the Fed's purchases appear to be a deterrence to private capital from coming back into the market and issuing new mortgage-backed securities. What effect does the Fed's role as the dominant buyer or mortgage-backed securities have on the market?**

The FOMC's MBS purchases have held mortgage rates lower than they otherwise would have been, which has supported the housing sector and the broader recovery. MBS purchases have also reduced other interest rates. As the Federal Reserve gradually reduces the pace of its MBS purchases, private capital should return and take up any slack. The fact that mortgage and MBS rates have been broadly stable since the FOMC began to reduce MBS purchases suggests that this is occurring in the market today.

QE affects the prices of MBS and other assets through a portfolio rebalancing channel and has decisively lowered MBS yields and mortgage rates. These interest rate effects have spillovers to other assets and corporate bond rates, which are also pushed down by QE. However, the extent of these effects varies depending on the economic and policy environment.

Thus, the Federal Reserve's purchases of government-backed MBS should have pushed investors out of government-backed MBS and encouraged them to seek higher returns by investing in other assets, including privately-backed MBS (e.g., MBS backed by jumbo mortgages that are above the conforming loan limit).

Enactment of GSE reform legislation would also support MBS activity and the housing market by reducing uncertainty about the structure of housing finance in the United States.

4. **For the size of the balance sheet and the quantity of assets that the Fed has accumulated, there seems to have been only a limited effect on businesses willingness to hire. Please discuss about whether QE policy and implementation has been effective in reducing employment, and how you view the importance of fiscal and regulatory reform in growing our economy.**

The evidence suggests to me that QE has meaningfully lowered interest rates and raised asset prices. It is likely that lower rates and higher asset prices have provided meaningful support for the economy, through channels that are reasonably well understood. Since we cannot know how the economy would have performed under a different policy, it is not possible to estimate these effects with high certainty.

That said, since the current asset purchase program began in September 2012, growth in payroll employment has been higher and declines in unemployment have been greater than many FOMC members expected at that time. Since September 2012, unemployment has declined from 8.1% to 6.7%, and approximately 3 million payroll jobs have been added.

While monetary policy is a useful tool in achieving stable prices and full employment, it is not generally thought to affect the potential of the economy in the long run. Fiscal and regulatory policies are more powerful tools that can have such effects. Surveys suggest that uncertainty about fiscal and regulatory policy may have raised uncertainty among business decision makers and caused them to hold back from hiring and investment. It is critical that all aspects of our economic policy support growth, including fiscal, regulatory and monetary policy.

5. **The New York Fed's report on household debt shows that one area we see an increase in individuals taking on significant amount of student loan debt. In addition, the Kansas City Fed recently held a conference on this same topic. In recent years, the vast majority of these loans are obtained by students through federal programs. The relative ease of access to these federal loans is encouraging students to take out significant amounts of loans. Should we be concerned about students acquiring this significant amount of debt? How will this affect the future of our nation's economy?**

Since 2007, outstanding student loan debt has more than doubled from about $550 billion to over $1.2 trillion. The main reasons for the rapid expansion of student loan debt are the increase in tuition and fees and an increase in college enrollment. An increasing share of borrowers (at least through 2011) has found it difficult to meet their student loan repayment obligations. The two-year cohort default rate on federal student loans has increased from 6.7 percent in 2007 to 10 percent in 2011—the latest data point available. However, the wage premium of college graduates over high school graduates has stayed substantial. In addition, recent improvements in labor market conditions should put downward pressure on student loan default rates.

This is an important issue that should be carefully monitored going forward.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 13, 2014

The Honorable Jeff Sessions
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 8, 2014, hearing before the Senate Budget Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Sessions:</u>

1. When the Federal Reserve holds risky assets on its balance sheet, there's a possibility that losses can occur when those assets are sold. The Federal Reserve created this possibility when it purchased $1.5 trillion mortgage backed securities and bonds, principally from Fannie Mae and Freddie Mac, that are not guaranteed by the federal government. In a note to its statistical release H 4.1, the Fed announced that losses stemming from these bonds would henceforth be a liability of the Treasury or of U.S. taxpayers.

Why may the Federal Reserve create liabilities for taxpayers without Congressional authorization to do so? Did the Fed create these liabilities when it purchased the non-guaranteed mortgage bonds of Fannie Mae and Freddie Mac and added these assets to the system's balance sheet?

The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment and price stability. In response to the recent financial crisis, economic recession, and the weak recovery that followed, the Federal Reserve has given the economy unprecedented support through large scale asset purchases (LSAPs) in an effort to put downward pressure on longer-term interest rates and ease financial conditions more broadly. Some of these purchases were in mortgage-backed securities issued and fully guaranteed by Fannie Mae and Freddie Mac. These purchases are consistent with the statutory authority governing Federal Reserve open market operations.

Once the economy improves sufficiently so that the effects of LSAPs are no longer needed, the FOMC will face issues of policy normalization. The Federal Reserve does not need to sell large volumes of its assets to normalize policy. Instead, balance sheet adjustment can occur gradually as existing securities mature over time. In particular, as noted in the June 2013 FOMC minutes, most participants anticipate that the FOMC will not sell agency mortgage-backed securities as part of the normalization process. As noted above, the FOMC conducts monetary policy at all times to foster its longer-term objectives of maximum employment and stable prices, and this principle will guide the process of normalizing the size and composition of the Federal Reserve's balance sheet.

It is important to note that the Federal Reserve is not exposed to any credit risk from its holdings of securities. The market value of the Federal Reserve's securities holdings—consisting almost entirely of Treasury securities and agency-backed mortgage-backed securities—is affected by the level of interest rates. However, any capital losses stemming from this sort of interest rate risk do not show through to Federal Reserve income unless the securities are sold. No losses are recorded for any security that is held to maturity. Even if the Federal Reserve were to sell some portion of its securities prior to maturity, capital losses would likely be modest and more than offset by positive interest earnings on its remaining securities holdings over the period affected by the LSAPs. For example, the Congressional Budget Office (CBO) recently projected that remittances from the Federal Reserve to the Department of Treasury (Treasury) will amount to about $484 billion from 2014 until the end of their projection period in 2024 (federal fiscal years, which run from October 1 to September 30), even with an assumption of some sales of longer-term securities and associated realized capital losses.[1] Moreover, Federal Reserve remittances to the Treasury from 2008-2013 were very large at about $400 billion. In short, the Federal Reserve's holdings of longer-term securities have already generated very sizable gains for U.S. taxpayers and will almost certainly continue to do so over coming years.

2. Your testimony before the Senate's Committee on the Budget contained your claim that the overall decline in the rate of labor force participation that has occurred since the end of the 2008-2009 recession is due in a part to the retirement of "baby boomers" and, thus, their departure from the labor force as they age. This claim is disputed by many labor economists who suggest that the rates of participation for older workers have increased since 2009 and that retirements have been offset by young people entering the labor force.

Please provide the evidence and research behind your claim or a correction. Furthermore, include in that production the change in the rates of labor force participation by age intervals (preferably 5-year intervals) for each year from (and including) 2009 to the most recent available data.

As indicated in my testimony, I believe that some of the decline in the aggregate labor force participation rate since the recession reflects the aging of the "baby boomers" and their departure from the labor force as they retire. In particular, while it is true that labor force participation rates have been rising for older individuals, the average rate of participation among those ages 65 and over is still only about 19 percent, well below the average participation rate of 62.8 percent for the entire working-age population. As a result of this substantial drop-off in labor force attachment at older ages, the movement of the large baby-boom cohort into their retirement years is putting downward pressure on the aggregate participation rate.

The attached table provides the data you requested. In addition, you will find an attached chart that shows a decomposition of the cumulative change in the aggregate labor participation rate since 2008 into the part due to the aging of the population and the part due to changes in age-specific participation rates. As indicated by the striped blue bar in the last column on the right, the aging of the population accounts for about 1 percentage point of the 2¾ percentage point decline in the aggregate participation rate since 2008; thus, according to this calculation, the aging of the population has accounted for more than one-third of the decline in the aggregate labor force participation rate since 2008. Declines in the participation rates of young people (ages 16-24) and prime-age individuals (ages 25-54) each contribute a little less than 1 percentage point to the decline, while the increases in participation rates among those 55 and older have added only about ¼ percentage point to the aggregate participate rate since 2008.

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[1] See "The Budget and Economic Outlook: 2014 to 2024" released by the CBO in April 2014. Also, see Carpenter et al. (2013), "The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections," Finance and Economics Discussion Papers 2013-01, Board of Governors of the Federal Reserve System (U.S.), for additional projections of Federal Reserve income associated different interest rate assumptions and exit strategies.

3. Your Budget Committee testimony contains the statement that the federal funds rate is your "...traditional policy tool." As you have noted elsewhere, this rate is the principal tool used by the Open Market Committee to affect the demand for credit and credit's price. The direction of the federal funds rate, up or down, presumably anticipates a similar movement in the same direction of other key market interest rates. That said, you also noted in answers to questions by Committee members that the key rates for mortgages and for Treasury bonds are increasing despite the federal funds rate being near zero since late 2008. Indeed, the increase in mortgage interest rates is one reason you mentioned for the slowdown in housing demand that you raised as a caution to your otherwise generally optimistic view of the near-term economic outlook.

What does the evidence say about the degree of direct control that the Federal Reserve has over market interest rates (both short and long-term)?

Historically, the Federal Reserve has been able to exert tight control over the level of the overnight federal funds rate by adjusting the supply of reserve balances on a regular basis to meet the expected demand for reserves at the FOMC's target federal funds rate. Apart from small idiosyncratic fluctuations, arbitrage by investors generally ensures that other short-term interest rates, such as Treasury bill yields, commercial paper rates, and repo rates, typically move closely with the level of the federal funds rate. As noted in the minutes of recent FOMC meetings, even in the current environment with extraordinarily elevated levels of excess reserves, the Federal Reserve is confident that it will be able to use a range of policy tools, including interest on reserves along with overnight and term reserve draining tools to put upward pressure on short-term interest rates and remove policy accommodation at the appropriate time.

The Federal Reserve's control over *longer-term interest rates* is more indirect and more limited than its influence over the level of the federal funds rate. Longer-term interest rates can be viewed as the sum of the expected average level of short-term interest rates over the maturity of the instrument and a "term premium" that accounts for the increased risk of longer-term investments. The first component importantly reflects investors' views about the economic outlook and how the Federal Reserve will adjust the level of the federal funds rate in response to changes in that outlook. Especially in the current environment, the Federal Reserve has provided greater clarity about the likely future path of short-term interest rates through various communications including FOMC statements and minutes, my post-meeting press conferences, and the quarterly Summary of Economic Projections.

The second component—the term premium—reflects many factors including uncertainties regarding the future course of the economy and of interest rates, changes in investors' willingness to bear risk, and changes in the aggregate supply of longer-term securities. Over recent years, the Federal Reserve has conducted large scale asset purchases of longer-term Treasury and MBS securities to put downward pressure on longer-term interest rates. Large scale asset purchases put downward pressure on long-term interest rates primarily by reducing the term premium.

The backup in longer-term interest rates witnessed over the past year or so seems to reflect a rise in both the expected future path of short-term rates and the term premium. In large part, the rise in the expected future path of policy appears to reflect the improvement in the economic outlook. Since last May, for example, the unemployment rate has declined from 7.5 to 6.3 percent. A portion of the rise in the term premium over the past year may also be related to the improvement in economic outlook. As the outlook has improved, investors anticipated some scaling back in the pace of the Federal Reserve's asset purchases and this likely put a little upward pressure on long-term rates. However, as noted above, the term premium embedded in long-term rates is affected by many factors. Over the summer of 2013, for example, many reports suggested that some investors had taken large positions in fixed income market that were premised on unrealistic expectations about Federal Reserve policy and the level of volatility in financial markets. The unwinding of these expectations contributed importantly to the substantial rise in long-term rates last year.

On balance, we have not seen convincing evidence to date suggesting that the short-run effect of monetary policy on long-term interest rates is diminished relative to that in the past. That said, long-term interest rates are volatile, and there will almost surely be future episodes in which long-term rates move up or down in ways that are difficult to reconcile with the economic outlook or the stance of monetary policy. For its part, as always, the Federal Reserve will strive to communicate its economic and policy outlook clearly so that investors can anticipate the likely future path of short-term rates. Of course, over the long run, the Federal Reserve exerts its strongest influence over the level of long-term interest rates through its commitment to foster maximum employment and price stability.

4. Your responses to several questions on the long-term fiscal outlook underscored your concern about rising deficits and rapidly accumulating debt. Indeed, you stated your view that debt increases as predicted by CBO would slow the economy and lead to an unsustainable fiscal situation.

Given those views as expressed in today's hearing, would balancing our budget over 10 years improve the long-term economic outlook? At what stage of the economic cycle is it appropriate to begin a process of fiscal consolidation?

Significant progress has been made in recent years toward reducing the federal budget deficit. The federal deficit was about 4 percent of nominal gross domestic product (GDP) last fiscal year, and the CBO estimates that the deficit this year will be below 3 percent of GDP. The federal deficit is now much smaller than its recent peak of almost 10 percent of GDP in fiscal year 2009, with this reduction reflecting both the budgetary effects of the economic recovery over the past five years along with fiscal policy actions taken to reduce federal spending and increase taxes. Although fiscal policy actions have helped reduce the budget deficit in the near term, this fiscal restraint has slowed the pace of the economic recovery. The CBO estimates that deficit-reduction policies reduced the rate of real GDP growth by roughly 1½ percentage point last year and will lower economic growth by about ¼ percentage point this year, relative to what it would have been otherwise.

Even with the progress made in shrinking near-term budget deficits, little has been done to address the projected longer-run imbalances in the federal government's budget. If current federal budget policies do not change, the CBO projects that the further aging of the population, rising health care costs, and growing interest payments on federal debt will all contribute importantly to rising budget deficits after next year. To promote economic growth and stability in the longer term, it will be essential for fiscal policymakers to put the federal budget on a sustainable long-run path. However, since our economy is not yet back to full employment, it would be appropriate to not impose additional near-term fiscal restraint. Nevertheless, fiscal policymakers could put in place now a credible plan to set fiscal policy on a sustainable path in the longer run while not restraining the economic recovery in the short run.

5. In December of 2013, the 10-year Treasury note rate rose to level over 3 percent. It has now fallen to under 2.6 percent. Is that a negative indication for long-term economic growth?

Between December 31, 2013 and May 16, 2014, the 10-year Treasury yield declined by more than ½ percentage point, from 3.08 percent to 2.54 percent. Shorter-dated Treasury yields declined substantially less over this period; for example, the 5-year Treasury yield declined by only 17 basis points, from 1.74 percent to 1.57 percent. Thus, the decline in the 10-year Treasury yield reflects an even larger decline in long-term forward rates; by contrast, expectations of lower policy rates in the near-term appear to play only a minor role. It is worth noting that, over this period, 10-year government bond yields in several advanced foreign economies, notably Canada, the United Kingdom, and Germany, have declined by amounts similar to the decline in the 10-year Treasury yield.

Long-term forward rates are quite volatile and often difficult to explain in terms of economic fundamentals. The sharp decline in long-term forward rates early last year and the subsequent reversal over the summer are a case in point. In principle, a decline in long-term forward rates could reflect a decline in expected future real short-term interest rates, expected future inflation, or the term premium, perhaps because of reduced uncertainty about the future course of the economy and of interest rates. If market participants expect a lower pace of longer-term economic growth, this would be primarily reflected in a lower level of expected real interest rates.

Market participants have pointed to a variety of factors that might have contributed to a decline in long-term forward rates this year, including a decline in uncertainty about long-term rates, reports of increased demand for long-duration assets by some investors, and perhaps also changes in forward guidance that have provided more information about the post liftoff policy path. In the Survey of Primary Dealers conducted by the Federal Reserve Bank of New York prior to the April 2014 FOMC meeting, dealers were asked to decompose the decline in long-horizon forward rates since the end of 2013 into expected real rates, expected inflation, and term premiums. On average, these dealers assigned about half of the decline to reduced term premiums, and a little more than a quarter to lower future real short-term interest rates. Thus, it is likely that expectations of lower long-term economic growth contributed only modestly to the decline in longer-term Treasury yields since the beginning of the year. Such an interpretation seems also consistent with the fact that broad stock prices are up a little since the end of last year and credit spreads have narrowed a touch. A significant decline in long-run growth expectations might have been expected to depress stock prices and boost risk spreads.

Annual change in labor force participation rates by age group

	2009/ 2008	2010/ 2009	2011/ 2010	2012/ 2011	2013/ 2012
Overall LFPR	-0.62	-0.69	-0.60	-0.41	-0.45
16 - 19	-2.67	-2.55	-0.80	0.14	0.18
20 - 24	-1.40	-1.54	-0.12	-0.35	-0.21
25 - 29	-0.97	-0.12	-0.85	0.16	-0.73
30 - 34	-0.36	-0.88	-0.45	0.11	-0.16
35 - 39	-0.22	-0.53	-0.62	-0.17	-0.16
40 - 44	-0.59	-0.37	-0.47	-0.06	-0.57
45 - 49	-0.44	-0.32	-0.42	-0.43	-0.58
50 - 54	-0.11	-0.51	-0.59	-0.39	-0.43
55 - 59	0.00	0.21	-0.47	-0.37	-0.03
60 - 64	1.09	0.04	-0.67	0.73	-0.25
65 - 69	0.43	0.32	0.65	-0.02	0.07
70 - 74	0.65	-0.42	0.82	0.64	-0.25
75+	-0.00	0.08	0.10	0.13	0.31
Memo:					
25 - 54	-0.46	-0.46	-0.57	-0.14	-0.44
55 - 64	0.38	0.01	-0.67	0.23	-0.12
65+	0.40	0.16	0.54	0.56	0.24

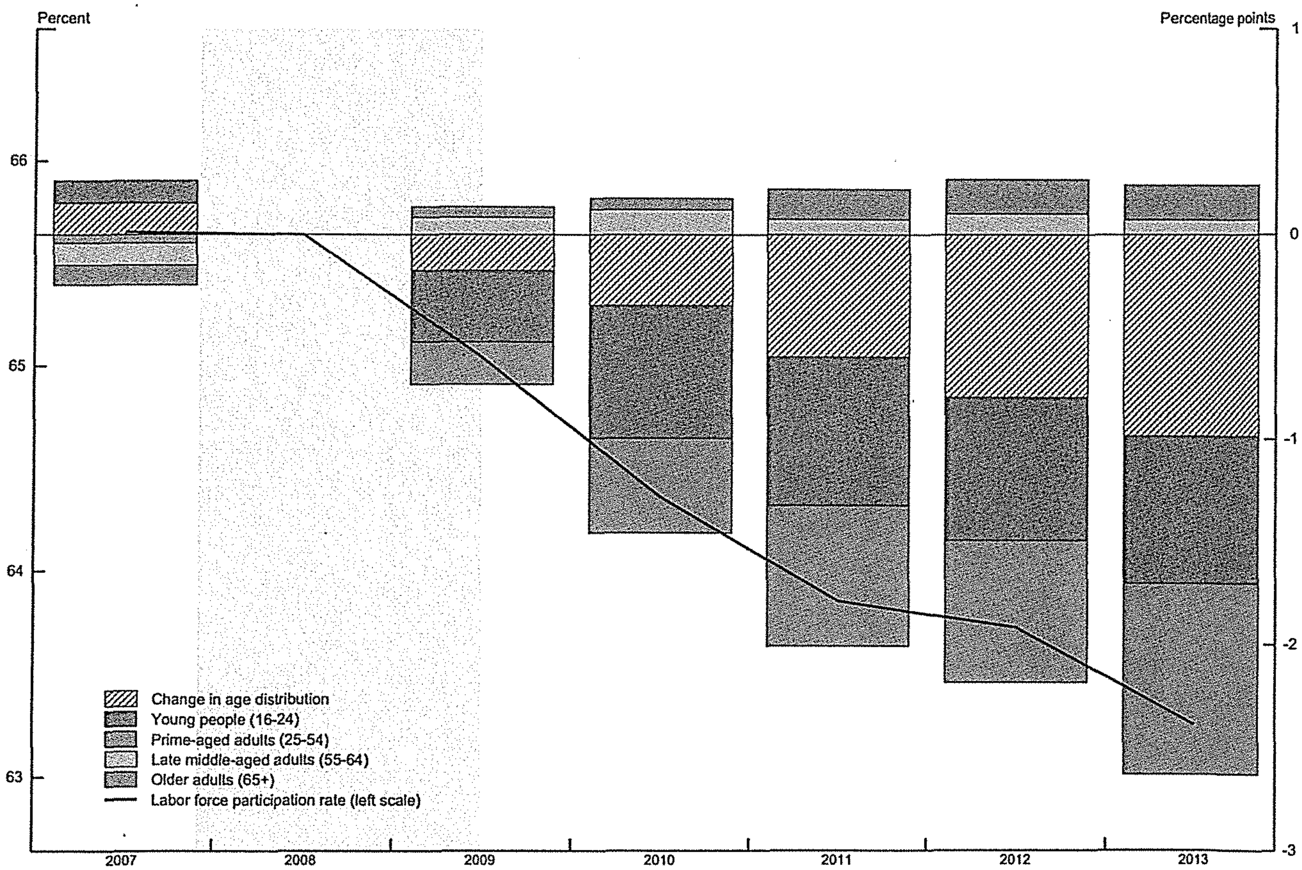
Source: Current Population Survey, Bureau of Labor Statistics.

Cumulative change since 2008 in labor force participation rates by age group

	2009/ 2008	2010/ 2008	2011/ 2008	2012/ 2008	2013/ 2008
Overall LFPR	-0.62	-1.30	-1.90	-2.31	-2.76
16 - 19	-2.67	-5.22	-6.02	-5.88	-5.70
20 - 24	-1.40	-2.95	-3.07	-3.42	-3.63
25 - 29	-0.97	-1.09	-1.94	-1.77	-2.51
30 - 34	-0.36	-1.25	-1.70	-1.59	-1.75
35 - 39	-0.22	-0.75	-1.37	-1.54	-1.69
40 - 44	-0.59	-0.96	-1.43	-1.50	-2.06
45 - 49	-0.44	-0.75	-1.17	-1.60	-2.18
50 - 54	-0.11	-0.62	-1.22	-1.60	-2.03
55 - 59	0.00	0.21	-0.26	-0.63	-0.66
60 - 64	1.09	1.13	0.46	1.18	0.94
65 - 69	0.43	0.76	1.40	1.39	1.46
70 - 74	0.65	0.23	1.06	1.70	1.45
75+	-0.00	0.08	0.18	0.31	0.62
Memo:					
25 - 54	-0.46	-0.92	-1.50	-1.63	-2.08
55 - 64	0.38	0.38	-0.29	-0.05	-0.17
65+	0.40	0.56	1.10	1.66	1.90

Source: Current Population Survey, Bureau of Labor Statistics.

Contributions to change in labor force participation rate since 2008



Source: Current Population Survey microdata. Data are adjusted for revisions to population controls.

Jeff Sessions

Ranking Member Sessions' Questions for the Record

to

Janet Yellen
Chair, Board of Governors
of the Federal Reserve System

CLO: #Y - 40
CCS: 14-3433
RECVD: 5/8/14

For the Hearing on

The Economic and Fiscal Outlook

May 8, 2014

Senate Committee on the Budget

Increasing Taxpayer Liabilities

1. When the Federal Reserve holds risky assets on its balance sheet, there's a possibility that losses can occur when those assets are sold. The Federal Reserve created this possibility when it purchased $1.5 trillion mortgage backed securities and bonds, principally from Fannie Mae and Freddie Mac, that are not guaranteed by the federal government. In a note to its statistical release H 4.1, the Fed announced that losses stemming from these bonds would henceforth be a liability of the Treasury or of U.S. taxpayers.

Why may the Federal Reserve create liabilities for taxpayers without Congressional authorization to do so? Did the Fed create these liabilities when it purchased the non-guaranteed mortgage bonds of Fannie Mae and Freddie Mac and added these assets to the system's balance sheet?

Decline in the Rates of Labor Force Participation

2. Your testimony before the Senate's Committee on the Budget contained your claim that the overall decline in the rate of labor force participation that has occurred since the end of the 2008-2009 recession is due in a part to the retirement of "baby boomers" and, thus, their departure from the labor force as they age. This claim is disputed by many labor economists who suggest that the rates of participation for older workers have increased since 2009 and that retirements have been offset by young people entering the labor force.

Please provide the evidence and research behind your claim or a correction. Furthermore, include in that production the change in the rates of labor force participation by age intervals (preferably 5-year intervals) for each year from (and including) 2009 to the most recent available data.

The Federal Reserve's Control of Interest Rates

3. Your Budget Committee testimony contains the statement that the federal funds rate is your "...traditional policy tool." As you have noted elsewhere, this rate is the principal tool used by the Open Market Committee to affect the demand for credit and credit's price. The direction of the federal funds rate, up or down, presumably anticipates a similar movement in the same direction of other key market interest rates. That said, you also noted in answers to questions by Committee members that the key rates for mortgages and for Treasury bonds are increasing despite the federal funds rate being near zero since late 2008. Indeed, the increase in mortgage interest rates is one reason you mentioned for the slowdown in housing demand that you raised as a caution to your otherwise generally optimistic view of the near-term economic outlook.

What does the evidence say about the degree of direct control that the Federal Reserve has over market interest rates (both short and long-term)?

Long-Term Fiscal Outlook

4. Your responses to several questions on the long-term fiscal outlook underscored your concern about rising deficits and rapidly accumulating debt. Indeed, you stated your view that debt increases as predicted by CBO would slow the economy and lead to an unsustainable fiscal situation.

Given those views as expressed in today's hearing, would balancing our budget over 10 years improve the long-term economic outlook? At what stage of the economic cycle is it appropriate to begin a process of fiscal consolidation?

Risk of Higher Interest Rates on the Economy

5. In December of 2013, the 10-year Treasury note rate rose to level over 3 percent. It has now fallen to under 2.6 percent. Is that a negative indication for long-term economic growth?

Jeff Sessions

Ranking Member Sessions' Questions for the Record

to

Janet Yellen
Chair, Board of Governors
of the Federal Reserve System

For the Hearing on

The Economic and Fiscal Outlook

May 8, 2014

Senate Committee on the Budget

Increasing Taxpayer Liabilities

1. When the Federal Reserve holds risky assets on its balance sheet, there's a possibility that losses can occur when those assets are sold. The Federal Reserve created this possibility when it purchased $1.5 trillion mortgage backed securities and bonds, principally from Fannie Mae and Freddie Mac, that are not guaranteed by the federal government. In a note to its statistical release H 4.1, the Fed announced that losses stemming from these bonds would henceforth be a liability of the Treasury or of U.S. taxpayers. MA & Legal

Why may the Federal Reserve create liabilities for taxpayers without Congressional authorization to do so? Did the Fed create these liabilities when it purchased the non-guaranteed mortgage bonds of Fannie Mae and Freddie Mac and added these assets to the system's balance sheet?

Decline in the Rates of Labor Force Participation

2. Your testimony before the Senate's Committee on the Budget contained your claim that the overall decline in the rate of labor force participation that has occurred since the end of the 2008-2009 recession is due in a part to the retirement of "baby boomers" and, thus, their departure from the labor force as they age. This claim is disputed by many labor economists who suggest that the rates of participation for older workers have increased since 2009 and that retirements have been offset by young people entering the labor force. R&S

Please provide the evidence and research behind your claim or a correction. Furthermore, include in that production the change in the rates of labor force participation by age intervals (preferably 5-year intervals) for each year from (and including) 2009 to the most recent available data.

Elsa Garcia

From:	Nancy Riley
Sent:	Thursday, May 08, 2014 6:14 PM
To:	Elsa Garcia
Cc:	Linda Robertson; Madelyn Marchessault; Jennifer Gallagher; Eric Morrissette
Subject:	FW: QFR's from Today's Hearing
Attachments:	Sessions QFRs for 05-08-14.pdf; Whitehouse QFRs for 05-08-14.pdf

Elsa – here are the QFRs from Senate Budget. Let's talk tomorrow about assigning them out. Thanks, Nancy

---

From: Scholl, Brian (Budget) [mailto:Brian_Scholl@budget.senate.gov]
Sent: Thursday, May 08, 2014 6:07 PM
To: Nancy Riley
Cc: Madelyn Marchessault; Eric Morrissette; Jennifer Gallagher
Subject: QFR's from Today's Hearing

Friends,

Thank you again so much for your help today, and please do pass personal thanks to Chair Yellen from Senator Murray and our members.

Attached are QFRs from today's hearing. Please send me responses at your earliest convenience. Please let me know if you have questions.

Best,

Brian Scholl, Ph.D.
Chief Economist
Committee on the Budget
United States Senate
(202) 224-6588
brian_scholl@budget.senate.gov

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 15, 2014

The Honorable Sheldon Whitehouse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 8, 2014, hearing before the Senate Budget Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Whitehouse:

1. Back in 1997 when you were Chair of the Council of Economic Advisors, you testified before the EPW Committee on climate change and said, "costs depend critically on how emission reduction policies are implemented. It boils down to this: if we do it dumb, it could cost a lot, but if we do it smart, it will cost much less and indeed could produce net benefits in the long run" Is it still your position that emissions reductions accomplished smartly can produce net benefits in the long run? Could a carbon fee under which the revenues were returned to the American people through spending programs or tax rate reductions produce net economic benefits?

In my current role as chair of the Federal Reserve, I am fully absorbed in executing the important responsibilities assigned by the Congress to the Federal Reserve among them, the pursuit of price stability, maximum sustainable employment, financial stability, and the prudential regulation of financial institutions. Issues pertaining to the question of climate change are also important, but are best addressed by the Congress and the President.

Questions for the Record
By Senator Sheldon Whitehouse
May 8, 2014
Senate Budget Committee

CLO:	#Y - 41
CCS:	14-3443
RECVD:	5/8/14

For Chair Yellen:

Back in 1997 when you were Chair of the Council of Economic Advisors, you testified before the EPW Committee on climate change and said, "costs depend critically on how emission reduction policies are implemented. It boils down to this: if we do it dumb, it could cost a lot, but if we do it smart, it will cost much less and indeed could produce net benefits in the long run." Is it still your position that emissions reductions accomplished smartly can produce net benefits in the long run? Could a carbon fee under which the revenues were returned to the American people through spending programs or tax rate reductions produce net economic benefits?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

September 26, 2014

The Honorable Peter King
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the April 8, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

<u>Questions for The Honorable Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System from Representative King</u>:

1. I am glad that representatives from the FDIC, OCC and the Fed are all here today, because I would like you all to comment on the Liquidity Coverage Ratio proposal your agencies put out to comply with the Basel Committee's requirements. I am particularly concerned about how the treatment of municipal securities and deposits will affect municipalities – including New York City and communities affected by Superstorm Sandy – which depend heavily on muni bonds to fund critical infrastructure. Can you explain why your agencies did not grant municipal bonds status as "High Quality Liquid Assets" (HQLA), despite the Basel Committee's recommendation to do so? I understand that under your proposal corporate bonds and even sovereign debt were given HQLA treatment. Why is the debt of small nations whose sovereign securities are illiquid or even distressed, are treated as higher quality than securities from our own states and districts? Can you explain that decision?

The goal of the liquidity coverage ratio (LCR) is to ensure that covered companies are able to meet their short-term liquidity needs during times of stress. The inability to meet those liquidity needs proved to be a significant cause of the failure or near failure of several large financial firms during the recent financial crisis. To ensure adequate liquidity, the final rule includes as high-quality liquid assets (HQLA) only securities that historically have been readily convertible into cash with little or no loss of value during a period of stress, either by sale or through a repurchase transaction. The OCC, FDIC, and Board considered various types of assets for treatment as HQLA and evaluated relevant market data relating to the liquidity characteristics.

Under the LCR final rule issued on September 3, 2014, securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities) do not qualify as HQLA. However, the Board has reviewed market data regarding municipal securities and the information provided by commenters and is exploring the development of a new proposal for public comment to treat as HQLA for purposes of the LCR requirement municipal securities that trade readily and have liquidity characteristics that are comparable to other HQLA assets.

2. Your agencies' LCR proposal also treats municipal deposits as secured transactions under the rule which means they would be subject to a 100% unwind for purposes of the ratio calculation. I am concerned this will hamper municipalities' ability to seek the banking services they need to make pay-roll and fund day-to-day activities. Can you comment on why these deposits were treated as secured transactions under the proposal?

Under the LCR notice of proposed rulemaking (NPR), collateralized municipal deposits would have been treated as secured funding transactions to permit the deposits to be eligible for lower outflow rate to the extent the deposits are secured by high-quality collateral. To the extent that a municipal deposit is not secured, the deposit would not be treated as a secured funding transaction. The NPR also had another feature that would have provided for a mathematical unwind of all secured funding transactions to ensure that firms did not enter into secured transactions for the purpose of manipulating their level of HQLA to avoid the liquid asset cap limitations.

The OCC, FDIC, and the Board recently finalized the LCR on September 3, 2014. In response to comments regarding the application of the unwind requirement for secured funding transactions to municipal and certain other types of secured deposits, the agencies determined in the LCR final rule not to require the unwind of secured municipal deposits.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

September 26, 2014

The Honorable Gwen Moore
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the April 8, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Scott G. Alvarez

Enclosure

<u>Questions for Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System from Representative Moore</u>:

1. On September 28, 2014, I was one of several Democrats that wrote Chairman Gruenberg to gain clarification regarding FDIC handling of bank examinations that do business with third-party processors and online non-bank lenders. I would appreciate further explanation of what your agencies are doing to coordinate with the Consumer Financial Protection Bureau to ensure a consistent regulatory regime of these products, given that the CFPB was given jurisdiction for these products under Dodd-Frank. I absolutely support the elimination of bad actors and unscrupulous practices that threaten the safety and soundness of banks, but I continue to believe that it is important for your agencies to work with the CFPB as not to preempt their jurisdiction over these products and to permit them to be lawfully offered consistent with CFPB regulations.

You have asked how the Federal Reserve coordinates with the Consumer Financial Protection Bureau (CFPB) to ensure consistent regulation of products offered by third-party processors and online non-bank lenders. We coordinate closely with the CFPB in a number of ways.

The Federal Reserve is responsible for ensuring that the financial institutions it supervises comply with applicable federal consumer financial laws. Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) transferred to the CFPB supervisory authority for insured depository institutions[1] with total assets in excess of $10 billion and their affiliates for compliance with eighteen enumerated consumer laws and their implementing regulations. Supervisory authority over these institutions for other federal consumer financial services statutes and regulations, including prohibitions on unfair and deceptive acts or practices under Section 5 of the Federal Trade Commission Act, was retained by the Federal Reserve. The Federal Reserve also retained supervisory authority for all federal consumer financial laws and regulations for financial institutions with total assets of $10 billion or less. Further, the Dodd-Frank Act generally transferred rulewriting authority under the enumerated consumer laws to the CFPB. The Board consults with the CFPB on its rulemaking activities under Section 1022(b) of the Dodd-Frank Act, which requires the CFPB to consult with the appropriate federal agencies before proposing rules and during the comment process. The Dodd-Frank Act also accorded the CFPB supervisory and rulewriting authority over non-banks, including payday lenders, under certain circumstances.

The Dodd-Frank Act requires that the Federal Reserve and the CFPB coordinate aspects of their consumer compliance supervision of insured depository institutions and their affiliates, including scheduling of examinations; providing reciprocal opportunities to comment upon reports of examination prior to issuance; and reciprocally providing final reports of examination after issuance. In May 2012, the Federal Reserve and the other prudential regulators entered into a Memorandum of Understanding on Supervisory Coordination (MOU) with the CFPB. The MOU establishes arrangements for coordination and information sharing among the parties, as required under the Dodd-Frank Act. In addition, the Federal Reserve works with the CFPB and

[1] Insured depository institutions supervised by the Federal Reserve are state member banks and insured state branches of foreign banking organizations.

other federal banking agencies through the FFIEC's Task Force on Consumer Compliance to develop interagency examination procedures.

As described above, the Dodd-Frank Act shifted certain federal consumer protection authorities and responsibilities to the CFPB, while others remained with the Federal Reserve. Further, the Federal Reserve's responsibility to ensure the safety and soundness of the U.S. banking system and of the banking organizations it supervises remained unchanged. For example, the Federal Reserve examines supervised institutions' anti-money laundering (AML) programs for compliance with the Bank Secrecy Act (BSA) and the USA PATRIOT Act. The Federal Reserve expects supervised institutions to implement appropriate BSA/AML policies and procedures, including regarding customer due diligence and transaction monitoring for suspicious activity. The FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) examination manual addresses relationships that pose higher BSA/AML risks due to the activities in which they engage, including those with businesses that use the banking organization to transfer funds. This guidance remains the policy of the Federal Reserve. It is not the Board's policy to discourage banking organizations from offering services to any class of financial service business operating within federal and state law. The Federal Reserve expects a banking organization that establishes relationships with customers engaging in higher-risk activities to identify the relevant risks and develop an effective monitoring regimen that addresses them.

Generally speaking, it is critical that all federal banking regulators work together as cooperatively and efficiently as possible. Clear lines of communication between the Federal Reserve and the CFPB have been essential to both entities in carrying out the work that ultimately impacts the other. As with other issues of mutual interest, Federal Reserve and CFPB staff have maintained an ongoing dialogue about issues relating to supervisory coordination, third-party payment processors and payday lending.

2. This question is regarding the recently proposed Liquidity Coverage Ratio (LCR), RIN 1557-AD74, treatment of municipal securities as non-High-Quality Liquid Assets (HQLA). I would appreciate clarification regarding the extent that your office considered various, unique differences in the municipal market when formulating the proposal. For example, did you consider the differences in so-called "dollar bonds," or those bonds of larger, frequent issuers, versus the bonds of less frequent issuers that trade based on yield.

The goal of the liquidity coverage ratio (LCR) is to ensure that covered companies are able to meet their short-term liquidity needs during times of stress. The inability to meet those liquidity needs proved to be a significant cause of the failure or near failure of several large financial firms during the recent financial crisis. To ensure adequate liquidity, the final rule includes as high-quality liquid assets (HQLA) only securities that historically have been readily convertible into cash with little or no loss of value during a period of stress, either by sale or through a repurchase transaction. The OCC, FDIC, and Board considered various types of assets for treatment as HQLA and evaluated relevant market data relating to the liquidity characteristics.

Under the LCR final rule issued on September 3, 2014, securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities) do not qualify as HQLA. However, the Board has reviewed market data regarding municipal securities and the information provided by commenters and is exploring the development of a new proposal for public comment to treat as HQLA for purposes of the LCR requirement municipal securities that trade readily and have liquidity characteristics that are comparable to other HQLA assets.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 27, 2014

The Honorable Amy Klobuchar
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 7, 2014, hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Klobuchar:</u>

1. At its March 2014 meeting, the Federal Open Market Committee presented the economic projections of the Federal Reserve Board members and Federal Reserve Bank presidents. Minutes of the meeting indicate that most members believe the basic measure of inflation will be 1.5 to 1.6 percent this year, 1.5 to 2.0 percent in 2015, and 1.7 to 2.0 percent at the end of 2016. In addition, most members believe that the longer run (3 years and beyond) rate of inflation will be 2.0 percent- just one-half a percentage point above where it is today.

I noted in my opening statement that inflation is relatively low and is expected to remain low for the foreseeable future. Senator Wicker stated that you and I differ on our views of inflation, but I was simply citing what you and the Federal Open Market Committee have said publicly: that inflation projections are consistent with low and stable inflation now and for the foreseeable future.

Is there any indication that Federal Reserve Board members and Federal Reserve Bank presidents have changed their views on inflation since the March meeting?

As you noted, the March Summary of Economic Projections showed that most FOMC participants expect both headline and core inflation to rise gradually over the next few years to 2 percent, supported by the stability in longer-run inflation expectations, as well as steadily diminishing resource slack. The more recent Summary of Economic Projections from June showed a similar projected path for inflation. Consistent with this outlook, the FOMC indicated in its March, April, and June post-meeting statements that inflation has been running below the FOMC's longer-run objective, but that longer-term inflation expectations remain stable.

Congress of the United States

JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)

Washington, DC 20510-6602

CLO: #Y - 48
CCS: 14-3779
RECVD: 5/22/14

The Economic Outlook
May 7, 2014

Question for the Record
The Honorable Janet L. Yellen
Chair of the Board of Governors of the Federal Reserve System

Vice Chair Klobuchar:

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 27, 2014

The Honorable Kevin Brady
United States Senate
Washington, D.C. 20510

Dear Chairman:

Enclosed are my responses to the written questions you submitted following the May 7, 2014, hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Chairman Brady:</u>

1. As you know, declining labor force participation has contributed significantly to recent declines in the unemployment rate. While the unemployment rate has declined from its October 2009 peak of 10.0% to 6.3%, over the same period the employment-to-population ratio has only increased by 0.4 percentage point. At this point in time, which measure, changes in the unemployment rate or the employment-to-population ratio is a better guide to the overall health of the labor market?

No single indicator can perfectly summarize the state of the labor market, and we look at a broad range of labor market measures when assessing the labor market's overall health and the degree of recent improvement. The unemployment rate is probably the best single indicator of current labor market conditions and a decent predictor of future labor market developments. Nevertheless, the unemployment rate may at times understate or overstate the health of the labor market. Indeed, if some portion of its decline in recent years is attributable to a decline in labor force participation that is related to labor market weakness (e.g. as discouraged job seekers drop out of the labor force), then declines in the unemployment rate may overstate the degree of overall labor market improvement.

Currently, however, at least some of the reasons for the exceptionally low levels of labor force participation and employment are because of structural factors that would be relevant even absent the recession and subsequent experience. Indeed, many researchers have argued that a primary contributor to the decline in labor force participation since 2007 is the movement of the large baby-boom cohort into their retirement years.[1] This puts downward pressure on the aggregate participation rate and the employment-to-population ratio because, even in the best of times, adults near or at retirement age have lower participation and employment rates than younger adults. The unemployment rate avoids these structural issues by only including people who currently want a job, and is therefore a better measure of the health of the labor market.

2. Since the recession ended in June 2009, the inflation-adjusted S&P 500 Total Return Index has more than doubled while real disposable income per capita has only increased by 4.2%. Do high stock prices reflect the fundamental strength of our economy? To what extent are they due to a highly accommodative monetary policy?

The substantial gains logged by equity prices since the middle of 2009 appear to have been driven by a sharp recovery in corporate profits and improved sentiment among market participants. Both of these factors have likely been supported by the accommodative stance of monetary policy.

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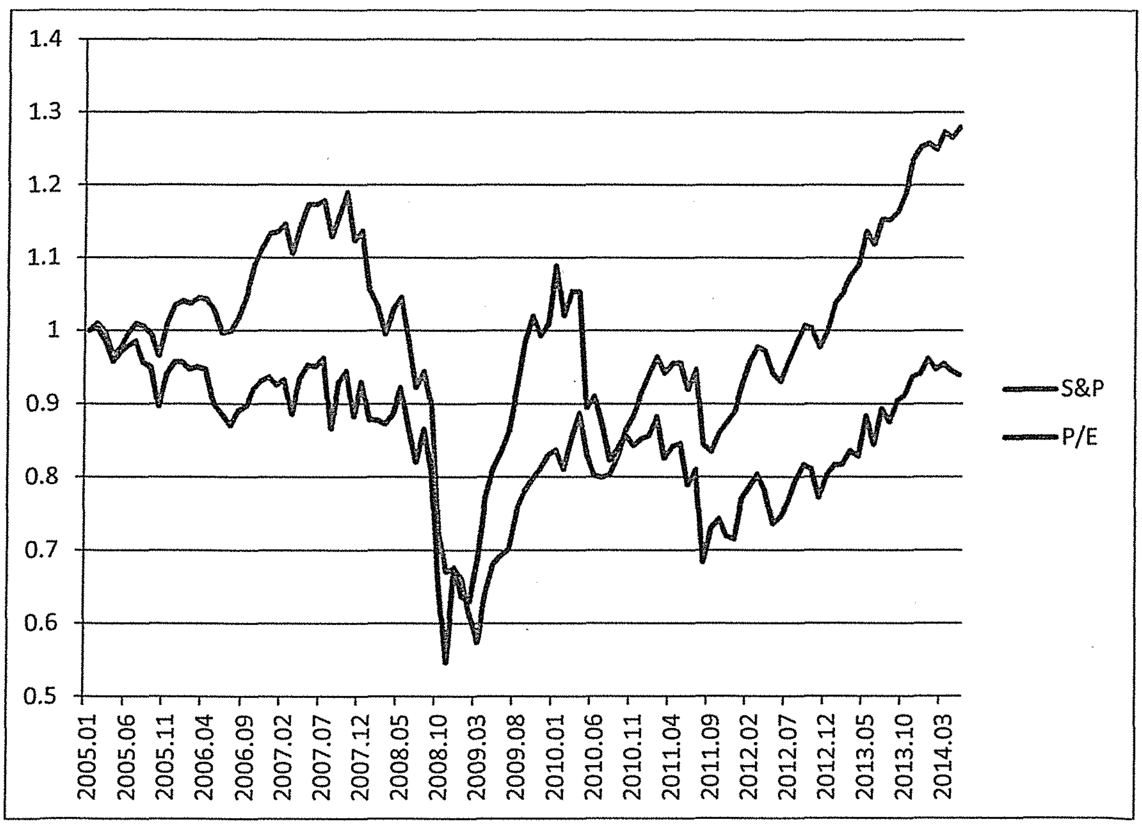
[1] See for example, Fujita, Shigeru. "On the Causes of Declines in the Labor Force Participation Rate." Federal Reserve Bank of Philadelphia *Research Rap Special Report*, November 2013; revised February 6, 2014; http://philadelphiafed.org/research-and-data/publications/research-rap/2013/on-the-causes-of-declines-in-the-labor-force-participation-rate.pdf.
Aaronson, Daniel; Davis, Jonathan and Hu, Luojia. "Explaining the Decline in the U.S. Labor Force Participation Rate." Federal Reserve Bank of Chicago *Chicago Fed Letter*, No. 296, March 2012; http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2012/cflmarch2012_296.pdf.

The inflation-adjusted level of the S&P 500 index has more than doubled since the end of the recession. However, real earnings for firms in the S&P 500 index now stand at a record high level of over 100 dollars per share, having recovered from a low of 10 in early 2009, largely due to higher productivity levels and improved profit margins. Therefore, on an earnings-adjusted basis, the increase in equity prices has been more moderate. For example, the price-to-earnings ratio for the S&P 500 index has moved up about 40 percent since the early 2009.

Second, the reduced uncertainty and enhanced sentiment on the part of equity investors seem to have contributed to the rise in stock prices. For instance, the option-implied volatility on the S&P 500 index, as measured by the VIX index, has dropped significantly since the end of the recession and now stands near historically low levels.

Accommodative monetary policy has likely helped to bolster stock prices by stabilizing the macroeconomic outlook and reducing investor uncertainty. It has also created a low interest rate environment, driving up stock prices as investors tilt their portfolios toward higher-yielding asset such as equities.



Source: all series are scaled to 1 at the beginning of 2005. The real S&P 500 level from the online database of Robert Shiller. http://www.econ.yale.edu/~shiller/data.htm; 12-month backward P/E ratio from S&P, Thomson Financial.

3. The Fed noted in its recent policy statement that "Fiscal policy is restraining economic growth, although the extent of restraint is diminishing." There is a real tendency for casual observers and many in the media to think of this statement only in the context of spending restraint. However, higher taxes, especially those on capital, also impose a fiscal drag on growth. Last June, the Federal Reserve Bank of San Francisco noted in its *Economic Letter* that the primary source of fiscal drag going forward was because of higher taxes, not because of spending restraint or sequestration. Do you agree or disagree with that assessment? And if not, why not?

The Congressional Budget Office (CBO) has estimated that real gross domestic product (GDP) growth last year was roughly 1-1/2 percentage points less than it would have been otherwise because of changes in fiscal policy that increased taxes and reduced federal government purchases. The CBO expects that the fiscal policy changes already in place for this year, which again includes both tax increases and spending reductions, will restrain GDP growth by about 1/4 percentage point. These estimates of the effects of fiscal policy restraint on economic growth are consistent with the Federal Open Market Committee's (FOMC) recent statement. Moreover, the CBO's analysis notes that fiscal restraint in recent years has come from both higher taxes and reductions in federal spending.

The analysis in the *Economic Letter* (June 3, 2013) published by the Federal Reserve Bank of San Francisco uses a different methodology than the CBO for calculating fiscal drag, and that study is focused on projecting the fiscal drag implicit in the CBO's forecast for the federal budget over the next several years compared to the historical norm for fiscal policy during an economic recovery. Even with these methodological differences, one of their main conclusions is that fiscal policy has become more restrictive for economic growth in recent years, which is consistent with the CBO's analysis.

4a. Your predecessor Ben Bernanke often cited "fiscal drag" as both an economic problem and as part of the justification for Quantitative Easing. He said in July of 2013, "The risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery." In response to a question regarding the sequester enacted as part of the *Budget Control Act of 2011*, he added "we're focusing too much on the short run and not enough on the long run." What if Congress created an across-the-board cap on non-interest spending tied to potential GDP, so federal spending could grow but grow at a slower pace than the economy?

I believe that it is appropriate for decisions about the details of fiscal policy to be made by the Congress and the Administration.

4b. Do you believe that this type of approach would be preferable to the current sequester in that it would put a focus on tying the aggregate growth of all programs to GDP instead of constraining a limited few?

Although I will not comment on specific fiscal policy proposals, I believe that it is appropriate to not impose additional near-term fiscal restraint while our economy is not yet back to full employment. Nevertheless, fiscal policymakers should put in place a credible plan to set fiscal policy on a sustainable path in the longer run while not restraining the economic recovery in the short run. If current federal budget policies do not change, the CBO projects that the further aging of the population, rising health care costs, and growing interest payments on federal debt will all contribute importantly to rising budget deficits after next year. To promote economic growth and stability in the longer term, it will be essential for fiscal policymakers to put the federal budget on a sustainable long-run path.

4c. Is it appropriate for the Federal Reserve to use monetary policy to counteract legislatively enacted policies?

Our monetary policy decisions are undertaken independent from the fiscal policy decisions implemented by the Congress and the Administration. The Federal Reserve's monetary policy decisions are made in the context of judging what is the most appropriate in order to help achieve our mandated goals of maximum sustainable employment and stable prices. Nevertheless, monetary policy cannot carry the entire burden of promoting a more robust economic recovery and speedier return to full employment.

5. Is the Fed willing to make its balance sheet more transparent? Specifically, will the Fed provide a consolidated list of holdings that includes not only maturity values, but also average purchase prices for each issue and the current market value of each holding?

The Federal Reserve provides a substantial amount of information about our securities holdings. In particular, the Federal Reserve Bank of New York publishes the results of each purchase on the day of the operation (including the security purchased and the par amount accepted at the auction) as well as individual transaction data (including Committee on Uniform Securities Identification Procedures (CUSIP), price, and counterparty) with a two-year lag, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Federal Reserve also publishes CUSIP-level data on system open market account holdings at par value (Treasuries) or current face value (for mortgaged backed securities) on a weekly basis. This and the above information are available to the public on the following website: http://www.newyorkfed.org/markets/OMO_transaction_data.html. Lastly, the Federal Reserve also publishes quarterly financial reports that show (among other information) the fair market value of its securities holdings as well as their amortized cost--and the difference between the two. That information, and additional information about the Federal Reserve's finances, is available to the public on the Federal Reserve Board's website from links on the following page: http://www.federalreserve.gov/monetarypolicy/bst_fedfinancials.html.

6a. In your April 16, 2014 remarks to the Economics Club of New York, you said, "The FOMC strives to avoid inflation slipping too far below its 2 percent objective because, at very low inflation rates, adverse economic developments could more easily push the economy into deflation. The limited historical experience with deflation shows that, once it starts, deflation can become entrenched and associated with prolonged periods of very weak economic performance."

Was it not a similar deflationary concern, which proved unfounded, that led the Fed at the close of the Great Moderation, to keep interest rates too low for too long, fueling the housing bubble and leading to the 2008 financial crisis and recession?

The data in hand at the time of the May 2003 FOMC meeting indicated that 12-month consumer price inflation excluding food and energy had declined to 1-1/2 percent, and the three-month change in these prices to an annual rate of 1 percent. In these circumstances, the FOMC expressed in its post-meeting statement the view that "the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level." The FOMC reiterated its concerns about inflation becoming undesirably low in its statements through October 2003. During this period, the FOMC reduced its target federal funds rate from 1-1/4 percent to 1 percent. In the event, consumer price inflation excluding the volatile food and energy components picked up to 2 percent by early 2004, and the FOMC began raising the federal funds rate target beginning in June of that year. Although the contribution of the low level of the federal funds rate target in 2003 and early 2004 to the leveling off of inflation in 2003 and its subsequent return to 2 percent is difficult to quantify with precision, statistical models suggest that deflationary concerns appear in hindsight as "unfounded" because monetary policy acted in a timely manner to forestall deflation.

The contribution of the low level of the federal funds rate to the house price boom, by contrast, was most likely only modest. Most observers date the beginning of rapid house price increases to 1998, well before the period of low short-term interest rates from late 2001 to 2004.[2] During the latter period, monetary policy was focused on preventing a sharper increase in the unemployment rate and a further decline in inflation. While low interest rates raise house prices, all else equal, the increase in prices during the mid-2000s was much larger than the historical relationship between interest rates and house prices suggest. More likely is an important role of a substantial loosening in terms and standards for mortgage credit.[3] Finally, rapid house price increases in the early 2000s were not confined to the United States, but were experienced in a number of advanced economies. There seems to be little relation between the stance of monetary policy in these countries and their respective rates of inflation-adjusted house price increases; by

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[2] Robert J. Shiller (2007), "Understanding Recent Trends in House Prices and Homeownership," in *Proceedings of the symposium "Housing, Housing Finance, and Monetary Policy."* Kansas City: Federal Reserve Bank of Kansas City, pp. 89-123.

[3] Jane Dokko, Brian M. Doyle, Michael T. Kiley, Jinill Kim, Shane Sherlund, Jae Sim, and Skander J. Van den Heuvel (2011), "Monetary Policy and the Global Housing Bubble," *Economic Policy*, vol. 26, no. 66, pp. 233-283.

contrast, countries that experienced larger capital inflows, the U.S. among them, tended to see stronger house price appreciation.[4]

6b. How is some deflation risk worse than risking inflation through asset prices, another bubble and a financial crisis?

Both deflation and financial crises pose serious risks to economic performance. In pursuing its dual mandate, the FOMC takes into consideration financial market developments that could pose a threat to financial stability. The risk of deflation is particularly pernicious in a situation like the current one, in which the federal funds rate and other short-term interest rates are already constrained by the effective lower bound on these rates while there remains slack in labor markets. In this situation, the ability of monetary policy to respond to any adverse shock to economic activity is severely limited. If, in such a scenario, inflation were to decline or even turn into deflation, this would push up real interest rates, thereby further weakening aggregate demand.

While the housing bubble demonstrated how dangerous credit-financed asset price bubbles can be, it seems more promising to address such bubbles, if they were to become evident, through regulatory and supervisory tools rather than by raising short-term interest rates. Apart from the question, discussed before, how effective short-term interest rate increases are in reining in asset price growth, it is an open question whether in current circumstances an increase in short-term interest rates would reduce risks to financial stability. With the economic recovery still incomplete, a premature increase in short-term interest rates could risk weakening the economy to the point that households', firms', and thereby banks' balance sheets would deteriorate, which might lead to an increase in financial fragility rather than a reduction.

6c. As you note, there is limited historical experience with deflation—and while we agree that deflation should be avoided—because of the limited data, is it possible that our fears could be somewhat overblown?

In the latest Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, the median forecast for consumer price inflation in 2014 is 1.6 percent. Moreover, forecasters assign only negligible probability to the event that consumer price inflation in 2014 will be negative, and only about 10 percent probability that it will be less than 1 percent. However, our ability to forecast inflation or, for that matter, deflation is limited. For example, the typical historical forecast errors reported in the FOMC's Summary of Economic Projections for consumer price inflation one year ahead is on the order of 1 percentage point. In addition, recent research has highlighted the fact that economic models tend to underestimate the likelihood of severe economic events, such as the financial crisis and the Great Recession.[5] Moreover, as mentioned before, with short-term interest rates already close to their effective

[4] Ben S. Bernanke (2010), "Monetary Policy and the Housing Bubble," speech delivered at the Annual Meeting of the American Economic Association, Atlanta, GA, January 3.

[5] See for example, Hess Chung, Jean-Philippe Laforte, David Reifschneider, and John C. Williams (2012), "Have we Underestimated the Likelihood and Severity of Zero Lower Bound Events?" *Journal of Money, Credit, and Banking,* vol. 44, pp. 47-82.

lower bound, the risks to economic performance from unexpectedly low versus unexpectedly high inflation are asymmetric. Whereas monetary policy would be able to respond to indications that inflation will exceed 2 percent by raising short-term interest rates, it would at present not be able to respond to unexpectedly low inflation or outright deflation by reducing interest rates further.

7a. One effect of Quantitative Easing has been that the Fed has purchased massive amounts of longer-term Treasuries. Treasury pays the interest on these securities to the Fed, which uses the funds to pay its operating costs—a relatively small amount—and then returns the majority of the proceeds right back to the Treasury.

Is the effect of this to monetize indirectly the debt, and then provide the government with an interest-free loan?

The FOMC's decisions are made in the context of judging the stance of monetary policy most appropriate to achieving its goals of maximum employment and stable prices, and assessments about monetary policy are made independent from fiscal policy decisions. The large-scale asset purchases that the FOMC has conducted do not constitute a monetization of U.S. federal government debt.

One important distinction is that decisions by the FOMC to increase the size of its balance sheet have been in response to temporarily weak economic conditions, and the current large balance sheet is not anticipated to be permanent. Once the current degree of monetary policy accommodation is no longer necessary, the FOMC will reduce the size of its balance sheet. Another important distinction is that the Federal Reserve is required to make its security purchases in the open market. This restriction has served the public well by ensuring that the Federal Reserve's purchases of Treasury securities are not a special source of funding at below-market prices.

7b. While we are running large federal deficits, the fact that—for now—the Fed basically returns the interest on these loans, makes our deficit situation look a little less bad. Are you concerned that Quantitative Easing may serve as an enabler of bad fiscal policy?

The Federal Reserve's large-scale asset purchase program has temporarily increased the size of our remittances to the Treasury, and, more importantly, monetary policy has helped to support faster economic growth and more employment than there would be otherwise, which also contributes to narrower federal budget deficits. However, even after the economy is back to full employment and the Federal Reserve's remittances have returned to normal, the CBO still projects that federal fiscal policy is not on a sustainable path over the longer run because of population aging, rising health care costs, and growing interest payments on federal debt, and the temporary surge in remittances does not meaningfully change that projection. We believe that it is essential for fiscal policymakers to put the federal budget on a sustainable long-run path in order to promote economic growth in the longer term.

8a. Economist Robert Higgs determined that regime uncertainty—uncertainty with respect to the nation's fiscal, monetary and regulatory policies—was one of the reasons the United States was one of the last countries to emerge out of the Great Depression.

Has the Federal Reserve's current departure from a rule-based monetary policy heightened uncertainty in the economy?

Uncertainty in the economy is reduced when the FOMC conducts policy in a manner that is guided by unchanging objectives and when the FOMC is transparent so that its objectives and strategies for achieving those objectives are well understood. As stipulated by Congress, the FOMC's policy objectives are stable prices and maximum employment; those objectives are well known and have not changed since the Congress first provided them in 1977. In addition, the Federal Reserve is arguably the most transparent central bank in the world, so its strategies for achieving its objectives are well understood. In particular, each year the FOMC reaffirms and publishes on the Federal Reserve website a "Statement on Longer-Run Goals and Monetary Policy Strategy," which specifies how the FOMC interprets the goals set by Congress and the strategies it will follow to achieve its goals including when the goals are in conflict. Twice a year, the Federal Reserve provides Congress a comprehensive report on monetary policy and the state of the economy, and the Chair testifies before Congress on that report. After every other meeting (once a quarter), the FOMC publishes participants' projections for the economy and the federal fund rate – the FOMC's primary policy tool – and the Chair answers questions on those forecasts and the FOMC's monetary policy decisions at a press conference. Finally, after each meeting the FOMC issues a statement describing its monetary policy decision and the reasons for that decision followed three weeks later by comprehensive minutes of the meeting.

Of course, each situation is different in unpredictable ways, so when the FOMC responds to an unexpected economic development, its actions will necessarily also be unexpected to some extent. Nevertheless, because the FOMC's objectives and strategies for achieving those objectives are well understood, the extent to which monetary policy contributes to economic uncertainty is kept to a minimum.

8b. The Federal Reserve's current mandate requires it to take monetary actions that seek price stability and maximum employment—the so-called dual mandate. Can monetary policy have a direct, positive, and lasting effect on the number of jobs, or is any effect of monetary policy simply a short, temporary spurt?

When employment is below its maximum sustainable level, appropriate monetary policy can help achieve a faster return to full employment. But the economy's maximum sustainable level of employment in the longer run is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market.

8c. Rules-based monetary policy, as we saw during the Great Moderation (1983-2000), was associated with positive economic growth and job creation. Why is this?

One striking feature of the U.S. economy during the period from 1983 to 2000 or so was a substantial decline in macroeconomic volatility. Three types of explanations have been suggested for this significant change in the U.S. macroeconomic environment: changes in the structure of the economy; improved macroeconomic policies, and good luck (meaning that the shocks or unexpected events hitting the economy in that particular period were smaller and less frequent than before or after).

The second explanation includes monetary policy. In basic form, monetary policy rules relate the Federal Reserve's policy instrument (the overnight federal funds interest rate, during those years) to the deviations of inflation and output from the central bank's desired levels for those variables. There is a general agreement among economists and policymakers that monetary policy performed poorly during much of the 1970s, a period of high volatility in both output and inflation. Researchers who estimate monetary policy rules tend to find a weaker response of the policy rate to inflation and (in some studies) a relatively stronger response to the output gap during the 1960s and 1970s than in more recent periods. Their results suggest that an insufficiently strong policy response to rising inflation during the 1960s and 1970s let inflation and inflation expectations get out of control and added to the economy's volatility. What we now understand, in retrospect, was that overly large estimates of the output gap contributed to the relatively weak policy response to rising inflation.

In more recent decades, monetary policy took a more balanced approach to inflation and employment. The observation that output volatility declined in parallel with inflation volatility, both in the United States and abroad, suggests that better monetary policy may have contributed to the decline in macroeconomic volatility.

While the rules' prescriptions sometimes differ appreciably over time, they do a reasonable job of capturing the broad characteristics of the FOMC's historical behavior covering the Great Moderation. Nevertheless, it is important to bear in mind that the available theory and evidence on simple monetary policy rules bears largely on the implications of following such rules when the policy rate is far from the effective lower bound. Unfortunately, several important considerations suggest that simple rules that are reliable in normal times will be less reliable under conditions such as those we face now. In particular, in the present context with the economy still recovering from the financial crisis and the federal funds rate still at its effective lower bound, it is likely that mechanical policy rules based on conditions during normal times would provide inadequate support for the recovery. As a consequence, use of such rules in today's economy could threaten both price stability and maximum employment.

8d. How would you expect today's economy to respond if the Fed were to adopt a rule-like monetary policy--that is, predictable and stable--such as the Taylor Rule?

Policy rules such as the well-known Taylor rule provide a mechanical rule linking the setting of the federal funds rate to a small number of economic variables, such as the inflation rate and an estimate of resource slack in the economy.

In normal times, a variety of rules of this type have been shown to be fairly reliable guides to the setting of the federal funds rate target. However, while policy rules can provide useful guides or indicators, in the present context with the economy still recovering from the financial crisis and the federal funds rate still at its effective lower bound, it is likely that mechanical policy rules based on conditions during normal times would provide inadequate support for the recovery. As a consequence, use of such rules in today's economy could threaten both price stability and maximum employment.

That said, the FOMC is committed to being as transparent as possible in informing the public about how it makes its policy decisions and about its longer-run goals. Toward this purpose, the FOMC has provided considerable guidance about its planned use of its policy tools in FOMC statements, including information on the economic determinants of its decisions. It has also provided guidance about its longer-run objectives in its "Statement on Longer-Run Goals and Monetary Policy Strategy," which is reaffirmed annually.

8e. In January 2012, the Fed acknowledged, "The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable." If this is the case, why should the Federal Reserve focus its monetary policy on attempting to achieve things it cannot control—such full employment?

The Federal Reserve's statutory mandate includes promoting "maximum employment" as well as "price stability." As we have noted, "The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable." However, it does not follow from this observation that in pursuing maximum employment the Federal Reserve is "attempting to achieve things it cannot control." It means that it will be difficult to be certain when the objective of maximum employment has been satisfied. In other words, while the level of employment that might be deemed consistent with maximum employment might evolve over time, it is still incumbent on the Federal Reserve to attempt to generate economic conditions under which actual employment will reach maximum employment over time. Economists, including the staff of the Federal Reserve, use a variety of models and a wide range of labor market indicators to assess when conditions in the labor market might be consistent with maximum employment. These indicators include not only the unemployment rate but the proportion of long-term unemployed, the labor force participation rate, and the share of part-time employees who would prefer to work full time, among other measures. Taken together, these variables signal the extent labor utilization.

Trying to achieve maximum employment, properly defined, together with price stability, is important for at least two reasons: first, underutilization of labor is a social waste that imposes costs on the unemployed themselves as well as their families and communities, particularly when spells of un- or underemployment are lengthy; second, establishing and maintaining maximum employment is generally regarded as a necessary condition for sustained periods of price stability. Indeed, the level of maximum employment is frequently, if imperfectly, inferred from the presence or absence of stable price inflation.

9a. At several points in your May 7, 2014 testimony before the Joint Economic Committee, you express possible alarm over "flattening out in housing activity" and what this could portend for economic growth. Also on May 7, 2014 in the Wall Street Journal, Allan

Meltzer observes "the Fed should have noticed in recent years that instead of a strong housing-market recovery, not many individuals were taking out first mortgages. Many of the sales were to real-estate speculators who financed their purchases without mortgages and are now renting the houses, planning to resell them later."

Is there a connection between your concern over housing activity and the points raised by Dr. Meltzer?

As I stated in my testimony, we at the Federal Reserve are carefully watching developments in the housing market, where the recovery in housing activity that began in 2012 seems to have stalled recently. Starts and permits of single-family homes have flattened out over the past year, while existing home sales have declined more than 10 percent from their peak last summer. The most obvious potential causal factor was the sharp increase in long-term interest rates last spring, but the effects on the housing market have been larger and more prolonged than might have been expected, especially since rates have declined since then, on net.

Even from a broader perspective, the recovery in residential investment has been much more gradual than in past housing recoveries, with total housing starts remaining well below their pre-recession trend. Although low long-term interest rates have improved housing affordability and supported the labor market, there have also been significant headwinds: household formation has been very slow, mortgage credit remains tight, especially for households with lower credit scores, and student debt may be weighing down housing demand among young adults. In addition, the relatively rapid recovery of house prices, even as construction has remained low, suggests that it is taking some time to draw resources back into the construction sector.

One way that the housing market has adjusted to the new environment of supply and demand is through a relative increase in construction of multifamily units, which are usually rented. Another form of adjustment, noted by Dr. Meltzer, has been the increase in purchases of single-family homes by investors, both large and small, who then rent out the homes. Federal Reserve economists have been studying the role of investors in the single-family rental market for some time.[6] They find that the share of home sales made to business investors rose to roughly 6 percent in 2012, although there is considerable heterogeneity in this share across cities. Investor activity was particularly concentrated in cities like Atlanta, Phoenix, and Las Vegas, where large numbers of properties were available at relatively low prices. A number of analysts have speculated that the slowdown in housing activity since the summer of 2013 might be related to a cooling of investor demand.[7] This possibility is certainly a topic that we will be monitoring going forward.

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[6] See for example, the FEDS Notes post "Business Investor Activity in the Single-Family Market" from December, 2013 by Raven Molloy and Rebecca Zarutskie: http://www.federalreserve.gov/econresdata/notes/feds-notes/2013/business-investor-activity-in-the-single-family-housing-market-20131205.html.

[7] See for example, some recent analysis by the Federal Reserve Bank of San Francisco: http://www.frbsf.org/economic-research/publications/economic-letter/2014/may/existing-home-sales-slowdown/?utm_source=mailchimp&utm_medium=email&utm_campaign=economic-letter-2014-05-19.

Congress of the United States

JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)

Washington, DC 20510-6602

CLO: #Y - 44
CCS: 14-3610
RECVD: 5/16/14

Additional questions submitted by Chairman Brady for the record of the May 7, 2014 hearing with Federal Reserve Board of Governors Chair, Janet Yellen.

1. As you know, declining labor force participation has contributed significantly to recent declines in the unemployment rate. While the unemployment rate has declined from its October 2009 peak of 10.0% to 6.3%, over the same period the employment-to-population ratio has only increased by 0.4 percentage point. At this point in time, which measure, changes in the unemployment rate or the employment–to-population ratio is a better guide to the overall health of the labor market?

2. Since the recession ended in June 2009, the inflation-adjusted S&P 500 Total Return Index has more than doubled while real disposable income per capita has only increased by 4.2%. Do high stock prices reflect the fundamental strength of our economy? To what extent are they due to a highly accommodative monetary policy?

3. The Fed noted in its recent policy statement that "Fiscal policy is restraining economic growth, although the extent of restraint is diminishing." There is a real tendency for casual observers and many in the media to think of this statement only in the context of spending restraint. However, higher taxes, especially those on capital, also impose a fiscal drag on growth. Last June, the Federal Reserve Bank of San Francisco noted in its *Economic Letter* that the primary source of fiscal drag going forward was because of higher taxes, not because of spending restraint or sequestration. Do you agree or disagree with that assessment? And if not, why not?

4. Your predecessor Ben Bernanke often cited "fiscal drag" as both an economic problem and as part of the justification for Quantitative Easing. He said in July of 2013, "The risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery." In response to a question regarding the sequester enacted as part of the *Budget Control Act of 2011*, he added "we're focusing too much on the short run and not enough on the long run."

    a. What if Congress created an across-the-board cap on non-interest spending tied to potential GDP, so federal spending could grow but grow at a slower pace than the economy?

b. Do you believe that this type of approach would be preferable to the current sequester in that it would put a focus on tying the aggregate growth of all programs to GDP instead of constraining a limited few?

c. Is it appropriate for the Federal Reserve to use monetary policy to counteract legislatively enacted policies?

5. Is the Fed willing to make its balance sheet more transparent? Specifically, will the Fed provide a consolidated list of holdings that includes not only maturity values, but also average purchase prices for each issue and the current market value of each holding?

6. In your April 16, 2014 remarks to the Economics Club of New York, you said, "The FOMC strives to avoid inflation slipping too far below its 2 percent objective because, at very low inflation rates, adverse economic developments could more easily push the economy into deflation. The limited historical experience with deflation shows that, once it starts, deflation can become entrenched and associated with prolonged periods of very weak economic performance."

   a. Was it not a similar deflationary concern, which proved unfounded, that led the Fed at the close of the Great Moderation, to keep interest rates too low for too long, fueling the housing bubble and leading to the 2008 financial crisis and recession?

   b. How is some deflation risk worse than risking inflation through asset prices, another bubble and a financial crisis?

   c. As you note, there is limited historical experience with deflation—and while we agree that deflation should be avoided—because of the limited data, is it possible that our fears could be somewhat overblown?

7. One effect of Quantitative Easing has been that the Fed has purchased massive amounts of longer-term Treasuries. Treasury pays the interest on these securities to the Fed, which uses the funds to pay its operating costs—a relatively small amount—and then returns the majority of the proceeds right back to the Treasury.

   a. Is the effect of this to monetize indirectly the debt, and then provide the government with an interest-free loan?

   b. While we are running large federal deficits, the fact that—for now—the Fed basically returns the interest on these loans, makes our deficit situation look a little less bad. Are you concerned that Quantitative Easing may serve as an enabler of bad fiscal policy?

8. Economist Robert Higgs determined that regime uncertainty—uncertainty with respect to the nation's fiscal, monetary and regulatory policies—was one of the reasons the United States was one of the last countries to emerge out of the Great Depression.
    a. Has the Federal Reserve's current departure from a rule-based monetary policy heightened uncertainty in the economy?

    b. The Federal Reserve's current mandate requires it to take monetary actions that seek price stability and maximum employment—the so-called dual mandate. Can monetary policy have a direct, positive, and lasting effect on the number of jobs, or is any effect of monetary policy simply a short, temporary spurt?

    c. Rules-based monetary policy, as we saw during the Great Moderation (1983-2000), was associated with positive economic growth and job creation. Why is this?

    d. How would you expect today's economy to respond if the Fed were to adopt a rule-like monetary policy--that is, predictable and stable--such as the Taylor Rule?

    e. In January 2012, the Fed acknowledged, "The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable." If this is the case, why should the Federal Reserve focus its monetary policy on attempting to achieve things it cannot control—such full employment?

9. At several points in your May 7, 2014 testimony before the Joint Economic Committee, you express possible alarm over "flattening out in housing activity" and what this could portend for economic growth. Also on May 7, 2014 in the Wall Street Journal, Allan Meltzer observes "the Fed should have noticed in recent years that instead of a strong housing-market recovery, not many individuals were taking out first mortgages. Many of the sales were to real-estate speculators who financed their purchases without mortgages and are now renting the houses, planning to resell them later."

    a. Is there a connection between your concern over housing activity and the points raised by Dr. Meltzer?

Additional questions submitted by Chairman Brady for the record of the May 7, 2014 hearing with Federal Reserve Board of Governors Chair, Janet Yellen.

1. As you know, declining labor force participation has contributed significantly to recent declines in the unemployment rate. While the unemployment rate has declined from its October 2009 peak of 10.0% to 6.3%, over the same period the employment-to-population ratio has only increased by 0.4 percentage point. At this point in time, which measure, changes in the unemployment rate or the employment–to-population ratio is a better guide to the overall health of the labor market?

2. Since the recession ended in June 2009, the inflation-adjusted S&P 500 Total Return Index has more than doubled while real disposable income per capita has only increased by 4.2%. Do high stock prices reflect the fundamental strength of our economy? To what extent are they due to a highly accommodative monetary policy?

3. The Fed noted in its recent policy statement that "Fiscal policy is restraining economic growth, although the extent of restraint is diminishing." There is a real tendency for casual observers and many in the media to think of this statement only in the context of spending restraint. However, higher taxes, especially those on capital, also impose a fiscal drag on growth. Last June, the Federal Reserve Bank of San Francisco noted in its *Economic Letter* that the primary source of fiscal drag going forward was because of higher taxes, not because of spending restraint or sequestration. Do you agree or disagree with that assessment? And if not, why not?

4. Your predecessor Ben Bernanke often cited "fiscal drag" as both an economic problem and as part of the justification for Quantitative Easing. He said in July of 2013, "The risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery." In response to a question regarding the sequester enacted as part of the *Budget Control Act of 2011*, he added "we're focusing too much on the short run and not enough on the long run."

    a. What if Congress created an across-the-board cap on non-interest spending tied to potential GDP, so federal spending could grow but grow at a slower pace than the economy?

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    d. How would you expect today's economy to respond if the Fed were to adopt a rule-like monetary policy--that is, predictable and stable--such as the Taylor Rule?

    e. In January 2012, the Fed acknowledged, "The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable." If this is the case, why should the Federal Reserve focus its monetary policy on attempting to achieve things it cannot control—such full employment?

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    a. Is there a connection between your concern over housing activity and the points raised by Dr. Meltzer?

Elsa Garcia

From: Nancy Riley
Sent: Friday, May 16, 2014 3:56 PM
To: Elsa Garcia
Cc: Linda Robertson; Jennifer Gallagher; Madelyn Marchessault; Eric Morrissette
Subject: FW: Chairman Brady's Questions for Chair Yellen-Joint Economic Committee Hearing, May 7, 2014
Attachments: Questions for the Record (Hearing on the Economic Outlook - May 7 2014).pdf; Questions for the Record (Hearing on the Economic Outlook - May 7 2014).doc

Elsa – please see the attached QFRs for the JEC hearing. I will drop off the assignment for these QFRs at your desk. Thanks, Nancy

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From: Healy, Colleen (JEC) [mailto:Colleen_Healy@jec.senate.gov]
Sent: Friday, May 16, 2014 3:44 PM
To: Nancy Riley
Cc: jeff_schlagenhauf@jec.senate.gov (External)
Subject: Chairman Brady's Questions for Chair Yellen-Joint Economic Committee Hearing, May 7, 2014

Hello Nancy,
I am forwarding Chairman Brady's questions for Chair Yellen. (I have included Jeff Schlagenhauf, Chairman Brady's Senior Advisor, on this email.)
Should you have any questions, please let me know.
I hope you have a nice weekend.
Colleen
(202) 224-0370

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 30, 2014

The Honorable Sean Duffy
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the May 7, 2014, hearing before the Joint Economic Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Duffy:

1. Former Federal Reserve Board Chairman Bernanke publicly acknowledged that insurance companies have unique business models that make them different from banks, as have you, and that a bank-centric regulatory model would not work for insurance companies. At the same time, however, the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) in Europe have begun the process of preparing international capital standards very similar to the capital bank requirements coming out of Basel, Switzerland. The implication is that they would be applicable to U.S. insurance companies, including those that have not been designated systemically important financial institutions under Dodd-Frank or globally systemically important institutions. Given the Fed's role as a member of the FSB, what concerns have you voiced on this move toward bank-like capital standards for U.S. insurance groups? Is it the position of the Federal Reserve that a quantitative capital standard is needed for U.S.-based insurers who also happen to do business overseas?

The international capital standards under development by the International Association of the Insurance Supervisors (IAIS) are not bank-centric. Moreover, they are not contemplated to replace existing insurance risk-based capital standards at U.S. domiciled insurance legal entities within the broader firm.

A goal of the standards being developed by the IAIS is to achieve greater comparability of the capital requirements of internationally active insurance groups (IAIGs) across jurisdictions at the group-wide level. This should promote financial stability, provide a more level playing field for firms and enhance supervisory cooperation and coordination by increasing the understanding among group-wide and host supervisors. It should also lead to greater confidence being placed on the group-wide supervisors' analysis by host supervisors.

Any IAIS capital standard would supplement existing legal entity risk-based capital requirements by evaluating the financial activities of the firm overall rather than by individual legal entity. Once developed by the IAIS, each national supervisor would determine the extent and manner in which any capital standards developed by the IAIS would be applied to firms regulated by that national supervisor.

2. Have you consulted with the state regulators on this subject? If you have, please provide details on those discussions, how their recommendations and concerns were incorporated into your actions, and if they were not, why they were dismissed or ignored.

State insurance supervisors, the National Association of Insurance Commissioners (NAIC), the Federal Insurance Office (FIO), and more recently, the Federal Reserve, are members of the IAIS. All three organizations are actively participating in the work of the IAIS to develop global insurance capital standards.

Federal Reserve staff meet with NAIC leadership, staff and state insurance regulators as well as with Federal Insurance Office staff on a regular basis to discuss IAIS activities.

3. How is US policy on insurance at these international forums decided on and presented? Are you, the industry, their state regulators, and other Federal representatives like the Secretary of the Department of Treasury speaking with a unified voice?

State insurance supervisors, the NAIC, the FIO, and more recently, the Federal Reserve, are members of the IAIS. As noted above, state insurance regulators, the FIO and the Federal Reserve actively communicate on matters related to the IAIS.

4. I've heard concerns that Section 616 of Dodd-Frank relating to the Federal Reserve's "Source of Strength" authorities could negatively impact insurance policyholders of savings and loan holding companies if their premium dollars could be raided to provide support to the holding company. It's my understanding that in a Bank Holding Company, the state insurance regulators would have to sign off on any funds leaving the insurance entities, but it's not clear how this works for insurers within savings and loan holding companies. I understand that rules have yet to be proposed by the banking agencies implementing that provision. When you do plan to issue such rules? Do you plan to consult with insurance regulators to ensure insurance policyholders are protected?

Section 616(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) provides that the Federal Reserve must require each bank holding company and savings and loan holding company to serve as a source of strength to its subsidiary depository institutions. This requirement applies to all savings and loan holding companies, including those that are insurance companies. As noted in your letter, in the case of bank holding companies, the Bank Holding Company Act provides that the appropriate state insurance regulator may object to any Federal Reserve order requiring that a bank holding company, that itself is an insurance company or an insurance company subsidiary that is an affiliate of a depository institution, provide funds or other assets to an affiliated depository institution.[1] The Home Owners Loan Act does not contain such a restriction; however, the Federal Reserve appreciates your concerns and will carefully consider them as it works with the other agencies to move forward with its rulemaking process under section 616 of the Dodd-Frank Act. Any proposal the Federal Reserve puts forth to implement section 616(d) would be subject to a notice and comment process. We welcome your input as well as that of state insurance regulators and the public, and will carefully consider all comments received over the course of the rulemaking.

5. I understand that in the United States the Fed is still in the process of developing capital standards for Savings and Loan Holding Companies and SIFIs that predominantly engage in insurance operations. To what degree have you consulted with state insurance regulators in developing such standards? What comfort can you provide that insurers won't be subject to bank-like capital rules that do not fit their business model?

The Federal Reserve is taking additional time to evaluate the appropriate capital framework for insurance nonbank systematically important financial institutions (SIFIs) and saving and loan holding companies (SLHCs) that are significantly engaged in insurance activities. We have been carefully evaluating public comments (including industry feedback) on how to design such a

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[1] 12 U.S.C. §§ 1844(g)(1) and (2).

capital framework. The business model and associated risk profile of insurance companies can differ materially from those of banking organizations, and the Federal Reserve is taking these differences into account. The Federal Reserve is committed to taking the necessary amount of time to develop workable capital requirements for insurance-related firms. It is important that we have strong consistent capital requirements for all depository institution holding companies, that we have a treatment for insurance risks that is economically sensible, and that we comply with the Collins amendment.

We do not have a specific deadline for issuing a proposal, but once we have developed a proposal, we will issue it for public notice and comment. We will provide insurance nonbank SIFIs and SLHCs, that are significantly engaged in insurance activities, with a reasonable amount of time to come into compliance with the final capital rules that we issue.

6. Former Fed staffers Joe Gagnon and Brian Sack have authored a paper that is getting a lot of attention in some circles. They argue that the Fed should replace the so-called federal funds rate target with a new operating framework. Specifically, they propose that the FOMC use the interest rate on its reverse repo program (or RRP) as the main policy instrument. You and other Fed officials have stated that tools have been developed that will allow the central bank to effectively manage short term interest rates despite the presence of a very large Fed balance sheet. Does the Fed plan to follow the recommendations laid out by Gagnon & Sack and transition to a new operating regime that relies on the RRP as a key target?

Decisions regarding policy normalization have not been made at this time. As noted in the minutes to the April meeting of the Federal Open Market Committee (FOMC) (http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20140430.pdf), as part of its prudent planning, the Federal Reserve is considering different approaches to raising short-term interest rates when it becomes appropriate to do so, and to controlling the level of short-term interest rates once they are above the effective lower bound during a period when it will have a very large balance sheet. The FOMC is considering different approaches to accomplish these goals using different combinations of policy tools, including the rate of interest paid on excess reserves balances, fixed rate overnight reverse repurchase operations, term reverse repurchase agreements, and the Term Deposit Facility. Because the Federal Reserve has not previously tightened the stance of policy while holding a large balance sheet, most FOMC participants judge that the FOMC should consider a range of options and be prepared to adjust the mix of its policy tools as warranted. Accordingly, the Federal Reserve is currently testing its various tools, including the Term Deposit Facility as well as fixed rate overnight reverse repurchase agreements.

SEAN DUFFY UNITED STATES REPRESENTATIVE
PROUDLY REPRESENTING WISCONSIN'S 7TH DISTRICT

1208 Longworth HOB
Washington, DC 20515
Office: 202-225-3365
http://duffy.house.gov

CLO: #Y - 43
CCS: 14-3574
RECVD: 5/15/14

Joint Economic Committee Hearing:
The Economic Outlook
May 7, 2014
Statement and Questions for the Record

Chair Yellen – Thank you for testifying before us today. I would like to submit for the record the following questions and look forward to your timely response.

1) Former Federal Reserve Board Chairman Bernanke publicly acknowledged that insurance companies have unique business models that make them different from banks, as have you, and that a bank-centric regulatory model would not work for insurance companies. At the same time, however, the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) in Europe have begun the process of preparing international capital standards very similar to the capital bank requirements coming out of Basel, Switzerland. The implication is that they would be applicable to U.S. insurance companies, including those that have not been designated systemically important financial institutions under Dodd-Frank or globally systemically important institutions. Given the Fed's role as a member of the FSB, what concerns have you voiced on this move toward bank-like capital standards for U.S. insurance groups? Is it the position of the Federal Reserve that a quantitative capital standard is needed for U.S.-based insurers who also happen to do business overseas?

2) Have you consulted with the state regulators on this subject? If you have, please provide details on those discussions, how their recommendations and concerns were incorporated into your actions, and if they were not, why they were dismissed or ignored.

3) How is US policy on insurance at these international forums decided on and presented? Are you, the industry, their state regulators, and other Federal representatives like the Secretary of the Department of Treasury speaking with a unified voice?

4) I've heard concerns that Section 616 of Dodd-Frank relating to the Federal Reserve's "Source of Strength" authorities could negatively impact insurance policyholders of savings and loan holding companies if their premium dollars could be raided to provide support to the holding company. It's my understanding that in a Bank Holding Company, the state insurance regulators would have to sign off on any funds leaving the insurance entities, but it's not clear how this works for insurers within savings and loan holding companies. I understand that rules

have yet to be proposed by the banking agencies implementing that provision. When you do plan to issue such rules? Do you plan to consult with insurance regulators to ensure insurance policyholders are protected?

5) I understand that in the United States the Fed is still in the process of developing capital standards for Savings and Loan Holding Companies and SIFIs that predominantly engage in insurance operations. To what degree have you consulted with state insurance regulators in developing such standards? What comfort can you provide that insurers won't be subject to bank-like capital rules that do not fit their business model?

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

July 21, 2014

The Honorable Randy Hultgren
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative Hultgren:

1. Federal Reserve and OCC staff are resident at bank holding companies and banks. Prior to the crisis did any examiner identify specific proprietary trading practices that if not corrected would cause an institution to fail? If examiners did identify proprietary trading practices as problematic did the Federal Reserve or the OCC take any actions to stop these practices?

Prior to the crisis, the Federal Reserve and other prudential supervisors examined trading activities at large banking organizations subject to their respective jurisdictions, including activities that would fall into the category of proprietary trading. Examiners have found instances where trading risks were not properly monitored, measured, or controlled. In those cases, the banking organizations were instructed to correct these practices through normal examination processes.

2. The California Public Employees Retirement System (CALPERS) has said that for "the Volcker Rule to work effectively, it should be implemented globally. Without multilateral agreements with regulators in other countries, establishing Volcker type restrictions on U.S. financial market-making institutions may put them at a competitive disadvantage." Has CALPERS raised a legitimate concern? What can be done to address this concern?

The Volcker Rule was enacted by Congress as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and refers to section 619 of that Act. The goal of the Federal Reserve with respect to section 619 of the Dodd-Frank Act and all other provisions of the Act is to implement the statute in a manner that is faithful to the language of the statute and that attempts to maximize financial stability and other social benefits at the least cost to credit availability and economic growth.

Various foreign governments are also currently undertaking evaluations of how the trading activities of their banking entities are structured. However, it remains to be seen how any resulting banking reforms will compare with the restrictions of section 619. More specifically, reforms dealing with the trading activities of banking firms have been recommended by the Vickers Commission in the United Kingdom and the Liikanen Group in the European Union. These approaches rely primarily on separating deposit--taking entities within large banking organizations from affiliates that engage in securities trading and securitization functions, along with requiring separate capitalization for the deposit-taking entities. This approach has been incorporated into implementing legislation enacted in the United Kingdom, France, and Germany. Furthermore, the European Commission's January 29, 2014 proposed regulation on bank structural reforms, which would prohibit certain large European banking firms from operating stand-alone proprietary trading desks, also differs from section 619 in a number of respects.

Section 619 restricts the worldwide proprietary trading activities of U.S. banking entities, as well as the U.S. proprietary trading activities of foreign banking entities, but exempts trading activities by foreign banking entities outside the United States. In this way, the statute attempts to establish a level playing field for U.S. and foreign banking entities operating within the United

States. However, the key activities that section 619 prohibits--proprietary trading and acquiring an ownership interest in or sponsorship of covered funds--traditionally have not been major sources of revenue for the vast majority of U.S. bank holding companies. Thus, the impact of the rule on U.S. financial firms' overseas competitiveness may be limited.

CLO: #23
CCS: 14-1326
RECVD: 2/25/14

TO: Committee on Financial Services
FROM: Representative Randy Hultgren
DATE: February 12, 2014
RE: Questions for the Record, 2/5 Hearing on the Volcker Rule

SEC Chair White: Firms that were subject to oversight by the SEC under the Consolidated Supervised Entities (CSE) program had onsite examiners reviewing their trading and other activities in the run-up to the 2008 crisis. Did any SEC employees embedded in one of those firms identify proprietary trading or investments in hedge funds or private equity funds as a concern?

Former SEC Chairman Christopher Cox ended the CSE program in the fall of 2008 when the two remaining investment banks (Goldman Sachs and Morgan Stanley) converted to bank holding companies. As you have investigated the SEC's implementation and operation of the CSE program, did you find any instances in which examiners questioned proprietary trading activity?

After Bear Stearns failed in March 2008, was there a post-mortem exam to determine the reasons for its failure? If so, was proprietary trading identified as a primary cause of that failure?

If Bear Stearns did fail because of proprietary trading, did the SEC deploy additional staff to the CSE program to focus on these activities at the remaining CSE program members such as Merrill Lynch or Lehman Brothers?

SEC Chair White and CFTC Acting Chairman Wetjen: SEC and CFTC Commissioners have criticized the Volcker rulemaking process, stating that they had less than one week to review a "voting draft" prior to the final vote on December 13, 2013.

- Given that it took nearly three years to complete the Volcker rule, why was a final, "voting draft" not issued until less than a week before the December 13th vote?
- Given the length and importance of this rule, would you have preferred to have some additional time for you or your fellow Commissioners to review and approve the final "voting draft" of the rule? Why the rush to judgment?
- Do you believe that the rulemaking process would have been improved by providing your fellow Commissioners with perhaps an additional month or even a couple of weeks to review and vote on the final, "voting draft," as some of them had requested?
- Given that certain members of the SEC and CFTC had asked for more time to review the final rule proposal, was there a specific reason(s) this rule had to be issued in December 2013 versus January or February 2014?

Federal Reserve Governor Tarullo and Comptroller Curry: Federal Reserve and OCC staff are resident at bank holding companies and banks. Prior to the crisis did any examiner identify specific proprietary trading practices that if not corrected would cause an institution to fail? If examiners did identify proprietary trading practices as problematic did the Federal Reserve or the OCC take any actions to stop these practices?

For all panelists: The California Public Employees Retirement System (CALPERS) has said that for "the Volcker Rule to work effectively, it should be implemented globally. Without multilateral agreements with regulators in other countries, establishing Volcker type restrictions on U.S. financial market-making institutions may put them a competitive disadvantage." Has CALPERS raised a legitimate concern? What can be done to address this concern?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

July 24, 2014

The Honorable Robert Hurt
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative Hurt:

1. There are five agencies represented here today, but we cannot forget to include the self-regulatory agencies, such as FINRA and the National Futures Association (NFA), who have to build out an examination program for this massive new mandate for the entities they regulate. How engaged were the SROs in the rulemaking process?

2. What issues or problems were raised by SROs during the rulemaking process and how were they addressed?

3. What feedback have you received from FINRA and the NFA about the final rule? Please provide specific details on challenges raised and how they have been addressed.

4. Have you provided FINRA or the NFA any guidance on how to implement the Volcker Rule?

5. What happens when FINRA and the NFA flag something that they believe may not be compliant - do they contact all of you?

Response to questions 1-5

The Federal Reserve, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC) provided many opportunities for commenters to provide input on implementation of section 13 of the Banking Holding Company Act (BHC Act), and many members of the public submitted comment letters to explain issues of concern.

Comment letters submitted by self-regulatory organizations (SROs) on the proposal to implement section 13 of the BHC Act generally focused on the proprietary trading provisions of section 13, and argued that the final rule should appropriately accommodate the market making-related activities of banking entities, including primary dealer activity. The final implementing rules exempt market making-related activity and make clear that the market making exemption permits banking entities to engage in primary dealer activity.

In addition to general comments on the treatment of market making-related activities, there were concerns expressed about the proposed source of revenue requirement in the market making exemption, and whether this requirement would impede the ability of market makers to manage their inventory. In recognition of these concerns and for other reasons noted in the preamble, the final rule does not include a source of revenue requirement.[1] Other commenters requested that the Agencies confirm that market making in exchange-traded futures and options would be permitted, and that the final rule exempt all proprietary trading in derivatives on U.S. government and agency obligations. The preamble to the final rule makes clear that the market making exemption is available for market making-related activities in any financial instrument, including exchange-traded futures and options. The final rule does not contain an exemption for

[1] See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 FR 5536 at 5621-5624 (Jan. 31, 2014).

derivatives on U.S. government or agency obligations. The preamble to the final rule explains in detail the reasons for this decision and explains other exemptions in the rule that may be available for this activity, such as the exemption for market making-related activity or risk-mitigating hedging.[2]

The Securities Exchange Act of 1934 defines the scope of authority of SROs related to securities activities. The SEC has regular discussions with representatives of FINRA about various compliance issues under the jurisdiction of the SROs, and we understand has discussed implementation of the final rules under section 13 of the BHC Act with representatives of FINRA. Similarly, the Commodity Exchange Act authorized the creation of SROs related to futures. The CFTC has discussed implementation of the final rules under section 13 of the BHC Act with representatives of NFA. Should FINRA or the NFA identify potential instances of noncompliance with section 13 and the final implementing rules, they may contact the SEC, CFTC, or the relevant Agency and, the Agencies will consider what action, if any, by the Agencies is appropriate.

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[2] See 79 FR at 5639-40 & 5646.

ROBERT HURT
5TH DISTRICT, VIRGINIA

125 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
PHONE: (202) 225-4711
FAX: (202) 225-5681

www.hurt.house.gov

COMMITTEE:
FINANCIAL SERVICES
VICE CHAIRMAN,
SUBCOMMITTEE ON CAPITAL MARKETS
AND GOVERNMENT SPONSORED ENTERPRISES

Congress of the United States
House of Representatives
Washington, DC 20515–4605

CLO: #24
CCS: 14-1327
RECVD: 2/25/14

Questions for the Record of the House Committee on Financial Services Hearing on "The Impact of the Volcker Rule on Job Creators, Part II"

Questions for All Witnesses

1. There are five agencies represented here today, but we cannot forget to include the self-regulatory agencies, such as FINRA and the National Futures Association (NFA), who have to build out an examination program for this massive new mandate for the entities they regulate. How engaged were the SROs in the rulemaking process?

2. What issues or problems were raised by SROs during the rulemaking process and how they were addressed?

3. What feedback have you received from FINRA and the NFA about the final rule? Please provide specific details on challenges raised and how they have been addressed.

4. Have you provided FINRA or the NFA any guidance on how to implement the Volcker Rule?

5. What happens when FINRA and the NFA flag something that they believe may not be compliant – do they contact all of you?

Questions for Chair White and Acting Chairman Wetjen

1. Do FINRA and NFA expect a rule from the SEC and CFTC, or are they left to figure out your intent on their own?

2. How will SROs know if issues that arise are not something that the bank regulators approved, such as a risk mitigation activity for a bank?

3. How will these decisions be made on the fly, without creating more risk or slowing market activity, impacting liquidity and hurting customers who need to find affordable, and predictable financing?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 15, 2014

The Honorable Sheldon Whitehouse
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 8, 2014, hearing before the Senate Budget Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Whitehouse:

1. Back in 1997 when you were Chair of the Council of Economic Advisors, you testified before the EPW Committee on climate change and said, "costs depend critically on how emission reduction policies are implemented. It boils down to this: if we do it dumb, it could cost a lot, but if we do it smart, it will cost much less and indeed could produce net benefits in the long run" Is it still your position that emissions reductions accomplished smartly can produce net benefits in the long run? Could a carbon fee under which the revenues were returned to the American people through spending programs or tax rate reductions produce net economic benefits?

In my current role as chair of the Federal Reserve, I am fully absorbed in executing the important responsibilities assigned by the Congress to the Federal Reserve among them, the pursuit of price stability, maximum sustainable employment, financial stability, and the prudential regulation of financial institutions. Issues pertaining to the question of climate change are also important, but are best addressed by the Congress and the President.

Questions for the Record
By Senator Sheldon Whitehouse
May 8, 2014
Senate Budget Committee

Sheldon Whitehouse

CLO:	**#Y - 41**
CCS:	**14-3443**
RECVD:	**5/8/14**

For Chair Yellen:

Back in 1997 when you were Chair of the Council of Economic Advisors, you testified before the EPW Committee on climate change and said, "costs depend critically on how emission reduction policies are implemented. It boils down to this: if we do it dumb, it could cost a lot, but if we do it smart, it will cost much less and indeed could produce net benefits in the long run." Is it still your position that emissions reductions accomplished smartly can produce net benefits in the long run? Could a carbon fee under which the revenues were returned to the American people through spending programs or tax rate reductions produce net economic benefits?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 13, 2014

The Honorable Jeff Sessions
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the May 8, 2014, hearing before the Senate Budget Committee. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Sessions:</u>

1. When the Federal Reserve holds risky assets on its balance sheet, there's a possibility that losses can occur when those assets are sold. The Federal Reserve created this possibility when it purchased $1.5 trillion mortgage backed securities and bonds, principally from Fannie Mae and Freddie Mac, that are not guaranteed by the federal government. In a note to its statistical release H 4.1, the Fed announced that losses stemming from these bonds would henceforth be a liability of the Treasury or of U.S. taxpayers.

Why may the Federal Reserve create liabilities for taxpayers without Congressional authorization to do so? Did the Fed create these liabilities when it purchased the non-guaranteed mortgage bonds of Fannie Mae and Freddie Mac and added these assets to the system's balance sheet?

The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment and price stability. In response to the recent financial crisis, economic recession, and the weak recovery that followed, the Federal Reserve has given the economy unprecedented support through large scale asset purchases (LSAPs) in an effort to put downward pressure on longer-term interest rates and ease financial conditions more broadly. Some of these purchases were in mortgage-backed securities issued and fully guaranteed by Fannie Mae and Freddie Mac. These purchases are consistent with the statutory authority governing Federal Reserve open market operations.

Once the economy improves sufficiently so that the effects of LSAPs are no longer needed, the FOMC will face issues of policy normalization. The Federal Reserve does not need to sell large volumes of its assets to normalize policy. Instead, balance sheet adjustment can occur gradually as existing securities mature over time. In particular, as noted in the June 2013 FOMC minutes, most participants anticipate that the FOMC will not sell agency mortgage-backed securities as part of the normalization process. As noted above, the FOMC conducts monetary policy at all times to foster its longer-term objectives of maximum employment and stable prices, and this principle will guide the process of normalizing the size and composition of the Federal Reserve's balance sheet.

It is important to note that the Federal Reserve is not exposed to any credit risk from its holdings of securities. The market value of the Federal Reserve's securities holdings—consisting almost entirely of Treasury securities and agency-backed mortgage-backed securities—is affected by the level of interest rates. However, any capital losses stemming from this sort of interest rate risk do not show through to Federal Reserve income unless the securities are sold. No losses are recorded for any security that is held to maturity. Even if the Federal Reserve were to sell some portion of its securities prior to maturity, capital losses would likely be modest and more than offset by positive interest earnings on its remaining securities holdings over the period affected by the LSAPs. For example, the Congressional Budget Office (CBO) recently projected that remittances from the Federal Reserve to the Department of Treasury (Treasury) will amount to about $484 billion from 2014 until the end of their projection period in 2024 (federal fiscal years, which run from October 1 to September 30), even with an assumption of some sales of longer-term securities and associated realized capital losses.[1] Moreover, Federal Reserve remittances to the Treasury from 2008-2013 were very large at about $400 billion. In short, the Federal Reserve's holdings of longer-term securities have already generated very sizable gains for U.S. taxpayers and will almost certainly continue to do so over coming years.

2. Your testimony before the Senate's Committee on the Budget contained your claim that the overall decline in the rate of labor force participation that has occurred since the end of the 2008-2009 recession is due in a part to the retirement of "baby boomers" and, thus, their departure from the labor force as they age. This claim is disputed by many labor economists who suggest that the rates of participation for older workers have increased since 2009 and that retirements have been offset by young people entering the labor force.

Please provide the evidence and research behind your claim or a correction. Furthermore, include in that production the change in the rates of labor force participation by age intervals (preferably 5-year intervals) for each year from (and including) 2009 to the most recent available data.

As indicated in my testimony, I believe that some of the decline in the aggregate labor force participation rate since the recession reflects the aging of the "baby boomers" and their departure from the labor force as they retire. In particular, while it is true that labor force participation rates have been rising for older individuals, the average rate of participation among those ages 65 and over is still only about 19 percent, well below the average participation rate of 62.8 percent for the entire working-age population. As a result of this substantial drop-off in labor force attachment at older ages, the movement of the large baby-boom cohort into their retirement years is putting downward pressure on the aggregate participation rate.

The attached table provides the data you requested. In addition, you will find an attached chart that shows a decomposition of the cumulative change in the aggregate labor participation rate since 2008 into the part due to the aging of the population and the part due to changes in age-specific participation rates. As indicated by the striped blue bar in the last column on the right, the aging of the population accounts for about 1 percentage point of the 2¾ percentage point decline in the aggregate participation rate since 2008; thus, according to this calculation, the aging of the population has accounted for more than one-third of the decline in the aggregate labor force participation rate since 2008. Declines in the participation rates of young people (ages 16-24) and prime-age individuals (ages 25-54) each contribute a little less than 1 percentage point to the decline, while the increases in participation rates among those 55 and older have added only about ¼ percentage point to the aggregate participate rate since 2008.

[1] See "The Budget and Economic Outlook: 2014 to 2024" released by the CBO in April 2014. Also, see Carpenter et al. (2013), "The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections," Finance and Economics Discussion Papers 2013-01, Board of Governors of the Federal Reserve System (U.S.), for additional projections of Federal Reserve income associated different interest rate assumptions and exit strategies.

3. Your Budget Committee testimony contains the statement that the federal funds rate is your "...traditional policy tool." As you have noted elsewhere, this rate is the principal tool used by the Open Market Committee to affect the demand for credit and credit's price. The direction of the federal funds rate, up or down, presumably anticipates a similar movement in the same direction of other key market interest rates. That said, you also noted in answers to questions by Committee members that the key rates for mortgages and for Treasury bonds are increasing despite the federal funds rate being near zero since late 2008. Indeed, the increase in mortgage interest rates is one reason you mentioned for the slowdown in housing demand that you raised as a caution to your otherwise generally optimistic view of the near-term economic outlook.

What does the evidence say about the degree of direct control that the Federal Reserve has over market interest rates (both short and long-term)?

Historically, the Federal Reserve has been able to exert tight control over the level of the overnight federal funds rate by adjusting the supply of reserve balances on a regular basis to meet the expected demand for reserves at the FOMC's target federal funds rate. Apart from small idiosyncratic fluctuations, arbitrage by investors generally ensures that other short-term interest rates, such as Treasury bill yields, commercial paper rates, and repo rates, typically move closely with the level of the federal funds rate. As noted in the minutes of recent FOMC meetings, even in the current environment with extraordinarily elevated levels of excess reserves, the Federal Reserve is confident that it will be able to use a range of policy tools, including interest on reserves along with overnight and term reserve draining tools to put upward pressure on short-term interest rates and remove policy accommodation at the appropriate time.

The Federal Reserve's control over *longer-term interest rates* is more indirect and more limited than its influence over the level of the federal funds rate. Longer-term interest rates can be viewed as the sum of the expected average level of short-term interest rates over the maturity of the instrument and a "term premium" that accounts for the increased risk of longer-term investments. The first component importantly reflects investors' views about the economic outlook and how the Federal Reserve will adjust the level of the federal funds rate in response to changes in that outlook. Especially in the current environment, the Federal Reserve has provided greater clarity about the likely future path of short-term interest rates through various communications including FOMC statements and minutes, my post-meeting press conferences, and the quarterly Summary of Economic Projections.

The second component—the term premium—reflects many factors including uncertainties regarding the future course of the economy and of interest rates, changes in investors' willingness to bear risk, and changes in the aggregate supply of longer-term securities. Over recent years, the Federal Reserve has conducted large scale asset purchases of longer-term Treasury and MBS securities to put downward pressure on longer-term interest rates. Large scale asset purchases put downward pressure on long-term interest rates primarily by reducing the term premium.

The backup in longer-term interest rates witnessed over the past year or so seems to reflect a rise in both the expected future path of short-term rates and the term premium. In large part, the rise in the expected future path of policy appears to reflect the improvement in the economic outlook. Since last May, for example, the unemployment rate has declined from 7.5 to 6.3 percent. A portion of the rise in the term premium over the past year may also be related to the improvement in economic outlook. As the outlook has improved, investors anticipated some scaling back in the pace of the Federal Reserve's asset purchases and this likely put a little upward pressure on long-term rates. However, as noted above, the term premium embedded in long-term rates is affected by many factors. Over the summer of 2013, for example, many reports suggested that some investors had taken large positions in fixed income market that were premised on unrealistic expectations about Federal Reserve policy and the level of volatility in financial markets. The unwinding of these expectations contributed importantly to the substantial rise in long-term rates last year.

On balance, we have not seen convincing evidence to date suggesting that the short-run effect of monetary policy on long-term interest rates is diminished relative to that in the past. That said, long-term interest rates are volatile, and there will almost surely be future episodes in which long-term rates move up or down in ways that are difficult to reconcile with the economic outlook or the stance of monetary policy. For its part, as always, the Federal Reserve will strive to communicate its economic and policy outlook clearly so that investors can anticipate the likely future path of short-term rates. Of course, over the long run, the Federal Reserve exerts its strongest influence over the level of long-term interest rates through its commitment to foster maximum employment and price stability.

4. Your responses to several questions on the long-term fiscal outlook underscored your concern about rising deficits and rapidly accumulating debt. Indeed, you stated your view that debt increases as predicted by CBO would slow the economy and lead to an unsustainable fiscal situation.

Given those views as expressed in today's hearing, would balancing our budget over 10 years improve the long-term economic outlook? At what stage of the economic cycle is it appropriate to begin a process of fiscal consolidation?

Significant progress has been made in recent years toward reducing the federal budget deficit. The federal deficit was about 4 percent of nominal gross domestic product (GDP) last fiscal year, and the CBO estimates that the deficit this year will be below 3 percent of GDP. The federal deficit is now much smaller than its recent peak of almost 10 percent of GDP in fiscal year 2009, with this reduction reflecting both the budgetary effects of the economic recovery over the past five years along with fiscal policy actions taken to reduce federal spending and increase taxes. Although fiscal policy actions have helped reduce the budget deficit in the near term, this fiscal restraint has slowed the pace of the economic recovery. The CBO estimates that deficit-reduction policies reduced the rate of real GDP growth by roughly 1½ percentage point last year and will lower economic growth by about ¼ percentage point this year, relative to what it would have been otherwise.

Even with the progress made in shrinking near-term budget deficits, little has been done to address the projected longer-run imbalances in the federal government's budget. If current federal budget policies do not change, the CBO projects that the further aging of the population, rising health care costs, and growing interest payments on federal debt will all contribute importantly to rising budget deficits after next year. To promote economic growth and stability in the longer term, it will be essential for fiscal policymakers to put the federal budget on a sustainable long-run path. However, since our economy is not yet back to full employment, it would be appropriate to not impose additional near-term fiscal restraint. Nevertheless, fiscal policymakers could put in place now a credible plan to set fiscal policy on a sustainable path in the longer run while not restraining the economic recovery in the short run.

5. In December of 2013, the 10-year Treasury note rate rose to level over 3 percent. It has now fallen to under 2.6 percent. Is that a negative indication for long-term economic growth?

Between December 31, 2013 and May 16, 2014, the 10-year Treasury yield declined by more than ½ percentage point, from 3.08 percent to 2.54 percent. Shorter-dated Treasury yields declined substantially less over this period; for example, the 5-year Treasury yield declined by only 17 basis points, from 1.74 percent to 1.57 percent. Thus, the decline in the 10-year Treasury yield reflects an even larger decline in long-term forward rates; by contrast, expectations of lower policy rates in the near-term appear to play only a minor role. It is worth noting that, over this period, 10-year government bond yields in several advanced foreign economies, notably Canada, the United Kingdom, and Germany, have declined by amounts similar to the decline in the 10-year Treasury yield.

Long-term forward rates are quite volatile and often difficult to explain in terms of economic fundamentals. The sharp decline in long-term forward rates early last year and the subsequent reversal over the summer are a case in point. In principle, a decline in long-term forward rates could reflect a decline in expected future real short-term interest rates, expected future inflation, or the term premium, perhaps because of reduced uncertainty about the future course of the economy and of interest rates. If market participants expect a lower pace of longer-term economic growth, this would be primarily reflected in a lower level of expected real interest rates.

Market participants have pointed to a variety of factors that might have contributed to a decline in long-term forward rates this year, including a decline in uncertainty about long-term rates, reports of increased demand for long-duration assets by some investors, and perhaps also changes in forward guidance that have provided more information about the post liftoff policy path. In the Survey of Primary Dealers conducted by the Federal Reserve Bank of New York prior to the April 2014 FOMC meeting, dealers were asked to decompose the decline in long-horizon forward rates since the end of 2013 into expected real rates, expected inflation, and term premiums. On average, these dealers assigned about half of the decline to reduced term premiums, and a little more than a quarter to lower future real short-term interest rates. Thus, it is likely that expectations of lower long-term economic growth contributed only modestly to the decline in longer-term Treasury yields since the beginning of the year. Such an interpretation seems also consistent with the fact that broad stock prices are up a little since the end of last year and credit spreads have narrowed a touch. A significant decline in long-run growth expectations might have been expected to depress stock prices and boost risk spreads.

Annual change in labor force participation rates by age group

	2009/ 2008	2010/ 2009	2011/ 2010	2012/ 2011	2013/ 2012
Overall LFPR	-0.62	-0.69	-0.60	-0.41	-0.45
16 - 19	-2.67	-2.55	-0.80	0.14	0.18
20 - 24	-1.40	-1.54	-0.12	-0.35	-0.21
25 - 29	-0.97	-0.12	-0.85	0.16	-0.73
30 - 34	-0.36	-0.88	-0.45	0.11	-0.16
35 - 39	-0.22	-0.53	-0.62	-0.17	-0.16
40 - 44	-0.59	-0.37	-0.47	-0.06	-0.57
45 - 49	-0.44	-0.32	-0.42	-0.43	-0.58
50 - 54	-0.11	-0.51	-0.59	-0.39	-0.43
55 - 59	0.00	0.21	-0.47	-0.37	-0.03
60 - 64	1.09	0.04	-0.67	0.73	-0.25
65 - 69	0.43	0.32	0.65	-0.02	0.07
70 - 74	0.65	-0.42	0.82	0.64	-0.25
75+	-0.00	0.08	0.10	0.13	0.31
Memo:					
25 - 54	-0.46	-0.46	-0.57	-0.14	-0.44
55 - 64	0.38	0.01	-0.67	0.23	-0.12
65+	0.40	0.16	0.54	0.56	0.24

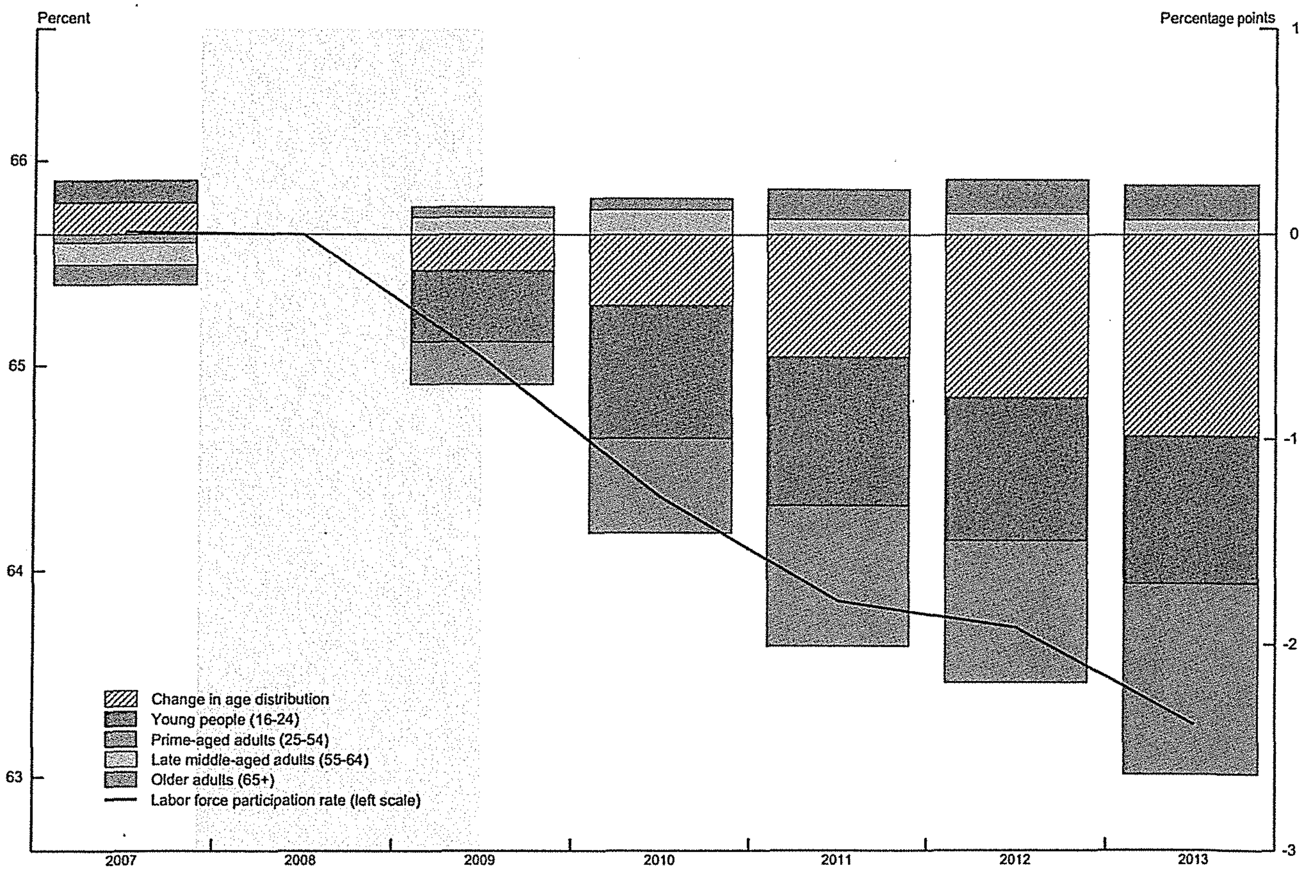
Source: Current Population Survey, Bureau of Labor Statistics.

Cumulative change since 2008 in labor force participation rates by age group

	2009/ 2008	2010/ 2008	2011/ 2008	2012/ 2008	2013/ 2008
Overall LFPR	-0.62	-1.30	-1.90	-2.31	-2.76
16 - 19	-2.67	-5.22	-6.02	-5.88	-5.70
20 - 24	-1.40	-2.95	-3.07	-3.42	-3.63
25 - 29	-0.97	-1.09	-1.94	-1.77	-2.51
30 - 34	-0.36	-1.25	-1.70	-1.59	-1.75
35 - 39	-0.22	-0.75	-1.37	-1.54	-1.69
40 - 44	-0.59	-0.96	-1.43	-1.50	-2.06
45 - 49	-0.44	-0.75	-1.17	-1.60	-2.18
50 - 54	-0.11	-0.62	-1.22	-1.60	-2.03
55 - 59	0.00	0.21	-0.26	-0.63	-0.66
60 - 64	1.09	1.13	0.46	1.18	0.94
65 - 69	0.43	0.76	1.40	1.39	1.46
70 - 74	0.65	0.23	1.06	1.70	1.45
75+	-0.00	0.08	0.18	0.31	0.62
Memo:					
25 - 54	-0.46	-0.92	-1.50	-1.63	-2.08
55 - 64	0.38	0.38	-0.29	-0.05	-0.17
65+	0.40	0.56	1.10	1.66	1.90

Source: Current Population Survey, Bureau of Labor Statistics.

Contributions to change in labor force participation rate since 2008



Source: Current Population Survey microdata. Data are adjusted for revisions to population controls.

Jeff Sessions

Ranking Member Sessions' Questions for the Record

to

Janet Yellen
Chair, Board of Governors
of the Federal Reserve System

CLO: #Y - 40
CCS: 14-3433
RECVD: 5/8/14

For the Hearing on

The Economic and Fiscal Outlook

May 8, 2014

Senate Committee on the Budget

Increasing Taxpayer Liabilities

1. When the Federal Reserve holds risky assets on its balance sheet, there's a possibility that losses can occur when those assets are sold. The Federal Reserve created this possibility when it purchased $1.5 trillion mortgage backed securities and bonds, principally from Fannie Mae and Freddie Mac, that are not guaranteed by the federal government. In a note to its statistical release H 4.1, the Fed announced that losses stemming from these bonds would henceforth be a liability of the Treasury or of U.S. taxpayers.

Why may the Federal Reserve create liabilities for taxpayers without Congressional authorization to do so? Did the Fed create these liabilities when it purchased the non-guaranteed mortgage bonds of Fannie Mae and Freddie Mac and added these assets to the system's balance sheet?

Decline in the Rates of Labor Force Participation

2. Your testimony before the Senate's Committee on the Budget contained your claim that the overall decline in the rate of labor force participation that has occurred since the end of the 2008-2009 recession is due in a part to the retirement of "baby boomers" and, thus, their departure from the labor force as they age. This claim is disputed by many labor economists who suggest that the rates of participation for older workers have increased since 2009 and that retirements have been offset by young people entering the labor force.

Please provide the evidence and research behind your claim or a correction. Furthermore, include in that production the change in the rates of labor force participation by age intervals (preferably 5-year intervals) for each year from (and including) 2009 to the most recent available data.

The Federal Reserve's Control of Interest Rates

3. Your Budget Committee testimony contains the statement that the federal funds rate is your "...traditional policy tool." As you have noted elsewhere, this rate is the principal tool used by the Open Market Committee to affect the demand for credit and credit's price. The direction of the federal funds rate, up or down, presumably anticipates a similar movement in the same direction of other key market interest rates. That said, you also noted in answers to questions by Committee members that the key rates for mortgages and for Treasury bonds are increasing despite the federal funds rate being near zero since late 2008. Indeed, the increase in mortgage interest rates is one reason you mentioned for the slowdown in housing demand that you raised as a caution to your otherwise generally optimistic view of the near-term economic outlook.

What does the evidence say about the degree of direct control that the Federal Reserve has over market interest rates (both short and long-term)?

Long-Term Fiscal Outlook

4. Your responses to several questions on the long-term fiscal outlook underscored your concern about rising deficits and rapidly accumulating debt. Indeed, you stated your view that debt increases as predicted by CBO would slow the economy and lead to an unsustainable fiscal situation.

Given those views as expressed in today's hearing, would balancing our budget over 10 years improve the long-term economic outlook? At what stage of the economic cycle is it appropriate to begin a process of fiscal consolidation?

Risk of Higher Interest Rates on the Economy

5. In December of 2013, the 10-year Treasury note rate rose to level over 3 percent. It has now fallen to under 2.6 percent. Is that a negative indication for long-term economic growth?

Jeff Sessions

Ranking Member Sessions' Questions for the Record

to

Janet Yellen
Chair, Board of Governors
of the Federal Reserve System

For the Hearing on

The Economic and Fiscal Outlook

May 8, 2014

Senate Committee on the Budget

Increasing Taxpayer Liabilities

1. When the Federal Reserve holds risky assets on its balance sheet, there's a possibility that losses can occur when those assets are sold. The Federal Reserve created this possibility when it purchased $1.5 trillion mortgage backed securities and bonds, principally from Fannie Mae and Freddie Mac, that are not guaranteed by the federal government. In a note to its statistical release H 4.1, the Fed announced that losses stemming from these bonds would henceforth be a liability of the Treasury or of U.S. taxpayers.

MA & Legal

Why may the Federal Reserve create liabilities for taxpayers without Congressional authorization to do so? Did the Fed create these liabilities when it purchased the non-guaranteed mortgage bonds of Fannie Mae and Freddie Mac and added these assets to the system's balance sheet?

Decline in the Rates of Labor Force Participation

2. Your testimony before the Senate's Committee on the Budget contained your claim that the overall decline in the rate of labor force participation that has occurred since the end of the 2008-2009 recession is due in a part to the retirement of "baby boomers" and, thus, their departure from the labor force as they age. This claim is disputed by many labor economists who suggest that the rates of participation for older workers have increased since 2009 and that retirements have been offset by young people entering the labor force.

R&S

Please provide the evidence and research behind your claim or a correction. Furthermore, include in that production the change in the rates of labor force participation by age intervals (preferably 5-year intervals) for each year from (and including) 2009 to the most recent available data.

United States Senate

COMMITTEE ON THE BUDGET
WASHINGTON, DC 20510-6100

CLO: #Y - 35
CCS: 14-3042
RECVD: 4/30/14
NRN

April 30, 2014

The Honorable Janet Yellen
Chair
Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Dear Chair Yellen:

We are writing to confirm your appearance as a witness before the Senate Budget Committee on Thursday, May 8, 2014. The hearing, entitled "The U.S. Economic and Fiscal Outlook" will begin at 9:30 a.m. in Room SD-608 of the Dirksen Senate Office Building.

Committee rules require that written testimony be submitted one calendar day prior to the hearing. You can comply with this rule by providing an electronic copy of your testimony in PDF, Word, or Wordperfect format. The committee also requires that you provide 75 hard copies of your testimony to the Committee Reception Office, Room SD-624, Dirksen Senate Office Building no later than one hour before the start of the hearing. Your testimony will be made available on the Senate Budget Committee websites at the time of the hearing.

Thank you for your time and effort in this matter. Should you have any questions, please contact Evan Schatz (202-224-0221) of the Budget Committee Democratic staff or Eric Ueland (202-224-0865) of the Budget Committee Republican staff.

Sincerely,

Patty Murray
Senator Patty Murray
Chairman

Jeff Sessions
Senator Jeff Sessions
Ranking Member

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

March 31, 2014

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the March 13, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs.

Please let me know if I can be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

Responses from Gov. Jerome Powell to Questions from Senator Kirk:

ISSUE: Capital Rules for Insurance Companies

1. **While many of us believe that the Dodd-Frank Act already gives the Federal Reserve the authority to distinguish between insurance companies and banks when promulgating capital standards under the Collins Amendment, the Federal Reserve has made statements publicly that it does not believe it has the statutory authority to do so. Therefore, a number of senators on this Committee introduced legislation, S. 1369 to codify and clarify that the Federal Reserve can and should make distinctions between insurance companies and banks when setting capital standards. Is it your interpretation that this authority currently exists?**

The Collins amendment requires that the Board establish consolidated minimum risk-based and leverage requirements for depository institution holding companies and nonbank financial companies designated by the FSOC that are no less than the generally applicable risk-based capital and leverage requirements that apply to insured depository institutions. If confirmed, I will continue to work with the other governors and the staff of the Federal Reserve to craft a regulatory capital regime for insurance companies and other nonbank financial companies that is strong but appropriate for the risk profile of the companies consistent with the Collins Amendment.

2. **This ability for distinction should also transfer to the Fed's ability to distinguish between insurance companies and banks for purposes of accounting practices. I have at least two insurance companies in my state that are supervised by the Fed as savings and loan holding companies. These companies are not publicly traded and do not prepare financial statements in accordance with GAAP—but rather, in accordance with GAAP-based insurance accounting known as Statutory Accounting Principles (SAP). Every person I consult tells me that SAP is the most effective and prudential way to supervise the finances of an insurance company. It is my understanding that the Federal Reserve may want to force these insurance companies that have used SAP reporting for many decades to spend hundreds of millions of dollars preparing GAAP statements—primarily because the Fed is comfortable with GAAP and understands it since it's what banks use. Is this is true? If it is true, is it simply b/c the Fed is so accustomed to bank regulation and not insurance regulation that it simply wants to make things easier for itself? Do you agree with this one-size fits all approach to regulation? Can you provide a cost benefit analysis to this as it seems to not add any additional supervisory value and only adds astronomic costs to these companies?**

One of the key differences between SAP and GAAP accounting is the financial reporting of subsidiaries; SAP does not allow for consolidation accounting. SAP accounting is prescribed by the National Association of Insurance Commissioners and is used by state insurance regulators to evaluate the financial condition and solvency of domestic insurance subsidiaries. The federal regulatory framework for depository institution holding companies, including regulatory and supervisory tools being developed and implemented under DFA, is based on protecting financial stability, protecting the safety and soundness of the consolidated holding company, and protecting the federal deposit insurance fund. I recognize the unique characteristics of insurance companies and understand the concerns raised by insurance companies that do not currently use GAAP for financial reporting. The Fed delayed the capital rulemaking for these entities in order to further study these issues, including the associated costs and benefits of requiring use of GAAP by insurance entities that do not use GAAP currently.

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March 31, 2014

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Sincerely,

Jerome H. Powell

Enclosure

Responses from Gov. Jerome Powell to Questions from Senator Reed:

1. **Several experts and witnesses have stated in comment letters, legal memoranda, and testimony that the Federal Reserve has broad flexibility in the way it develops and applies minimum capital standards under Section 171 of the Dodd-Frank Act – known as the Collins Amendment – for insurance companies and other nonbank financial companies supervised by the Federal Reserve. If and when you are confirmed and confronted with this issue, can we have your assurance that you will consider and evaluate the total mix of information available on this issue, including these legal memoranda and other views that were shared with the Subcommittee on Financial Institutions and Consumer Protection at its hearing on March 11, 2014?**

The Collins amendment requires that the Board establish consolidated minimum risk-based and leverage requirements for depository institution holding companies and nonbank financial companies designated by the FSOC that are no less than the generally applicable risk-based capital and leverage requirements that apply to insured depository institutions. If confirmed, I will continue to work with the other Governors and the staff of the Federal Reserve to craft a regulatory capital regime for insurance companies and other nonbank financial companies that is strong but appropriate for the risk profile of the companies consistent with the Collins Amendment.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
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March 31, 2014

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing,
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United States Senate
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Please let me know if I can be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

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Sincerely,

Jerome H. Powell

Enclosure

<u>Responses from Gov. Jerome Powell to Questions from Ranking Member Crapo:</u>

1. **A recent paper presented at the US Monetary Policy Forum suggests the possibility that current monetary stimulus may involve a "tradeoff between more stimulus today at the expense of a more challenging and disruptive policy exit in the future." How concerned are each of you about the exit from all this monetary stimulus of the past several years?**

As the recovery continues, the Federal Reserve will move over time to return monetary policy to a more normal stance. The pace and timing of this process will depend on developments in the economy – particularly, further progress in reducing unemployment, and inflation moving back toward the FOMC's 2% longer range target for inflation – as well as financial market developments. After such a long period of highly accommodative policy, it is important that the FOMC be as predictable and transparent as possible about the path of policy. In all likelihood, the process of normalization will take several years.

The Federal Reserve and the FOMC have a growing range of tools to manage the normalization process. The FOMC has indicated that interest rates will be the main tool used to tighten policy when economic and financial conditions warrant such a change. The FOMC has also indicated that most Committee participants do not anticipate sales of mortgage-backed securities during the normalization process.

Increasing the interest rate paid on reserve balances that depository institutions hold at the Federal Reserve Banks is also likely to be an important tool for raising the federal funds rate when doing so becomes appropriate. In addition, the FOMC has been testing a number of additional tools, including a term deposit facility, term reverse repurchase agreements, and an overnight fixed-rate reverse repurchase agreements, in order to strengthen the link between the rate paid on reserve balances and market rates. I am confident that the Federal Reserve has the tools it needs to exit over time from its highly accommodative stance of policy. While the process of exiting may not always be a smooth one, I believe that it will be manageable.

2. **I worry that the aggregate impact of the rules implementing Dodd-Frank will be immense. For some financial companies it will result in a regulatory death-by-a-thousand-cuts, with significant impact for the economy at large. If confirmed to the Board of Governors, how will each of you intend to monitor the cumulative regulatory burden on entities affected by the Fed's rulemakings?**

I agree that regulators should be careful to consider the cumulative regulatory burden on entities of regulations. The Federal Reserve considers the costs and benefits of every rule that it issues. The Federal Reserve seeks to minimize burden and the impact on the economy of regulations it issues while faithfully implementing the requirements of each statutory mandate. The Federal Reserve looks to present its proposed regulations as a package of integrated changes wherever possible to ensure that banking institutions have a good opportunity to evaluate the impact of the changes collectively. The Federal Reserve also includes explanations in the preambles to proposed regulations of the interaction between the proposal and other regulations.

Many of the regulations that are being put in place are targeted at the large banks. The Federal Reserve is working with other regulators to help ensure that its rules are properly calibrated so that smaller institutions are not faced with the same burdens as large institutions. If confirmed, I will be attentive to the costs and benefits of Federal Reserve rulemakings.

3. **As part of its QE purchases, the Fed has accumulated a significant percentage of all new federal mortgage-backed security issuances. The large nature of the Fed's purchases appear to be a deterrence to private capital from coming back into the market and issuing new mortgage-backed securities. What effect does the Fed's role as the dominant buyer or mortgage-backed securities have on the market?**

The FOMC's MBS purchases have held mortgage rates lower than they otherwise would have been, which has supported the housing sector and the broader recovery. MBS purchases have also reduced other interest rates. As the Federal Reserve gradually reduces the pace of its MBS purchases, private capital should return and take up any slack. The fact that mortgage and MBS rates have been broadly stable since the FOMC began to reduce MBS purchases suggests that this is occurring in the market today.

QE affects the prices of MBS and other assets through a portfolio rebalancing channel and has decisively lowered MBS yields and mortgage rates. These interest rate effects have spillovers to other assets and corporate bond rates, which are also pushed down by QE. However, the extent of these effects varies depending on the economic and policy environment.

Thus, the Federal Reserve's purchases of government-backed MBS should have pushed investors out of government-backed MBS and encouraged them to seek higher returns by investing in other assets, including privately-backed MBS (e.g., MBS backed by jumbo mortgages that are above the conforming loan limit).

Enactment of GSE reform legislation would also support MBS activity and the housing market by reducing uncertainty about the structure of housing finance in the United States.

4. **For the size of the balance sheet and the quantity of assets that the Fed has accumulated, there seems to have been only a limited effect on businesses willingness to hire. Please discuss about whether QE policy and implementation has been effective in reducing employment, and how you view the importance of fiscal and regulatory reform in growing our economy.**

The evidence suggests to me that QE has meaningfully lowered interest rates and raised asset prices. It is likely that lower rates and higher asset prices have provided meaningful support for the economy, through channels that are reasonably well understood. Since we cannot know how the economy would have performed under a different policy, it is not possible to estimate these effects with high certainty.

That said, since the current asset purchase program began in September 2012, growth in payroll employment has been higher and declines in unemployment have been greater than many FOMC members expected at that time. Since September 2012, unemployment has declined from 8.1% to 6.7%, and approximately 3 million payroll jobs have been added.

While monetary policy is a useful tool in achieving stable prices and full employment, it is not generally thought to affect the potential of the economy in the long run. Fiscal and regulatory policies are more powerful tools that can have such effects. Surveys suggest that uncertainty about fiscal and regulatory policy may have raised uncertainty among business decision makers and caused them to hold back from hiring and investment. It is critical that all aspects of our economic policy support growth, including fiscal, regulatory and monetary policy.

5. **The New York Fed's report on household debt shows that one area we see an increase in individuals taking on significant amount of student loan debt. In addition, the Kansas City Fed recently held a conference on this same topic. In recent years, the vast majority of these loans are obtained by students through federal programs. The relative ease of access to these federal loans is encouraging students to take out significant amounts of loans. Should we be concerned about students acquiring this significant amount of debt? How will this affect the future of our nation's economy?**

Since 2007, outstanding student loan debt has more than doubled from about $550 billion to over $1.2 trillion. The main reasons for the rapid expansion of student loan debt are the increase in tuition and fees and an increase in college enrollment. An increasing share of borrowers (at least through 2011) has found it difficult to meet their student loan repayment obligations. The two-year cohort default rate on federal student loans has increased from 6.7 percent in 2007 to 10 percent in 2011—the latest data point available. However, the wage premium of college graduates over high school graduates has stayed substantial. In addition, recent improvements in labor market conditions should put downward pressure on student loan default rates.

This is an important issue that should be carefully monitored going forward.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

March 31, 2014

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the March 13, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs.

Please let me know if I can be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

Reponses from Gov. Jerome Powell to questions from Senator Warren:

1. **Each of you testified that there is still work to be done to end Too Big to Fail. Do you think that ending Too Big to Fail should be the Board of Governors of the Federal Reserve System's (Fed) top regulatory priority?**

As I mentioned in my testimony before the Committee, I believe that ending Too Big to Fail ("TBTF") is at the heart of the post-financial crisis reform program. We need a strong financial system that can play its critical role in supporting economic activity by providing credit to businesses and households, without exposing taxpayers to losses or creating incentives for excessive risk taking. Ending TBTF is a necessary step in ensuring financial stability

Ending TBTF is and will continue to be a core objective of the Federal Reserve, in coordination with the other U.S. bank regulatory agencies, the SEC, the CFTC, and international regulatory agencies. Regulators around the world have made significant progress on this front – including the Basel 3 capital and liquidity rules for large, global banks; capital surcharges for the most systemically important banking firms; and new statutory resolution regimes to handle the failure of systemically important financial firms. But we also realize that much work remains to be done to end TBTF. I am committed to continuing this critical effort.

2. **Do you think that regulators must ultimately reduce the size of the largest financial institutions to end Too Big to Fail? Do you believe it will be possible through other regulatory approaches – such as resolution authority – to convince the markets that the government will truly let a massive institution fail?**

I am committed to ending TBTF. I believe that regulatory reforms around the world since the financial crisis have produced significant progress to that end. If those reforms ultimately prove inadequate, then additional measures should be considered.

In the past few years, the Federal Reserve and other regulators have taken important actions to reduce the likelihood of a failure of a systemically important institution. Such actions include:

- Basel III capital rules, plus proposed supplementary leverage ratio and planned SIFI risk-based capital surcharges.
- Stress tests of large US banking firms
- Basel III liquidity rules
- Improvements in supervision of firms
- Derivatives transparency, central clearing, and margining

In addition, regulatory checks are in place that aim to curb the expansion of the largest financial firms. These include the 10-percent deposit cap and DFA 10-percent liability cap on BHC acquisitions, as well as the Federal Reserve's consideration of the effect on financial stability of proposed acquisitions by large banking organizations.

Further, regulators are taking many steps to make systemically important financial firms more resolvable -- through the living wills process and the development of the FDIC's preferred "single point of entry" resolution strategy. And the Federal Reserve is working with the FDIC on a minimum long-term debt requirement that would promote the resolvability of the largest, most complex U.S. banking firms.

While meaningful progress has been made, more work needs to be done, and I am committed to finishing the job. Over time, these efforts and continued use of regulatory and supervisory tools should contribute to greater market confidence that these institutions are less likely to fail and resolvable without systemic impact if they do fail.

3. **At a Banking subcommittee hearing this January, I asked four economists – Luigi Zingales from the University of Chicago, Simon Johnson from the MIT Sloan School of Management, Harvey Rosenblum from the Southern Methodist University, and Allan H. Meltzer of the Tepper School of Business – whether the Dodd-Frank Act would end Too Big to Fail when it was fully implemented. They each said it would not. Do you agree? If so, what kind of additional authority do you think the Fed needs to ensure that Too Big to Fail is ended? If not, what gives you confidence that Dodd-Frank, once fully implemented, will successfully address Too Big to Fail?**

As discussed in the prior response, the Federal Reserve and the global regulatory community have made significant progress towards eliminating TBTF in the past few years by reducing the probability of failure of large financial firms and reducing the damage to the system if a large financial firm were to fail. The rating agencies and other market participants have recognized that progress. More work remains to be done to eliminate TBTF, including work to fully implement the provisions of the Dodd-Frank Act, and we are committed to completing that work as expeditiously as possible.

If the statutory implementation and regulatory reform work in train proves to be insufficient to solve the TBTF problem, we should be willing to look at the costs and benefits of additional approaches.

4. **Congressman Cummings and I sent a letter to Chair Yellen in February urging her to revise the Fed's delegation rules so that the Fed's Board would have to vote on any settlement that included at least $1 million in payments, or that banned an individual from banking or required new management. At a hearing last month, Chair Yellen testified that it was "completely appropriate for the Board to be fully involved in important decisions," and that she "fully intend[ed]" to make sure the Board would be more involved going forward. Do you agree in principle with Chair Yellen's testimony and will you support her efforts to require Board members to vote on major settlement agreements?**

I support the principle that members of the Board should be involved in important enforcement decisions and will work with Chair Yellen on future steps for carrying out that principle.

5. **Last February, the Fed and the Office of the Comptroller of the Currency entered into what they touted as a $9.3 billion settlement with mortgage servicers accused of illegal foreclosure practices. In their joint press release accompanying the settlement, the agencies claimed they had secured $5.7 billion in relief for homeowners in the form of "credits" for what the agencies described as "assistance to borrowers such as loan modifications and forgiveness of deficiency judgments." The press release did not disclose that the manner in which the credits were calculated could allow the servicers to pay only a small fraction of that $5.7 billion, potentially reducing the direct relief to injured borrowers by billions of dollars.**

   Senator Coburn and I recently introduced the Truth in Settlements Act, which would require agencies to publicly disclose all the key details of their major settlement agreements – including the method of calculating any credits. Of course, agencies are not required to wait for congressional action to adopt such basic transparency measures. Do you think the Fed should voluntarily adopt the disclosure provisions of the Truth in Settlements Act?

The Federal Reserve is required by law to publicly disclose any written agreement that is enforceable by the agency against a regulated entity or individual and any final order in any administrative enforcement proceeding. This requirement applies to enforcement actions entered into by consent with the regulated institution or individual.

Accordingly, the amended consent orders that implemented the payment agreement with the mortgage servicers relating to illegal foreclosure practices were publicly disclosed by the Federal Reserve in February 2013 as attachments to the press release that announced the issuance of those actions. The publicly disclosed amended consent orders contain all of the enforceable provisions governing the payment agreement, including the methodology under which the servicers would obtain credit for specific foreclosure assistance activities in connection with the servicers' obligations under the amended consent order to provide such activities.

6. **For the last five years, the Fed has kept interest rates extremely low and has used asset purchases to drive rates down even further. Yet the unemployment rate still remains higher than the Fed's target for full employment. In such situations – where the Fed is struggling to fulfill its full employment mandate using monetary policy alone – should the Fed consider using its regulatory authority to attempt to boost job growth?**

The Federal Reserve carries out its responsibilities to regulate and supervise financial firms so as to help ensure the safety and soundness of regulated firms and to help protect financial stability. In doing so, the Federal Reserve adopts a macro- as well as microprudential perspective, which means, among other things, that it takes into account the potential systemic consequences of financial distress as well as the safety and soundness of individual firms.

Relaxing its supervision of regulated financial firms in an effort to support economic growth would risk greater economic volatility in the future, and could ultimately result in worse economic performance over time. That said, the Federal Reserve monitors its regulatory actions for signs that its supervision may inadvertently reduce credit availability and thereby restrain economic growth.

7. **Section 165(d) of the Dodd-Frank Act requires the Fed and the Federal Deposit Insurance Corporation (FDIC) to ensure that large financial institutions can be resolved in an orderly fashion using the conventional bankruptcy process. These institutions are required to submit "living wills" that describe how such a conventional resolution could occur. If the Fed and the FDIC find that those plans lack credibility, they may require the financial institution to divest subsidiaries, hold increased capital, reduce leverage, or take other steps to shrink or simplify the institution. To date, over 100 institutions have submitted living wills, and the Fed and the FDIC have not rejected a single plan as lacking credibility.**

   What gives you confidence that our largest financial institutions could currently be resolved through a conventional bankruptcy procedure? What criteria would you use to determine whether a resolution plan is "credible" for the purposes of Section 165(d)? Are you willing to take the actions identified in Section 165(d)(5) of Dodd-Frank – including mandating divestiture of subsidiaries – if you believe a resolution plan lacks credibility?

One of the most important goals of the Dodd-Frank Act and the regulatory community after the crisis is to end "too-big-to fail." The perception of "too-big-to-fail" is greatly mitigated when market participants understand that losses from the failure of a major financial firm would fall exclusively on shareholders and creditors. The "living wills" provision of the Dodd-Frank Act helps guide institutions and regulators to improve the resolvability in bankruptcy of large financial institutions.

The staff of the Federal Reserve and FDIC are reviewing and assessing the plans filed by the large financial firms under Section 165(d) of the Dodd-Frank Act. At this time, no decision has been reached by the Board regarding the adequacy of the plans for facilitating the resolution of the firms in bankruptcy. If confirmed, I expect to explore the adequacy of the plans and whether improvements should be made in the plans and/or the bankruptcy code to ensure that no firm is too big to fail.

Section 165(d)(5) of the Dodd-Frank Act permits the Board and FDIC to take action if a resolution plan is determined to not be credible and the institution does not correct the plan within a certain period of time. I would be willing to support any actions appropriate to ensure compliance with the law and mitigate risks to the financial stability of the United States.

8. **As a fraction of GDP, the financial sector today is about twice as large as it was in the 1970s. Despite this growth in size, researchers have found that the sector is less efficient than it once was in allocating credit for the real economy. Do you believe that there are effectively "reverse economies of scale," such that financial institutions can grow so large that they become less efficient at performing their primary function of allocating credit?**

Many fundamental changes have occurred in the financial sector and the broader economy since the 1970's. Without a doubt, one important development is the increased concentration in the financial services industry. There is not a consensus among researchers that increased concentration has a direct effect on the efficiency of credit allocation, either adverse or otherwise. However, increased concentration in the financial sector has raised a number of other pressing public policy issues, notably the concern that some institutions have grown "too big to fail."

9. **Last year, the Financial Stability Board (FSB) directed the International Association of Insurance Supervisors (IAIS) to propose global qualitative capital standards by 2016 for "internationally active insurance groups" (IAIGs) – a category that includes U.S.-based insurance companies that have not been designated as systemically important financial institutions. Ostensibly, the three U.S. representatives to the FSB – the Fed, the Securities Exchange Commission, and the Treasury Department – supported the FSB's directive to the IAIS.**

    a. **[To Powell]: As a member of the Fed at the time of the FSB's directive to the IAIS, did you agree with the Fed's decision to support (or at a minimum, not oppose) the directive?**

    Yes. In its July 2013 press release announcing the policy measures that would apply to the designated global systemically important insurers (GSIIs), the IAIS also stated that it considered a sound capital and supervisory framework for the global insurance sector more broadly to be essential for supporting financial stability and that it planned to develop a comprehensive, group-wide supervisory and regulatory framework for internationally active insurance groups (IAIGs), including a capital standard (ICS). The business of insurance has become increasingly global in the past few decades. The decision of the IAIS to develop an ICS for IAIGs reflects that trend and has a parallel in the development of capital standards for internationally active banks by the Basel Committee on Banking Supervision.

    The FSB endorsed these proposed measures by the IAIS. That endorsement was consistent with the mission of the FSB to coordinate at the international level the work of national financial authorities and international standard setting bodies, including the IAIS, and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. State insurance supervisors, the National Association of Insurance Commissioners, the Federal Insurance Office, and more recently, the Federal Reserve, are members of the IAIS.

b. **[To Fischer, Brainard, and Powell]: U.S. insurance regulation is primarily state-based and relies on state guaranty funds, whereas European insurance regulation is primarily based on capital standards and does not rely on guaranty funds. Given this difference in regulatory approach, do you think it is appropriate for U.S.-based IAIGs to be subject to a single, global capital standard for their U.S. operations?**

A goal of the international capital standard (ICS) being developed by the IAIS is to achieve greater comparability of the capital requirements of IAIGs across jurisdictions at the group-wide level. This should promote financial stability, provide a more level playing field for firms and enhance supervisory cooperation and coordination by increasing the understanding among group-wide and host supervisors. It should also lead to greater confidence being placed on the group-wide supervisor's analysis by host supervisors. The standards under development by the IAIS are not contemplated to replace existing insurance risk-based capital standards at U.S. domiciled insurance legal entities within the broader firm. Any IAIS capital standard would supplement existing legal entity risk-based capital requirements by evaluating the financial activities of the firm overall rather than by individual legal entity.

It is important to note that neither the FSB, nor the IAIS, has the ability to implement requirements in any jurisdiction. Implementation in the United States would have to be consistent with U.S. law and comply with the administrative rulemaking process.

It is also important to note that the Basel Committee on Banking Supervision has been promulgating capital requirements for internationally active banks since the 1980s. The U.S. federal banking agencies, which are members of the Basel Committee, have long contributed to and supported the work of the Committee to develop common baseline prudential standards for global banks.

10. **What do you see as the proper role of the General Counsel's office in both the Fed's rulemaking process and its supervisory and enforcement processes? Does it go beyond the duties that are specifically delegated to the General Counsel's office in 12 C.F.R. § 265.6?**

The role of the Legal Division is to provide legal advice and services to the Board to meet it responsibilities in all aspects of its statutory duties, including the Board's bank supervisory and regulatory responsibilities and authority. The Legal Division also is responsible for drafting regulations and assisting the Board in analyzing legislation and drafting statutory changes affecting the Board and its work. The Legal Division provides legal support for the Board's role in developing and implementing monetary policy, employing its financial stability tools, and all aspects of the Board's operations, including the Board's procurement and personnel functions, ethics, and information disclosure. In addition, the Legal Division represents the Board in litigation in federal and state court, and pursues enforcement actions against individuals and companies over which the Board has supervisory authority.

Section 11(k) of the Federal Reserve Act permits the Board to delegate to Board members and employees functions other than those relating to rulemaking or pertaining principally to monetary and credit policies. 12 C.F.R. § 265.6 lists various authorities the Board had delegated to its staff and to the Reserve Banks. Importantly, the Board retains ultimate responsibility for all authorities it has delegated, and provided in section 265.3 that any single Board member may, on the member's own initiative, require the full Board to review a matter delegated to staff or the Reserve Banks.

11. In your view, did deregulation cause the 2008 financial crisis?

The argument that deregulation caused the financial crisis may well hold some truth. I believe that the more fundamental explanation is that the pace of innovation and change in the financial sector led over time to a situation where the existing regulatory regimes were inadequate.

Beginning in the 1970's and accelerating in the 1980's, many traditional forms of credit intermediation as practiced by commercial banks were supplemented and in some cases displaced by securities-based financing models, with mortgage securitizations and money market funds being only the most important examples. During the same period, banks and broker-dealers were increasingly organized on a global basis, with multiple legal entities in various jurisdictions. These developments brought considerable benefits, but ultimately allowed a systemic crisis that imposed enormous costs on the broader economy in 2008.

In my view, most of these key developments were not spawned directly by deregulation; rather, they reflect the failure of regulatory regimes to keep up with the pace of innovation. A number of the provisions of Dodd-Frank have been crafted to recognize this reality, and provide policymakers tools that will be sufficiently flexible over time to address new and emerging concerns as institutions and market practices evolve.

12. The Senate Permanent Subcommittee on Investigations recently released a report detailing Credit Suisse's role in aiding thousands of Americans evade their U.S. tax obligations. Credit Suisse and the Swiss government have not been cooperating with the Department of Justice's investigation. Do you think it is appropriate for the Fed to use any of its regulatory or enforcement authority under the circumstances?

Authority to enforce compliance with U.S. law is by law administered by a number of Federal agencies. For example, the Department of Justice is responsible for criminal prosecutions. The Federal Reserve has authority to take specific types of regulatory and enforcement actions against foreign banks and their U.S. operations to ensure safe and sound operations and compliance with U.S. law. These actions can include informal direction to institutions as well as formal actions such as cease and desist orders, civil money penalties, or, in serious cases, termination of U.S. officers. We consider use of this enforcement authority in appropriate circumstances within the limits imposed by law, and believe that firms of all sizes, including the largest financial firms, must be held accountable for failure to comply with the law.

With regard to Credit Suisse, I understand that firm is under investigation by the Department of Justice. It would not be appropriate to comment on an ongoing investigation or potential supervisory actions related to a specific firm.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 30, 2014

The Honorable Patrick Toomey
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the February 27, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Toomey:</u>

1. There have been a lot of unintended consequences coming out of the Volcker Rule. I am concerned about one that hasn't gotten a lot of attention but could force institutions to take losses, have a harmful effect on the economy, and drive more assets to the shadow banking system. Congress included a special extended transition period in the Volcker Rule that was intended to allow preexisting "illiquid" private equity investments to run off naturally, without the need for forced fire-sales. I am concerned that the Federal Reserve may have defined an illiquid fund in such a way as to make it virtually impossible for organizations to take advantage of this transition period. I understand the Federal Reserve did not "re-finalize" its conformance period rule (which includes the illiquid fund definition) when the rest of the Volcker regulations were finalized. What is the Federal Reserve doing to take comments on this issue into account and to prevent institutions from being forced to sell these investments at a loss? Are you worried about these assets moving into the unregulated shadow banking system?

Congress determined that section 13 of the Bank Holding Company Act ("BHC Act") was necessary to promote and enhance the safety and soundness of banking entities and the financial stability of the United States by prohibiting banking entities from engaging in short-term proprietary trading of financial instruments and making certain types of investments in private equity funds and hedge funds, subject to certain exemptions.

By statute, the requirements of section 13 are subject to a conformance period that ended on July 21, 2014, absent action to extend the period by the Federal Reserve. The conformance period for section 13 may be extended for up to three additional one-year periods if, in the judgment of the Federal Reserve, an extension is consistent with the purposes of section 13 and would not be detrimental to the public interest. Additionally, the Federal Reserve may, upon application of a banking entity, extend for up to an additional five years the period during which a banking entity, to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010, may take or retain its ownership interest in, or otherwise provide additional capital to, an illiquid fund.

On February 9, 2011, the Federal Reserve issued its final conformance rule as required under section 13(c)(6) of the BHC Act,[1] and stated that the Federal Reserve expected to review the final conformance rule after completion of the final rule implementing section 13 of the BHC Act, to determine whether modifications or adjustments to the rule are appropriate in light of the final rules adopted under that section. In October 2011, as part of proposing implementing rules for 13, the Federal Reserve requested comment on whether any of the conformance provisions in that rule should be revised.

Consistent with the statute and in order to give markets and firms an opportunity to adjust to the prohibitions and requirements of any implementing rules, the Federal Reserve in December 2013, exercised its statutory authority to extend the general conformance period under section 13

[1] See Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 FR 8265 (Feb. 14, 2011).

of the BHC Act until July 21, 2015, on the same date that the final implementing rules for section 13 were issued.[2]

Staff of the Federal Reserve has met with representatives of interested parties and is currently reviewing comments submitted on the conformance rule and definition of illiquid fund. These commenters have requested that the Federal Reserve broaden the definition of illiquid assets in the conformance rule and the meaning of what is "necessary to fulfill a contractual obligation" of the banking entity. The Federal Reserve is considering these comments in light of the final rule implementing section 13 to determine whether to revisit the conformance rule. To the extent that the Federal Reserve's conformance rule has unintended impacts, the Federal Reserve would evaluate and address those impacts within the parameters of the statute if possible, and otherwise to inform Congress.

2a. You may already be in receipt of a bi-partisan letter to which I am a signatory that raises concerns about new global capital standards being contemplated by the Financial Stability Board (FSB) for "internationally active insurance groups."

In the United States, unlike in Europe, policy holders are protected by state guaranty funds. Furthermore, U.S. insurance companies already comply with the capital standards requirements in European countries. The FSB's effort may be a solution in search of a problem.

In its July 2013 press release announcing the policy measures that would apply to the designated global systemically important insurers (GSIIs), the International Association of Insurance Supervisors (IAIS) stated that it considered a sound capital and supervisory framework for the global insurance sector more broadly to be essential for supporting financial stability, and that it planned to develop a comprehensive, group-wide supervisory and regulatory framework for internationally active insurance groups (IAIGs), including an international capital standard (ICS). The business of insurance has become increasingly global in the past few decades. The decision of the IAIS to develop an ICS for IAIGs reflects that trend, and has a parallel in the development of capital standards for internationally active banks by the Basel Committee on Banking Supervision (BCBS). The BCBS has been promulgating capital requirements for internationally active banks since the 1980s. The U.S. federal banking agencies, which are members of the BCBS, have long contributed to and supported the work to develop common baseline prudential standards for global banks.

The Financial Stability Board (FSB) endorsed the proposed measures announced by the IAIS. That endorsement was consistent with the mission of the FSB to coordinate at the international

[2] See Board Order Approving Extension of the Conformance Period (Dec. 10, 2013). On April 7, 2014, the Federal Reserve issued a statement that it intends to grant two additional one-year extensions of the conformance period under section 13 of the BHC Act that would allow banking entities additional time to conform to the statute ownership interests in and sponsorship of collateralized loan obligations ("CLOs") in place as of December 31, 2013, that do not qualify for the exclusion in the final rule implementing section 13 of the BHC Act for loan securitizations. This would permit banking entities to retain ownership interests in and sponsorship of CLOs held as of that date until July 21, 2017.

level the work of national financial authorities and international standard setting bodies, including the IAIS, and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. State insurance supervisors, the National Association of Insurance Commissioners, the Federal Insurance Office, and more recently, the Federal Reserve, are members of the IAIS.

2b. I am not aware of any legal authority for the FSB to pursue the creation and adoption of capital standards for "internationally active insurance groups" in the US. Will you commit to resisting efforts by others on the FSB to establish and impose new global capital standards that are at odds with the current regulatory and structural framework of U.S. insurers or would put U.S. insurers at a competitive disadvantage?

The Federal Reserve is fully committed to transparency and due process in the development and promulgation of regulatory standards. We support the practice of the IAIS to release for public comment its proposals for the basic capital requirements for globally systemically important insurers and expect that the IAIS will follow a similar process in the development of the ICS. It is important to note that neither the FSB nor the IAIS has the ability to implement requirements in any jurisdiction. Implementation in the United States would have to be consistent with U.S. law and comply with the administrative rulemaking process, including an opportunity for public comment.

CLO: #Y - 25
CCS: 14-1770
RECVD: 3/14/14

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 27, 2014

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Toomey:

1. There have been a lot of unintended consequences coming out of the Volcker Rule. I am concerned about one that hasn't gotten a lot of attention but could force institutions to take losses, have a harmful effect on the economy, and drive more assets to the shadow banking system. Congress included a special extended transition period in the Volcker Rule that was intended to allow preexisting "illiquid" private equity investments to run off naturally, without the need for forced fire-sales. I am concerned that the Federal Reserve may have defined an illiquid fund in such a way as to make it virtually impossible for organizations to take advantage of this transition period. I understand the Federal Reserve did not "re-finalize" its conformance period rule (which includes the illiquid fund definition) when the rest of the Volcker regulations were finalized. What is the Federal Reserve doing to take comments on this issue into account and to prevent institutions from being forced to sell these investments at a loss? Are you worried about these assets moving into the unregulated shadow banking system?

BS&R/Legal

2. You may already be in receipt of a bi-partisan letter to which I am a signatory that raises concerns about new global capital standards being contemplated by the Financial Stability Board (FSB) for "internationally active insurance groups."

    a. In the United States, unlike in Europe, policy holders are protected by state guaranty funds. Furthermore, U.S. insurance companies already comply with the capital standards requirements in European countries. The FSB's effort may be a solution in search of a problem.

    b. I am not aware of any legal authority for the FSB to pursue the creation and adoption of capital standards for "internationally active insurance groups" in the US. Will you commit to resisting efforts by others on the FSB to establish and impose new global capital standards that are at odds with the current regulatory and structural framework of US insurers or would put US insurers at a competitive disadvantage?

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

May 15, 2014

The Honorable Tom Coburn
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the February 27, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Coburn:</u>

1a. During your testimony, you indicated the FOMC will try to get a "firmer handle" on what is causing the recent soft economic reports and that the FOMC is open to reconsidering adjusting the pace of asset purchases accordingly.

In your estimate, how much lag time exists between Fed monetary policy adjustments and their impact on the real economy?

Estimates from standard econometric models of the U.S. economy suggest that monetary policy adjustments begin to affect growth of output and employment after a lag of about one quarter, and that the effects build for a few quarters thereafter. Standard estimates are that inflation responds with a longer lag. These estimates are derived from studies of the economy's responses to adjustments in the Federal Open Market Committee's ("Committee") target for the federal funds rate in normal times. We have less evidence with which to estimate the lags in the effects of changes in asset purchases on the economy, but the lags seem unlikely to be shorter.

1b. Do you believe that the Fed's December announcement to begin the slow taper of asset purchases could have impacted employment data in January?

No. The reported sluggishness in job growth early this year appears to reflect unusually severe weather, at least in part. After assessing a wide range of indicators of economic activity and labor market conditions, the Committee judged that there is sufficient underlying strength in the U.S. economy to support a pickup in job growth and ongoing improvement in labor market conditions. Moreover, even with the reduction in the pace of its asset purchases, the Federal Reserve continues to add to its securities holdings, thereby putting downward pressure on longer-term interest rates and providing stimulus to the economy.

1c. If the FOMC decided to discontinue or even reverse the taper based on weak economic data, how long would you expect it to take for the decision to impact employment and economic growth?

I would expect such a decision to affect interest rates quickly; indeed interest rates likely would begin to decline in response to surprisingly weak economic data before the Committee even released its decision. Employment and output growth, in turn, likely would begin to respond to lower interest rates in a quarter or two.

2a. In your testimony, you mention that the reduction of large-scale asset purchases would depend on inflation and employment data along with the likely efficacy and costs of such purchases.

Can you explain what the Board's current view is on the efficacy and costs of additional LSAPs?

Based on research conducted by economists at the Federal Reserve and by many outside experts, our judgment is that LSAPs have put downward pressure on longer-term interest rates and helped to make financial conditions more accommodative. These changes in financial conditions, in turn, have had a meaningful effect in supporting the economic recovery and have helped keep inflation nearer the Committee's 2 percent goal. As we have noted many times, LSAPs and monetary policy generally are not a panacea for all of the nation's economic difficulties. But our judgment is that our policy actions have helped to foster progress toward our statutory mandate of maximum employment and price stability.

The Committee has discussed the potential costs of LSAPs at length. Among the possible costs of LSAPs, policymakers have pointed to potential risks to financial stability; possible complications for the Federal Reserve's strategy for removing policy accommodation at the appropriate time, which could contribute to inflation pressures; and the possible implications of LSAPs for Federal Reserve net income in some scenarios. To date, all of these risks appear manageable. We are monitoring financial markets very carefully, but there is little evidence at this point of excessive risk-taking or broad-based reliance on leverage. We are confident that we have the tools necessary to remove policy accommodation at the appropriate time and inflation has been running below the Committee's 2 percent goal for some time and is expected to move up only gradually over time. Finally, we have examined the likely path of Federal Reserve net income in many alternative scenarios. In all but the most extreme cases, Federal Reserve income is expected to remain positive in coming years. Moreover, cumulative Federal Reserve net income over the entire period from 2008-2025 is virtually certain to be very large, and much larger than would have been the case in the absence of asset purchases. That said, the Federal Reserve takes all these possible risks of LSAPs very seriously and, as our statements suggest, an increase in our assessment of the likely costs of asset purchases would certainly be taken into account in judging the appropriate pace of such purchases.

3a. You have indicated your commitment to using forward guidance to inform market observers about Fed intentions in order to maintain a stimulative monetary footing. You and your predecessor have also repeatedly stated that any adjustments to the pace of asset purchases would be wholly dependent on the data.

Do you believe there is a contradiction between the Fed adamantly stating that any changes in quantitative easing will be data dependent while simultaneously stating that in the future the Fed will keep rates lower for longer than economic conditions would otherwise necessitate?

Both the Committee's forward guidance and its asset purchases have been designed to provide stimulus while being data dependent. The Committee has provided three types of forward guidance: qualitative guidance (extended period), date-based guidance, and guidance using economic thresholds. All have been designed to provide stimulus by conveying the Committee's expectation that the federal funds rate target would be lower for longer than may otherwise have been expected without the guidance. However, the guidance has consistently been expressed as the Committee's current assessment of the policy it expects to be appropriate in the future given future economic conditions. Indeed the threshold-based guidance was explicitly data-dependent. Thus, the Committee always reserved the option to raise interest rates sooner or keep them unchanged for longer than indicated in the guidance. Asset purchases have been designed to provide economic stimulus by putting downward pressure on longer-term interest rates, and have also been explicitly data dependent, especially the current flow-based asset purchase program, which the Committee has indicated will continue until there has been a substantial improvement in the outlook for the market, conditional on an ongoing review of their efficacy and costs.

3b. Does the Fed run the risk of losing credibility if you do not stick to your forward guidance in the coming years? Or, does the Fed run the danger of exercising monetary policy that is no longer appropriate for the economic conditions in the future in order to maintain the commitments a previous Board has already made?

The Committee's forward guidance is intended to provide the public with a better understanding of how it will conduct monetary policy in the future, but the guidance has consistently been expressed in terms of what policy would be appropriate in the future given the Committee's current outlook for future economic conditions. Indeed, the threshold-based forward guidance was explicitly data-contingent. If the Committee were to conduct policy in the future in a manner that was inconsistent with its past statements, that could harm its credibility. But those past statements do not constrain the Committee to conduct policy in the future in a fixed manner, regardless of the future prevailing economic conditions.

CLO: #Y - 24
CCS: 14-1769
RECVD: 3/14/14

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 27, 2014

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Coburn:

1. During your testimony, you indicated the FOMC will try to get a "firmer handle" on what is causing the recent soft economic reports and that the FOMC is open to reconsidering adjusting the pace of asset purchases accordingly.

    a. In your estimate, how much lag time exists between Fed monetary policy adjustments and their impact on the real economy?

    b. Do you believe that the Fed's December announcement to begin the slow taper of asset purchases could have impacted employment data in January?

    c. If the FOMC decided to discontinue or even reverse the taper based on weak economic data, how long would you expect it to take for the decision to impact employment and economic growth?

2. In your testimony, you mention that the reduction of large-scale asset purchases would depend on inflation and employment data along with the "likely efficacy and costs of such purchases."

    a. Can you explain what the Board's current view is on the efficacy and costs of additional LSAPs?

3. You have indicated your commitment to using forward guidance to inform market observers about Fed intentions in order to maintain a stimulative monetary footing. You and your predecessor have also repeatedly stated that any adjustments to the pace of asset purchases would be wholly dependent on the data.

    a. Do you believe there is a contradiction between the Fed adamantly stating that any changes in quantitative easing will be data dependent while simultaneously stating that in the future the Fed will keep rates lower for longer than economic conditions would otherwise necessitate?

    b. Does the Fed run the risk of losing credibility if you do not stick to your forward guidance in the coming years? Or, does the Fed run the danger of exercising monetary policy that is no longer appropriate for the economic conditions in the future in order to maintain the commitments a previous Board has already made?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 24, 2014

The Honorable David Vitter
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the February 27, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Sen. Vitter:

1a. Chairwoman Yellen, since the financial crisis, the implantation of Dodd-Frank, and industry consolidation, community banks are still facing many challenges that impend the continued success of this relationship-based lending model. Because independent research is so crucial in helping lawmakers and regulators understand and effectively shape laws and regulation affecting community banks, the fact that the Federal Reserve and Conference of State Bank Supervisors hosted a national community banking research and policy conference last year is laudable. I am glad that a similar event is planned for this year, and hope that, under your leadership the Federal Reserve will continue this partnership.

Do you support this effort encouraging community banking research, and do you believe that continued research in this area is beneficial and can better inform public policy?

I strongly support continued research to assist policymakers in understanding how successful community banks can contribute to the health of the U.S. economy. Better research on community banking issues should allow policymakers to make more effective supervisory and regulatory decisions that are appropriate to the unique characteristics of community banks. The inaugural research conference on Community Banking in the 21st Century that the Federal Reserve and Conference of State Bank Supervisors sponsored at the Federal Reserve Bank of St. Louis in October 2013 provided a unique opportunity for community bankers, academics, policymakers, and bank supervisors to discuss research findings and practical experience. I am pleased that planning is well under way for a similar conference in 2014, and my hope is that events such as these will serve as a catalyst for additional high-quality research that can inform effective policymaking with regard to community banks.

1b. What other ways can the Federal Reserve support and encourage independent research on the role community banks play in our economy?

Our newly-instituted annual community banking research conference, which we co-sponsor with the Conference of State Bank Supervisors, is the primary way that the Federal Reserve can encourage independent research on the role community banks play in our economy. These conferences provide a unique opportunity for academics who are interested in community banking to present their research to a diverse audience, including not only other researchers, but also community bankers and bank regulators. The conferences facilitate conversations among these three groups that might not otherwise take place. These conversations can lead to future collaborations that benefit all parties involved. In addition, the annual conferences provide a known venue for presenting community banking research, and send a strong signal to academics that such research is highly valued by bankers and bank regulators. Beyond the conferences, the Federal Reserve can encourage research on community banking topics by providing opportunities for community banking researchers to present their work in seminars held at the Board of Governors or at Reserve Banks and to interact with Federal Reserve System staff.

Committee on Banking, Housing, and Urban Affairs
The Semiannual Monetary Policy Report to the Congress
February 27, 2014

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, from Senator Vitter:

1. Chairwoman Yellen, since the financial crisis, the implantation of Dodd-Frank, and industry consolidation, community banks are still facing many challenges that impend the continued success of this relationship-based lending model. Because independent research is so crucial in helping lawmakers and regulators understand and effectively shape laws and regulation affecting community banks, the fact that the Federal Reserve and Conference of State Bank Supervisors hosted a national community banking research and policy conference last year is laudable. I am glad that a similar event is planned for this year, and hope that, under your leadership the Federal Reserve will continue this partnership.

    a. Do you support this effort encouraging community banking research, and do you believe that continued research in this area is beneficial and can better inform public policy?

    b. What other ways can the Federal Reserve support and encourage independent research on the role community banks play in our economy?

Both BS&R

CLO:	**#Y - 23**
CCS:	**14-** 1768
RECVD:	3/14/14

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

July 9, 2014

The Honorable Mick Mulvaney
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 11, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosures

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Mulvaney:

1. Chair Yellen, did Secretary Lew, Secretary Geithner or anyone else at the Treasury Department or anyone acting on their behalf at any time request that the Federal Reserve Board, the Federal Reserve System or the Federal Reserve Bank of New York examine the viability of prioritizing payments on Treasury obligations in relation to a failure to lift the statutory debt ceiling? Have any officials or staff at the Federal Reserve Board or the Federal Reserve System examined that issue? If so, please name those staffers and provide any records or communications related to that inquiry.

2. Chair Yellen, the minutes of emergency meetings of the Federal Open Market Committee (FOMC) held on October 16, 2013 and August 1, 2011 regarding the debt ceiling reflect a briefing provided to the FOMC. The minutes of the most recent meeting reference that "[t]he staff provided an update on legislative developments bearing on the debt ceiling and the funding of the federal government, recent conditions in financial markets, technical aspects of the processing of federal payments..." Please provide the names of all staffers who briefed the FOMC regarding those matters during either meeting or assisted in the preparation of those updates. Please provide any documents, records or other communications related to those updates.

3. Chair Yellen, were any staff or officials at the Federal Reserve Board or the Federal Reserve System consulted by any staff or officials at the Treasury Department regarding Secretary Lew's testimony on the debt limit before the Senate Finance Committee on October 10, 2013? What were the names of those officials or staff at the Treasury Department and at the Federal Reserve Board or the Federal Reserve System? Please provide any documents, records or other communications related to any such consultations.

4. Chair Yellen, you testified before our Committee on February 11, 2014 that the Federal Reserve's function as the fiscal agent of the United States allows the Federal Reserve to keep information confidential from the United States Congress. Please provide all legal authority you consulted or relied upon, or that anyone who advised you consulted or relied upon, to make that argument during your testimony. Please explain why you think this confidentiality obligation trumps the Federal Reserve's statutory independence.

5. Have you or any other staff or officials at the Federal Reserve had any discussions with any staff or officials of the Treasury Department or with the President or a member of his Administration about whether and how the Federal Reserve will act or provide resources to prevent a default in the event the debt ceiling is breached? Has the Federal Reserve had any discussion about either funding or forbearing, with respect to the payments on the trillions of dollars of Treasury debt and agency securities now held by the Federal Reserve System? Please provide the names of all persons with whom such discussions occurred and any documents, records or other communications related to those discussions.

Response to questions 1-5:

As I indicated in my testimony, the Federal Open Market Committee (FOMC) received updates in August 2011 and October 2013 on developments regarding the debt ceiling. As you know, one of the most important methods by which the Federal Reserve implements monetary policy is through the purchase and sale of obligations of the United States. Moreover, depository institutions often access the Federal Reserve's discount window during periods of stress and post obligations of the United States as collateral for those borrowings.

Understanding market functioning and any potential disruption to efficient market functioning is critical to the Federal Reserve's ability to implement monetary policy and fulfill its responsibilities for financial stability. It is imperative that the Federal Reserve be aware of developments in the market for obligations of the United States in order to understand whether the Federal Reserve's ability to implement monetary policy effectively will become impaired, whether use of the discount window is likely to increase, and how well secured the Federal Reserve will be in extending discount window credit. It is also imperative for the Federal Reserve to be aware of operational issues for the payments system that might be associated with processing obligations of the United States in the event it is at the debt ceiling. Federal Reserve staff briefed the FOMC and the Board of Governors of the Federal Reserve System (Board) on these matters in joint meetings, as you noted. As the Federal Reserve has explained previously, the Federal Reserve considered what steps it might take if a principal or interest payment were not paid on time, and in particular, what it could do to ensure the transferability of a defaulted security over the Fedwire Securities System. Attached are documents that have been developed and published by the Treasury Market Practices Group that align with the operational planning efforts of the Federal Reserve. The Treasury Market Practices Group is an advisory group of market professionals sponsored by the Federal Reserve Bank of New York that seeks to foster market practices that support the integrity and efficiency of the markets for U.S. Treasury, agency debt and agency mortgage-backed securities.

We understand that the Treasury Department considered a range of options regarding how it would operate if the United States exhausted its borrowing authority. We also understand that the Treasury Department has previously stated that no final decisions were made during the recent debt limit impasse because Congress ultimately took action to extend the debt limit.[1] Moreover, as the Treasury Department has discussed, there was no plan other than raising the debt ceiling that would permit the United States to meet all of its obligations.

Let me emphasize that there is no degree of planning or other action by the Federal Reserve that will offset the devastating effects for the nation of a failure to adjust the Federal debt ceiling to accommodate the spending decisions of the nation. A failure to pay social security benefits, contractors, our armed forces, Medicare patients and health care providers, government employees and others as those obligations come due will in fact be, and will be viewed publicly

[1] See Response to the Honorable Orrin G. Hatch from the Chair of the Council of Inspectors General on Financial Oversight and the Inspector General of the Department of the Treasury, dated August 24, 2012, at 6.

as, a default by the United States on its obligations even if principal and interest payments continue to be made to domestic and foreign holders of United States securities.

6. Since the Volcker final rule ("Volcker") was released, we have heard conflicting reports about which, and how many, regulators may examine and enforce banking entities' compliance with Volcker. Given the myriad scenarios that could result in a single trade being overseen by multiple regulators, the threat of duplicative and potentially conflicting oversight is obvious. However, Governor Tarullo testimony at this Committee's February 5th hearing indicated that only one regulator would have the power to enforce compliance with the Rule for a given trade.

In response to my question about enforcement jurisdiction, Governor Tarullo responded, "Whoever is the primary regulator of [an entity making a trade] has, by congressional delegation, the regulatory authority over them." He went on to state that the other Volcker regulators would not have authority to overturn the primary regulator's determination of the permissibility of a trade, stating that none of the other four Volcker regulators "has the authority under the Volcker rule and the statute to say no, that's incorrect." Governor Tarullo finished this point by stating that "there's not really shared jurisdiction over a particular trade."

Given the importance of a transparent and predictable enforcement process, I would like to know whether Governor Tarullo's testimony comports with your interpretation of how Volcker's ban on proprietary trading will be enforced. In short, can multiple regulators review and impose a binding determination over a single trade, or will only the primary regulator for a given trade have such authority?

Section 13 of the Bank Holding Company Act (BHC Act) clearly allocates rulewriting authority to a specific federal regulator for each legal entity. By statute, the Office of the Comptroller of the Currency (OCC) is the primary financial regulatory agency for national banks and federal branches of foreign banking entities, the Federal Deposit Insurance Corporation (FDIC) for state nonmember banks and state-chartered insured branches of foreign banking entities, the Securities and Exchange Commission (SEC) for U.S. broker-dealers and securities-based swap dealers, and the Commodity Futures Trading Commission (CFTC) for Futures Commission Merchants and swap dealers. The Federal Reserve is the primary financial regulatory agency for depository institution holding companies, state member banks, certain unregulated and foreign subsidiaries of depository institution holding companies, and state-chartered uninsured branches of foreign banking entities.

As Governor Tarullo testified, any trade conducted within a particular legal entity would thus be subject to the rules of only the primary financial regulatory agency for that legal entity.

As Governor Tarullo also testified, it is also important that the rules be applied as uniformly as possible across different organizations, each of which may be subject to the jurisdiction of a different agency. To encourage and facilitate consistency, staff of the Federal Reserve will continue to engage with staffs of the other agencies, and the Federal Reserve, OCC, FDIC, SEC, and CFTC have agreed to work together in applying the final rule to activities conducted by banking entities within their respective jurisdictions.

7. During your service as the President and CEO of the Federal Reserve Bank of San Francisco, you often spoke publically and in meetings of the Federal Open Market Committee about growing concerns you had with the potential of broad economic damage from the boom in housing prices. In fact, you were one of the first to describe the rise in prices as a "bubble." Yet, you did not lead the Federal Reserve Bank of San Francisco to check the increasingly indiscriminate lending of Countrywide Financial. You said that despite your concerns, you had not explored the San Francisco Fed's ability to act unilaterally, and argued against deflating the housing bubble because the "arguments against trying to deflate a bubble outweigh those in favor of it" and predicted that the housing bubble "could be large enough to feel like a good-sized bump in the road, but the economy would likely be able to absorb the shock."

In 2010, during your testimony to the Financial Crisis Inquiry Commission, you admitted that you "did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system, the S.I.V.'s [structured investment vehicles]— I didn't see any of that coming until it happened."

You went on to state that, "This experience has strongly inclined me toward tougher standards and built-in rules that will kick into effect automatically when things like this happen, that make tightening up a less discretionary matter."

Do you think your experience at the Federal Reserve Bank of San Francisco, particularly related to the failure of Countrywide Financial, may result in overcompensation by the Federal Reserve in the regulation of banks and the pursuit of mortgage settlements? Please describe why or why not.

The Federal Reserve carefully weighs the costs and benefits of the standards in our rules in order to properly address past problems and current conditions, as well as to promote a stable U.S. financial system with the ability to provide financial services to consumers and businesses even during periods of economic stress. Further, the Federal Reserve develops rules that contain supervisory trigger points that require financial institutions to take corrective action so that they are able to meet their financial obligations.

The annual Comprehensive Capital Analysis and Review (CCAR) process is a good example of this principle in practice. The CCAR is an annual supervisory exercise by the Federal Reserve to ensure that institutions have robust, forward-looking capital planning processes that account for risks and capital so that an institution's operations will continue throughout times of economic and financial stress. As part of the CCAR process, the Federal Reserve evaluates institutions' capital adequacy, internal capital adequacy assessment processes, and capital distribution plans, such as dividend payments or stock repurchases. This supervisory exercise is anchored to our capital plan rule which applies to the largest banking organizations, and recognizes the greater risk these firms pose to financial stability.

8.1. I previously asked your predecessor, Chairman Bernanke, about the losses the Federal Reserve will face when interest rates rise. Since rates have in fact risen significantly since the trough in Treasury yields in 2012, the supposition is that the Federal Reserve already faces large losses on its portfolio. However, as the Federal Reserve does not "mark to market," these loses are not shown on the balance sheet.

Actually selling the bonds, however, would force the Federal Reserve to incur the losses, which would negatively impact the combined earnings of the Fed, and thus the money available for remittances to the Treasury. When I asked Chairman Bernanke about this, he indicated that the same policy goals could be achieved by "repo-ing" the bonds instead of selling them.

Do you agree with Chairman Bernanke on the desirability of repo-ing bonds instead of selling them as part of monetary tightening? If so, do you believe the repo market is large enough to absorb hundreds of billions, if not trillions, of dollars of bonds? What historical evidence do you have to support your position?

As noted in the minutes of the FOMC meetings, the FOMC has discussed at length the various tools it might employ to remove policy accommodation at the appropriate time. These tools include the payment of interest on reserves, reserve draining tools such as term deposits and term reverse repurchase agreements, and possibly asset sales. Moreover, the Federal Reserve has been actively developing an additional tool--fixed-rate overnight reverse repurchase operations--that could also be quite helpful when the FOMC chooses to normalize the stance of monetary policy.

As noted in the minutes of our meeting last June, most FOMC participants do not expect to sell agency mortgage-backed securities (MBS) as part of the process of normalizing the size of the balance sheet. Moreover, a substantial volume of Treasury securities will mature in coming years, and these securities can simply be allowed to mature without replacement. As a result, the Federal Reserve is unlikely to incur significant capital losses associated with asset sales.

Regarding the process of removing policy accommodation through means other than asset sales, it is important to note that the Federal Reserve has a considerable degree of flexibility in how it could employ its various policy tools. The FOMC might choose to employ overnight and term reverse repurchase operations as part of this effort, but it need not rely exclusively on such tools. Indeed, raising the interest rate paid on reserves by itself will put substantial upward pressure on short-term interest rates. The Federal Reserve can also issue term deposits to depository institutions to drain reserves and put additional upward pressure on interest rates. At all times, the Federal Reserve will be very closely monitoring the market effects of its operations. If it appeared that the use of repurchase operations was having adverse effects on repo markets, the Federal Reserve could rely more heavily on its other tools.

As part of prudent planning, the Federal Reserve has been testing its various tools for some time, and these tests have provided both the Federal Reserve and market participants with useful experience regarding the operational capabilities of these tools. As a result, we are quite confident that these tools will allow the Federal Reserve to remove policy accommodation at the appropriate time.

As a final note, the Federal Reserve publishes a full set of financial statements on a quarterly basis and these statements include the fair value of our securities holdings. The Federal Reserve's financial statements are available on the Board's public website at (http://www.federalreserve.gov/monetarypolicy/bst_fedfinancials.htm#audited).

8.2. Are you concerned about the political ramifications of incurring dramatic losses at the Federal Reserve as a result of selling large portions of the bond portfolio in a rising interest rate environment? Has the FOMC discussed this issue, and if so, can you summarize the positions offered by the FOMC members?

The FOMC's objective is to promote progress toward maximum employment and price stability, not to make gains on its balance sheet. Research by Federal Reserve staff and academic economists indicates that the FOMC's purchases of longer-term Treasury securities, agency debt securities, and agency-guaranteed mortgage-backed securities have helped put downward pressure on longer-term interest rates—including mortgage rates—and thus have supported recovery in interest-sensitive sectors such as housing and motor vehicles, thereby promoting job gains. The FOMC is, of course, aware that interest rates will begin to rise once the economy has strengthened sufficiently and the economic expansion has become self-sustaining. The FOMC has asked for and discussed staff analyses of the potential implications of rising interest rates for the value of its securities portfolio and its net income. A recent staff discussion paper offers a careful analysis of a number of "normalization scenarios" in which interest rates rise by larger or smaller amounts, and the Federal Reserve's balance sheet shrinks.[2] In some scenarios in which interest rates rise appreciably more than market participants seem to expect (judging from history and the term structure of interest rates), Federal Reserve remittances to the Treasury would fall to zero temporarily as the average interest rate it would pay on its liabilities in these scenarios rises above the average rate it would earn on its assets. Nonetheless, even in these scenarios, average remittances over the entire period affected by asset purchases are higher than they would have been otherwise.

I should make clear that the Federal Reserve need not sell a large portion of its securities portfolio to normalize the stance of monetary policy, or to shrink its securities portfolio, for two reasons. First, the Federal Reserve has a number of tools that will make it possible to increase the level of short-term interest rates, when doing so become appropriate, without reducing the size of its securities holdings. These tools include raising the interest rate paid on reserve balances, expanding the use of the term deposit facility to drain reserve balances, and potentially using term and overnight reverse repurchase agreements to drain reserve balances and help set a floor under short-term interest rates. Second, the Federal Reserve can, if economic and financial conditions warrant, substantially reduce its securities holdings and the supply of reserve balances

[2] "The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections," by Seth B. Carpenter, Jane E. Ihrig, Elizabeth C. Klee, Daniel W. Quinn, and Alexander H. Boote, Federal Reserve Board Finance and Economics Discussion Series #2013-01, updated in September 2013. This paper can be found at: http://www.federalreserve.gov/pubs/feds/2013/201301/201301abs.html.

over time by ending its current practice of reinvesting principal received from mortgage-backed securities and from maturing Treasury securities. As illustrated in the staff paper, ending reinvestment would normalize the size of the securities portfolio over a period of five years or so, without asset sales.

8.3. On a mark to market basis, the Federal Reserve could face significant losses and require recapitalization in the event interest rates return to mean. What plans have you or the Federal Reserve made with the President, Secretary Lew or other members of the Administration concerning recapture of Federal Reserve losses?

Federal Reserve capital and income are not affected by the mark-to-market value of its securities portfolio. Federal Reserve income would be affected by a reduction in the value of its securities holdings only if the Federal Reserve sold some of the securities that had declined in value. That said, as discussed in the minutes of FOMC meetings and in staff analysis, the Federal Reserve has examined a number of possible scenarios in which Federal Reserve income could be depressed by interest rate developments.[3] For example, a rapid rise in short-term rates could lead to an increase in the Federal Reserve's interest expense that exceeds the rise in its interest income.

Concerning the possibility of capital losses on sales of securities, the FOMC has noted that most FOMC participants do not expect that it will be necessary to sell agency MBS as part of the process of removing policy accommodation. Moreover, a substantial volume of Treasury securities will mature in coming years, and these securities can simply be allowed to mature without replacement. As a result, the risk of capital losses associated with the sale of securities is quite low.

Regarding the risks associated with a rapid rise in short-term rates, it is certainly true that such an increase would boost the Federal Reserve's interest expense in the short-run. This effect will be reduced over time by the gradual decline in the size of the Federal Reserve's balance sheet. Although income is likely to decline from its recent elevated levels as interest rates normalize, our analysis shows that Federal Reserve income will likely remain positive and substantial.

The Congressional Budget Office (CBO) and the Office of Management and Budget arrive at similar conclusions based on their own analysis. For example, CBO projects Federal Reserve remittances to the Department of the Treasury (Treasury) over the period 2014-2024 of about $485 billion (see http://www.cbo.gov/publication/45010). Moreover, the Federal Reserve has already remitted nearly $400 billion to the Treasury over the period 2008-2013. Thus, it seems highly likely that cumulative Federal Reserve remittances to the Treasury over the period affected by our asset purchases will be considerably higher than they would have been otherwise.

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[3] "The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections," by Seth B. Carpenter, Jane E. Ihrig, Elizabeth C. Klee, Daniel W. Quinn, and Alexander H. Boote, Federal Reserve Board Finance and Economics Discussion Series #2013-01, updated in September 2013. This paper can be found at: http://www.federalreserve.gov/pubs/feds/2013/201301/201301abs.html. The Federal Reserve Bank of New York's Annual Report on Domestic Open Market Operations: http://www.newyorkfed.org/markets/annual_reports.html.

9. I previously discussed with your predecessor, Chairman Bernanke, the effect long-term zero interest rates have on the government, the economy and on consumer behavior in terms of the consequences of borrowing and debt accumulation. Has the Federal Reserve conducted any studies on the long-term impact of the zero or very low interest rate policy on: 1) the Social Security Trust Fund; and 2) discouraging saving and investment by individuals? Please provide any such studies or detail the findings and conclusions of any such research on these topics.

The primary reason that interest rates are low is that the economy has been very weak and inflation has been very low. In response to those conditions, the Federal Reserve and central banks around the world have worked hard to foster accommodative financial conditions in order to promote a speedier return to a normally functioning economy. Overall, low interest rates will contribute to the pace of economic recovery, and so will help generate better returns for savers, including those relying heavily on interest income. If interest rates were to rise prematurely in a way that choked off the economic recovery, any benefits accruing to savers would likely be short-lived, as a weaker economy would tend to depress future returns. When the economy has strengthened, interest rates will rise in a sustainable way. Indeed, most forecasters anticipate that rates will rise as the economic recovery progresses. To your question on studies, we have not conducted studies of the issues that you mention.

The Federal Reserve looks forward to the day when the economic health of the nation will have improved greatly on many dimensions. We pledge to do everything we can to bring that day about as quickly as possible.

10. Has the Federal Reserve conducted any studies on the impact of rising interest rates on the market for interest rate derivatives? Has the Federal Reserve conducted any studies on the impact of rising interest rates on systemically important financial institutions, on account of their exposure to interest rate derivatives? Please provide any such studies or detail the findings and conclusions of any such research on this topic.

The Federal Reserve has been paying close attention to the potential risks associated with rising interest rates, and we have been working with the firms we supervise to increase their resilience to possible interest rate shocks. In general, a gradual rise in interest rates as the economy strengthens should be beneficial to financial institutions: it should be associated with widening lending margins and an increase in loan volumes. But given that interest rates are at all-time lows, firms should also be prepared for the possibility of an unexpectedly sharp rise in rates, and we have focused supervisory attention on this issue.

Supervisors periodically review firms' own estimates of the effects of a variety of large movements in interest rates on the value of firms' assets, including their loans and securities and the value of their interest rate derivatives, taking into account the magnitude of any potential offset from banks' ability to issue low-cost deposits. Our analysis to this point suggests that banking firms are sufficiently well capitalized to withstand the net losses that would arise from large spikes in rates. This finding is consistent with the lack of widespread stress during the period of May through June 2013, when market interest rates increased considerably.

We have used the annual stress test and capital planning exercises to examine this conclusion in greater detail. This process allows us to analyze jointly the resilience of large bank-holding companies to various scenarios for the evolution of interest rates going forward. In this year's stress test we incorporated a scenario in which long-term interest rates increase suddenly, steepening the yield curve. The resulting losses and effects on capital of the participating firms were published on March 20, 2014, and are available on the Federal Reserve's website.

11. The Federal Reserve has tapered its quantitative easing policy approximately 20%, causing a marginal increase in interest rates in the United States. However, this policy has had a significant impact on emerging markets such as Turkey or Brazil, and our own equity markets have fallen roughly 9%. How do you plan to wind down quantitative easing and exit the markets without a global recession in equity markets and an equity market reset in the United States? What impact will this have on holding purchasing power?

Early in the year, stock prices in a number of emerging market economies declined sharply. The downward pressure on emerging market equities did not seem to be closely connected to the Federal Reserve's policy actions. In fact, this pressure came at a time when there was relatively little new information about Federal Reserve policy. Rather, the declines reportedly reflected investors' concerns about the political situations and economic vulnerabilities in a number of those countries. While these concerns have not gone away, stock prices in emerging market countries have recovered considerably over recent weeks. Stock prices in the United States are now up appreciably since the Federal Reserve began tapering its asset purchases, apparently reflecting increasing investor confidence in the U.S. economic outlook.

As noted in the minutes of numerous FOMC meetings, FOMC participants have long recognized the possible risk of rapid and sizable changes in asset prices in response to changing market expectations about the future course of monetary policy. A key element of the FOMC's approach to mitigating such risks is effective communication. Providing market participants with information about the FOMC's economic outlook and its policy intentions should allow investors to anticipate future monetary policy decisions. Moreover, the risk that FOMC policy actions could trigger outsized changes in asset prices should be reduced if investors understand the FOMC's economic outlook and how the FOMC is likely to adjust the stance of monetary policy in response to economic developments.

In keeping with these general principles, recent FOMC statements have provided substantial information about the FOMC's policy intentions. In its most recent statement, the FOMC noted that it will likely continue to reduce the pace of asset purchases in further measured steps at future meetings if incoming information broadly supports the FOMC's expectation of continued improvement in labor markets and inflation moving back toward 2 percent.

Moreover, the FOMC provided additional information about the likely future course of the federal funds rate. The FOMC noted that in deciding how long to maintain the current level of the funds rate, it would assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. Moreover, the FOMC continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable period after the asset purchase program ends, especially if projected inflation continues to run below the FOMC's 2 percent longer-run goal, and provided that longer-term expectations remain well anchored.

The FOMC also noted that once it begins to remove policy accommodation, it will take a balanced approach, and it currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the FOMC views as normal in the longer run.

While these types of communications should mitigate the risk of unintended market developments, that risk can never be completely eliminated. For its part, the Federal Reserve will remain firmly committed to conducting policy in a way that fosters its macroeconomic objectives of maximum employment and stable prices. As always, the Federal Reserve will adjust its stance of policy in light of incoming economic data and readings on financial market developments that have implications for the U.S. economic outlook.

12. What rate of inflation do you deem to be acceptable? What definition of inflation are you using to make that determination?

In January 2012, the FOMC released a statement of its longer-run goals and policy strategy that included for the first time a numerical objective for inflation. Specifically, the FOMC stated that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. Over time, a higher inflation rate would reduce the public's ability to make accurate longer-term economic and financial decisions, whereas a lower inflation rate--especially if it led to outright deflation--also could cause significant economic problems. The FOMC has reaffirmed its statement on longer-run goals and strategy, with minor amendments, each year since it was originally released.

13. The average time between recessions during the post-war period is 59 months, which would be April of this year. The longest period between recessions has been 10 years, which would put the next recession no later than May, 2019. The average of the past three cycles is around 7 and one-half years, which would be around November, 2016. If we do go into a recession with near zero interest rates, then we could most likely face another protracted recovery. How do these historical experiences impact your outlook, if at all? What tools could you bring to bear if we did enter another recession with near zero interest rates?

Although I do not view the timing of future recessions as in any way bound to the past, the historical facts about recessions that you cite are a reminder that adverse shocks will without doubt occur again. When such shocks occur, we want the economy to be as strong and resilient as possible to help prevent the economy from falling back into recession.

Furthermore, when an adverse shock occurs, we would like to have available a full toolkit of policy responses. Since December 2008, with the federal funds rate at its effective lower bound, the Federal Reserve has needed to use alternative tools to support to the economic recovery and promote its mandated objectives of maximum employment and price stability. In particular, the FOMC has used large-scale asset purchases and forward guidance on the future path of the federal funds rate to put downward pressure on longer-term interest rates and make financial conditions more accommodative.

Forward guidance and asset purchases would likely again be important tools for the Federal Reserve in any future episode in which the federal funds rate had been cut to the effective zero lower bound. However, there are uncertainties and potential costs associated with the use of such tools. As the FOMC has discussed at length, the effectiveness of these nontraditional tools is less certain than changes in the federal funds rate. And there may be side effects of such tools, such as possible risks to long-term inflation expectations, financial stability, and the Federal Reserve's balance sheet that must be considered. Thus, while I believe that these tools have been effective and have helped to promote a stronger economic recovery than otherwise would have occurred, they are not a panacea.

These considerations help explain why the FOMC has judged it is so important to provide the monetary accommodation needed to help bring the economy back to full strength, move inflation back toward our 2 percent target, and allow a normalization of the stance of monetary policy, as soon as possible.

14. What areas of the economy appear currently at the greatest risk of forming asset bubbles?

Our ongoing efforts to monitor potential risks to financial stability suggest that current valuations for broad categories of assets, such as real estate and corporate equities, remain within historical norms. While there are signs of stretched valuations, these are confined to narrower segments of markets--notably, high-yield corporate bonds and leveraged loans, farmland prices, and the equity prices of some small technology firms.

Broad U.S. equity price indexes have risen robustly of late, and at present are near record levels. Despite this, when measured against traditional valuation metrics, equity prices do not appear to be stretched. For instance, the equity risk premium, which is the difference between the expected return on stocks and safe assets such as Treasuries, is somewhat elevated when compared to historical norms, suggesting that valuations are not unusually high. Risk premiums are narrower though for small-cap equities, including some social media and biotech firms.

Residential house prices have risen in recent years, but here too, valuations appear to be modest and roughly back in line with their historical relationship to rents. Moreover, price increases have been largest in areas with the steepest previous declines. The pace of house price increases has slowed of late, and inventories appear to have stopped contracting. By contrast, the boom in agricultural land prices over the last decade has led to stretched valuations, which remain a concern for policymakers. Estimates of farmland-related debt suggest the overall financial system has limited exposure, however.

The main exception to this generally sanguine picture is the robust demand for risky corporate debt. High-yield corporate bond spreads are at their narrowest level since the financial crisis, reflecting a benign credit outlook and possibly stretched valuations. Low yields have spurred robust issuance. Credit quality has also deteriorated--for instance, the share of payment-in-kind (PIK) bonds, which allow the issuer to amortize the interest by increasing the face value of the bonds rather than paying cash, has risen. Similar dynamics are at play in the leveraged loan market, where issuance has increased notably and spreads have narrowed, though they remain well above pre-crisis levels. Here too, market participants have signaled some erosion in lending standards: for instance, the share of loan issuance without financial maintenance covenants, known as "cov-lite" loans, has risen steeply over the past two years.

The Federal Reserve, the OCC, and the FDIC issued updated guidance on leverage lending in March 2013. This guidance outlined principles related to safe and sound leveraged lending activities, including the expectation that banks and thrifts originate leveraged loans using prudent underwriting standards regardless of their intent to hold or distribute them.

15. What is the Federal Reserve's view toward Bitcoin? Do you believe the Federal Reserve has the legal authority to regulate Bitcoin? Do you believe the Federal Reserve should? If so, do you anticipate doing so?

Bitcoin is a recent financial innovation that can be used to make payments between participants in the Bitcoin system, and is reportedly held by some as an investment product. Innovations such as Bitcoin are sometimes described as reducing transaction costs and providing faster processing speeds compared to current payment alternatives, which suggests that virtual currency products may have some potential to improve payment system efficiency in the long run. However, current virtual currency products such as Bitcoin also pose certain risks. Criminals may take advantage of virtual currencies to mask their identity and to conduct illegal transactions. In addition, users of a virtual currency may face a risk that their holdings could be stolen or altered, particularly if adequate steps are not taken to secure records about holdings and other data. Finally, users may face price risk due to volatility in the conversation rate of a virtual currency into dollars or other currencies.

We do not believe that the Federal Reserve has the legal authority to regulate Bitcoin directly as it is currently configured. In general, the Federal Reserve would have supervisory authority with respect to virtual currency activities only to the extent a virtual currency is issued by, or cleared or settled through, a banking organization that the Federal Reserve supervises. To date, however, virtual currencies are not being issued by U.S. banks and basic transactions between buyers and sellers of Bitcoin and other virtual currencies generally take place outside the banking system. Some settlements of dollar payments resulting from the purchase or sale of Bitcoin by users, exchanges, or related businesses may inevitably be taking place through U.S. banks. To the extent those banks are under the Federal Reserve's jurisdiction, their activities would be subject to Federal Reserve supervisory programs. With respect to the direct supervision and regulation of non-bank issuers of virtual currencies at the federal level, it would be up to Congress to review the overall risks of virtual currency activities and to decide whether any changes are needed in the federal regulatory and supervisory framework to address the new developments.

TMPG Meeting Minutes
March 22, 2012

TMPG attendees

Art Certosimo (BNY Mellon)
Daniel Dufresne (Citadel)
Brian Egnatz (HSBC)
John Fath (BTG Pactual)
Michael Garrett (Wellington)
Beth Hammack (Goldman Sachs)
James Hraska (Barclays Capital)
Murray Pozmanter (DTCC)
Jerry Pucci (BlackRock)
Joerg Stephan (Deutsche Bundesbank)
Nancy Sullivan (BNY Mellon)
Mark Tsesarsky (Citigroup)
Stu Wexler (ICAP)
Tom Wipf (Morgan Stanley)

FRBNY attendees

David Finkelstein
Josh Frost
Peggy Kauh
Frank Keane
Lorie Logan
Brian Sack
Janine Tramontana
Josh Wright
Nate Wuerffel

Treasury Department attendee

Colin Kim

- The meeting commenced with a discussion of market conditions, including recent developments in money markets.

- The Group then discussed the recently implemented agency debt and agency MBS fails charges:

  - Members remarked that they observed continued improvement in the level of fails from mid-February to mid-March. Several members observed that a high percentage of their agency MBS fails have been resolved within the two-day resolution period following a settlement fail.
  - The Group reviewed minor suggested updates to the fails charge FAQ document on the TMPG's website and agreed to update the FAQs to respond to questions received regarding the netting of fails charges between counterparties.
  - Discussion turned to the SEC's recent approval of the DTCC's Mortgage-Backed Securities Division's (MBSD) application to operate as a central counterparty (CCP) in the agency MBS market. Members commented that the CCP will significantly reduce the operational work associated with processing interdealer agency MBS fails charges when its operations are launched on April 2.
  - Finally, it was agreed that the Group will continue to closely monitor settlement fails activity and periodically evaluate the effectiveness of the fails charges.

- Members then discussed questions received regarding the potential expansion of the Group's recommended fails charge trading practice to cover free delivery transactions:

  - The Group discussed the frequency of settlement fails in free delivery transactions and the impact that a fails charge would have on free delivery trades, concluding that the aggregated incidence of settlement fails arising from free deliveries was minimal. Moreover, unlike delivery versus payment fails, the incentives surrounding free delivery fails are similar in low- and high-rate environments. As such, members noted that the fails charge, which is only applicable in low-rate environments, is unlikely to address the root causes of free delivery fails in all rate environments.

- The Group agreed to reach out to other industry organizations to share its views and further discuss this topic.

- Attention then shifted to a discussion of the debt ceiling events that took place during the summer of 2011:

    - There was general consensus that a delayed payment on Treasury debt could arise from circumstances other than those observed last summer, including system failures, terrorist attacks, or natural disasters. In light of the risk, members agreed it would be prudent to explore potential trading, settlement or infrastructure recommendations in the event of a delayed payment situation. The Group confirmed that the focus of any exploration should be technical in nature and targeted at trading and settlement practices and conventions to address some of the operational challenges which could arise during such an event. Members agreed that any recommendations could help to reduce, but could not eliminate many of the adverse operational consequences of a delayed Treasury payment.
    - Members noted that while the consequences of a delayed Treasury payment on financial markets could be widespread and severe, depending on the circumstances that prompted the delay and the inference that investors drew about the risk characteristics of Treasury securities, the Group does not plan to make any judgments about those broader effects.
    - The members agreed to explore this topic in greater detail at future meetings.

- The meeting closed with an update from the working group formed to study margining practices for to-be-announced (TBA) agency MBS transactions:

    - The working group members relayed that they continue to focus on developing a summary of some of the legal and operational issues associated with TBA margining.
    - The working group members also reported that they continue to discuss with SIFMA their interest in exploring an update to the current standard form of master securities forward transaction agreement (MSFTA).

- The next TMPG meeting will take place on **Wednesday, May 2, 4:00 – 6:00 PM.**

TMPG Meeting Minutes
May 2, 2012

TMPG attendees

Art Certosimo (BNY Mellon)	Beth Hammack (Goldman Sachs)	Joerg Stephan (Deutsche Bundesbank)
Daniel Dufresne (Citadel)	James Hraska (Barclays Capital)	Stu Wexler (ICAP)
Brian Egnatz (HSBC)	Curt Hollingsworth (Fidelity)	Tom Wipf (Morgan Stanley)
John Fath (BTG Pactual)	Jerry Pucci (BlackRock)	Matt Zames (J.P. Morgan)

FRBNY attendees

David Finkelstein	Lorie Logan
Josh Frost	Nate Wuerffel
Peggy Kauh	Michael Nelson
Frank Keane	Brian Sack

Treasury Department attendee
Colin Kim

- The meeting commenced with a review of current market conditions, including a discussion of events in Europe and the market reaction to the FOMC's policy statement from the April 24-25 meeting. In addition, a representative from the Treasury Department provided a brief overview of the announcement in the *May 2012 Quarterly Refunding Statement* that the Treasury continues to analyze the significant amount of feedback received on the possibility of issuing floating rate notes (FRNs), including the benefits and optimal terms of Treasury FRNs. The Treasury representative noted that the Treasury plans to announce its conclusion about the issuance of FRNs at a later date.

- In the March 22 TMPG meeting, the Group decided to explore potential practices to support trading, settlement, and operational processes in the event of a delayed payment on Treasury debt. The Group continued that discussion at this meeting.
  - The Group noted that the debt ceiling events in the summer of 2011 had highlighted the importance of this issue. Members also noted that a delayed payment could arise from circumstances other than those observed last summer, including system failures, terrorist attacks, and natural disasters. Members confirmed that the focus of this exploration would be technical in nature, addressing some of the operational challenges that could arise during such an event.
  - Members highlighted that, while no solution exists that could eliminate the adverse operational consequences of a delayed payment on Treasury debt, the market could adopt standards to decrease some of the operational risk associated with such circumstances and to provide greater clarity to help support market functioning. The Group decided to avoid making any collective judgements about the potential consequences of a payment delay on financial markets more broadly, although some members pointed out that these consequences would be severe.
  - The members discussed a potential practice under which Treasury securities affected by a delayed payment could continue to trade and be transferred in such circumstances. Recognizing that a security ceases to be operationally transferable over the Fedwire Securities system once its maturity date is reached, the potential practice involves lengthening in Fedwire the maturity date field of any affected security by one day at a time until the delay is resolved. The Group noted that Fedwire and many industry systems could likely accommodate this practice as long

as the increase of the maturity date field occurred prior to the close of Fedwire on the day before scheduled maturity. Members noted that while increasing the maturity date field would allow a security to continue to be transferred, it would not change the legal maturity date of the security.

- The Group then discussed appropriate settlement conventions associated with a practice of lengthening the maturity date field. Specifically, the Group suggested that paying any delayed principal payments to the holder as of the close of business the day before the actual payment is made, and paying any delayed interest payments to the holder of record as of the close of business the day before the originally scheduled coupon payment date, would allow most systems to continue to track the proper settlement proceeds of trades with reduced manual intervention.
- The Group identified several trading and operational challenges that would be presented by the practice, including the need to coordinate quoting conventions for securities affected by the delay. Members also noted that some existing systems would need to be modified in advance to accommodate such a practice.
- The members concluded by noting that, while the practice described above would not remove the operational risk associated with a delayed payment, such a practice might be preferable to the alternative of allowing securities with delayed payments to become immobilized, as would occur if the maturity date field were not lengthened. The Group noted that the potential practice would not be feasible under some circumstances--specifically, ones that would not allow for a lengthening of the maturity date field before the close of Fedwire on the day prior to maturity-- in which case the security would not be transferrable on Fedwire. The Group noted that it planned to continue to review the topic at future meetings.

- Given time constraints, the Group agreed to postpone discussion of the market impact of the agency debt and agency MBS fails charges, as well as an update from the working group reviewing margining practices for to-be-announced agency MBS transactions, until the next meeting.

- The next TMPG meeting will take place on **Wednesday, May 30, 4:00 – 6:00 PM.**

TMPG Meeting Minutes
June 28, 2012

TMPG attendees

Art Certosimo (BNY Mellon)
Daniel Dufresne (Citadel)
Brian Egnatz (HSBC)
Michael Garrett (Wellington)
Beth Hammack (Goldman Sachs)
James Hraska (Barclays Capital)
Gerald Pucci (BlackRock)
Joerg Stephan (Deutsche Bundesbank)
Mark Tsesarsky (Citigroup)
Stu Wexler (ICAP)
Tom Wipf (Morgan Stanley)
Matt Zames (J.P. Morgan)

FRBNY attendees

David Finkelstein
Frank Keane
Lorie Logan
Sean Savage
Janine Tramontana
Josh Wright
Nate Wuerffel

- The meeting began with a discussion of the outlook for domestic financial markets and developments in Europe.

- The Group then turned to discuss the agency debt and agency MBS fails charges that went into effect on February 1, 2012:
  - Members remarked that agency debt and agency MBS fails levels remain low and no material issues with the fails charge collection process have been observed. The Group agreed to continue monitoring settlement fails activity and to periodically evaluate the effectiveness of the fails charges practices. A few members expressed interest in holding future discussions on whether the current two-day length of the resolution period should be shortened.

- The Group's focus then shifted to a discussion of potential practices to support trading, settlement, and operational processes in the event of a delayed payment on Treasury debt. Recognizing that a security ceases to be operationally transferable over the Fedwire Securities system once its maturity date is reached, the potential practices are intended to help preserve the transferability of securities for which payment is not made in a timely way.
- The discussion emphasized that the potential practices, if implemented, would only mitigate, not eliminate, the operational difficulties posed by a delayed payment on Treasury debt. It was also noted that the Treasury Department would ultimately determine whether the potential practices that involve Fedwire would be implemented, and that the market cannot be assured that such a course would be chosen in all circumstances.
- The Group reviewed each of the previously discussed[1] potential practices, and agreed they would be useful to support trading, settlement, and operational processes in the event of a delayed payment. The potential practices discussed are as follows:
  - Prior to the close of Fedwire on the day before a principal payment is due, the maturity date field would be rolled forward by one day. This process would be repeated until the delay is resolved. Participants noted that Fedwire could likely accommodate this, but only if notice is given before the prior day's close, and recognized that rolling the maturity date field would not change the legal maturity date of security.
  - The eventual principal payments for securities with delayed maturities would be made to the final holder of the security.
  - The eventual interest payments for securities with delayed maturities would be made to the holder of the security as of the originally scheduled payment date, allowing most systems to track and monitor interest payments without substantial manual intervention.

[1] See May 2, 2012 TMPG meeting minutes at http://www.newyorkfed.org/tmpg/meetings.html

  - Quoting conventions would remain unchanged, with bills quoted on a discount rate basis and notes and bonds quoted on a clean price basis.
  - If there was a decision to compensate investors for lost interest, any compensation that may be authorized would ultimately be owed to the same parties that receive the delayed principal and interest payments, as specified above.
- In light of these potential practices, members also discussed a range of useful operational questions that could be considered by Treasury market participants:
  - What systems issues arise and what manual procedures would need to be invoked if the potential practices were implemented? Are there opportunities to adapt systems and processes to support the potential practices as a part of routine planning or maintenance?
  - Are there any operational modifications that can shorten the time needed to roll forward the maturity date field in key systems?
  - If the maturity date field was not rolled forward on Fedwire in a timely manner, what system changes would be necessary to support continued trading and transfer of Treasuries bilaterally or within a clearing bank (i.e., not over Fedwire)? Would other sources of funding be available?
  - Would settlement and custodial systems process maturities on an automated basis on the night before maturity for the next day's settlement? As such, would positions in the maturing securities automatically be reduced to zero in anticipation of the receipt of cash, posing a problem if the cash is not received as scheduled?
  - Would changing the maturity of the instrument lead systems to cancel and re-book entries? Would systems continue to accrue interest for a security that has its maturity date field rolled? Would there be a need to manually intervene to zero out the coupon during the delay period?
  - Are there other operational considerations that should be considered, such as updates to legal agreements, pricing services, or other issues?

- The Group then turned to discuss the operational, legal, and financial implications of margining forward-settling agency MBS transactions:
  - The Group discussed a possible best practice for margining of forward-settling agency MBS transactions. The Group also discussed the potential scope of the possible best practice recommendation, including whether to include certain types of agency MBS and Treasury forward transactions, such as specified pool, CMO, and when-issued transactions. In general, the Group agreed that a risk-based approach to margining would focus first on the margining of agency MBS forward transactions. The Group agreed to revisit potential margining practices for other security forward transactions, including when-issued Treasury transactions, at a future meeting.
  - Members agreed to continue to engage SIFMA in a review of the current form of *Master Securities Forward Transaction Agreement*.
  - The Group also agreed to continue work on a white paper elaborating the risks posed by unmargined agency MBS trading and how margining could help mitigate such exposures. The Group expects to finalize the white paper and proposed practice recommendation for the September meeting.

- The next TMPG meeting will take place on **Thursday, September 20, 2012, 4:00–6:00 PM.**

TMPG Meeting Minutes
September 25, 2013

TMPG attendees

Art Certosimo (BNY Mellon)
Daniel Dufresne (Citadel)
Brian Egnatz (HSBC)
John Fath (BTG Pactual)
Michael Garrett (Wellington)
Beth Hammack (Goldman Sachs)
Curt Hollingsworth (Fidelity)
Jim Hraska (Barclays)
Murray Pozmanter (DTCC)
Gerald Pucci (BlackRock)
Nancy Sullivan (BNY Mellon)
Mark Tsesarsky (Citigroup)
Tom Wipf (Morgan Stanley)
Matt Zames (J.P. Morgan)

FRBNY attendees

Vic Chakrian
Frank Keane
Lorie Logan
Simon Potter
Susmitha Thomas
Janine Tramontana
Joshua Wright
Nate Wuerffel

- The meeting commenced with a review of potential 2014 TMPG meeting dates.

- The Group then discussed recent market developments, including reactions to the Federal Open Market Committee's (FOMC) actions at its September meeting and related FOMC communications. Members also discussed the potential ramifications of the Fed's fixed-rate, full-allotment overnight reverse repo operational exercise. Finally, members discussed the current state of market function for the Treasury, agency, and agency MBS markets.

- The TMPG's focus then shifted to the Treasury market's operational readiness for the introduction of Floating Rate Notes (FRN) as well as a discussion of the industry's state of readiness related to a potential debt ceiling episode.
  - Members discussed operational readiness for the Treasury's first FRN auction, which is expected to occur in January 2014. From an operational perspective, members noted that in order to trade and settle FRNs, various front and back-end securities systems would likely need to be updated. The Group also discussed potential changes to collateral schedules and haircuts. Members agreed that it would be worthwhile for all Treasury market participants to devote the operational and legal resources necessary to accommodate the new security type in a timely manner.
  - Members also discussed the current industry contingency planning around the debt ceiling episode. Members recalled prior discussions of the Group with respect to the market's operational capacity to process Treasury securities that experience a delayed payment of principal or interest. The Group agreed that prior discussions regarding potential practices to support trading, settlement, and operational processes in the event of a delayed payment on Treasury debt, along with a list of useful operational questions, remained relevant for other industry bodies to contemplate in ongoing contingency efforts. The discussion emphasized these contingency actions, if implemented, would only mitigate, not eliminate, expected operational difficulties in the event of delayed payments on Treasury debt.
  - Members highlighted a number of remaining uncertainties with their contingency preparations, including whether pricing service providers have robust contingency plans in place. Members also highlighted uncertainty of some market participants

about whether Treasury securities with delayed payments would be eligible for the Discount Window and in Open Market Operations. Some also indicated the importance of resolving eligibility practices in a range of collateral market transactions as another important consideration in prudent planning around a debt ceiling episode. Moreover, members expressed concerns that contingency planning was uneven across market participants.

- Members recognized that efforts by industry trade organizations, to coordinate operational efforts and identify recommended actions, in response to a contingency event were more advanced than in prior years. Some members referenced lessons learned from the response to Superstorm Sandy, and highlighted the need to continue to enhance cross-market contingency response mechanisms, as well as those between the public and private sectors.

– The Group then turned to review the market's progress with implementing its best practice recommendation to margin forward-settling agency MBS transactions:
  - Members discussed feedback from industry trade groups and various market participants, much of which focused on the legal issues and operational costs of implementation, and recognized that these may be particularly burdensome to smaller firms. The Group acknowledged that some market participants may experience an increase in operational and legal resource requirements; however, members agreed that the benefits of widespread margining of agency MBS transactions – including enhancements to counterparty risk management and the reduction of systemic risks – significantly outweigh these costs.
  - Some members noted the challenges for certain types of market participants that need to engage third-party service providers for margining services. Members also noted concerns around reports of terms being negotiated by market participants that, despite meaningful credit exposures, may not result in the regular exchange of two-way variation margin. This was seen as being inconsistent with the best practice recommendation.
  - It was noted that certain common issues have been raised by market participants to the Group, including whether to margin fails, and whether the TMPG can provide guidance on appropriate collateral eligibility types, thresholds and cure periods. Members noted that the TMPG's current recommendation guides market participants to address these issues bilaterally, but agreed to further discuss these and other issues and determine if additional guidance should be provided by the TMPG.
  - Despite the noted challenges, most members reported continued improvement in market implementation over the last several weeks, and all members reaffirmed the recommendation that market participants substantially complete the process to exchange two-way variation margin on forward-settling agency MBS exposures by December 31, 2013.

- The TMPG then reviewed progress towards implementing its practice recommendations designed to support more timely trade confirmation in the tri-party repo market, which were released on May 23:
    - Members reported that trading behavior that has been observed following the release of the TMPG's recommendation reflects improved practices that supported clearing bank end of day settlement, diminished use of intra-day credit, and reduced systemic risk.
    - Members added that, following the August 1 effective date, substantially all tri-party repo trades that were executed before 3:00 pm were matched and confirmed by 3:00 pm.

- Members then briefly reviewed potential future priorities for the Group, previously discussed at the June 27 meeting:
    - Members reaffirmed possible areas of focus that could help to further support the integrity and efficiency of the Treasury, agency debt and agency MBS markets, including the impact of algorithmic and high frequency trading on Treasury markets, initiatives to enhance government securities market data transparency, business resiliency efforts, and ongoing vigilance with respect to identifying gaps in the existing recommended *Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets*.
    - The Group agreed to continue its consideration of these potential areas of focus at future meetings.

- The next TMPG meeting will take place on Monday, October 21, from 4:00-6:00 PM.

TMPG Meeting Minutes
October 21, 2013

TMPG attendees

Art Certosimo (BNY Mellon)
Julia Coronado (BNP Paribas)
Daniel Dufresne (Citadel)
Brian Egnatz (HSBC)
John Fath (BTG Pactual)
Michael Garrett (Wellington)
Beth Hammack (Goldman Sachs)
Curt Hollingsworth (Fidelity)
Jim Hraska (Barclays)
Murray Pozmanter (DTCC)
Gerald Pucci (BlackRock)
Nancy Sullivan (BNY Mellon)
Mark Tsesarsky (Citigroup)
Tom Wipf (Morgan Stanley)
Matt Zames (J.P. Morgan)

FINRA attendees

Alie Diagne
Steve Joachim
Mehrdad Samadi
Jonathan Sokobin
Bill Wollman

FRBNY attendees

Joshua Frost
Frank Keane
Lorie Logan
Susan McLaughlin
Simon Potter
Roman Shimonov
Susmitha Thomas
Janine Tramontana
Nate Wuerffel

- The meeting commenced with a welcome to new member Julia Coronado, from BNP Paribas.

- Representatives from the Financial Industry Regulatory Authority (FINRA) presented to the Group on TRACE reporting in the Agency MBS markets (see appendix). The FINRA representatives discussed certain summary data regarding trading in the To-Be-Announced (TBA) and specified pool markets following the introduction of public TRACE reporting.
    - Some TMPG members shared views regarding the potential initial impact of TRACE reporting on agency MBS market depth and liquidity, as well as what they saw as possible differences between TRACE reporting within the markets for corporate bonds and agency MBS.
    - The Group commended FINRA on its efforts to promote market transparency and its consideration of feedback from TMPG members, and noted that transparency was also an ongoing priority for the TMPG.

- The discussion then shifted to recent market developments, focusing principally on the impact of the government shutdown and debt ceiling episode on the state of market functioning.
    - Members reiterated their concern that a delayed payment on Treasury debt, even if only temporary, would cause significant damage to and undermine confidence in the markets for Treasury securities and other assets. Some members expressed the view that the risks of a technical Treasury default could have severe and unforeseen consequences across markets that may not be fully understood by policy makers or market participants. In addition, members shared concerns about the long-term impact of recurring debt ceiling episodes on fixed income markets and the U.S. Treasury's cost of borrowing.

- Some members observed that during this episode, more market participants seemed to be managing risks earlier and more comprehensively than most participants had done in 2011. Members further noted that, as a result, market stresses emerged earlier and continued for a longer period than in 2011. Some members expressed concern that such market stresses might be even more widespread or arise earlier in the future.

– The Group then discussed some lessons learned from the recent debt ceiling episode.
  - Members acknowledged the contributions of industry groups to help coordinate contingency planning responses and channel communications across market participants.
  - Some members noted that greater clarity around potential official sector actions with respect to the timing and medium of communications could have been beneficial.
  - Certain members expressed uncertainty around the operational capabilities of the Fedwire system and the ability of the Federal Reserve to meaningfully address financial market disruptions following a delayed Treasury payment.
  - Some members suggested that coordination and contingency planning by pricing vendors needed further improvement.
  - Members discussed a complication surrounding the financing of one-day-to-maturity securities in the tri-party repo market, which could be particularly problematic in debt ceiling scenarios. Specifically, market participants have noted that the maturation of a security used as collateral in a repo transaction could leave the repo uncollateralized for some time. In addition, the treatment of maturing securities varies across clearing banks and is not well understood by market participants, and the exposures that result may not be well understood either. Members broadly agreed that it would be important to determine how best to handle these securities in tri-party repo operations for both day-to-day operations and in a scenario in which there was a delayed payment and the maturity date for maturing securities is rolled forward on Fedwire.
  - Members reaffirmed the relevance of the potential practices discussed by the TMPG during its June 28, 2012 meeting in which members noted that prior to the close of Fedwire the day before a principal payment is due, the maturity date field would be rolled forward by one day. Members noted that the operational implications of a security that is not rolled forward and is therefore no longer transferable on Fedwire would be severe.
  - Members discussed the need for a common vocabulary of key terms for planning related to operational readiness for debt ceiling related processes and to generally facilitate clear communications and timely cross market coordination.
  - More broadly, members highlighted the value of compiling a playbook of emergency responses for financial markets which would identify key decision points and appropriate communication channels, and could be used as a procedural reference during a debt ceiling episode or other contingency events.

- Members then turned to a discussion of its best practice recommendation to margin forward-settling agency MBS transactions.
  - The Group agreed that, in response to questions received, further clarification on the group's best practice recommendation would be beneficial with respect to the applicability of the practice recommendation across market participants and for transactions that are failing at settlement, and considerations when implementing this best practice recommendation.
  - The Group agreed to release additional guidance on these topics with revised frequently asked questions for margining agency MBS transactions.
  - The Group again reaffirmed its recommendation that market participants substantially complete the process of margining forward-settling agency MBS exposures by December 31, 2013.

- The TMPG agreed to defer its discussion of preparations around Floating Rate Notes to a future meeting given time constraints.

- The next TMPG meeting will take place on Wednesday, November 20, from 4:00-6:00 PM.

TMPG Teleconference Meeting Minutes – *November 12, 2013*

TMPG attendees

Julia Coronado (BNP Paribas)	Jim Hraska (Barclays)	Tom Wipf (Morgan Stanley)
Daniel Dufresne (Citadel)	Gerald Pucci (BlackRock)	
Michael Garrett (Wellington)	Stu Wexler (ICAP)	

FRBNY attendees

Joshua Frost	Simon Potter	Nate Wuerffel
Frank Keane	Susmitha Thomas	
Lorie Logan	Janine Tramontana	

- On November 12, the TMPG held a brief teleconference to discuss general market preparedness for the introduction of Treasury Floating Rate Notes (FRN) early next year and to review progress in implementing the TMPG's agency MBS margining practice recommendation.

- TMPG members broadly noted that their firms were operationally prepared for Treasury's first FRN auction, which is expected to occur in late January.

- The Group then discussed its best practice recommendation to margin forward-settling agency MBS transactions.

- Members highlighted increased momentum among market participants in moving negotiations toward conclusion. Overall, members were encouraged by an apparent industry push to substantially complete margining of forward-settling agency MBS transactions by year end.
- Some members of the TMPG noted their attendance at events organized by the Fixed Income Forum and the Bond Dealers of America to discuss the TMPG's agency MBS margining recommendation. Members discussed feedback from these events, and other industry trade association forums. The group also discussed questions raised by these and other industry groups regarding the effective implementation date for the recommendation, the margining of transactions that are failing at settlement, and the definition of forward settlement for To-Be-Announced, specified pool and adjustable-rate mortgage transactions, and collateralized mortgage obligation transactions. The Group agreed that no changes should be made to the recommendation with respect to these issues. Members agreed to continue to direct market participants to the existing practice and recently revised frequently asked questions for margining agency MBS transactions for additional guidance.
- Members agreed to continue to closely monitor progress toward implementation of margining for forward-settling agency MBS transactions through year-end. In addition, the TMPG unanimously reaffirmed its recommendation that market participants substantially complete the process of margining forward-settling agency MBS exposures by December 31, 2013.

APPENDIX

FINRA TRACE:
Trade Reporting and Compliance Engine

Treasury Market Practices Group
October 2013

FINRA™
Financial Industry Regulatory Authority

Agenda

- Status of the TRACE Program
- Characteristics of the TBA market
- Volume trends
- Questions and Discussion

TRACE Program Status

Segment	Trade Reporting	Approach	Current status	Scope
Corporate Debt	July 2002	Phased in dissemination and gradually reduced reporting time	Reportable within 15 minutes, Real-time dissemination of all publicly traded securities. SEC approved disseminated of Rule 144A transactions, which will be implemented in 2014.	Over 60,000 CUSIPs
Agency Debentures	March 2010	Subject to immediate dissemination	Reportable within 15 minutes, Real-time dissemination	Just under 20,000 CUSIPs
To-Be-Announced	May 16, 2011	Initially reporting only, FINRA to study the data to propose dissemination policy	Disseminated as of 11/12/2012. GD reportable in 15 minutes. NGD reportable in 1 hour.	Over 40,000 CUSIPs
Specified Pools			Dissemination based on pool characteristics as of 7/22/2013. Reportable within 2 hours of execution. Will change to 1 hour in January 2014.	Over 1 million CUSIPs
Asset Backed Securities*			Reportable on T (as of 11/18/2011) Trade dissemination approved by FINRA Board. Proposal will be filed with the SEC and published for Notice and Comment.	Over 30,000 CUSIPs
CMO/REMIC / RMBS			Reportable on T (as of 11/18/2011). Dissemination TBD	Just under 250,000 CUSIPs

Fact and Figures

- 2013, ending September

	Securitized Products		
	MBS	TBA Dollar Roll	TBA Non-Dollar Roll
Average Daily Par Value	$17.5 Billion	$119 Billion	$106 Billion
- Customer Par Value %	84%	62%	57%
Average Daily Trades	3.7K	1.7K	5.8K
- Customer Trades %	68%	42%	36%
- Retail Sized Customer (less than $100K) Trades % of Total Customer Trades	38%	0.3%	1.7%
Average Trade Size	4.7 Million	69.4 Million	18.4 Million
Unique Reporting Firms	538	160	
Average Daily Reporting Firms	118	74	

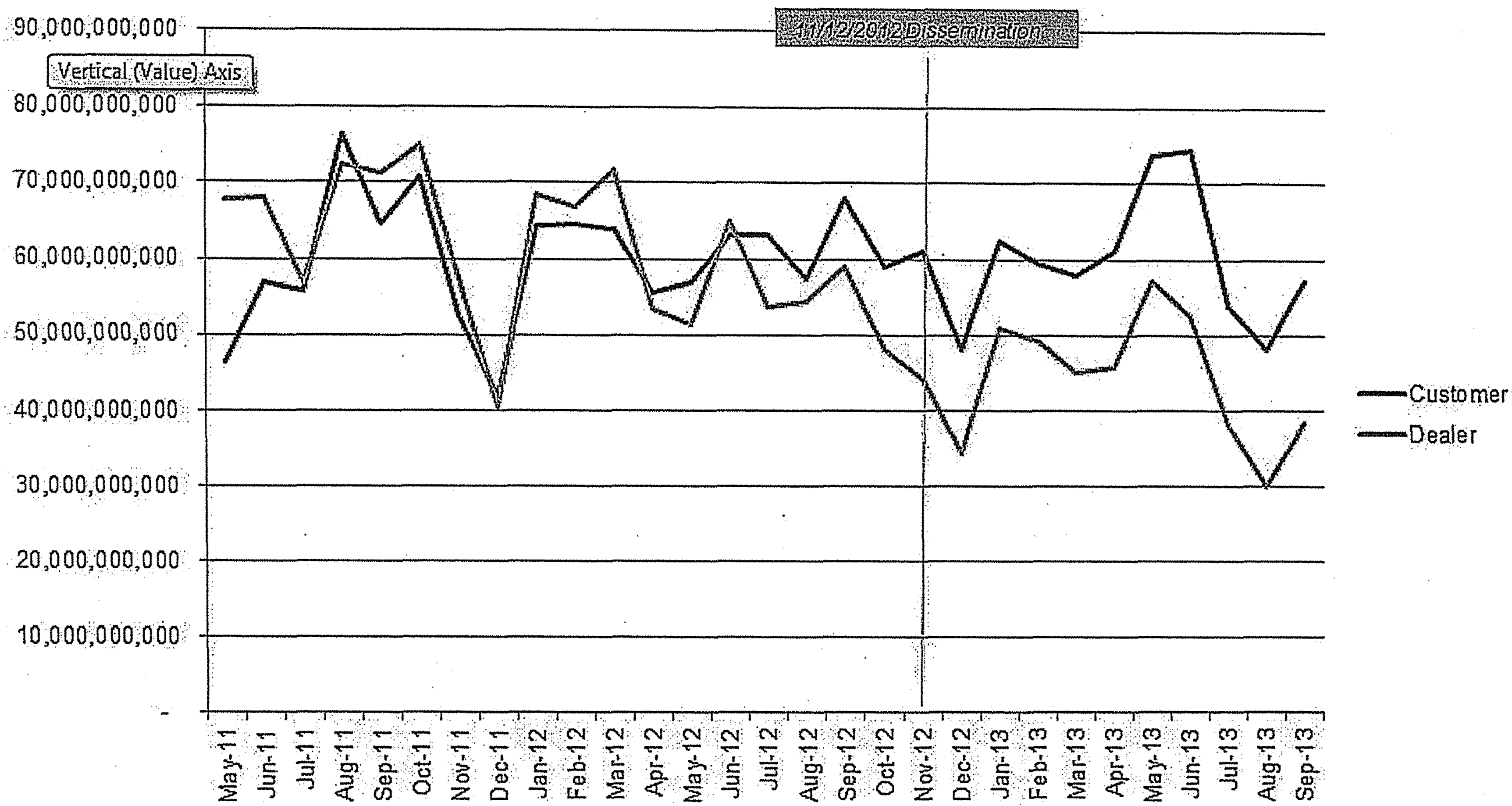
Trading Concentration by Product Types

- 99% of trading is in single family products.
- 75% of trading in Fannie Mae issued pools
  - Two thirds in 30-year Single Family Fannie Mae pools.

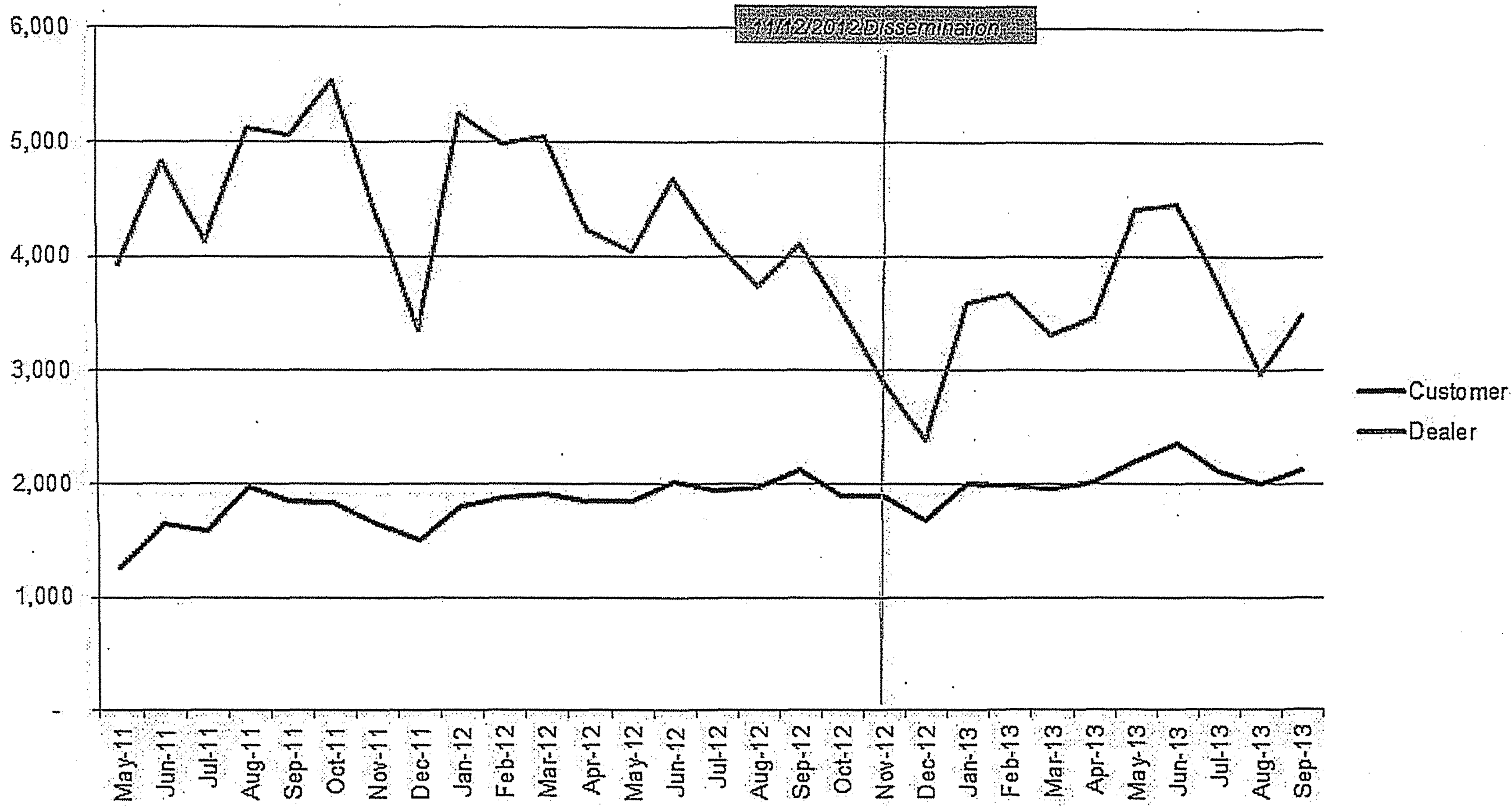
	Freddie Mac	Fannie Mae	Ginnie Mae I	Ginnie Mae II	Total
Single Family	11.0%	74.9%	6.2%	7.7%	99.9%
15yr	2.0%	12.5%	0.0%	0.0%	14.6%
30yr	8.9%	62.3%	6.2%	7.7%	85.2%
other maturity	0.0%	0.1%	-	0.0%	0.1%
Multi-Family	-	0.1%	-	-	0.1%
15yr	-	0.0%	-	-	0.0%
30yr	-	0.0%	-	-	0.0%
other maturity	-	0.0%	-	-	0.0%
Other Product Type	0.0%	0.0%	0.0%	0.0%	0.1%
15yr	-	-	0.0%	-	0.0%
other maturity	0.0%	0.0%	0.0%	0.0%	0.1%
Grand Total	11.0%	75.0%	6.3%	7.8%	100.0%

FINRA

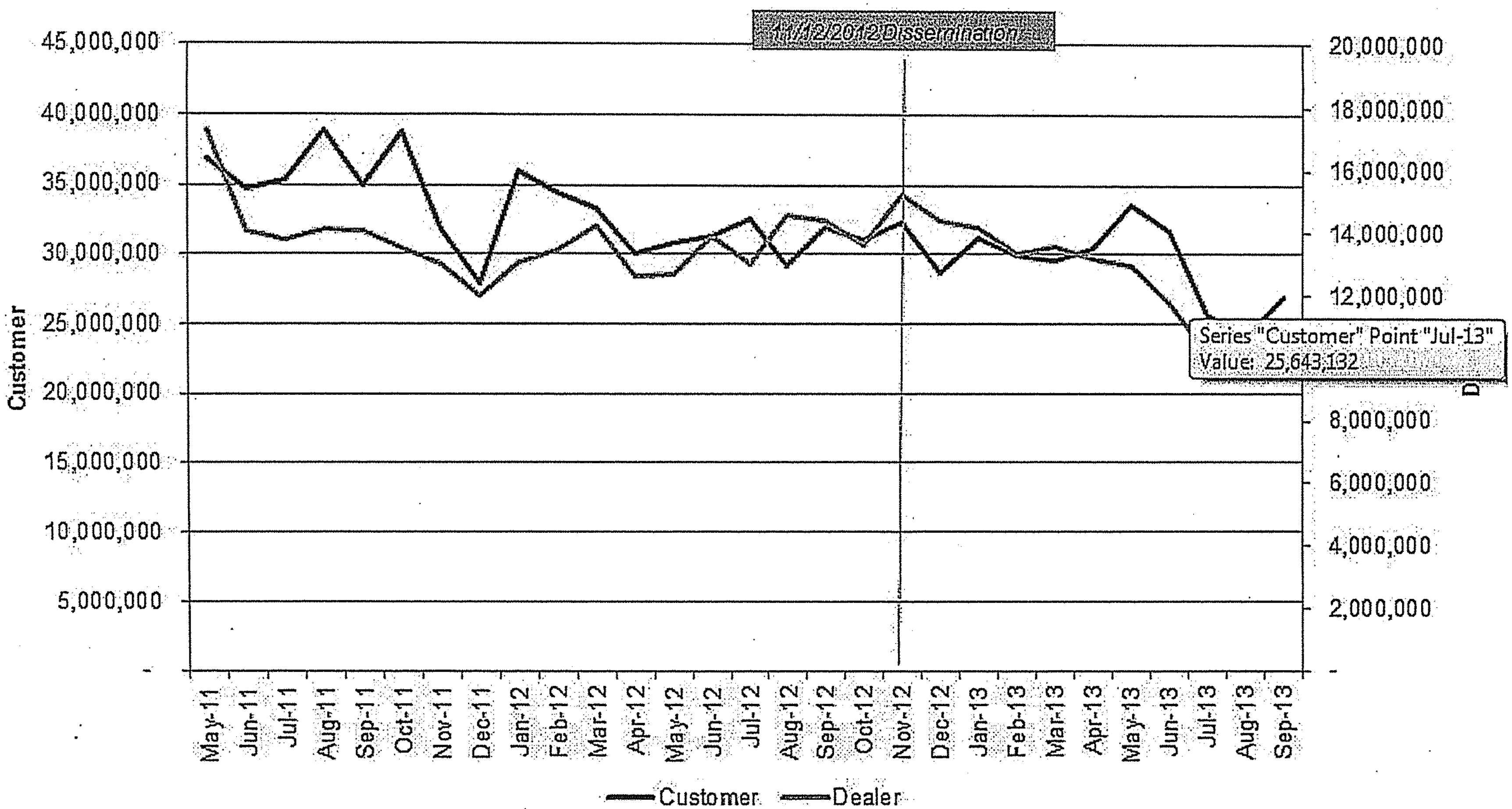
Average Daily Face Value – excluding Dollar Rolls



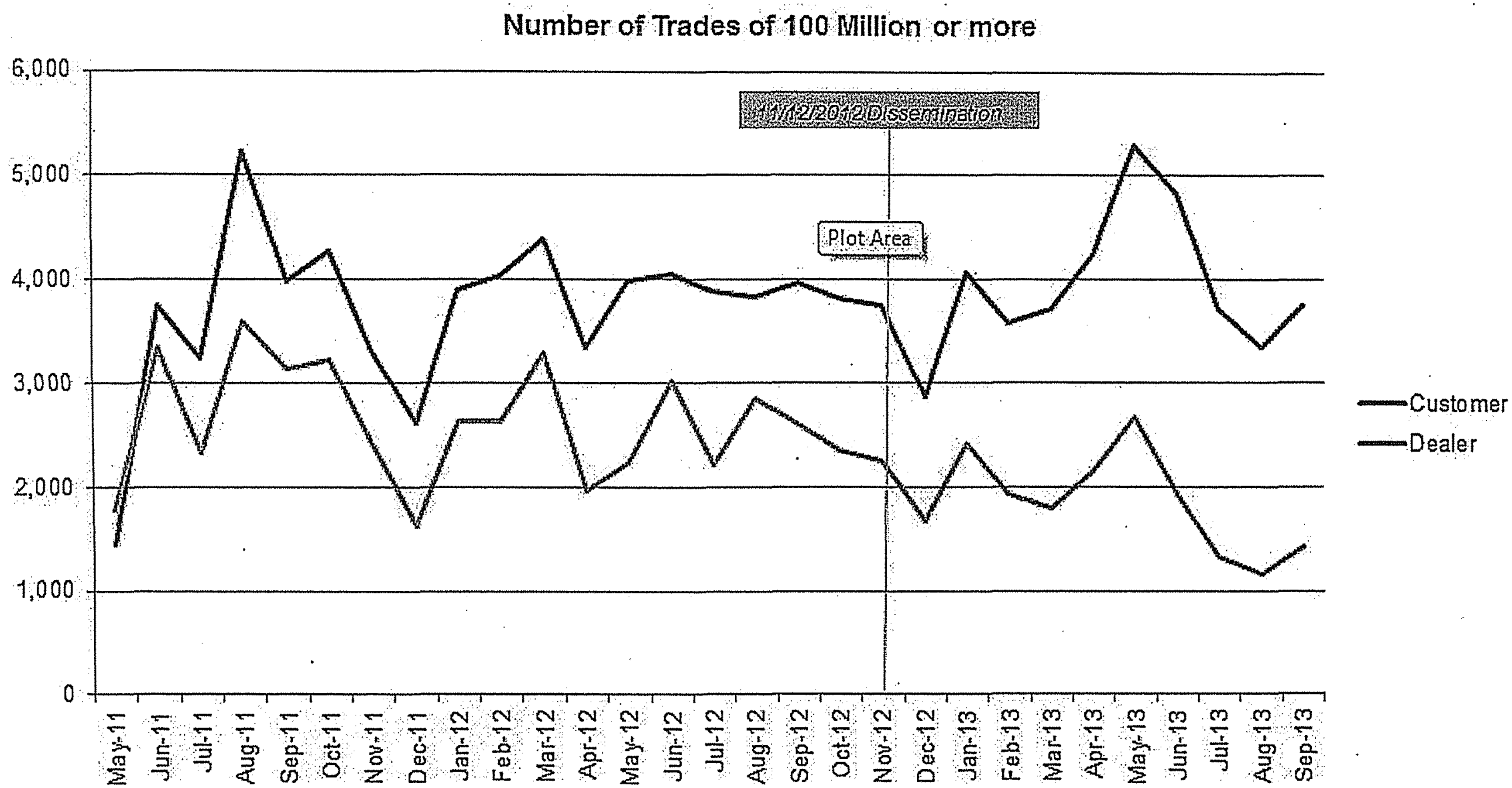
Average Daily Trades – excluding Dollar Rolls



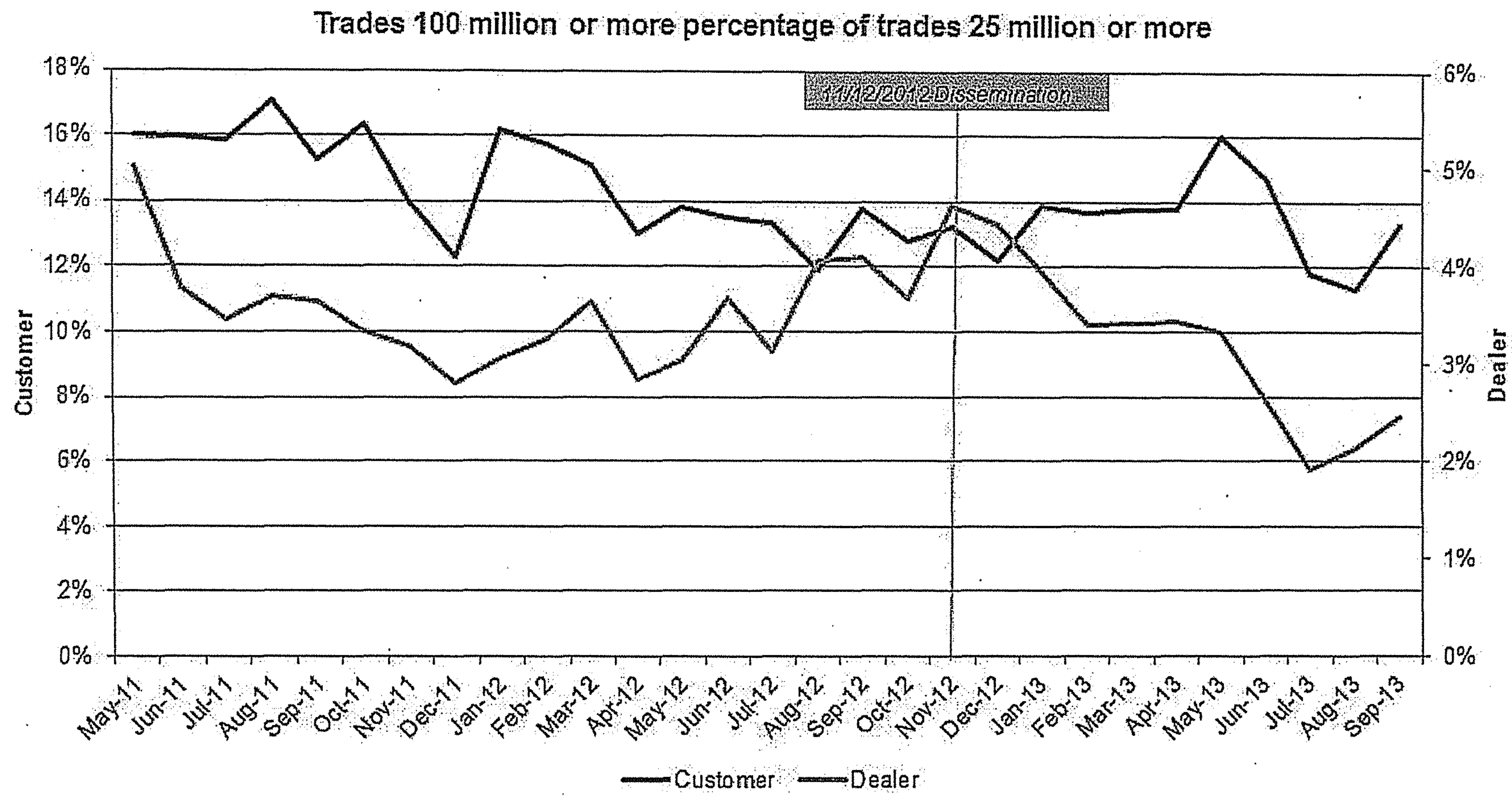
Average Trade Size – excluding Dollar Rolls



Trades of $100 Million or more

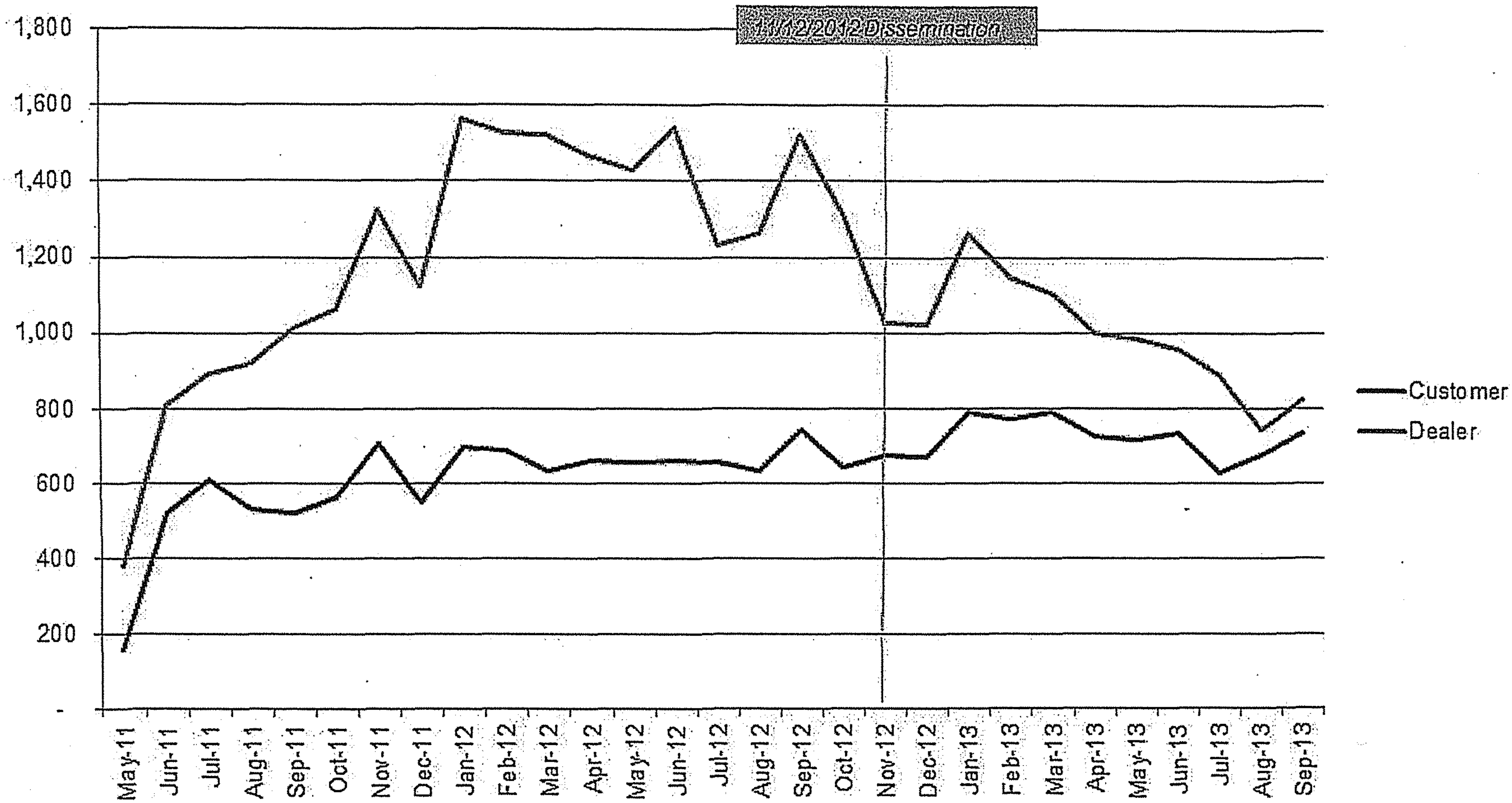


Proportion of Large Trades

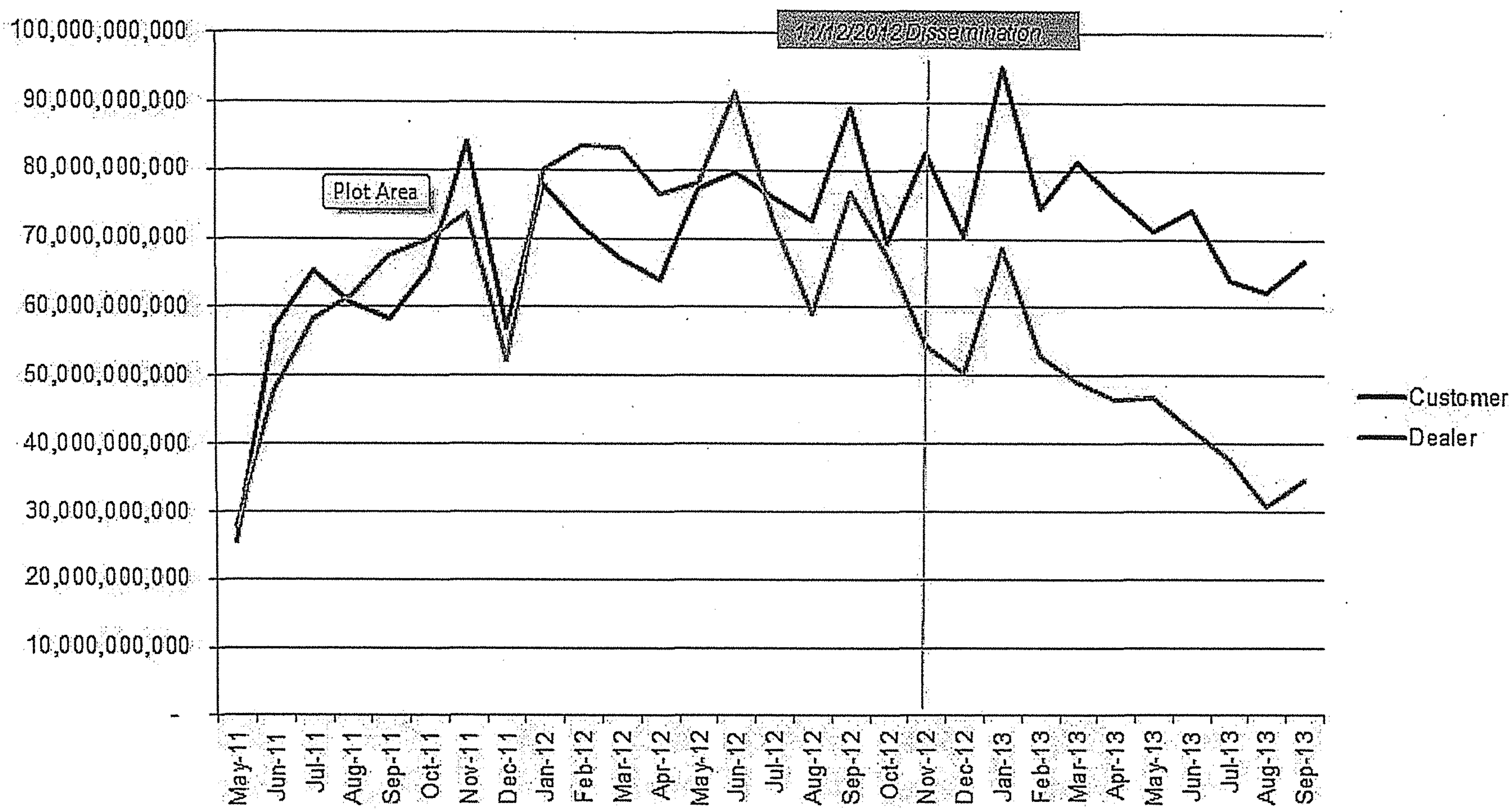


FINRA

Average Daily Trades – Dollar Rolls



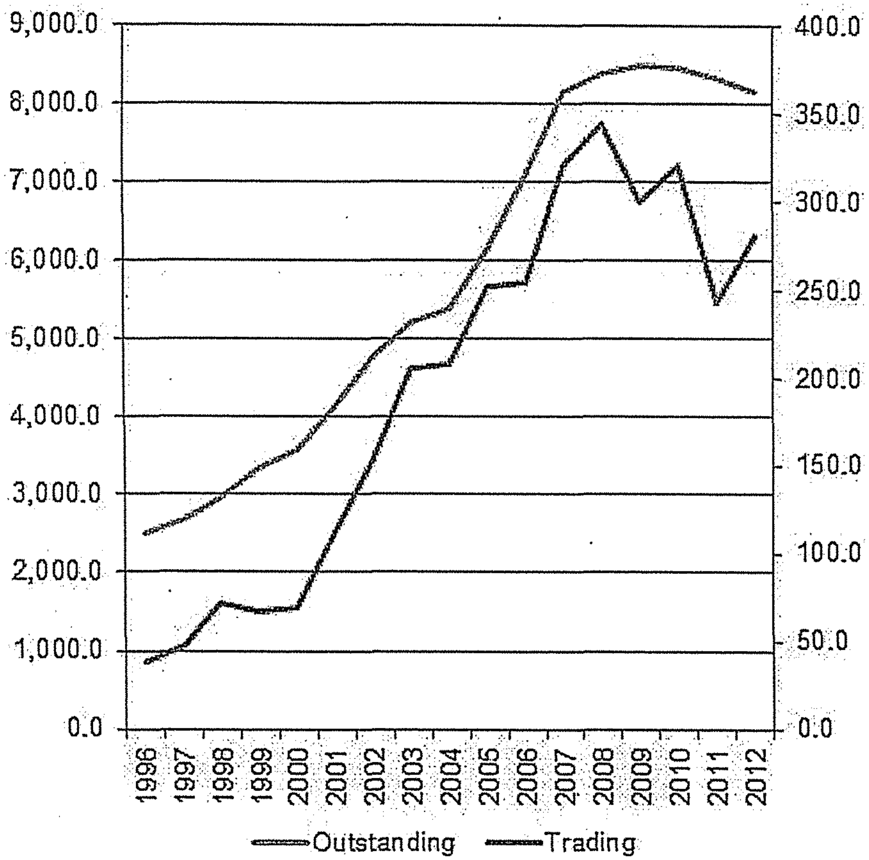
Face Value Traded – Dollar Rolls



Trading vs. MBS Outstanding and MBS Issuance

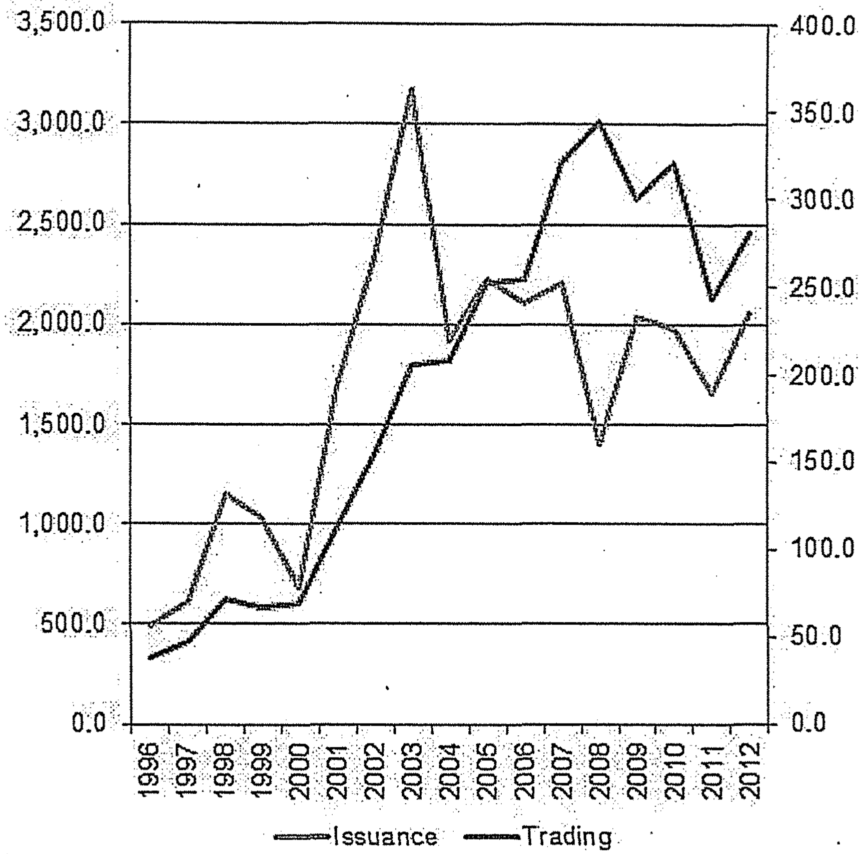
Correlation: 0.97

Source: SIFMA



Correlation: 0.65

Source: SIFMA



FINRA

TMPG Meeting Minutes
November 20, 2013

TMPG attendees

Julia Coronado (BNP Paribas)
Daniel Dufresne (Citadel)
Brian Egnatz (HSBC)
Michael Garrett (Wellington)
Beth Hammack (Goldman Sachs)
Curt Hollingsworth (Fidelity)
Jim Hraska (Barclays)
Mark Tsesarsky (Citigroup)
Stu Wexler (ICAP)
Tom Wipf (Morgan Stanley)
Matt Zames (J.P. Morgan)

FINRA attendees

Peter Tennyson
Grace Vogel
Bill Wollman

FRBNY attendees

Vic Chakrian
Joshua Frost
Frank Keane
Lorie Logan
James Narron
Simon Potter
Roman Shimonov
Susmitha Thomas
Janine Tramontana
Nate Wuerffel

- Representatives from the Financial Industry Regulatory Authority (FINRA) provided an overview of a draft proposed rule[1] under consideration by FINRA to establish margin requirements aligned with and informed by the TMPG's best practice recommendation for forward-settling agency MBS transactions.
  - FINRA representatives highlighted that the proposed rule would require bilateral margining of the same categories of forward-settling agency mortgage-backed security (MBS) transactions as those covered by the TMPG recommendation.
  - FINRA representatives also noted that the proposed rule would include specific requirements covering issues such as minimum transfer amounts, cure periods and counterparty exemptions. In addition, FINRA representatives noted that the proposed rule would require the collection of maintenance (or initial) margin from non-exempt accounts.
  - The Group commended FINRA on its efforts and emphasized the importance of continued dialogue between market participants and FINRA representatives as the complementary initiatives moved forward.

- The TMPG then turned to a discussion of feedback received on its best practice recommendation to margin forward-settling agency MBS transactions.
  - The Group reaffirmed its recommendation that market participants substantially complete the process of margining forward-settling agency MBS exposures by December 31, 2013.

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[1] FINRA's Board subsequently authorized FINRA to publish a *Regulatory Notice*) soliciting comment on proposed amendments to FINRA Rule 4210 (Margin Requirements) to establish margin requirements for To Be Announced (TBA) transactions, Specified Pool Transactions, and transactions in Collateralized Mortgage Obligations (CMOs), with extended settlement dates (referred to broadly as the TBA market). See: http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/P401515

- Members then discussed a request to harmonize the definition of forward settling across all covered transactions (to-be-announced (TBA), specified pool and adjustable-rate mortgage (ARM) transactions) to greater than T+3. The Group agreed to leave the definition of forward settlement unchanged, in light of the large volume of TBA activity that takes place two days before the standard settlement dates. The Group added that CMO transactions are less ready substitutes for TBA trades and pointed to the standard settlement cycle of T+3 for secondary trading in the spot CMO market.
- Members also discussed feedback that some market participants have been having difficulty obtaining agreement from all counterparties to implement the margining practice recommendation. The Group agreed that the best practices call for margining wherever there is counterparty exposure. Further, members noted that its best practice recommendation is not unlike best practices in other markets like the swaps market where market participants manage such risks through the use of collateral agreements and that counterparties that engage in margining for other markets should engage in margining of forward settling agency MBS transactions as well.
- Members then reviewed summary statistics showing progress to date and expected progress by year-end among TMPG members for the implementation of the margining practice recommendation. It was reported that as of November 15, TMPG member firms had, on average, covered roughly half of their notional trading volume (non-MBSCC) and that members estimated that by year-end they would, on average, expect to cover nearly 80 percent of their notional trading volume (non-MBSCC).

– The TMPG then discussed the possible publication of a white paper that would provide guidance on potential operational practices in the event of a delayed payment on a Treasury security.
  - Members agreed that market participants could benefit from a technical reference that examined potential operational, trading, and settlement practices, previously discussed by the group, and included in its June 28, 2012 meeting minutes, in order to support market liquidity in the event of a delayed payment. In addition, it was noted that the TMPG might provide clarity on common vocabulary used to describe various terms related to such a scenario to help facilitate further industry discussions.
  - A staff member of the Federal Reserve Bank of New York then provided an overview of the operational aspects of principal and interest payment processing for the Fedwire® Securities Service. The TMPG agreed that it would be helpful to market participants if such operational details were part of the potential white paper.

– The Group then discussed industry efforts to handle the financing of one-day-to-maturity securities in the tri-party repo market. Members suggested that these were ongoing discussions and the TMPG agreed to continue to monitor progress by industry groups.

- Members then reconfirmed their firms' operational readiness for Treasury's first FRN auction, which is expected to occur in late January 2014. The Group also noted that most market participants expect to include this new security type in general collateral financing transactions.

- The meeting then concluded with a discussion of recent market developments, focused principally on reactions to the Federal Open Market Committee's October meeting minutes and the recent functioning of the Treasury, agency debt, and agency MBS markets.
  - Some members noted the release of minutes from an October 16 FOMC video conference, including the discussion of the possible treatment of Treasury securities in Federal Reserve operations in the event Treasury was temporarily unable to meet its obligations because the statutory federal debt limit was not raised, which they suggested might reduce uncertainty and and be useful for market participants making contingency plans.

- Members agreed to hold a teleconference on December 5, 2013 from 2:00 to 3:00 pm to discuss a potential white paper related to potential operational practices the market could adopt in the event of a delayed payment on a Treasury security, and to review progress towards implementing the TMPG's agency MBS margining practice recommendation.

TMPG Teleconference Meeting Minutes – *December 5, 2013*

TMPG attendees

Daniel Dufresne (Citadel)	Beth Hammack (Goldman Sachs)	Nancy Sullivan (BNY Mellon)
Brian Egnatz (HSBC)	Jim Hraska (Barclays)	Mark Tsesarsky (Citigroup)
John Fath (BTG Pactual)	Murray Pozmanter (DTCC)	Stu Wexler (ICAP)
Michael Garrett (Wellington)	Gerald Pucci (BlackRock)	Tom Wipf (Morgan Stanley)

FRBNY attendees

Joshua Frost	Simon Potter	Nate Wuerffel
Frank Keane	Susmitha Thomas	
Lorie Logan	Janine Tramontana	

- On December 5, the TMPG held a teleconference to further discuss two items before year-end: a draft white paper related to potential operational practices the market could adopt in the event of a delayed payment on a Treasury security, and to review progress towards implementing the TMPG's agency MBS margining practice recommendation.

- Members reviewed a draft white paper (outlined during the meeting on November 20) that provides guidance on potential operational practices in the event of a delayed payment on a Treasury security, and provided feedback on this document.

- The Group then discussed its best practice recommendation to margin forward-settling agency MBS transactions.
    - Members reviewed summary statistics for TMPG member firms, which had increased slightly from previously reported averages and demonstrated continued progress with implementing the margining recommendation. As of November 29, 2013, TMPG member firms, on average, had covered about half of their notional trading volume (non-MBSCC) and expect to cover about 80 percent of their notional trading volume (non-MBSCC).
    - The above estimates suggested to all members that most market participants are actively engaged in negotiations to implement the best practice recommendation and expect that these negotiations will be substantially complete by year-end. Members stressed the importance of the terms of written agreements being subject to good faith negotiations and consistent with the prudent management of counterparty risk.
    - Members were encouraged by an increased focus on implementation across market participants and agreed that most of their counterparties were on track to substantially complete the process of margining forward-settling agency MBS exposures by December 31, 2013. The TMPG agreed to continue to monitor implementation progress on a weekly basis.

- The next TMPG meeting will take place on Wednesday, January 15, from 3:00-5:00 PM.

TMPG
TREASURY MARKET PRACTICES GROUP

December 2013

Operational Plans for Various Contingencies for Treasury Debt Payments

Introduction

This document is intended to provide a technical reference on some of the trading, clearing, settlement, and other operational challenges that might arise in the unlikely event of a delayed payment on Treasury debt. It focuses strictly on operational practices, with the intention of outlining steps that market participants might take to reduce some of the adverse consequences stemming from the operational complications associated with a delayed payment.

A delayed payment on Treasury debt could arise from a number of circumstances, such as systems failures, natural disasters, terrorist acts or other reasons. Contingency planning for such remote events is valuable, because a delay would present significant technical problems for the trading, clearing, and settlement of affected Treasury securities. Moreover, market participants would have difficulty preparing for these contingencies and coordinating with one another without some framework for understanding how payments and other operational matters might be handled.

Given these challenges, the Treasury Market Practices Group (TMPG) evaluated what practices might be adopted to support market functioning. The results of that effort are summarized in this document. It should be emphasized that the practices described here, if implemented, would only modestly reduce, not eliminate, the operational difficulties posed by a delayed payment on Treasury debt. Indeed, even with these limited contingency practices, a temporary delayed payment on Treasury debt could cause significant damage to, and undermine confidence in, the markets for Treasury securities and other assets. Moreover, some participants might not be able to implement these practices, and others could do so only with substantial manual intervention in their trading and settlement processes, which itself would pose significant operational risk. Other operational difficulties would also likely arise that could be severe and cannot currently be foreseen.

Of course, the appropriate approach for addressing these operational issues might depend on the exact circumstances that prompted the delay, and on how various systems and market infrastructure, including the Fedwire® Securities Service, evolve in the future. Nevertheless, we hope that this document will provide a sharper focus on some of the relevant issues

This document is available on the Treasury Market Practices Group website, www.newyorkfed.org/tmpg.

and, at a minimum, serve as a useful starting point for any future discussions.

Some Important Operational Features of the Fedwire Securities Service

Before discussing the potential practices contemplated in this document, we briefly review some important operational features of the Fedwire Securities Service, including how securities are ordinarily handled upon their maturity.

In the normal course of business, a security becomes non-transferable at the close of the Fedwire Securities Service the day prior to its maturity date, and the holders of record at that time receive payment on the maturity date. The Fedwire Securities Service ordinarily closes at around 7 p.m. eastern time (ET),[1] but this close can be extended by a couple of hours in exigent circumstances. Once a security becomes non-transferable, it cannot be transferred from one participant to another in the Fedwire Securities Service; in essence, the security is "frozen."[2] Given the design of the Fedwire Securities Service, once frozen, a security cannot be unfrozen.

Assuming that today and tomorrow are business days, if a security matures tomorrow, the final holders of the security on the Fedwire Securities Service at the close of business today will receive the principal payment on the maturity date (tomorrow). Ordinarily, at or around 8:05 a.m. ET on the maturity or coupon payment date, the Fedwire Securities Service makes principal and interest payments. The Fedwire Securities Service has the capability to delay a principal and/or interest payment if necessary or if requested to do so in advance by the issuer.

Summary of Potential Practices

The potential practices described here are designed to allow for the continued trading and transfer of securities that are subject to delayed principal payments. The potential practices rely on rolling the operational maturity date forward in the Fedwire Securities Service and other systems to allow affected securities to continue to trade and be transferable. Extending the operational maturity date of securities with delayed payments would allow more liquid market function than if the securities were frozen in the Fedwire Securities Service. In some cases, there may not be sufficient time to make this necessary adjustment.

To help preserve the transferability of securities for which payment is not made in a timely manner, the potential practices are explained below.

- Prior to running the Fedwire Securities Service end-of-day process on the day before a *principal* payment is due, if the Treasury determines that a principal payment cannot be made the following day, the operational maturity date of the securities on trading, custodial, settlement, and transfer platforms would be rolled forward, or extended, by one business day.[3] This practice could be repeated each day until the principal payment is made.[4] Once Treasury notifies the Reserve Banks that the principal payment will be made, the operational maturity date would no longer be rolled forward in the Fedwire Securities Service, and the principal payment would be made on the last established operational maturity date. This eventual payment of principal would be made to the holder of record as of the close of business the day before the actual principal payment is made.
- If a *coupon* payment is delayed, the eventual payment of the coupon would be made to the holder of record as of the close of business the day before the originally scheduled coupon payment date.
- Additionally, under these potential practices, the standard market conventions of quoting bills on a discount basis and notes and bonds on a "clean price" basis are expected to remain as viable market standards.

The asymmetric treatment of principal and coupon payments is preferable because of a number of operational issues faced by many large participants in the market, including clearing banks, utilities, and others. The proposed treatment of coupon payments would allow most systems to continue to track the proper settlement

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[1] Under normal circumstances, interbank originations for delivery-versus-payment transactions close at 3:15 p.m. ET, reversals related to those transactions close at 3:30 p.m. ET, transfers against payment between two accounts of the same participant close at 4:30 p.m. ET, and transfers free of payment between two accounts of the same participant close at 7:00 p.m. ET.

[2] Please see the appendix for a glossary of terms.

[3] The Fedwire Securities Service's roll of the operational maturity date would need to be instructed by the Treasury.

[4] The Fedwire Securities Service has the capacity to roll maturity dates day by day, if instructed to do so by the issuer before the close of the Fedwire Securities Service on the day prior to the maturity date. The Fedwire Securities Service can roll the maturity date for operational purposes for Treasury bills, principal payments on coupon-bearing instruments, and principal STRIPS. Interest STRIPS would not roll forward and would be treated consistently with the associated coupon payment for a fully constituted note or bond, which would also not roll forward, given a delay. Of note, the process of rolling the operational maturity date forward would not change the actual maturity date specified in the terms and conditions of the Treasury Offering Circular—it would simply be intended to facilitate continued transferability in the affected securities.

proceeds of trades with less manual intervention, as it is consistent with conventional calculations of accrued interest, overall settlement proceeds, etc.

Even under the potential practices, a delay in the payment of Treasury debt would still entail significant operational difficulties and require manual intervention for nearly all market participants. Moreover, from an operational perspective, these practices can only be accommodated by the Fedwire Securities Service if instructions to roll forward the operational maturity date are provided by the Treasury before the close of the Fedwire Securities Service on the day prior to a scheduled maturity.

Of course, there may be circumstances under which notification on the required timeline would not be possible. If circumstances do not allow for timely notification, the affected issues would cease to be transferable over the Fedwire Securities Service. In such cases, market participants would need to consider securing other sources of funding or making bilateral arrangements to contractually transfer interests in the security outside of the Fedwire Securities Service.

Market participants should recognize that how the Fedwire Securities Service will treat a delayed payment would be determined by the Treasury. The potential practices discussed in this document represent just one approach that the Treasury could take.

Treatment of Securities with Delayed Principal

Across various systems (including the Fedwire Securities Service), the operational maturity date of securities with delayed principal payments could be rolled forward one day at a time until payment is made. The eventual payment of principal would be made to the holder of the security as of the close of Fedwire the day before the actual principal payment is made.

Operationally, this practice would be triggered each day by a communication from the Treasury prior to the close of the Fedwire Securities Service and would need to continue on a day-by-day basis for as long as the delay lasts. If no action was taken, the operational maturity date for affected issues would not be rolled forward and these securities would cease to be transferable over Fedwire Securities Service. Trading in these issues would likely dramatically decrease or might cease altogether.

Rolling forward the operational maturity date appears operationally feasible for most large market service providers. Most large clearing banks have indicated that they would likely still be able to clear trades and perform other services for their clients (including custody services, tri-party repurchase agreements, and securities lending), albeit with substantial manual intervention. The primary central counterparty utility for the Treasury market, Fixed Income Clearing Corporation (FICC), would also be able to accommodate this solution.

Importantly, while the potential practices envision rolling forward the operational maturity date by one day, such action would not change the underlying payment terms or the legal maturity date of the security; the practices would simply represent an operational step taken to allow the affected securities to continue to be transferred.

Treatment of Delayed Coupons

All coupon payments should be paid to the holder of record as of the close of business the day before the originally scheduled, or contractual, coupon payment date.

Two potential treatments of delayed coupon payments were initially considered: paying the coupon to the holder of record at the time that the funds become available to make the payment, or paying the coupon to the holder of record at the time of the originally scheduled payment.

The originally scheduled payment date approach appears to work best with existing accounting and settlement systems across a range of market participants. Most systems are set up to trade and settle on a standard invoice price basis, and continuing to carry missed coupons in the invoice price would require significant manual overrides and lead to considerable additional operational risk.

Accordingly, the TMPG recommends that the eventual payment of interest be made to the holder of the security as of the close of business the day before the originally scheduled coupon payment date.

Compensation for Delayed Payments

It would require explicit legislation by Congress to provide compensation to holders of securities affected by a delayed payment on Treasury debt for the delay in these payments. As a result, at the time of a delay, investors most likely would not know whether this compensation would be provided and what form it might take. Nevertheless, market prices of Treasury securities would take into account the possibility of such compensatory payments, and hence this document proposes a potential practice to accommodate this. The most straightforward practice for the market to accommodate would likely be as follows:

- The parties that receive the delayed payments (either the holder of record as of the close of business the day before the actual payment date in the case of delayed principal payments, or the holder of record as of the contractual payment date in the case of delayed coupon payments) should also be the ultimate beneficiaries of any subsequent related compensatory payments. Although the parties would likely not know at the time of the delay whether compensatory payments would be forthcoming, to whom they would initially be paid, or the magnitude of any such payments, agreeing to their ultimate disposition (should the compensation be realized) in the trade confirmation would serve to reduce uncertainty and support liquidity in affected issues.

This practice recognizes that parties entitled to receive the coupon payments would receive such payments later than originally scheduled, and hence could be compensated for not receiving the payment in a timely way. It also clarifies who receives any compensatory interest on the delayed principal payments in a simple manner, allowing the security to trade at a price that appropriately reflects any expected accrual of compensatory interest. To be clear, the TMPG makes no presumption that such a compensatory payment would be made.

Proposed Quoting Conventions

Given the recommended practices above, the TMPG recommends that standard market practices for trading and quoting Treasury securities should continue to be used in the event of a delayed payment on Treasury debt. In particular, Treasury bills should continue to be quoted on a discount basis, and notes, bonds, and Treasury Inflation-Protected Securities (TIPS) should continue to be quoted using the practices that are in place currently.[5] Of note, for Treasury bills, relatively small price discounts could result in unusually high discount rates given a one-day effective maturity under a delay. Market participants should ensure that their systems for processing bill trades are able to handle abnormally high discount rates.

Most trading systems are set up to transform "clean" quotes on notes, bonds, and TIPS into invoice prices (that is, price quotes inclusive of accrued interest). We believe continuing to quote notes, bonds, and TIPS that have experienced a delayed payment of principal or interest on a clean price basis should allow most systems to continue to process trades in a more straightforward manner than would be seen if quoting for affected issues moved to an invoice, or "dirty price," basis. Even if the operational maturity date was not rolled forward in the Fedwire Securities Service, the market might still adopt the same convention of quoting securities based on an assumed maturity date of the following business day.

Pricing Conventions

In the event of a delayed payment on Treasury debt, another key issue would be how pricing vendors would treat Treasury securities with delayed payments. Some service providers, such as large clearing banks, typically accept quotes obtained from pricing vendors without adjustment. Therefore, if vendors were to provide problematic pricing data, such as setting the price of a Treasury with a delayed payment to $0 (as is common treatment for defaulted commercial paper or certificates of deposit) or selecting a different quoting convention than their customers use, they will generally accept this pricing. We believe that the market would benefit from having pricing service providers continue to provide reasonable (that is, non-zero) prices for Treasury securities that have experienced a delayed payment and such prices should be provided on a timely basis.

Payment System and Custody Considerations

Under a delayed Treasury debt payment scenario, there would likely be a number of problems encountered by custodians, but these might be somewhat less disruptive with some preparatory work. Most custodial arrangements for Treasury securities operate such that custodians advance payments that are to be generated by securities held in custody. In the event that these payments were not paid to custodians in a timely manner, custodians would need to decide whether or not to advance principal and interest proceeds. In light of the potential practices in this document, custodians and their customers may wish to discuss the potential challenges faced in the event of delayed payment on Treasury debt.

At present, differences in systems capabilities exist across various market utilities that process Treasury trades. The two major clearing banks can roll forward the operational maturity date and still clear trades and perform other services for their clients (including custody, securities lending, and tri-party repo), albeit with a fair amount of manual intervention. It is recommended that all firms that clear Treasury trades or perform related custodial or payment system functions review the capability of their systems to operate under the practices provided in this document.

Documentation Considerations

In light of the proposed practices, the TMPG recommends

[5] The date used to convert a discount rate to price should be the value of the maturity date in place at the time of the trade. As an example, if a payment was originally due on a Thursday, and on Wednesday night the operational maturity date had been rolled forward to Friday, trades that take place on Thursday should use Friday as the assumed maturity date for discount rate-to-price conversion purposes.

that market participants review existing contractual documentation to determine if extending the operational maturity date for a security with a delayed payment would raise concerns with respect to terms and conditions related to pricing or default provisions.

Operational Practices

Treasury market stakeholders should keep in mind the potential practices discussed in this document during routine systems maintenance efforts, and should consider opportunistically incorporating the ability to follow the practices. This planning should consider questions such as:

- What systems issues arise and what manual procedures would need to be invoked if the proposed treatment of delayed interest and principal payments was implemented?
- Are there any operational modifications that can shorten the time needed to roll forward the operational maturity date in key systems, given short notice?
- If the operational maturity date was not rolled forward in the Fedwire Securities Service before the close one day before the legal maturity date, what system changes would be necessary to support continued trading of Treasuries that would only be transferable within a clearing or custodial bank (that is, not over the Fedwire Securities Service)?
- Would settlement and custodial systems process maturities on an automated basis on the night before maturity for the next day's settlement? If so, would positions automatically reflect the receipt of cash, posing a problem if the cash was not received as scheduled?
- Would changing the operational maturity date of the security lead systems to cancel and re-book entries? Would systems continue to accrue interest for a security that has its operational maturity date rolled forward? Would there be a need to manually intervene to zero out the coupon during the delay period?
- Would the manual nature of the potential practices lead to operational bottlenecks?
- Would the protocol for handling one-day-to-maturity securities in tri-party repo transactions in the normal course of business apply as well in a payment delay scenario?

Summary

While the practices contemplated in this document might, at the margin, reduce some of the negative consequences of a delayed payment on Treasury debt for Treasury market functioning, the TMPG believes the consequences of such a delay would nonetheless be severe. In part, this reflects the fact that some participants may not be able to implement these practices. Moreover, participants that do implement them may need to rely on substantial manual intervention—a recourse that poses additional operational risks. In general, it is difficult to anticipate the full range and severity of problems that could emerge from delayed payments. Nevertheless, the potential practices outlined here provide a framework under which market participants can begin to make adjustments to their contingency plans. As participants consider the robustness of their internal systems to these practices, we believe it would be a matter of prudent planning to begin developing more flexible internal systems and processes for this remote contingency.

Appendix: Glossary of Terms

Discussing operational arrangements given a delayed payment on Treasury securities is made easier if participants use a common vocabulary.

Actual payment date: The date on which payments are made to the holder of record. In the normal course of business, this is the same as the contractual payment date, but in a contingency scenario, delayed payments might be made and settled after the original maturity date.

Contractual payment date: The date on which payments are originally due to be paid. All principal and interest payments in the normal course of business are paid on this date.

Fedwire Securities Service: A book-entry securities transfer system that provides safekeeping, transfer, and delivery-versus-payment settlement services. "Fedwire" is a registered service mark of the Federal Reserve Banks.

Frozen: Refers to a security no longer being transferable on the Fedwire Securities Service. Once frozen, a security cannot be transferred from one holder of record to another on Fedwire.

Legal maturity date: The scheduled maturity date of a security, which does not change whether or not the operational maturity date is rolled forward on Fedwire.

Operational maturity date: The date reflected in the maturity date field in various systems. Under a payment delay, it is envisioned that the operational maturity date can be extended by modifying the maturity date in Fedwire and other systems beyond the legal maturity date to maintain transferability and liquidity on a one-day rolling basis (subject to timely authorization by Treasury). Such an operational roll would not change the legal maturity date.

Rolling the operational maturity date: Refers to a situation in which, subject to timely authorization from an issuer, the operational maturity date of a security is extended one day at a time to maintain transferability over Fedwire until a delay is resolved. Rolling forward the operational maturity date would not change the legal maturity date.

Transferable: Refers to a security's ability to be transferred from one holder of record to another across the Fedwire Securities Service.

The Treasury Market Practices Group (TMPG) is a group of market professionals committed to supporting the integrity and efficiency of the Treasury, agency debt, and agency mortgage-backed securities markets. The TMPG is composed of senior business managers and legal and compliance professionals from a variety of institutions—including securities dealers, banks, buyside firms, market utilities, and others—and is sponsored by the Federal Reserve Bank of New York. Like other Treasury Market Practices Group publications, this document represents the views of the private sector members. The ex officio members do not express a position on the matters herein. More information is available at www.newyorkfed.org/tmpg.

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CLO: #Y - 16
CCS: 14- 1442
RECVD: 2/28/14

Questions for the Record submitted by Rep. Mick Mulvaney (R-SC)
Committee on Financial Services
Hearing on "Monetary Policy and the State of the Economy"
Witness: The Honorable Janet Yellen, Chair of the Board of the Federal Reserve
Hearing Date: February 11, 2014

Question #1: Chair Yellen, did Secretary Lew, Secretary Geithner or anyone else at the Treasury Department or anyone acting on their behalf at any time request that the Federal Reserve Board, the Federal Reserve System or the Federal Reserve Bank of New York examine the viability of prioritizing payments on Treasury obligations in relation to a failure to lift the statutory debt ceiling? Have any officials or staff at the Federal Reserve Board or the Federal Reserve System examined that issue? If so, please name those staffers and provide any records or communications related to that inquiry.

Question #2: Chair Yellen, the minutes of emergency meetings of the Federal Open Market Committee (FOMC) held on October 16, 2013 and August 1, 2011 regarding the debt ceiling reflect a briefing provided to the FOMC. The minutes of the most recent meeting reference that "[t]he staff provided an update on legislative developments bearing on the debt ceiling and the funding of the federal government, recent conditions in financial markets, technical aspects of the processing of federal payments..." Please provide the names of all staffers who briefed the FOMC regarding those matters during either meeting or assisted in the preparation of those updates. Please provide any documents, records or other communications related to those updates.

Question #3: Chair Yellen, were any staff or officials at the Federal Reserve Board or the Federal Reserve System consulted by any staff or officials at the Treasury Department regarding Secretary Lew's testimony on the debt limit before the Senate Finance Committee on October 10, 2013? What were the names of those officials or staff at the Treasury Department and at the Federal Reserve Board or the Federal Reserve System? Please provide any documents, records or other communications related to any such consultations.

Question #4: Chair Yellen, you testified before our Committee on February 11, 2014 that the Federal Reserve's function as the fiscal agent of the United States allows the Federal Reserve to keep information confidential from the United States Congress. Please provide all legal authority you consulted or relied upon, or that anyone who advised you consulted or relied upon, to make that argument during your testimony. Please explain why you think this confidentiality obligation trumps the Federal Reserve's statutory independence.

Question #5: Have you or any other staff or officials at the Federal Reserve had any discussions with any staff or officials of the Treasury Department or with the President or a member of his Administration about whether and how the Federal Reserve will act or provide resources to prevent a default in the event the debt ceiling is breached? Has the Federal Reserve had any discussion about either funding or forbearing, with respect to the payments on the trillions of dollars of Treasury debt and agency securities now held by the Federal Reserve System? Please provide the names of all persons with whom such discussions occurred and any documents, records or other communications related to those discussions.

Question #6: Since the Volcker final rule ("Volcker") was released, we have heard conflicting reports about which, and how many, regulators may examine and enforce banking entities' compliance with Volcker. Given the myriad scenarios that could result in a single trade being overseen by multiple regulators, the threat of duplicative and potentially conflicting oversight is obvious. However, Governor Tarullo testimony at this Committee's February 5th hearing indicated that only one regulator would have the power to enforce compliance with the Rule for a given trade.

In response to my question about enforcement jurisdiction, Governor Tarullo responded, "Whoever is the primary regulator of [an entity making a trade] has, by congressional delegation, the regulatory authority over them." He went on to state that the other Volcker regulators would not have authority to overturn the primary regulator's determination of the permissibility of a trade, stating that none of the other four Volcker regulators "has the authority under the Volcker rule and the statute to say no, that's incorrect." Governor Tarullo finished this point by stating that "there's not really shared jurisdiction over a particular trade."

Given the importance of a transparent and predictable enforcement process, I would like to know whether Governor Tarullo's testimony comports with your interpretation of how Volcker's ban on proprietary trading will be enforced. In short, can multiple regulators review and impose a binding determination over a single trade, or will only the primary regulator for a given trade have such authority?

Question #7: During your service as the President and CEO of the Federal Reserve Bank of San Francisco, you often spoke publically and in meetings of the Federal Open Market Committee about growing concerns you had with the potential of broad economic damage from the boom in housing prices. In fact, you were one of the first to describe the rise in prices as a "bubble." Yet, you did not lead the Federal Reserve Bank of San Francisco to check the increasingly indiscriminate lending of Countrywide Financial. You said that despite your concerns, you had not explored the San Francisco Fed's ability to act unilaterally, and argued against deflating the housing bubble because the "arguments against trying to deflate a bubble outweigh those in favor of it" and predicted that the housing bubble "could be large enough to feel like a good-sized bump in the road, but the economy would likely be able to absorb the shock."

In 2010, during your testimony to the Financial Crisis Inquiry Commission, you admitted that you "did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system, the S.I.V.'s [structured investment vehicles]— I didn't see any of that coming until it happened."

You went on to state that, "This experience has strongly inclined me toward tougher standards and built-in rules that will kick into effect automatically when things like this happen, that make tightening up a less discretionary matter."

Do you think your experience at the Federal Reserve Bank of San Francisco, particularly related to the failure of Countrywide Financial, may result in overcompensation by the Federal Reserve in the regulation of banks and the pursuit of mortgage settlements? Please describe why or why not.

Question #8: I previously asked your predecessor, Chairman Bernanke, about the losses the Federal Reserve will face when interest rates rise. Since rates have in fact risen significantly since the trough in Treasury yields in 2012, the supposition is that the Federal Reserve already faces large losses on its portfolio. However, as the Federal Reserve does not "mark to market," these loses are not shown on the balance sheet.

Actually selling the bonds, however, would force the Federal Reserve to incur the losses, which would negatively impact the combined earnings of the Fed, and thus the money available for remittances to the Treasury. When I asked Chairman Bernanke about this, he indicated that the same policy goals could be achieved by "repo-ing" the bonds instead of selling them.

1. Do you agree with Chairman Bernanke on the desirability of repo-ing bonds instead of selling them as part of monetary tightening? If so, do you believe the repo market is large enough to absorb hundreds of billions, if not trillions, of dollars of bonds? What historical evidence do you have to support your position?

2. Are you concerned about the political ramifications of incurring dramatic losses at the Federal Reserve as a result of selling large portions of the bond portfolio in a rising interest

rate environment? Has the FOMC discussed this issue, and if so, can you summarize the positions offered by the FOMC members?

3. On a mark to market basis, the Federal Reserve could face significant losses and require recapitalization in the event interest rates return to mean. What plans have you or the Federal Reserve made with the President, Secretary Lew or other members of the Administration concerning recapture of Federal Reserve losses?

Question #9: I previously discussed with your predecessor, Chairman Bernanke, the effect long-term zero interest rates have on the government, the economy and on consumer behavior in terms of the consequences of borrowing and debt accumulation. Has the Federal Reserve conducted any studies on the long-term impact of the zero or very low interest rate policy on: 1) the Social Security Trust Fund; and 2) discouraging saving and investment by individuals? Please provide any such studies or detail the findings and conclusions of any such research on these topics.

Question #10: Has the Federal Reserve conducted any studies on the impact of rising interest rates on the market for interest rate derivatives? Has the Federal Reserve conducted any studies on the impact of rising interest rates on systemically important financial institutions, on account of their exposure to interest rate derivatives? Please provide any such studies or detail the findings and conclusions of any such research on this topic.

Question #11: The Federal Reserve has tapered its quantitative easing policy approximately 20%, causing a marginal increase in interest rates in the United States. However, this policy has had a significant impact on emerging markets such as Turkey or Brazil, and our own equity markets have fallen roughly 9%. How do you plan to wind down quantitative easing and exit the markets without a global recession in equity markets and an equity market reset in the United States? What impact will this have on holding purchasing power?

Question #12: What rate of inflation do you deem to be acceptable? What definition of inflation are you using to make that determination?

Question #13: The average time between recessions during the post-war period is 59 months, which would be April of this year. The longest period between recessions has been 10 years, which would put the next recession no later than May, 2019. The average of the past three cycles is around 7 and one-half years, which would be around November, 2016. If we do go into a recession with near zero interest rates, then we could most likely face another protracted recovery. How do these historical experiences impact your outlook, if at all? What tools could you bring to bear if we did enter another recession with near zero interest rates?

Question #14: What areas of the economy appear currently at the greatest risk of forming asset bubbles?

Question #15: What is the Federal Reserve's view toward Bitcoin? Do you believe the Federal Reserve has the legal authority to regulate Bitcoin? Do you believe the Federal Reserve should? If so, do you anticipate doing so?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 2, 2014

The Honorable Kyrsten Sinema
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the February 11, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

Questions for The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Sinema:

1. In your testimony, you noted that recovery in the job market is proceeding slowly, but [t]hose out of a job for more than six months continue to make up an unusually large fraction of the unemployed. As you know, the long-term unemployed depend on extended unemployment benefits to stay afloat while they look for jobs. When Emergency Unemployment Compensation benefits expired this past December, over 12,000 families in Arizona lost crucial benefits, and failure to extend this program could cost the state's economy over $150 million in 2014 alone. But this situation is not unique to Arizona. Given the uncertain future of unemployment insurance extensions in Congress, what effect on the job market does FOMC foresee if we fail to extend relief to the long-term unemployed?

The primary effect of extended unemployment insurance (UI) benefits is to help to support the income and consumption of those who have been out of work long enough to have exhausted their regular state UI benefits. In addition, extended UI benefits can help to blunt some of the effects that long-term joblessness can have on the broader economy. In particular, because people receiving unemployment benefits tend to spend a high fraction of their income, by offsetting a portion of these individuals lost wages, extended UI benefits help to support aggregate spending.

It is also possible that extended unemployment benefits could discourage some unemployed individuals from taking jobs. However, most economists believe that this effect is relatively small, in part because only a fraction of one's previous paycheck is typically replaced by unemployment benefits. Hence, on balance, extended unemployment benefits most likely help to support the job market in a weak economy through their effects on aggregate spending.

2. In your testimony, you mentioned that last year's increase in mortgage rates has slowed recovery in the housing sector. Home prices are rebounding slowly but surely. Arizona alone has seen over a ten percent increase in home values this past year and three percent growth is projected for next year. Given that prices continue to rise, are you concerned that increasing mortgage rates could discourage home buying and cost us the critical growth we have seen in recent years?

As you suggest, the rise in home prices and mortgage rates over the past year has cut into the affordability of homes for many potential home buyers. Reflecting this development, the volume of existing home sales has dropped over the past several months. Nonetheless, to date, broader measures of economic growth have been fairly resilient in the face of slowing housing market activity. I currently expect such activity to turn up some in the coming months as macroeconomic and labor market conditions continue to improve.

3. Several American insurance companies were concurrently designated Globally Systemically Important Institutions (G-SIIs) by the international Financial Stability Board (FSB) and Systemically Important Financial Institutions (SIFIs) by domestic regulators under the Dodd-Frank Act. The Fed apparently participated in FSB deliberations, which in some cases resulted in American companies designation on the international level as

G-SIIs before they were labeled SIFIs by regulators at home. Did the Fed make any effort to forestall FSB designation until the SIFI process was complete, and do you see a problem with such international determination predating decision making by American regulators?

The International Association of Insurance Supervisors (IAIS) was established in 1994 as the international standards setting body responsible for the insurance sector. In 2013, the IAIS published a methodology for identifying global systemically important insurers (G-SIIs) and a set of policy measures that will apply to them. At the time that the IAIS formulated the G-SII methodology and policy measures, the Federal Insurance Office (FIO) (an office within the Treasury Department), the National Association of Insurance Commissioners, and state insurance regulators were members of the IAIS and participated actively in the process. The Financial Stability Board (FSB) subsequently endorsed the IAIS methodology and the policy measures and published a list of nine G-SIIs, three of which are U.S. insurance firms. The Financial Stability Oversight Council (FSOC) has designated two of the three U.S. G-SII firms for supervision by the Federal Reserve.

There is considerable overlap in membership between the FSOC and FSB. The three U.S. members of the FSB--the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission are also voting members of the FSOC. In addition, FIO and the state insurance regulators are nonvoting members that participate in the FSOC. The FSOC had done considerable work on non-bank insurance SIFIs by the time the FSB published the G-SII list. Moreover, the FSOC and its committees had been briefed several times on the progress of IAIS work on G-SII designation before the IAIS and FSB made their final decisions about G-SII designations.

International regulatory standards and designations developed by the FSB or IAIS are not legally binding. Neither the FSB, nor the IAIS, has the ability to implement requirements in any jurisdiction. Implementation in the United States would have to be pursuant to U.S. law and would have to comply with the administrative rulemaking process, including an opportunity for public comment.

4. In your confirmation hearing, you agreed that banks and insurance providers should be subject to regulations that are tailored to their unique features, rather than a one-size-fits all approach. How will you ensure that the Federal Reserve works with industry and other experts to develop an insurance-based capital framework and what is the timetable for rulemaking on this topic?

The Federal Reserve understands the challenges posed by applying the enhanced prudential standards, in particular the capital and liquidity standards, to firms primarily engaged in insurance activities. The Federal Reserve is assessing the designated insurance firms to determine how enhanced prudential standards should apply to them and the extent to which tailored application of the standards would be appropriate. Each firm will receive notice and opportunity to comment prior to a final determination of the enhanced prudential standards that the Federal Reserve will apply to the company. It is important to note the Federal Reserve's ability to tailor the enhanced capital requirements for designated insurance firms is limited by the

Collins Amendment, which requires the Federal Reserve to subject all FSOC-designated firms to capital requirements that are at least as stringent as those applicable to banks.

CLO:	#Y - 18
CCS:	14-1441
RECVD:	2/28/14

Questions for the Record – Committee on Financial Services

From: Congresswoman Kyrsten Sinema

Date: February 11, 2014

Title: "Monetary Policy and the State of the Economy"

For Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System

1. In your testimony, you noted that recovery in the job market is proceeding slowly, but "[t]hose out of a job for more than six months continue to make up an unusually large fraction of the unemployed." As you know, the long-term unemployed depend on extended unemployment benefits to stay afloat while they look for jobs. When Emergency Unemployment Compensation benefits expired this past December, over 12,000 families in Arizona lost crucial benefits, and failure to extend this program could cost the state's economy over $150 million in 2014 alone. But this situation is not unique to Arizona. Given the uncertain future of unemployment insurance extensions in Congress, what effect on the job market does FOMC foresee if we fail to extend relief to the long-term unemployed?

2. In your testimony, you mentioned that last year's increase in mortgage rates has slowed recovery in the housing sector. Home prices are rebounding slowly but surely. Arizona alone has seen over a ten percent increase in home values this past year and three percent growth is projected for next year. Given that prices continue to rise, are you concerned that increasing mortgage rates could discourage home buying and cost us the critical growth we have seen in recent years?

3. Several American insurance companies were concurrently designated Globally Systemically Important Institutions (G-SIIs) by the international Financial Stability Board (FSB) and Systemically Important Financial Institutions (SIFIs) by domestic regulators under the Dodd-Frank Act. The Fed apparently participated in FSB deliberations, which in some cases resulted in American companies' designation on the international level as G-SIIs before they were labeled SIFIs by regulators at home. Did the Fed make any effort to forestall FSB designation until the SIFI process was complete, and do you see a problem with such international determination predating decision making by American regulators?

4. In your confirmation hearing, you agreed that banks and insurance providers should be subject to regulations that are tailored to their unique features, rather than a one-size-fits all approach. How will you ensure that the Federal Reserve works with industry and other experts to develop an insurance-based capital framework and what is the timetable for rulemaking on this topic?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

April 11, 2014

The Honorable Ed Royce
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 11, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Ed Royce:</u>

1. I would like to get an update on the deepening economic crisis in Puerto Rico. In February 2014, Puerto Rico's debt was given junk designation by both Moodys and S&P.

Our constituents are not immune from this crisis - with much of the $70 billion in debt held by U.S. institutional investors and mutual funds.

Other than the standing White House task force created during the Clinton Administration is Federal Reserve participating in discussions with the Puerto Rican government related to the crisis? Are you aware of any Fed authority that would allow you to lend money to Puerto Rico? Would Section 14b powers apply? Have you considered using these powers?

The financial troubles of the Commonwealth of Puerto Rico have the potential to pose significant challenges for the government and people of the Commonwealth. Puerto Rico faces serious fiscal challenges. Economic activity in Puerto Rico has contracted since 2005 and unemployment is currently about 15 percent. Total public debt--driven by primary fiscal deficits and borrowing by agencies of the government--has increased sharply and now stands at roughly $70 billion, which is more than 100 percent of the Commonwealth's gross domestic income. Of course, we are monitoring developments and continue to analyze the potential consequences for financial stability of these and other recent events.

Even prior to enactment of the Dodd-Frank Act amendments to the Federal Reserve's emergency lending authority, Chairman Bernanke explained to Congress that the Federal Reserve had little or no authority to lend directly to a state or municipal government. The Dodd-Frank Act subsequently repealed the authority of the Federal Reserve to lend to a single and specific individual, partnership or corporation in emergency situations and the Federal Reserve is not in discussions with the Commonwealth about arranging Federal Reserve credit for the Commonwealth.

Section 13(3) of the Federal Reserve Act, as revised by the Dodd-Frank Act, permits the Federal Reserve to lend only to participants in a broad-based lending facility established for the purpose of providing liquidity to the financial system, and prohibits lending to a single and specific borrower for the purpose of assisting the borrower to avoid an insolvency proceeding. Section 13(3) also specifically prohibits lending to a borrower that is insolvent or for the purpose of aiding a failing financial company. Lending under section 13(3) requires approval of at least 5 members of the Board of Governors (except in specific and rare circumstances) and the approval of the Secretary of the Treasury, and may only occur during unusual and exigent circumstances. The Federal Reserve is, however, permitted to lend to depository institutions located in Puerto Rico, and to accept obligations of the Puerto Rican government as collateral for discount window loans to depository institutions (with appropriate haircuts).

Section 14 of the Federal Reserve Act provides the Federal Reserve only limited authority to purchase obligations that are not obligations of, or guaranteed by, the United States or an agency of the United States. For example, the Federal Reserve may purchase only certain types of obligations of States and municipalities and only when those obligations have a maturity from the date of purchase of six months or less and have been issued in anticipation of the collection of taxes or receipt of assured revenues.

I continue to support the view expressed previously by Chairman Bernanke to past congressional inquiries that it is more appropriate for the Congress to address financial issues faced by States and municipalities. Congress has established extensive fiscal relationships between the federal government and state and local governments. Moreover, it is important that the Federal Reserve be able to protect itself and the taxpayer from credit losses in all lending situations and to maintain its independence. These principles would be challenged in the event the Federal Reserve became a creditor of a State or municipality.

2. Chair Yellen, would you support holding a press conference after every meeting of the Federal Open Market Committee? If no, why not?

Chairman Bernanke began holding press conferences following the four FOMC meetings per year for which Committee participants provide detailed economic projections. Those projections help shape the Committee's monetary policy decisions and its views about the outlook for monetary policy, so it makes sense to hold press conferences at these times so that the Chair can provide updates on the Committee's views about the economy as well as monetary policy. My intention is to continue that practice.

Whether there is a scheduled press conference or not, every FOMC meeting is a meeting in which a policy decision can be taken. If the Committee were to make a decision that required additional explanation beyond that contained in the Committee's post-meeting statement, we would make any necessary arrangements to explain that decision to the public and answer questions from the media.

CLO: #Y - 17
CCS: 14- 1440
RECVD: 2/28/14

Rep. Ed Royce (CA-39)
FC Hearing: "Monetary Policy and the State of the Economy."
Question for the Record
02.11.13

Questions for The Honorable Janet L. Yellen, Chair, Federal Reserve Board

QUESTION 1 - PUERTO RICO ECONOMIC CRISIS

I would like to get an update on the deepening economic crisis in Puerto Rico. In February 2014, Puerto Rico's debt was given junk designation by both Moody's and S&P.

Our constituents are not immune from this crisis - with much of the $70 billion in debt held by U.S. institutional investors and mutual funds.

Other than the standing White House task force created during the Clinton Administration – is Federal Reserve participating in discussions with the Puerto Rican government related to the crisis? Are you aware of any Fed authority that would allow you to lend money to Puerto Rico? Would Section 14b powers apply? Have you considered using these powers?

QUESTION 2 – TRANSPARENCY

Chair Yellen, would you support holding a press conference after every meeting of the Federal Open Market Committee? If no, why not?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 4, 2014

The Honorable Blaine Luetkemeyer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 11, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

Questions for The Honorable Janet Yellen, Chair Board of Governors of the Federal Reserve System from Rep. Blaine Luetkemeyer:

1. The SIFI designation process should focus on not size alone but also the business and complexity of an institution. Do you believe that business model, complexity, global interconnectedness, and other metrics beyond size alone should be considered when making SIFI determinations?

I agree that many variables need to be considered in determining whether a firm's financial distress could damage the financial stability of the United States. Indeed, a key lesson from the financial crisis is that distress at, or the disorderly failure of, large interconnected financial institutions can have a devastating impact on the functioning of the financial system and inflict severe harm on the real economy. The externalities created by the failure of such systemically important financial institutions (SIFIs) were illustrated by the collapse of Lehman Brothers in the fall of 2008, which triggered a dramatic rise in the pricing of risk across asset markets.

Measuring the systemic importance of financial institutions is far from straightforward. In many cases, the impact of a firm's failure on the financial system as a whole is likely to be correlated with its size. But several other factors will also typically be relevant. Several academic papers, for instance, equate systemic importance with the interconnectedness of a firm's activities with the rest of the financial system, measured using either readily observed factors such as intra-financial assets and liabilities, cross-border activity, and the use of various complex financial instruments such as derivatives, or using statistical techniques to draw inferences from market price data.[1] Other relevant factors will include the extent to which the firm relies on short-term liabilities to fund illiquid assets, and the degree to which the financial intermediation services provided by the firm are relied upon by households, businesses and other parts of the financial system for which there are no ready substitutes.

It is for this reason that section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the Financial Stability Oversight Council (FSOC) to consider 10 statutory factors when assessing whether a nonbank financial company should be designated as systemically important; these include the leverage of the firm, its importance in credit provision, and many other factors potentially unrelated to a firm's size.

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[1] Among the useful efforts along these lines are a measure of "Conditional Value-at-Risk" (CoVaR) (see Tobias Adrian and Markus K. Brunnermeier (2011), "CoVaR (PDF)," Federal Reserve Bank of New York Staff Reports 348 (New York: Federal Reserve Bank of New York, September), and a measure of systemic risk based on each firm's contribution to the expected capital shortfall of the entire financial system in a crisis (see Christian T. Brownlees and Robert F. Engle (2011), "Volatility, Correlation and Tails for Systemic Risk Measurement," New York University Working Paper (New York: New York University, June). The concept behind the latter measure is also described in Viral V. Acharya, Christian Brownlees, Robert Engle, Farhang Farazmand, and Matthew Richardson (2011), "Measuring Systemic Risk," in Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance (New York: Wiley Publishers), pp. 87-119. Updated systemic risk rankings are maintained by the authors here. A helpful review of the efforts to measure systemic risk is Monica Billio, Mila Getmansky, Andrew W. Lo, and Loriana Pelizzon (2010), "Measuring Systemic Risk in the Finance and Insurance Sectors (PDF)," MIT Sloan School Working Paper 4774-10 (Cambridge, MA: MIT Sloan School of Management, March).

2. There has been very little transparency from the Federal Reserve on the details of the SIFI designation process, particularly for nonbank institutions. Will you provide the Committee with information on the methodology used to make these SIFI determinations?

The Federal Reserve Board is firmly committed to promoting transparency and accountability in connection with its activities. The FSOC is charged by Congress with designating SIFIs. The FSOC established a robust process, after seeking public notice and comment on an initial and revised proposal, for exercising its designation authority. The process contains three stages during which the FSOC screens companies for review and conducts an in-depth analysis of companies that pass the screen.

In developing this process, the FSOC sought to maximize transparency with respect to the Determination Process by providing a detailed description of (i) the profile of those nonbank financial companies likely to be evaluated by the FSOC for a potential determination, and (ii) the metrics that the FSOC intends to use when analyzing companies at various stages of the Determination Process. There are numerous opportunities during this process for a nonbank financial company to communicate with the FSOC and its staff and submit information regarding the company's activities and its potential to pose a threat to U.S. financial stability.

The FSOC applies quantitative metrics to a broad group of nonbank financial companies in determining whether a firm should be considered for designation. A nonbank financial company will be evaluated in Stage 2 of the Determination Process, if it meets both a size threshold ($50 billion in total consolidated assets) and any one of five thresholds that measure a company's interconnectedness, leverage, liquidity risk and maturity mismatch. During Stage 2, a nonbank financial company is analyzed based on a wide range of quantitative and qualitative information available to the FSOC primarily through public and regulatory sources.

A nonbank financial company that is advanced to Stage 3 receives a notice that the company is under consideration for a Proposed Determination, which also may include a request that the nonbank financial company provide information relevant to the FSOC's evaluation. In addition, the nonbank financial company is provided an opportunity to submit written materials to the FSOC. Following a Proposed Determination, a nonbank financial company is provided a written notice of the Proposed Determination, which includes an explanation of the basis of the Proposed Determination. A nonbank financial company that is subject to a Proposed Determination may request a written or oral hearing to contest the Proposed Determination. If the FSOC determines to subject a company to supervision by the Board of Governors and prudential standards, the FSOC will provide the nonbank financial company with written notice of the FSOC's final determination, including an explanation of the basis for the FSOC's decision.

In 2013, the FSOC determined that material financial distress at each of three nonbank financial companies, American International Group, Inc., General Electric Capital Corporation, and Prudential Financial, Inc., could pose a threat to U.S. financial stability and that those companies should be subject to Federal Reserve Board Supervision and enhanced prudential standards. The FSOC released the bases of its determinations, which were posted on its website. The FSOC evaluated these firms using the three-stage process.

The Federal Reserve Board recognizes the critical importance of transparency and will continue to pursue ways to promote further transparency that are consistent with the FSOC's central mission to monitor emerging threats to the financial system.

3. Under what authority does the International Association of Insurance Supervisors (IAIS) develop and implement international capital standards for Internationally Active Insurance Groups (IAIGs) who have not been named GSIIs or SIFIs? What entity will enforce those capital standards on U.S. domiciled multinational insurance groups?

In its July 2013 press release announcing the policy measures that would apply to the designated global systemically important insurers, the International Association of Insurance Supervisors (IAIS) stated that it considered a sound capital and supervisory framework for the global insurance sector more broadly to be essential for supporting financial stability, and that it planned to develop a comprehensive, group-wide supervisory and regulatory framework for internationally active insurance groups (IAIGs), including an international capital standard (ICS). State insurance supervisors, the National Association of Insurance Commissioners (NAIC), the Federal Insurance Office (FIO), and more recently, the Federal Reserve, are members of the IAIS. The business of insurance has become increasingly global in the past few decades. The decision of the IAIS to develop an ICS for IAIGs reflects that trend and has a parallel in the development of capital standards for internationally active banks by the Basel Committee on Banking Supervision (BCBS). The BCBS has been promulgating capital requirements for internationally active banks since the 1980s. The U.S. federal banking agencies, which are members of the BCBS, have long contributed to and supported the work to develop common baseline prudential standards for global banks.

Once developed by the IAIS, each national supervisor would determine the extent and manner in which any capital standards developed by the IAIS would be applied to IAIGs regulated by that national supervisor.

4. Should the IAIS develop global insurance capital standards and, if so, why? How would global insurance standards be implemented, given the different accounting standards and solvency systems across the world?

Please see response for question 3.

5. Can these international standards be implemented without compromising the state-based system of regulation in the United States? Can you guarantee that new rules will be compatible with our state-based regulatory system?

The standards under development by the IAIS are not bank-centric. Moreover, they are not contemplated to replace existing insurance risk-based capital standards at U.S. domiciled insurance legal entities within the broader firm. A goal of the international capital standard being developed by the IAIS is to achieve greater comparability of the capital requirements of IAIGs across jurisdictions at the group-wide level. This should promote financial stability, provide a more level playing field for firms and enhance supervisory cooperation and coordination by increasing the understanding of firms among group-wide and host supervisors.

It should also lead to greater confidence being placed on the group-wide supervisor's analysis by host supervisors.

Any IAIS capital standard would supplement existing legal entity risk-based capital requirements by evaluating the financial activities of the firm overall rather than by individual legal entity.

6. What insurance expertise does the Federal Reserve have? Are you actively hiring more staff with insurance expertise?

The Federal Reserve has hired staff with expertise in analyzing and supervising insurance companies to conduct inspections of insurance firms and assist in training other Federal Reserve examiners and staff on insurance issues. In addition, Federal Reserve staff consults with the FIO on issues related to our supervisory framework, including insurance capital requirements and stress testing. Federal Reserve staff also meets regularly with industry representatives, the NAIC and state insurance regulators to discuss insurance-related issues. The Federal Reserve expects to continue consultations with other regulators and standard-setters, the FSOC, the industry and the public, to further the Federal Reserve's expertise and to gain additional perspectives on the regulation and supervision of insurance companies.

Questions for the Record from
Rep. Blaine Luetkemeyer (MO-3)
Committee on Financial Services
U.S. House of Representatives

CLO: #Y - 15
CCS: 14-1439
RECVD: 2/28/14

Hearing held on February 11, 2014
"Monetary Policy and the State of the Economy"

Witness: The Honorable Janet Yellen, Chair of the Board of Governors of the Federal Reserve System

1. The SIFI designation process should focus on not size alone but also the business and complexity of an institution. Do you believe that business model, complexity, global interconnectedness, and other metrics beyond size alone should be considered when making SIFI determinations?

2. There has been very little transparency from the Federal Reserve on the details of the SIFI designation process, particularly for nonbank institutions. Will you provide the Committee with information on the methodology used to make these SIFI determinations?

3. Under what authority does the International Association of Insurance Supervisors (IAIS) develop and implement international capital standards for Internationally Active Insurance Groups (IAIGs) who have not been named GSIIs or SIFIs? What entity will enforce those capital standards on U.S. domiciled multinational insurance groups?

4. Should the IAIS develop global insurance capital standards and, if so, why? How would global insurance standards be implemented, given the different accounting standards and solvency systems across the world?

5. Can these international standards be implemented without compromising the state-based system of regulation in the United States? Can you guarantee that new rules will be compatible with our state-based regulatory system?

6. What insurance expertise does the Federal Reserve have? Are you actively hiring more staff with insurance expertise?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

July 2, 2014

The Honorable Scott Garrett
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 11, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Garrett:</u>

1. Would you agree to holding a press conference after every meeting of the FOMC? If no, why not?

Chairman Bernanke began holding press conferences following the four Federal Open Market Committee (FOMC) meetings per year for which FOMC participants provide detailed economic projections. Those projections help shape the FOMC's monetary policy decisions and its views about the outlook for monetary policy. Therefore, it makes sense to hold press conferences at these times so that the Chair can provide updates on the FOMC's views about the economy as well as monetary policy. My intention is to continue that practice.

Whether there is a scheduled press conference or not, every FOMC meeting is one in which a policy decision can be taken. If the FOMC were to make a decision that required additional explanation beyond that contained in the FOMC's post-meeting statement, we would arrange an on-the-record way of explaining that decision to the public and answering questions from the media.

2. In your annual CCAR process, you require firms to maintain the same capital distributions in the baseline and stress scenarios, i.e. firms are not allowed to assume any capital conservation actions. This is different than the approach for stress tests under Dodd-Frank and in contradiction to the capital conservation actions required under Basel III (when fully implemented). Can you explain why you have chosen such an approach and how you will ultimately harmonize it with other regulations?

Although the stress tests in Comprehensive Capital Analysis and Review (CCAR) and the Dodd-Frank Act stress tests (DFAST) are the same, they perform different functions in CCAR and DFAST. As such, the associated capital assumptions are different. A fundamental purpose of CCAR is to ensure that a large bank holding company (BHC) will not make distributions of capital that it would otherwise need during adverse conditions. As a result, for the CCAR capital analysis, the Federal Reserve uses a large BHC's planned capital actions in its baseline scenario, and assesses whether the large BHC could meet supervisory expectations for minimum capital ratios even if stressful conditions emerged and the large BHC did not reduce its planned capital distributions. This assumption also strengthens incentives for firms to consider the appropriateness of their capital plans.

In contrast, the Federal Reserve prescribes a common set of capital action assumptions in DFAST stress tests. As mentioned in your question, one such assumption is that common stock dividend payments continue at the same level as the previous year. Scheduled dividend, interest, or principal payments on certain other capital instruments also are assumed to be paid. Repurchases of common stock are assumed to be zero, and issuances of common stock and other capital instruments are generally assumed not to occur. The purpose of these assumptions in DFAST is to provide a more consistent comparison of the stress test results across companies, which is critical to the public's ability to analyze the outcomes of the companies' stress tests.

The Federal Reserve has not addressed the operation of the capital conservation buffer in the CCAR or DFAST stress tests because, as you noted, the buffer has yet to become effective in the revised risk-based capital framework. The Federal Reserve is considering the effects of the capital conservation buffer's operation in the context of the CCAR and DFAST stress tests and expects to address effects in due course.

3. The proposed LCR rule contains many factors that describe how customers will behave (e.g. deposit outflows, draws of lines of credit, etc.). To date, no empirical support for these factors has been disclosed. Can you please provide the empirical basis underlying these factors?

The Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation (FDIC), and Federal Reserve issued the Liquidity Coverage Ratio (LCR) Notice of Proposed Rulemaking (NPR) in late 2013. In developing the LCR NPR, the banking agencies evaluated data from both domestic and international banking organizations. The data was collected primarily through the banking agencies' supervisory processes, and therefore is confidential supervisory information. Other data was collected through the Basel Committee on Banking Supervision (BCBS) on a confidential basis. The banking agencies are currently working on the LCR final rule. As part of that process, we are continuing to analyze empirical data and are carefully reviewing the many public comments on the LCR NPR that discuss, among other things, inflow and outflow rates.

4. Requiring all foreign banks whose U.S. non-branch operations exceed a specified asset threshold to organize those operations under a U.S. intermediate holding company (IHC) constitutes a fundamental change in the Federal Reserve's approach to regulating foreign banks. Substantial concerns have been raised regarding the impact such a requirement may have on the role of foreign banks as providers of credit and other financial services to U.S. consumers and investors, the implications for the competitiveness, depth and liquidity of U.S. markets, and the impact on the dollar as the predominant reserve currency of the international financial system. In formulating the IHC requirement, did the Federal Reserve conduct a cost-benefit analysis, otherwise attempt to quantify its impact on the economy, the dollar's status as reserve currency, and financial markets or consider alternative requirements that might be less costly but equally effective?

Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the Federal Reserve to establish enhanced prudential standards for U.S. and foreign banking organizations (FBOs) in order to protect the financial stability of the United States. Applying those standards to foreign banks that operate in the United States is an important task made more difficult by the fact that foreign banks that pose material risks to the financial stability of the United States often operate through structures that are different than those of U.S. banking organizations.

The Federal Reserve's final rule establishing enhanced prudential standards for U.S. bank holding companies and FBOs would adjust the Federal Reserve's existing regulatory approach to address the increased complexity and risk profile that has developed over the last decade at the U.S. operations of large foreign banks. For example, the liquidity provisions applied to foreign banks would address the increased funding vulnerabilities of the U.S. operations of foreign banks that emerged in the years leading up to the financial crisis. In the 1980s and 1990s, U.S.

branches and agencies of foreign banks maintained in the aggregate a neutral funding position with their foreign bank parents. In the years leading up to the crisis, however, U.S. branches and agencies became very substantial net lenders to their foreign bank parents and non-U.S. affiliates.

In formulating the final rule, the Federal Reserve considered the impact that the enhanced prudential standards could have on banks and financial markets, the provision of financial services, and on the broader economy. U.S. subsidiaries of FBOs play a large role in U.S. financial markets. Because of their importance, there are significant financial stability benefits to be gained from requiring the U.S. intermediate holding company (IHC) of an FBO to comply with minimum capital standards and other prudential requirements. Ultimately, a more stable financial system promotes the smooth functioning of all U.S. markets. Moreover, the IHC requirement helps to make the U.S. financial system safer, and the competitive playing field in the United States more level, while still allowing FBOs to operate fully in the United States.

In this regard, there are a number of U.S. firms with business profiles very similar to the U.S. subsidiaries of the FBOs that actively participate in the U.S. financial markets. Those firms continue to participate in the financial markets, despite the fact that they are subject to minimum leverage ratios and other prudential requirements consistent with those that will apply to IHCs. To the extent that the largest FBOs subject to the IHC requirement decide to reduce the size of their presence in U.S. markets, their market share could be reallocated among other market participants.

Furthermore, the final rule would give FBOs until July 2016, to establish their IHC and until 2018, to comply with leverage ratio requirements, as compared to July 2015, under the proposal. The longer transition period should mitigate some costs for FBOs.

The Federal Reserve considered alternative structures in formulating the IHC requirement. As noted in the preamble to the final rule, the Federal Reserve considered whether to permit FBOs to establish a "virtual" IHC that would not require corporate restructuring of their U.S. operations. Commenters suggested that a virtual IHC would be able to calculate, measure, and report its capital and liquidity as if its U.S. subsidiaries were consolidated under the IHC. However, the wide variety of FBO structures and operations would make it difficult to consistently apply enhanced prudential standards to FBOs' U.S. operations using a virtual IHC approach. Moreover, the virtual IHC would not provide a consistent platform for supervision and regulation or risk management comparable to a U.S. IHC. Under the final rule, the Federal Reserve may permit use of an alternative structure by an FBO in exceptional circumstances.

5. In formulating the U.S. intermediate holding company (IHC) requirement for the U.S. non-branch operations of certain foreign banks, what discussions did the Federal Reserve conduct with the SEC regarding the operation of the SEC's net capital requirements and the impact imposing bank capital requirements (including a leverage ratio) at the IHC level might have on an IHC's SEC-registered broker-dealer subsidiary, especially in circumstances where the broker-dealer would comprise a significant part of the IHC's

operations, and to what extent are the views expressed by the SEC in those discussions reflected in the requirement?

The Federal Reserve consulted with the Securities and Exchange Commission (SEC) and with all members of the Financial Stability Oversight Council (FSOC) and member agencies in developing the IHC rule. As part of those consultations, Federal Reserve staff discussed the proposed and final rule, including the IHC requirement. Federal Reserve staff also provided periodic updates to agencies represented on the FSOC and their staff on the development of the final enhanced prudential standards. The final rule reflects comments provided to the Federal Reserve as a part of this consultation process.

6. How many Federal Reserve employees, or employees of Federal Reserve banks, are detailed to the Financial Stability Board? What is their role at the FSB and what is the length of their tenure at the FSB?

As of mid-March 2014, one employee of the Board of Governors of the Federal Reserve System was on detail to the Financial Stability Board (FSB); this detail is scheduled to last 12 months, from January 2014 to December 2014. While on detail, the employee's salary continues to be paid by the Board of Governors. This employee will work on issues related to the resolution of large, internationally active firms.

In addition, a second employee of the Board of Governors of the Federal Reserve System was on detail at the Bank for International Settlements (BIS); this detail is scheduled to last 24 months, from August 2012 to August 2014. While on detail, the employee's salary and benefits are paid by the BIS. This employee works on the secretariat of the BCBS.

7. How often do Federal Reserve personnel travel to meetings at the FSB and Bank of International Settlements? What is the total cost involved?

We identified 25 staff of the Board of Governors who are involved in various ongoing BIS or FSB committees or working groups, including groups devoted to analyzing issues in cross-border resolution, OTC derivatives, and data gaps. Board staff typically participate in these groups via email and conference calls. In-person meetings tend to be held infrequently. Our accounting systems do not permit us to identify travel expenses related purely to participation in FSB or BIS working groups. However, we take seriously our obligation to minimize cost to the taxpayer.

8. What other international organizations does the Federal Reserve interact with?

The Federal Reserve interacts with a number of international organizations in the process of carrying out its missions on monetary policy and the supervision of important aspects of the U.S. financial system. These include the International Monetary Fund, the BIS, and the Organization for Economic Cooperation and Development. In these interactions, the Federal Reserve represents U.S. views and interests, learns about conditions in the global economy and financial system, and coordinates with other countries on matters of joint interest, such as the regulation of banking organizations with international reach and strengthening the global payment system.

9. What is the formal process of the FSB to decide which entities are G-SIFIs? Is there a voting mechanism? Is there a formal notice and comment period? What types of transparency do these international bodies have as it relates to deciding where to expand the Fed's prudential regulation?

The FSB has identified two sets of global systemically important financial institutions (G-SIFIs): global systemically important banks (G-SIBs) and global systemically important insurers (G-SIIs). The FSB's identification of G-SIBs was based on a methodology developed by the BCBS, while the FSB's identification of G-SIIs was based on a methodology developed by the International Association of Insurance Supervisors (IAIS). Both the BCBS and the IAIS sought public comment on their proposed assessment methodologies, and U.S. agencies contributed significantly to the development of the assessment methodologies through their membership and participation in the FSB, BCBS, and IAIS. The FSB's designation decisions are reviewed and approved by the FSB's Standing Committee on Regulatory and Supervisory Cooperation, FSB Steering Committee and the FSB Plenary, which make decisions by consensus.

FSB designation of an entity as a G-SIFI does not automatically result in the Federal Reserve becoming the entity's prudential regulator, nor does it impose any other legal obligation on any U.S. government agency or U.S. financial firm. Under the Dodd-Frank Act, the FSOC is responsible for deciding whether a nonbank financial company should be regulated and supervised by the Federal Reserve, based on its assessment of the extent to which the failure, material financial distress, or ongoing activities of that entity could pose risk to the U.S. financial system.

10. If the FSB designates a non-bank U.S. firm as a G-SIFI and the FSOC does not designate that same entity as a SIFI (under U.S. law), what does that mean for the U.S. firm? Does the Fed have the legal authority to regulate that non-bank firm based on the FSB's designation?

The decision-making body in the United States for designating financial firms for enhanced supervision is the FSOC. The FSB process is an international process that attempts to encourage consistency around the world in identifying, monitoring, and applying regulatory standards to financial firms that are globally systemic. The FSB makes recommendations to each relevant national supervisor and strives for internationally agreed-upon standards. Legally binding designations and standards are the province, however, of the national supervisors.

In considering whether to determine that a nonbank financial company could pose a threat to U.S. financial stability and should be subject to Federal Reserve supervision and prudential standards, the FSOC is required by statute to consider various factors set forth in the statute that could result in a different determination (either including or excluding a firm) by the FSOC under the Dodd-Frank Act than a determination that may be made by the FSB. For instance, one factor that the FSOC must consider is the degree to which a firm is already regulated by another financial regulatory agency.

The Federal Reserve and the FSOC are working with the FSB on a number of initiatives, including the process for identifying G-SIFIs, and financial market infrastructures. Furthermore, the Federal Reserve and the FSOC are working to ensure the consistency of the approaches used by the FSB and the FSOC for assessing whether a nonbanking company is systemically important, and to better understand the potential for different determinations.

11. On January 8, the Financial Stability Board issued a proposed assessment methodology for identifying globally systemic financial firms that are not banks or insurers. As a leading member of the FSB, did you object to or have any concerns about this proposal or is it consistent with your views?

The FSB in consultation with the International Organization of Securities Commissions (IOSCO) is currently developing methodologies to identify systemically important non-bank non-insurer entities. This is a very difficult task given the heterogeneity of entities within the scope of this assessment process, which includes finance companies, broker-dealers and investment funds. The January 8, 2014 consultative document on "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" was released with a request for comments by April 7, 2014. It is a first step among many. In fact, the comments received, including those from U.S. firms and asset managers, will be an important input that will help shape the assessment methodologies to be used to identify these entities. Moreover, there will continue to be significant input from U.S. agencies before an assessment methodology is approved by the FSB's Standing Committee on Regulatory and Supervisory Cooperation, FSB Steering Committee, and FSB Plenary, which make decisions by consensus.

FSB designation of an entity as a G-SIFI does not automatically result in the Federal Reserve becoming the entity's prudential regulator, nor does it impose any other legal obligation on any U.S. government agency or U.S. financial firm. Under the Dodd-Frank Act, the FSOC is responsible for deciding whether a nonbank financial company should be regulated and supervised by the Federal Reserve, based on its assessment of the extent to which the failure, material distress, or ongoing activities of that entity could pose a risk to the U.S. financial system.

12. Also, do you believe that Section 165 of Dodd-Frank provides the proper tools for the FSOC to regulate any U.S. asset managers that may be deemed systemically important. If not, in your view is there some alternative to Section 165 that would be more appropriate? Is it your belief that the Fed has the legal authority to exempt certain classes of risky foreign sovereign debt from the Volcker rule but does not have the legal authority to appropriately tailor capital requirements to potential nonbank SIFIs such as Asset Managers and Insurance companies?

Section 165 of the Dodd-Frank Act[1] directs the Federal Reserve to establish prudential standards for BHCs with total consolidated assets of $50 billion or more and for nonbank financial companies that the FSOC has determined will be supervised by the Federal Reserve in order to prevent or mitigate risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities of, large, interconnected financial institutions. The standards must also increase in stringency based on several factors, including the size and risk characteristics of a company subject to the rule, and the Federal Reserve must take into account the difference among BHCs and nonbank financial companies based on the same factors.[2] Generally, the Federal Reserve has authority under section 165 of the Dodd-Frank Act to tailor the application of the standards, including differentiating among companies subject to section 165 on an individual basis or by category.

Section 165 requires the Federal Reserve to adopt prudential standards that include enhanced risk-based and leverage capital requirements, liquidity requirements, risk-management and risk-committee requirements, resolution-planning requirements, single counterparty credit limits, stress-test requirements, and a debt-to-equity limit for companies that the FSOC has determined pose a grave threat to the financial stability of the United States. Section 165 also permits the Federal Reserve to establish other prudential standards in addition to the mandatory standards, including three enumerated standards--a contingent capital requirement, enhanced public disclosures, and short-term debt limits--and any "other prudential standards" that the Federal Reserve determines are "appropriate."

The Federal Reserve recognizes that the companies designated by the FSOC may have a range of businesses, structures and activities, that the types of risks to financial stability posed by nonbank financial companies will likely vary, and that the enhanced prudential standards applicable to BHCs and FBOs may not be appropriate, in whole or in part, for all nonbank financial companies. Following designation of a nonbank financial company for supervision by the Federal Reserve, the Federal Reserve intends to assess the business model, capital structure, and risk profile of the designated company to determine how the proposed enhanced prudential standards should apply, and as appropriate, to tailor application of the standards by order or regulation to that nonbank financial company or to a category of nonbank financial companies. In applying the standards to a nonbank financial company supervised by the Federal Reserve, the Federal Reserve will take into account differences among nonbank financial companies supervised by the Federal Reserve and BHCs with total consolidated assets of $50 billion or more. The Federal Reserve will ensure that a nonbank financial company supervised by the Federal Reserve receives notice and opportunity to comment prior to determination of their enhanced prudential standards.

With respect to section 171 of the Dodd-Frank Act (the Collins amendment), it requires that the Federal Reserve establish consolidated minimum risk-based and leverage requirements for depository institution holding companies and nonbank financial companies supervised by the

[1] Public Law 111-203, 124 Stat 1376 (2010).

[2] See 12 U.S.C. 5365(a)(1)(B). Under section 165(a)(1)(B) of the Dodd-Frank Act, the enhanced prudential standards must increase in stringency based on the considerations listed in section 165(b)(3).

Federal Reserve that are no less than the generally applicable risk-based capital and leverage requirements that apply to insured depository institutions, which the statute specifically provides shall serve as the floor for capital requirements applied to depository institution holding companies and any nonbank financial companies supervised by the Federal Reserve.

13. Could you please describe the difference between the Basel (bank) capital regime and the SEC's net capital (broker-dealer) rules? Why do we have different capital requirements for these entities? Do you have any reason to believe that the SEC's current net capital rules are defective or inadequate?

For several years, BHCs with broker-dealer operations have been subject to the Federal Reserve's capital rules on a consolidated basis, and broker-dealer subsidiaries of these BHCs have been subject to the SEC's net capital rules.

The Federal Reserve applies consolidated capital requirements to top-tier domestic BHCs and U.S. IHCs. The Federal Reserve's capital requirements are designed to help ensure that a banking organization, on a consolidated basis, is better able to absorb losses and continue to lend in future periods of economic stress.

In contrast, the SEC applies net capital requirements to broker-dealers, including those that are subsidiaries of United States and FBOs. The SEC's net capital requirements are designed to protect customers from the consequences of the financial failure of a broker-dealer by requiring a broker-dealer to have sufficient liquid assets to pay all liabilities to customers.

14. Can you explain in detail exactly what the Fed's plans are for additional regulation of the wholesale funding markets, specifically repo and securities lending markets? There have been a number of speeches given by Fed Governors that appear to be building the case for additional regulation in this space. Does the Fed have the ability to regulate Broker-Dealers, Hedge Funds, and others in this market that are not part of a larger holding company and are not designated as a SIFI? Please provide a detailed description of your or Governor Tarullo's plan for addressing your concerns.

Short-term wholesale funding, such as repurchase and reverse repurchase agreements, securities lending and borrowing transactions, and securities margin lending (collectively, "securities financing transactions"), provides an important alternative to bank funding and is part of the healthy functioning of financial markets. However, the funding of longer-term assets with short-term liabilities can lead to damaging runs and asset fire sales. One of the challenges with implementing reforms to address the risks associated with short-term wholesale funding is that this type of funding is used by various types of financial institutions, including regulated and unregulated entities.

Since the crisis, regulators have collectively made progress in addressing some of the risks posed by wholesale short-term funding with respect to regulated entities. For example, the banking regulators proposed a LCR standard that includes requirements for banks to hold liquidity buffers when they provide credit or liquidity facilities to securitization vehicles or other special purpose entities. Changes also have been made to accounting and capital rules that make it more difficult for banks to reduce the amount of capital they are required to hold by shifting assets off balance sheet. In addition, many of the reforms required by Title VII of the Dodd-Frank Act help to address risks posed by derivatives transactions. These transactions can pose some of the same contagion and financial stability risks as short-term wholesale funding if large volumes of derivatives positions had to be liquidated quickly.

We continue to work on developing proposals related to short-term wholesale funding and will seek public comment on specific proposals before adoption. Other federal agencies have proposed reforms to money market mutual funds (MMMFs), which are among the most significant lenders to broker-dealer firms through repurchase agreements. In November 2012, the FSOC issued proposed recommendations to the SEC to implement reforms to address the structural vulnerabilities of MMMFs under Section 120 of the Dodd-Frank Act. The SEC subsequently issued a proposal for reform, and currently is evaluating the comments that it received on that proposal.

15. Did you support the Fed's bailout of Bear Stearns of 2008? Do you think the Fed's bailout of Bear Stearns potentially exacerbated the market reaction of the Lehman bankruptcy because of the moral hazard created by the bailout of Bear Stearns? Do you believe that creditors and counterparties were more or less concerned about their exposure to large U.S. investment banks after the bailout? Do you believe that that the bailout of Bear Stearns created an expectation by market participants that other investment banks would receive the same treatment and when Lehman did receive the same treatment, the impact of its failure was compounded?

In 2008, there was no resolution authority that provided the tools to address the systemic impact of the failure of a large, interconnected financial company. Due to concerns regarding the impact of the failure of Bear Stearns on the U.S. financial system, which was evidencing significant stress, the Federal Reserve, pursuant to authority in the Federal Reserve Act, made a loan to facilitate the purchase of Bear Stearns by J.P. Morgan. When Lehman Brothers Holdings, Inc. failed six months later, there was no third party willing to purchase the company.

Market expectations today must reflect the changes enacted as part of the Dodd-Frank Act to the framework governing U.S. government action in the event of the failure of a large financial firm. As part of the reforms enacted in the Dodd-Frank Act, Congress included resolution authority in Title II to provide the tools for an orderly liquidation of a systemically significant financial company. Title II establishes a mechanism to resolve such a firm in a manner that could mitigate the impact of the failure on U.S. financial stability. As a general matter, if Title II is invoked for a company, the FDIC would be appointed receiver and responsible for resolving a firm in a manner consistent with the direction in the Dodd-Frank Act that any firm put into receivership in Title III must be liquidated and taxpayers must suffer no losses. Moreover, the Dodd-Frank Act has removed the authority of the Federal Reserve to establish a facility under its emergency lending authority to lend to a single and specific entity. These are important steps to ending the perception that any firm is too-big-to fail.

16. It appears to some that the Fed's new mandate of promoting and ensuring financial stability is also another rationale to regulate nonbank entities that fall outside of the social safety net even if those entities are not designated as SIFIs. Some Fed governors have stated they believe the failure of a large broker-dealer would be "destabilizing" – but did not say in a systemic sense. Do you support formally expanding the Fed's discount window access to broker-dealers and other nonbanks in order to ensure their survival during turbulent economic times and expand your regulatory scope?

I do not favor expanding access to the Federal Reserve's discount window to broker-dealers and other nonbanks. Instead, I support the application of stringent capital and liquidity requirements to entities whose failure could imperil financial stability, and I support the development of resolution regimes to help ensure that any failures of such firms that occur can be addressed in an orderly manner.

The Federal Reserve has adopted the Basel III capital reforms to materially strengthen the capital requirements applicable to large U.S. banking firms on a consolidated basis. The Federal Reserve has also proposed liquidity requirements for large consolidated U.S. banking firms based on the Basel Committee's LCR, and we are working with the Basel Committee to finalize a longer-term liquidity regulation for global banks called the Net Stable Funding Ratio. These rules should reduce the probability of failure of systemically important BHCs and their bank and nonbank subsidiaries (which includes the large broker-dealers) and the likelihood that such firms would require emergency liquidity support from the central bank in the future. In addition, we are reviewing the resolution plans of our largest banking firms and consulting with the FDIC on a proposal that would require the most systemic U.S. banking firms to maintain minimum amounts of long-term debt to improve their resolvability. Furthermore, we have supported the efforts of the SEC to accomplish structural reform of the MMMF industry to reduce systemic risk.

CLO: #Y - 13
CCS: 14-1438
RECVD: 2/28/14

Congressman Scott Garrett – Questions for the Record
Full Committee Humphrey-Hawkins Hearing (2-27-14)

Would you agree to holding a press conference after every meeting of the FOMC? If no, why not?

Stress Testing Transparency

In your annual CCAR process, you require firms to maintain the same capital distributions in the baseline and stress scenarios, i.e. firms are not allowed to assume any capital conservation actions. This is different than the approach for stress tests under Dodd-Frank and in contradiction to the capital conservation actions required under Basel III (when fully implemented). Can you explain why you have chosen such an approach and how you will ultimately harmonize it with other regulations?

The proposed LCR rule contains many factors that describe how customers will behave (e.g. deposit outflows, draws of lines of credit, etc.). To date, no empirical support for these factors has been disclosed. Can you please provide the empirical basis underlying these factors?

FBO Rulemaking

Requiring all foreign banks whose U.S. non-branch operations exceed a specified asset threshold to organize those operations under a U.S. intermediate holding company (IHC) constitutes a fundamental change in the Federal Reserve's approach to regulating foreign banks. Substantial concerns have been raised regarding the impact such a requirement may have on the role of foreign banks as providers of credit and other financial services to U.S. consumers and investors, the implications for the competitiveness, depth and liquidity of U.S. markets, and the impact on the dollar as the predominant reserve currency of the international financial system. In formulating the IHC requirement, did the Federal Reserve conduct a cost-benefit analysis, otherwise attempt to quantify its impact on the economy, the dollar's status as reserve currency, and financial markets or consider alternative requirements that might be less costly but equally effective?

In formulating the U.S. intermediate holding company (IHC) requirement for the U.S. non-branch operations of certain foreign banks, what discussions did the Federal Reserve conduct with the SEC regarding the operation of the SEC's net capital requirements and the impact imposing bank capital requirements (including a leverage ratio) at the IHC level might have on an IHC's SEC-registered broker-dealer subsidiary, especially in circumstances where the broker-dealer would comprise a significant part of the IHC's operations, and to what extent are the views expressed by the SEC in those discussions reflected in the requirement?

Dealings with International Organizations

How many Federal Reserve employees, or employees of Federal Reserve banks, are detailed to the Financial Stability Board? What is their role at the FSB and what is the length of their tenure at the FSB?

How often do Federal Reserve personnel travel to meetings at the FSB and Bank of International Settlements? What is the total cost involved?

What other international organizations does the Federal Reserve interact with?

What is the formal process of the FSB to decide which entities are G-SIFIs? Is there a voting mechanism? Is there a formal notice and comment period? What types of transparency do these international bodies have as it relates to deciding where to expand the Fed's prudential regulation?

If the FSB designates a non-bank U.S. firm as a G-SIFI and the FSOC does not designate that same entity as a SIFI (under U.S. law), what does that mean for the U.S. firm? Does the Fed have the legal authority to regulate that non-bank firm based on the FSB's designation?

On January 8, the Financial Stability Board issued a proposed assessment methodology for identifying globally systemic financial firms that are not banks or insurers. As a leading member of the FSB, did you object to or have any concerns about this proposal or is it consistent with your views?

Also, do you believe that Section 165 of Dodd-Frank provides the proper tools for the FSOC to regulate any U.S. asset managers that may be deemed systemically important. If not, in your view is there some alternative to Section 165 that would be more appropriate? Is it your belief that the Fed has the legal authority to exempt certain classes of risky foreign sovereign debt from the Volcker rule but does not have the legal authority to appropriately tailor capital requirements to potential nonbank SIFIs such as Asset Managers and Insurance companies?

Broker-Dealers

Could you please describe the difference between the Basel (bank) capital regime and the SEC's net capital (broker-dealer) rules? Why do we have different capital requirements for these entities? Do you have any reason to believe that the SEC's current net capital rules are defective or inadequate?

Wholesale Funding

Can you explain in detail exactly what the Fed's plans are for additional regulation of the wholesale funding markets, specifically repo and securities lending markets? There have been a number of speeches given by Fed Governors that appear to be building the case for additional regulation in this space. Does the Fed have the ability to regulate Broker-Dealers, Hedge Funds, and others in this market that are not part of a larger holding company and are not designated as a SIFI? Please provide a detailed description of your or Governor Tarullo's plan for addressing your concerns.

Bear Stearns

Did you support the Fed's bailout of Bear Stearns of 2008? Do you think the Fed's bailout of Bear Stearns potentially exacerbated the market reaction of the Lehman bankruptcy because of the moral hazard created by the bailout of Bear Stearns? Do you believe that creditors and counterparties were more or less concerned about their exposure to large U.S. investment banks after the bailout? Do you believe that that the bailout of Bear Stearns created an expectation by market participants that other investment banks would receive the same treatment and when Lehman did receive the same treatment, the impact of its failure was compounded?

Financial Stability

It appears to some that the Fed's new mandate of promoting and ensuring financial stability is also another rationale to regulate nonbank entities that fall outside of the social safety net even if those entities are not designated as SIFIs. Some Fed governors have stated they believe the failure of a large broker-dealer would be "destabilizing" – but did not say in a systemic sense. Do you support formally expanding the Fed's discount window access to broker-dealers and other nonbanks in order to ensure their survival during turbulent economic times and expand your regulatory scope?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JANET L. YELLEN
CHAIR

June 6, 2014

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed are my responses to the written questions you submitted following the February 11, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Janet L. Yellen

Enclosure

<u>Questions for The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System from Chairman Jeb Hensarling:</u>

1. Chair Yellen, you committed during your confirmation hearing before the Senate Committee on Banking, Housing and Urban Affairs to bring more transparency to operating procedures of the Financial Stability Oversight Council. What concrete steps have you taken to fulfill that commitment?

I recognize the critical importance of transparency and have worked for many years to improve transparency at the Federal Reserve. With my new responsibilities as Chair of the Federal Reserve, I attended my first Financial Stability Oversight Council (FSOC) meeting on March 27, 2014. As a member of FSOC, I will help pursue ways to promote further transparency that are consistent with the FSOC's central mission to monitor emerging threats to the financial system and its responsibility to protect sensitive information.

2. Chair Yellen, would you be willing to support the following amendment to the bylaws of the Financial Stability Oversight Council:

"Any member of a board or commission represented at the Financial Stability Oversight Council shall be permitted to attend all meetings of the Financial Stability Oversight Council, shall receive the same notice of scheduled meetings granted to members of the Financial Stability Oversight Council, and shall have the same rights to information provided to members of the Financial Stability Oversight Council."

If not, why not?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established the FSOC, which is composed of 10 voting members, including the heads of the banking and market regulatory agencies, and five nonvoting members who serve in an advisory capacity. The FSOC serves an important role in promoting financial stability in the United States by providing a forum for the heads of financial regulatory agencies to discuss and analyze emerging market developments, threats to financial stability, and financial regulatory issues.

Under the FSOC's bylaws, an FSOC member may designate another person from the same agency, including a fellow board member or commissioner, as his or her Deputy. All Deputies are invited to FSOC meetings and may serve on the FSOC's Deputies Committee.

The FSOC also draws upon the collective policy and supervisory expertise of the FSOC members and of the agencies.

In my role as a member of the FSOC, I draw on the expertise of other members of the Federal Reserve Board. I will continue to encourage the FSOC to take advantage of opportunities to benefit from the expertise of senior officials and staff from the agencies represented by the FSOC members.

3. Chair Yellen, would you be willing to support the following amendment to the bylaws of the Financial Stability Oversight Council:

"At every meeting of the Financial Stability Oversight Council and at every meeting of any Committee of the Financial Stability Oversight Council, a transcript of the meeting shall be taken and that transcript shall be made public after a reasonable period."

If not, why not?

The FSOC has important responsibilities, and I believe transparency is a necessary and useful part of the toolkit by which the FSOC can fulfill those responsibilities. The FSOC is charged by law with monitoring and identifying risks and vulnerabilities to the financial system and identifying systemically important financial firms that warrant supervision by the Federal Reserve. To do this job effectively, the FSOC must consider confidential information about specific firms as well as risks and vulnerabilities in various markets and segments of the financial system. Disclosing this information through a verbatim transcript could damage markets, specific firms and confidence in the financial system. It also could impair the willingness of members of the FSOC to candidly discuss their views and concerns about the financial system, thereby impairing the ability of the FSOC to fulfill its responsibilities.

At the same time, it is important for the FSOC to engage the public in understanding actions that are necessary to improve the resiliency of the financial system. Accordingly, I fully support the FSOC's decision to publish an agenda of the matters it discusses and minutes of all of its meetings, and to hold open meetings whenever consistent with fulfilling the FSOC's responsibilities. I also support the publication of an annual report by FSOC, that includes its view of vulnerabilities in the financial system and recommendations for action to address those vulnerabilities. I will continue to look for opportunities for the FSOC to increase transparency consistent with the duties the U.S. Congress has conferred on the FSOC.

4. Chair Yellen, would you be willing to support the following amendment to the bylaws of the Financial Stability Oversight Council:

"Prior to designating a firm as a systemically important financial institution, the Financial Stability Oversight Council shall provide such firm with a detailed summary of the steps the firm can take to avoid being so designated. Any firm previously designated as a systemically significant financial institution shall also be provided with such a plan within a reasonable time."

If not, why not?

Section 113 authorizes the FSOC to designate a nonbank financial company for Federal Reserve supervision if the FSOC determines that either the company's material financial distress or its activities could pose a threat to the financial stability of the United States.[1] The FSOC established a robust process, after public notice and comment, for implementing its authority

[1] See section 113(a) of the Dodd-Frank Act; 12 U.S.C. 5323(a).

under section 113 to designate nonbank financial companies for enhanced supervision by the Federal Reserve (Determination Process). The process contains three stages during which the FSOC screens companies for review and conducts an in-depth analysis of companies that pass the screen. There are numerous opportunities during this process for a nonbank financial company to communicate with the FSOC and its staff, and submit information regarding the company's activities and its potential to pose a threat to U.S. financial stability.

A nonbank financial company that receives a notice that the company is under consideration for a Proposed Determination has the opportunity to provide information as to why it should not be designated. Following a Proposed Determination, a nonbank financial company is provided a written notice of the Proposed Determination, which includes an explanation of the basis of the Proposed Determination. A nonbank financial company that is subject to a Proposed Determination may request a written or oral hearing to contest the Proposed Determination and must submit written materials in connection with both a written and oral hearing. If the FSOC determines to subject a company to supervision by the Federal Reserve and prudential standards, the FSOC provides the nonbank financial company with written notice of the FSOC's final determination, including an explanation of the basis for the FSOC's decision.

The FSOC also is required to review annually whether designated nonbank financial companies continue to meet the statutory standard for designation. The FSOC is in the process of conducting the annual review of the three nonbank financial companies that were designated in 2013. The FSOC expects to request information from these companies that bears on whether the companies continue to meet the statutory standard for designation. Because these companies were provided with a written explanation of the FSOC's final determination that the company met the statutory standard, they will be able to provide information relevant to the FSOC's consideration of whether the company continues to meet this standard.

5. Chair Yellen, would you be willing to support the following amendment to the bylaws of the Financial Stability Oversight Council:

"Prior to taking any official action, the Financial Stability Oversight Council shall conduct a formal cost-benefit analysis of the action which complies with all applicable executive orders on cost-benefit analysis regarding the White House Office of Information and Regulatory Affairs and shall make that analysis publicly available."

If not, why not?

The FSOC is committed to considering the potential impact of its actions on financial markets, firms, and financial stability. For example, in considering whether to subject a nonbank financial company to Federal Reserve supervision under section 113 of the Dodd-Frank Act, the FSOC is required to consider 10 factors specifically determined by the U.S. Congress and set forth in the statute related to the company's vulnerability to financial distress and its potential to transmit financial distress to other firms and markets. In this process, the FSOC engages in company-specific evaluations and discussions with the firm. The FSOC also annually reviews whether designated nonbank financial companies should continue to be subject to enhanced prudential standards.

The Government Accountability Office (GAO) issued a report in September of 2012 that contained specific recommendations to strengthen the accountability and transparency of FSOC and the Office of Financial Research (OFR). Among other things, the GAO Report recommended that the FSOC establish a framework for assessing the impact of FSOC designations of nonbank financial companies on the wider economy and on the designated firms. The FSOC noted in its response to the September 2012 GAO Report that in conducting its annual review of designated firms, the FSOC likely would consider the effects on the financial system resulting from designation.

6a. Chair Yellen, in response to a question regarding the Federal Reserve's examination of its exit plan for its Quantitative Easing program, you referenced a study by Seth Carpenter that was updated in 2013. Will you commit to run a similar study using parameters requested by Representative Stivers and Representative Pittenger during the Semiannual Hearing on Monetary Policy and the State of the Economy of July 17, 2012?

Will you conduct a study of the Federal Reserve's exit plan using the worst-case scenario of the last 50 years, a practice the Fed uses in stress testing of banks, and conduct a study otherwise similar to the Carpenter study, but use the timeframe of the Great Inflation of the 1970s and 1980s as the worst case scenario?

If not, why not?

The Federal Reserve regularly considers what would happen to its balance sheet and remittances to the United States Department of Treasury (Treasury) in a wide range of economic scenarios, including scenarios consistent with market expectations for rates and others where interest rates rise substantially. Numerous publications available to the public also evaluate the evolution of the Federal Reserve's balance sheet with a broad set of economic and interest rate assumptions.[2] The findings suggest that, with assumptions consistent with market views of the evolution of the economy and Federal Reserve monetary policy, cumulative remittances to the Treasury will be significant over the next decade.

Scenarios with high interest rates are shown to dampen remittances for a period of time, but cumulative remittances still tend to be sizable, especially when recognizing the significant remittances generated over the past few years. This conclusion holds for scenarios where rates rise about 200 basis points more than predicted by market participants, as shown in Carpenter et al. (2012); this scenario is consistent with interest rate paths chosen in some of the Federal Reserve's 2013 and 2014 supervisory stress-test scenarios. Even if one considered a

[2] A few publications include the Congressional Budget Office report (http://www.cbo.gov/publication/45010), the Office of Management and Budget (http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/budget.pdf); Carpenter et al. (http://www.federalreserve.gov/pubs/feds/2013/201301/201301abs.html), Christensen et al. (http://www.frbsf.org/economic-research/files/wp2013-38.pdf), Greenlaw et al. (http://www.nber.org/papers/w19297), and Resi and Hall (www.columbia.edu/~rr2572/papers/13-HallReis.pdf).

more extreme interest rate path, it is highly likely that the analysis would find that total remittances to the Treasury over the entire period 2008-2024 would remain sizable. Consistent with this analysis, Christensen et al. (2013) provides a range of stress tests on the Federal Reserve's balance sheet, including one where short term rates peak at 400 basis points above the consensus forecast. They note this scenario is very unlikely and conclude that the chance of the Federal Reserve producing below-trend cumulative remittances to the Treasury is less than 0.1 percent.

While the Federal Reserve regularly conducts stress tests for its balance sheet and income, it is important to note that the Federal Reserve's balance sheet is unique in many respects. For example, the Federal Reserve's assets largely consist of Treasury and agency securities; as a result, the Federal Reserve is not exposed to credit risk to any significant degree. Moreover, the liabilities of the Federal Reserve, predominantly currency and reserves, are an important medium of exchange for households, businesses, and financial institutions. As a result, the Federal Reserve is not exposed to liquidity risks to any significant degree. As noted above, the Federal Reserve is exposed to interest rate risk, but based on our analysis (and analysis by others cited above) Federal Reserve cumulative remittances from 2008-2024 will almost certainly be quite large. Even in scenarios in which the Federal Reserve remittances could fall to zero for a time, this does not affect the Federal Reserve's ability to meet its dual mandate of maximum employment and price stability. In addition, monetary policy can achieve the most for the country by focusing generally on improving economic performance rather than narrowly on possible gains or losses on the Federal Reserve's balance sheet. Of course, the FOMC evaluates the efficacy and costs of its asset purchases and other policy actions when choosing appropriate monetary policy.

6b. In providing the study requested in the previous question, please address the following questions:

If the Federal Reserve were required to respond to inflation levels like those seen in the 1970s and 1980s over the course of a ten-year period, and assuming interest on excess reserves served as the Federal Reserve's primary policy tool, what is the largest estimate of total interest on excess reserves the Federal Reserve would be required to pay over such a ten-year period?

Please see response for question 6a.

6c. How would the Federal Reserve's remittances to the Treasury Department change in that scenario?

Please see response for question 6a.

7. Chair Yellen, I wrote to your predecessor requesting information about the Federal Reserve's December 23, 2013, proposed rule under Section 1101 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In that letter I requested a written response.[3] Will you commit to providing this Committee with a written response during the timeframe requested in the letter? Will you commit to share my letter with the other members of the Federal Reserve Board of Governors, and allow them an opportunity to respond to the letter?

As Chairman Bernanke indicated in his January 29, 2014, response to your letter, the policy options and questions your letter raises will be considered by the Federal Reserve as it finalizes the proposed rule. In accordance with the Administrative Procedures Act, your letter has become part of the record for the rulemaking and is available for review by all of the members of the Board.

8. Chair Yellen, the Government Accountability Office is conducting a study of the impact of low interest rates on seniors. Will you commit to giving this matter your personal attention, and will you pledge the Federal Reserve's full cooperation in the GAO's review?

The primary reason that interest rates are low is that the economy has been very weak and inflation has been very low. In response to those conditions, the Federal Reserve and central banks around the world have worked hard to foster accommodative financial conditions in order to promote a speedier return to a normally functioning economy.

Nonetheless, for those who rely disproportionately on interest-bearing investments have been receiving low returns, for some, this situation has no doubt created real economic difficulty. Overall, though, low interest rates will contribute to the pace of economic recovery, and so will help generate better returns for savers, including those relying heavily on interest income. If interest rates were to rise prematurely in a way that choked off the economic recovery, any benefits accruing to savers would likely be short-lived, as a weaker economy would tend to depress future returns. When the economy has strengthened, interest rates will rise in a sustainable way. Indeed, most forecasters anticipate that rates will rise as the economic recovery progresses.

The Federal Reserve looks forward to the day when the economic health of the nation will have improved greatly on many dimensions. We pledge to do everything we can to bring that day about as quickly as possible. And yes, the Federal Reserve will cooperate fully in the GAO's review.

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[3] See Seth B. Carpenter et al., The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections, (FEDS Working Paper No. 2012-56, 2013), that letter is available at http://www.federalreserve.gov/apps/foia/ViewComments.aspx?do id=R-1476&doc ver=1.

9. Chair Yellen, in an article titled *Federal Reserve Employees Afraid to Speak Put Financial System at Risk*, the Huffington Post reported:

In 2011, [Chairman] Bernanke told Congress that [Federal Reserve Board Governor Daniel] Tarullo was taking the lead on regulatory matters, while the other six members of the seven-person Board of Governors play lesser roles. Employees said Tarullo has a view of what the financial system should look like, particularly with respect to large financial groups, and is focused on developing policy that closely matches his worldview. He can be a bully, people who work with him said. In the past, banking supervision and regulation division leaders would brief members of the Feds seven-person Board of Governors in the Feds large board room, with a big contingent of Fed staffers seated inside the room listening to -- but not participating in -- the discussions. That no longer occurs, employees said. *The staff is so weak that they can't credibly go to him with alternative views to change his mind, said one former top banking supervision and regulation division official. They go to him only with possible solutions that they know Tarullo wants to hear. They play to his biases, rather than looking at nuance and balancing what the Fed is trying to achieve.*

Do you believe that the concerns expressed by the staff of the Federal Reserve Board were valid?

Regardless of your views on the merits of those concerns, have you taken any steps to address them, particularly the charge that Governor Tarullo does not permit Federal Reserve officials to participate in rulemaking if they challenge his assumptions?

Since 2009, the Federal Reserve has taken numerous steps to improve its supervision and regulation. Among those steps are the creation of a new committee of supervisors from throughout the Federal Reserve System responsible for decisions regarding the largest banking organizations under the Federal Reserve's jurisdiction, the adoption of improved consolidated capital requirements, the design and conduct of stress tests of the largest banking organizations, adoption of liquidity requirements, the implementation of enhanced prudential standards for large and systemically important banking organizations, and the implementation of many of the provisions of the Dodd-Frank Act designed to enhance financial stability. Governor Tarullo has been instrumental in leading these efforts over the past five years. I expect him to continue to take the lead in this area, and the full Board to take a prominent role in adopting new regulatory and supervisory policies.

One of the great strengths of the Federal Reserve is the healthy and vigorous exchange of ideas and opinions among the staff and between the staff and the Board members. I, as well as all the other Board members, have and will continue to strongly encourage this type of interaction because discussion of different points of view leads to better ideas and more creative solutions to complex and difficult problems.

10. Chair Yellen, did the Federal Reserve conduct a study of the secondary impact of the Volcker Rule on minority or women-owned businesses? If not, why not?

As part of implementing section 13 of the Bank Holding Company Act (BHCA), the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and U.S. Commodity Futures Trading Commission (the Agencies) met with and received comment from members of the public about how to structure the proposal and issues raised by the statute. The Agencies provided a detailed proposal and posed numerous questions in the preamble to the proposal to solicit and explore alternative approaches in many areas. In addition, the Agencies continued to receive comment letters after the extended comment period deadline, which the Agencies considered in developing the final rule. More than 18,000 written comments were submitted to the Agencies covering a wide variety of issues. In addition, the Agencies held numerous meetings with commenters on issues raised by the statute and proposal. All of these comments and meetings were posted on the Agencies' websites to further public discussion and input.

Among other issues, the proposed rule specifically sought comment on the impact of the statute and proposal on smaller, less complex banking entities, and asked questions about whether the proposal would unduly constrain the ability of banking entities to meet the convenience and needs of the community such as through meeting their obligations under the Community Reinvestment Act (CRA) or by making other public welfare investments.

In order to address concerns about CRA investments and other investments designed to promote the public welfare, the final rule excludes from the definition of covered fund small business investment companies and other public interest funds. The final rule also tailors application of the compliance program requirements by including more rigorous requirements on banking entities with significant covered trading activities and investments than for smaller banking entities. In this manner, the Agencies provided relief to smaller, less-complex institutions, many of which are minority or women-owned businesses.

11. Chair Yellen, in response to questions regarding the inappropriateness of applying bank capital requirements to insurers, you appeared to agree that capital and liquidity standards for insurers should be tailored to the unique risk profiles of insurance companies and that requirements designed for banks would not necessarily be appropriate for insurance companies. Do you believe that section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Collins amendment, requires consolidated minimum risk-based capital and leverage requirements for insurance holding companies that are no lower than those that apply to insured depository institutions, or do you instead believe that interpretation of the Collins Amendment is inconsistent with the legislative history of the statute?

Section 171 of the Dodd-Frank Act (the Collins Amendment), by its terms, requires the Federal Reserve to establish on a consolidated basis minimum risk-based and leverage capital requirements for bank holding companies, savings and loan holding companies, and nonbank financial companies supervised by the Federal Reserve. This statutory provision further provides that these minimum consolidated capital requirements shall not be less than the generally applicable capital requirements for insured depository institutions. In addition, the minimum capital requirements cannot be quantitatively lower than the generally applicable capital requirements for insured depository institutions that were in effect in July 2010. The Collins Amendment does not contain an exception from these statutory requirements, or give the Federal Reserve Board authority to establish consolidated capital requirements for an insurance company (or any other type of company) that is a bank holding company, savings and loan holding company, or supervised nonbank financial company (Federal Reserve-supervised company) that would not meet the statutory requirements.

The Collins Amendment therefore constrains the scope of the Federal Reserve's discretion in establishing minimum capital requirements for Federal Reserve-supervised companies. The Federal Reserve continues to carefully consider how to design capital rules for Federal Reserve-supervised companies that are insurance companies or that have subsidiaries engaged in insurance underwriting, consistent with the Collins Amendment. The Federal Reserve remains willing to work with the U.S. Congress on this important matter.

CLO: #Y - 12
CCS: 14- 1455
RECVD: 2/28/14

Questions for the Record from Chairman Hensarling to Chair Yellen

Semi-Annual Hearing on Monetary Policy and the State of the Economy, February 11, 2014

Question 1:

Chair Yellen, you committed during your confirmation hearing before the Senate Committee on Banking, Housing and Urban Affairs to bring more transparency to operating procedures of the Financial Stability Oversight Council. What concrete steps have you taken to fulfill that commitment?

Question 2:

Chair Yellen, would you be willing to support the following amendment to the bylaws of the Financial Stability Oversight Council:

"Any member of a board or commission represented at the Financial Stability Oversight Council shall be permitted to attend all meetings of the Financial Stability Oversight Council, shall receive the same notice of scheduled meetings granted to members of the Financial Stability Oversight Council, and shall have the same rights to information provided to members of the Financial Stability Oversight Council."

If not, why not?

Question 3:

Chair Yellen, would you be willing to support the following amendment to the bylaws of the Financial Stability Oversight Council:

"At every meeting of the Financial Stability Oversight Council and at every meeting of any Committee of the Financial Stability Oversight Council, a transcript of the meeting shall be taken and that transcript shall be made public after a reasonable period."

If not, why not?

Question 4:

Chair Yellen, would you be willing to support the following amendment to the bylaws of the Financial Stability Oversight Council:

"Prior to designating a firm as a systemically important financial institution, the Financial Stability Oversight Council shall provide such firm with a detailed summary of the steps the firm can take to avoid being so designated. Any firm previously designated as a systemically significant financial institution shall also be provided with such a plan within a reasonable time."

If not, why not?

Question 5:

Chair Yellen, would you be willing to support the following amendment to the bylaws of the Financial Stability Oversight Council:

"Prior to taking any official action, the Financial Stability Oversight Council shall conduct a formal cost-benefit analysis of the action which complies with all applicable executive orders on cost-benefit analysis regarding the White House Office of Information and Regulatory Affairs and shall make that analysis publicly available."

If not, why not?

Question 6:

Chair Yellen, in response to a question regarding the Federal Reserve's examination of its exit plan for its Quantitative Easing program, you referenced a study by Seth Carpenter that was updated in 2013.[1] Will you commit to run a similar study using parameters requested by Representative Stivers and Representative Pittenger during the Semiannual Hearing on Monetary Policy and the State of the Economy of July 17, 2012?

Will you conduct a study of the Federal Reserve's exit plan using the worst-case scenario of the last 50 years, a practice the Fed uses in stress testing of banks, and conduct a study otherwise similar to the Carpenter study, but use the timeframe of the Great Inflation of the 1970s and 1980s as the worst case scenario?

If not, why not?

In providing the study requested in the previous question, please address the following questions:

If the Federal Reserve were required to respond to inflation levels like those seen in the 1970s and 1980s over the course of a ten-year period, and assuming interest on excess reserves served as the Federal Reserve's primary policy tool, what is the largest estimate of total interest on excess reserves the Federal Reserve would be required to pay over such a ten-year period?

How would the Federal Reserve's remittances to the Treasury Department change in that scenario?

Question 7:

Chair Yellen, I wrote to your predecessor requesting information about the Federal Reserve's December 23, 2013, proposed rule under Section 1101 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In that letter I requested a written response.[2] Will you commit to providing this Committee with a written response during the timeframe requested in the letter? Will you commit to share my letter with the other members of the Federal Reserve Board of Governors, and allow them an opportunity to respond to the letter?

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[1] *See* Seth B. Carpenter et al., *The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections*, (FEDS Working Paper No. 2012-56, 2013),

[2] That letter is available at http://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=R-1476&doc_ver=1.

Question 8:

Chair Yellen, the Government Accountability Office is conducting a study of the impact of low interest rates on seniors. Will you commit to giving this matter your personal attention, and will you pledge the Federal Reserve's full cooperation in the GAO's review?

Question 9:

Chair Yellen, in an article titled *Federal Reserve Employees Afraid to Speak Put Financial System at Risk*, the Huffington Post reported:[3]

> In 2011, [Chairman] Bernanke told Congress that [Federal Reserve Board Governor Daniel] Tarullo was "taking the lead" on regulatory matters, while the other six members of the seven-person Board of Governors play lesser roles. Employees said Tarullo has a view of what the financial system should look like, particularly with respect to large financial groups, and is focused on developing policy that closely matches his worldview. He can be a bully, people who work with him said....In the past, banking supervision and regulation division leaders would brief members of the Fed's seven-person Board of Governors in the Fed's large board room, with a big contingent of Fed staffers seated inside the room listening to -- but not participating in -- the discussions. That no longer occurs, employees said. *"The staff is so weak that they can't credibly go to him with alternative views to change his mind," said one former top banking supervision and regulation division official. "They go to him only with possible solutions that they know Tarullo wants to hear. They play to his biases, rather than looking at nuance and balancing what the Fed is trying to achieve."*

Do you believe that the concerns expressed by the staff of the Federal Reserve Board were valid?

Regardless of your views on the merits of those concerns, have you taken any steps to address them, particularly the charge that Governor Tarullo does not permit Federal Reserve officials to participate in rulemaking if they challenge his assumptions?

Question 10:

Chair Yellen, did the Federal Reserve conduct a study of the secondary impact of the Volcker Rule on minority or women-owned businesses? If not, why not?

Question 11:

Chair Yellen, in response to questions regarding the inappropriateness of applying bank capital requirements to insurers, you appeared to agree that capital and liquidity standards for insurers should be tailored to the unique risk profiles of insurance companies and that requirements designed for banks would not necessarily be appropriate for insurance companies. Do you believe that section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Collins amendment, requires consolidated minimum risk-based capital and leverage requirements for insurance holding companies

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[3] See http://www.huffingtonpost.com/2013/08/28/federal-reserve-employees-survey_n_3826165.html

that are no lower than those that apply to insured depository institutions, or do you instead believe that interpretation of the Collins Amendment is inconsistent with the legislative history of the statute?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 30, 2014

The Honorable Gwen Moore
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative Moore:

1. I know that there is a working group among the regulators to coordinate, but I would appreciate some additional details on the mechanics of complying with the multi-agency rule so as to achieve consistency in compliance and enforcement.

Authority for issuing regulations and implementing section 13 of the Bank Holding Company Act (BHC Act) is by statute clearly allocated to the primary federal regulator(s) of each legal entity. As a general matter, the Office of the Comptroller of the Currency will supervise and enforce the final rule for national banks and federal branches of foreign banking entities, the Federal Deposit Insurance Corporation for state nonmember banks and state-chartered insured branches of foreign banking entities, the Securities and Exchange Commission for U.S. broker-dealers and securities-based swap dealers, and the Commodity Futures Trading Commission (CFTC) for Futures Commission Merchants and swap dealers. The Federal Reserve's primary responsibilities are for depository institution holding companies, state member banks, certain unregulated and foreign subsidiaries of depository institution holding companies, and state-chartered uninsured branches of foreign banking entities.

In pursuit of our goals for a consistent application of the rule across Agencies and across banking entities, staffs of the implementing Agencies meet regularly to address key implementation and supervisory issues as they arise. Staffs of the Agencies also continue to meet with and collect questions from banking entities under their respective jurisdictions, and banking entities may submit questions regarding matters of interest raised by section 13 and the implementing rules to the Agencies. Staffs of the Agencies expect to coordinate responding to matters that are of common interest in public statements, including through public responses to frequently asked questions and in public guidance.

2. As you know, there's been a lot of congressional scrutiny in the Federal Reserve's oversight of bank holding company activities in the aluminum and other base metal markets, which are creating economic anomalies in those markets.

Under the Federal Reserve's BHCA exemption, U.S. bank holding companies have effective control of the LME, which, as we have seen, banks are using to this control to created a bottleneck in the supply of commodities, specifically aluminum. Building on the example of aluminum, prices of aluminum have remained inflated relative to the massive oversupply and record production, especially with regard to can sheet aluminum.

My question is, under the Volker Rule, and argument can be made that there appears to be straightforward guidance that this sort of conflict of interest in market-making are explicitly banned? Do you agree? Additionally, could you provide the sense of the Federal Reserve whether the exemptions for U.S. merchant banks that allow them to continue their involvement in non-banking businesses like owning London Metal Exchange certified warehouses should be revoked?

Section 13 of the BHC Act does not prohibit a banking entity from engaging in proprietary trading of physical or spot commodities such as aluminum or other base metals. Moreover, Congress vested authority over commodity exchanges and trading in the CFTC.

Financial holding companies are expressly authorized by statute to make merchant banking investments. Specifically, the Gramm-Leach-Bliley Act authorized financial holding companies to engage in merchant banking activities involving any type of company. See 12 U.S.C. §§ 1843(k)(4)(H)-(I). Congress also expressly authorized several companies that became financial holding companies after November 1999 to engage in a broad range of commodities activities, including trading, storage, transportation and investment of commodities, if the firm engaged in those activities prior to September 30, 1997. The Federal Reserve authorized about a dozen financial holding companies to engage in limited commodities activities that are complementary to their derivatives trading activities, but has expressly prohibited those financial holding companies from using this complementary authority to engage in storage, transportation, refining or similar activities.

In January 2014, the Federal Reserve noted that merchant banking investments in companies engaged in physical commodities activities and use of other authorities to engage in physical commodities activities could expose financial holding companies to legal, environmental, and reputational risks that greatly exceed the financial holding company's equity. See 79 Fed. Reg. 3329, 3335 (Jan. 21, 2014). Consequently, the Federal Reserve sought public comment on, and is currently considering, additional actions that are consistent with the statutory authority for merchant banking investments but that may better address the potential risks associated with such investments. These actions could include more restrictive limitations on physical commodities activities, additional restrictions on merchant banking investments, and additional capital or other requirements on financial holding companies that conduct physical commodities activities.

CLO: #25
CCS: 14- 1328
RECVD: 2/25/14

Question for the Record
Representative Gwen Moore
The Impact of the Volcker Rule on Job Creators, Part II
House Financial Services Committee

February 5, 2014

Question for Mr. Tarullo:

I know that there is a working group among the regulators to coordinate, but I would appreciate some additional details on the mechanics of complying with the multi-agency rule so as to achieve consistency in compliance and enforcement.

Question for Mr. Tarullo:

As you know, there's been a lot of congressional scrutiny in the Federal Reserve's oversight of bank holding company activities in the aluminum and other base metal markets, which are creating economic anomalies in those markets.

Under the Federal Reserve's BHCA exemption, U.S. bank holding companies have effective control of the LME, which, as we have seen, banks are using to this control to created a bottleneck in the supply of commodities, specifically aluminum. Building on the example of aluminum, prices of aluminum have remained inflated relative to the massive oversupply and record production, especially with regard to can sheet aluminum.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 30, 2014

The Honorable Dennis Ross
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative Ross:</u>

1a. How do you expect to notify market participants about how they are supposed to report Volcker Rule data and to whom the data will be sent? When will you notify market participants? Will that notification be done jointly?

Authority for issuing regulations and implementing section 13 of the Bank Holding Company Act (BHC Act) is by statute clearly allocated to the primary federal regulator(s) of each legal entity. As a general matter, the Office of the Comptroller of the Currency (OCC) will supervise and enforce the final rule for national banks and federal branches of foreign banking entities, the Federal Deposit Insurance Corporation (FDIC) for state nonmember banks and state-chartered insured branches of foreign banking entities, the Securities & Exchange Commission (SEC) for U.S. broker-dealers and securities-based swap dealers, and the Commodity Futures Trading Commission (CFTC) for Futures Commission Merchants (FCMs) and swap dealers. The Federal Reserve's primary responsibilities are for depository institution holding companies, state member banks, certain unregulated and foreign subsidiaries of depository institution holding companies, and state-chartered uninsured branches of foreign banking entities.

Under the final rule, a banking entity engaged in significant trading activity must calculate and report certain quantitative measurements ("metrics") to its primary supervisory agency as outlined above. These metrics are widely used by banking entities to measure and manage trading risks and activities. However, the Agencies expect to issue supervisory guidance regarding the form and date for reporting the metrics and to conduct comparisons of these metrics across similarly situated trading desks and across entities to help in reviewing compliance with the requirements of section 13.

The Agencies recently released FAQs to address the date of metrics reporting and to which Agency or Agencies metrics must be reported. The final rule requires a banking entity at or above the $50 billion threshold to report metrics data for each calendar month within 30 days of the end of the month unless the relevant Agency notifies the banking entity in writing that it must report on a different basis. All of the Agencies have informed their respective institutions that the first report of metrics data will be due on September 2, 2014, for data as of July 30, 2014. Furthermore, for a trading desk that spans multiple affiliated legal entities, the same set of desk-wide measurements should be reported to each Agency that has supervisory authority under section 13 over any of the entities that compose the trading desk so that the Agency may understand the context of the trading activity and discharge its responsibility for the legal entity that the Agency supervises or regulates.

1b. Who on this panel has been tasked with ensuring that there will be a consistent reporting format across all of the regulators?

Please see response to question 1a.

1c. Will one agency serve as the central repository for all reporting?

Please see response to question 1a.

1d. Here is my concern, we are already hearing that at least two of you cannot agree about one of the metrics – the inventory turnover and customer facing trade ratio. The SEC has said that data should be recorded as of July 1, while the OCC has said this data should be recorded as of April 1. Who is correct? Assuming you believe that you are both correct, then whose interpretation controls for an entity that is subject to examination by both of your agencies?

Please see response to question 1a.

2a. I've been contacted by a businessman in my district who operates a registered investment advisory firm. They wish to offer a municipal bond fund to community banks that is comprised of investment grade bank qualified municipal bonds. The fund would be exempt from registration under the Investment Company Act of 1940 and would be completely unleveraged and without any debt. Under the Volker Rule, they are unable to offer this fund unless it is registered—but registration would require over $200,000 in compliance and registration costs. That cost would ultimately be passed on to the consumer—thereby negating benefit of the fund. Was this an intended consequence of the Volcker Rule?

The statutory definition of hedge fund and private equity fund (together "covered fund") generally covers any entity that would be an investment company under the Investment Company Act of 1940 but for the exclusion under sections 3(c)(1) or 3(c)(7) of the Investment Company Act, or such similar funds as the Agencies may, by rule, determine. Whether a particular fund is a covered fund will, therefore, depend on what exemption (if any) the fund claims from the Investment Company Act of 1940. Moreover, the prohibition in the statute on ownership of a covered fund applies only to banking entities and only in certain situations.

Neither the statute nor final rule prohibits a registered investment adviser that is not itself an insured depository institution or an affiliate of an insured depository institution from offering or owning a municipal bond fund.

2b. If not, what would be the appropriate action moving forward to solve this issue?

Please see response to question 2a.

CLO: #21
CCS: 14-1324
RECVD: 2/25/14

Questions for the Record
Congressman Dennis Ross
Hearing entitled "The Impact of the Volcker Rule on Job Creators, Part II"
Wednesday, February 5, 2014

Please submit to all witnesses.

1. How do you expect to notify market participants about how they are supposed to report Volcker Rule data and to whom the data will be sent?

   a. When will you notify market participants? Will that notification be done jointly?

   b. Who on this panel has been tasked with ensuring that there will be a consistent reporting format across all of the regulators?

   c. Will one agency serve as the central repository for all reporting?

   d. Here is my concern, we are already hearing that at least two of you cannot agree about one of the metrics – the inventory turnover and customer facing trade ratio. The SEC has said that data should be recorded as of July 1, while the OCC has said this data should be recorded as of April 1. Who is correct? Assuming you believe that you are both correct, then whose interpretation controls for an entity that is subject to examination by both of your agencies?

2. I've been contacted by a businessman in my district who operates a registered investment advisory firm. They wish to offer a municipal bond fund to community banks that is comprised of investment grade bank qualified municipal bonds. The fund would be exempt from registration under the Investment Company Act of 1940 and would be completely unleveraged and without any debt. Under the Volker Rule, they are unable to offer this fund unless it is registered—but registration would require over $200,000 in compliance and registration costs. That cost would ultimately be passed on to the consumer—thereby negating benefit of the fund.

   a. Was this an intended consequence of the Volcker Rule?
   b. If not, what would be the appropriate action moving forward to solve this issue?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

July 2, 2014

The Honorable Peter T. King
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative King:

1. If the U.S. remains the only developed country to implement a restriction on proprietary trading, will U.S. corporations—faced with higher borrowing costs—be placed at a competitive disadvantage against their foreign counterparts?

The goal of the Federal Reserve with respect to section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and all other provisions of the Act is to implement the statute in a manner that is faithful to the language of the statute and that maximizes financial stability and other social benefits at the least cost to credit availability and economic growth.

To that end both the statute and the final rule incorporate a number of provisions that are designed to limit the impact of section 619 on U.S. commercial firms' cost of funding, such as through the issuance of securities. Most notably, section 619 and the final rule explicitly allow banking entities to engage in market making and underwriting that is designed to meet the reasonably expected near term demands of a banking entity's clients, customers, and counterparties. Market making and underwriting activities are important areas of competition for banking entities and serve the vital needs of commercial firms.

To the extent that the final rule has unintended impacts on banking entities or the U.S. financial system, the federal banking agencies would seek to evaluate and address those impacts within the parameters of the statute if possible, and otherwise to inform Congress.

2. What effect will the U.S.'s decision to adopt the Volcker Rule have on the ability of U.S. financial institutions to compete against their foreign counterparts?

Various foreign governments are also currently undertaking evaluations of how the trading activities of their banking entities are structured. However, it remains to be seen how any resulting banking reforms will compare with the restrictions of section 619 of the Dodd-Frank Act. More specifically, reforms dealing with the trading activities of banking firms have been recommended by the Vickers Commission in the United Kingdom and the Liikanen Group in the European Union. These approaches rely primarily on separating deposit-taking entities within large banking organizations from affiliates that engage in securities trading and securitization functions, along with requiring separate capitalization for the deposit-taking entities. This approach has been incorporated into implementing legislation enacted in the United Kingdom, France, and Germany. Furthermore, the European Commission's January 29, 2014 proposed regulation on bank structural reforms, which would prohibit certain large European banking firms from operating stand-alone proprietary trading desks, also differs from section 619 in a number of respects.

It should also be noted that the final rule implementing section 619 restricts U.S. banking entities' worldwide proprietary trading activities, as well as foreign banking entities' U.S. proprietary trading activities. Yet, the final rule exempts trading activities by foreign banking entities outside the United States. As a result, there will be a level playing field for U.S. and foreign banking entities operating within the United States. The only differences in trading requirements between U.S. and foreign banking entities will be with respect to their foreign trading operations.

3. Will the U.S. financial system be made more robust and safer by the adoption of the Volcker Rule? Or will the U.S. financial system find itself left behind as those institutions and business that can look elsewhere for liquidity leave the U.S.?

Congress determined that section 13 of the Bank Holding Company Act was necessary to promote and enhance the safety and soundness of banking entities and financial stability by prohibiting banking entities from engaging in short-term proprietary trading in financial instruments and making certain types of investments in private equity funds and hedge funds. Both the statute and the final implementing rules incorporate a number of provisions that are designed to limit the impact the statute on liquidity in the United States. Most notably, the statute explicitly allows banking entities to engage in trading activities that are done in the context of market making and underwriting designed to meet the reasonably expected near term demands of a banking entity's clients, customers, and counterparties. In addition, the statute and final rule allow banking entities to trade on behalf of customers, including acting as agent and in trading financial instruments. These exemptions help to preserve liquidity in markets by allowing banking entities to continue in their traditional role in the intermediation of trades in financial instruments.

The competitive impact the prohibitions of section 13 in the United States should be minimized because the statute and implementing rules apply equally to U.S. banking entities and the operations of foreign banking entities in the United States. U.S. firms may be at a competitive disadvantage outside the United States in foreign jurisdictions that have not adopted similar requirements. However, the key activities that section 13 prohibits--namely, proprietary trading and acquiring an ownership interest in or sponsorship of private funds--traditionally have not been major sources of revenue for the vast majority of U.S. bank holding companies. This suggests that the impact of section 13 and the final implementing rules on U.S. financial firms' overseas competitiveness may be limited. Moreover, foreign jurisdictions are considering adopting restrictions similar to those in section 13.

The Federal Reserve and the other implementing agencies will be monitoring the effect of section 13 and the implementing rules on U.S. capital markets and U.S. commercial firms to allow Congress to determine whether the statute is achieving its intended purpose.

4. What effect will this weakening of the U.S. capital markets have on the U.S. economy?

Section 619 of the Dodd-Frank Act provides for a number of means by which banks may engage in trading to facilitate the needs of their customers and clients. In particular, both section 619 and the final rule provides banks with the flexibility to engage in market making to facilitate the capital markets needs of their clients and counterparties. As the primary function of capital markets is to serve the underlying needs of financial end users such as corporations in need of capital and funding and investors, curtailing bank proprietary trading while preserving the ability of banks to make markets ensures that capital markets will be able to continue to meet the needs of financial end users.

In addition to the market making exemption the final rule implementing section 619 contains a number of additional provisions that are designed to ensure that capital markets can continue to operate efficiently to meet the needs of banks customers and counterparties. These provisions would include the ability to trade U.S. and foreign sovereign debt, the ability to trade on behalf of clients as well as the ability to engage in trading activities on behalf of insurance companies.

PETER T. KING
Member of Congress
Second District, New York

339 Cannon House Office Building
Washington, DC 20515-3202
(202) 225-7896

1003 Park Boulevard
Massapequa Park, NY 11762
(516) 541-4225

For Suffolk County:
(631) 541-4225

pete.king@mail.house.gov
www.peteking.house.gov
Twitter: @RepPeteKing

Congress of the United States
House of Representatives
Washington, DC 20515-3202

Committee on Homeland Security
Chairman, Counterterrorism and Intelligence
Emergency Preparedness, Response and Communications

Permanent Select Committee on Intelligence

CLO: #20
CCS: 14- 1323
RECVD: 2/25/14

February 13, 2014

The Honorable Daniel Tarullo
Governor, Federal Reserve Board
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

The Honorable Martin Gruenberg
Chairman, Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

The Honorable Mary Jo White
Chairwoman, Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable Thomas Curry
Comptroller of the Currency
400 7th Street, S.W.
Suite 3E-218
Washington, D.C. 20219

The Honorable Mark Wetjen
Acting Chair, Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Governor Tarullo, Chair White, Chairman Gruenberg, Comptroller Curry and Acting Chair Wetjen:

Thank you for your February 5th testimony on the implementation of Section 619 of the Dodd-Frank Act, known as the Volcker Rule, before the House Financial Services Committee. I would like to submit the below questions for the record regarding the impact of the Volcker Rule on the global competitiveness of U.S. financial institutions.

The U.S. is the only nation that has prohibited its banks from engaging in proprietary trading. By contrast, not only have other countries refused to adopt such a ban on "proprietary trading," they have encouraged their banks to follow a universal banking model in which there is no effort to segregate proprietary trading from commercial banking.

- If the U.S. remains the only developed country to implement a restriction on proprietary trading, will U.S. corporations—faced with higher borrowing costs—be placed at a competitive disadvantage against their foreign counterparts?

- What effect will the U.S.'s decision to adopt the Volcker Rule have on the ability of U.S. financial institutions to compete against their foreign counterparts?

- Will the U.S. financial system be made more robust and safer by the adoption of the Volcker Rule? Or will the U.S. financial system find itself left behind as those institutions and business that can look elsewhere for liquidity leave the U.S.?

- What effect will this weakening of the U.S. capital markets have on the U.S. economy?

Thank you for your consideration. I look forward to your response.

Sincerely,

PETER T. KING
Member of Congress

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 30, 2014

The Honorable Scott Garrett
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative Garrett:</u>

1. Given that the rule was out for proposal for two years and given the broad impact that it is going to have our U.S. financial markets, why was the new rule not put out for additional public comment? If it had been, would the problems associated with TruPS and CLOs been caught and been addressed instead of causing all of the problems those provisions have?

The Federal Reserve, the Office of Comptroller of the Currency, the Federal Deposit Insurance Company, the Securities and Exchange Commission, and Commission Futures Trading Commission (the "Agencies") engaged in an extensive public process in the course of developing and finalizing the rules to implement section 13 of the Bank Holding Company Act ("BHC Act"). The Agencies individually and jointly, provided many opportunities for commenters to provide input on implementation of section 13 of the BHC Act and have collected substantial information in the process. Before initially proposing the implementing rules, the Agencies met with and received comment from members of the public about how to structure the proposal and issues raised by the statute. The public also provided substantial comment in response to a request for comment from the Financial Stability Oversight Committee regarding its findings and recommendations for implementing section 13 before the Agencies proposed implementing rules.

After these public interactions, the Agencies published detailed proposed implementing rules and posed numerous questions in the preamble to the proposal to solicit and explore alternative approaches in many areas. More than 18,000 written comments were submitted to the Agencies covering a wide variety of issues. The Agencies continued to receive comment letters after the extended comment period deadline, which the Agencies considered in developing the final rule. In addition, the Agencies held numerous meetings with commenters on issues raised by section 13 and the proposal. All of these comments and meetings were posted on the Agency websites to further public discussion and input. Thus, the Agencies believe interested parties had ample opportunity to review the proposed rules, as well as the comments made by others, and to provide views on the proposal.

The Agencies have been mindful of the importance of providing certainty to banking entities and financial markets and of providing sufficient time for banking entities to understand the requirements of the final rule and to design, test, and implement compliance and reporting systems. The further substantial delay that would necessarily have been entailed by reproposing the rule would extend the uncertainty that banking entities would face, which could have proved disruptive to banking entities and the financial markets.

Among other issues, the proposed rule specifically sought comment on the impact of section 13 and the proposal on securitization vehicles, which includes collateralized loan obligations ("CLOs") and collateralized debt obligations ("CDOs") like trust preferred securities (TruPS) CDOs. The proposal included a number of questions about the treatment of securitizations, as well as regarding the legal, accounting and tax treatment of interests in securitizations and how debt interests should be treated under the rules. Although comments were received on many other aspects of the proposal relating to securitizations, no comments were received on securitizations backed by trust preferred securities under the proposed rule.

To address concerns regarding TruPS CDOs, in January 2014, the Agencies approved an interim final rule to authorize the retention of interests in and sponsorship of TruPS CDOs that were acquired on or before December 10, 2013. The final rules exclude all securitizations backed entirely by loans, including CLOs backed entirely by loans. To address investments in CLOs that are backed in part by non-loan assets, the Federal Reserve issued a statement that it intends to grant two additional one-year extensions of the conformance period that would allow banking entities additional time to conform these ownership interests and sponsorship activities to the statute and implementing rules. The other Agencies support this action.[1]

2. The Riegle Community Development and Regulatory Improvement Act ('Riegle Act,' 12 U.S.C. §4802(a)), requires all "Federal banking agencies including the OCC, the Fed, and the FDIC, to: "[i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest - (1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations."

Why did you not follow the law when promulgating this rule? How can you expect others you are regulating to follow the law when you yourself don't follow it?

The Agencies carefully considered the administrative compliance requirements resulting from the requirements imposed by the rules to implement section 13 of the BHC Act. As explained in detail in the statement explaining the final rules, the Agencies have tailored the compliance requirements to reduce burden on smaller banking entities. In particular, the final rule applies data reporting requirements and comprehensive compliance program requirements only on the largest banking entities with significant trading activities. This reduces the cost of the implementing rules while achieving the benefits sought by Congress in enacting section 13. In addition, to relieve burden while also achieving the benefits sought by the statute, the Federal Reserve extended the conformance date for the implementing rules for an additional year to July 15, 2015, to allow all firms greater opportunity to meet the compliance requirements of the statute over time.

3. The Volcker preamble states that the regulators are using safety and soundness authority to exempt certain foreign sovereign debt. Some of this foreign sovereign debt can be extremely risky, as we have seen with Spain, Italy, Portugal and Greece. One could easily make the case that actually means you are using safety and soundness authority to make banks less safe and less sound.

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[1] See Letter to Chairman Hensarling re: CLOs (Apr. 7, 2014).

On the other hand, when it comes to addressing the problems in the CLO market, the preamble also states that you could use your safety and soundness authority to address the concerns surrounding those assets but you have refused to do so. If banks are forced to fire-sale their legacy CLO holdings, this could drive down asset prices, hurt the market, and actually make banks less safe and less sound. In fact, some banks have stated specifically that if is not addressed, the new rules will force them to collapse.

Why are you using your safety and soundness powers to allow banks to prop trade risky sovereign debt which will make banks less safe and less sound? Shouldn't you be using your safety and soundness authorities to help save little community banks like First Federal instead of putting them out of business solely based on overly aggressive interpretation of the statute, one never intended by Congress?

Congress determined that section 13 of the BHC Act was necessary to promote and enhance the safety and soundness of banking entities and the financial stability of the United States by prohibiting banking entities from engaging in short-term proprietary trading of financial instruments and making certain types of investments in private equity funds and hedge funds, subject to certain exemptions. The statute permits the agencies charged with implementing section 13 of the BHC Act to provide additional exemptions if the agencies determine, by rule, that the activity would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

The final rule implementing section 13 of the BHC Act contains a limited exemption to the prohibition on proprietary trading to permit trading in foreign sovereign debt in two circumstances. First, the final rule permits foreign banking entities to engage in proprietary trading in the United States in the debt of the foreign sovereign under whose laws the foreign banking entity is organized. Many foreign supervisors focus home country liquidity requirements on investment by foreign banking entities in the sovereign debt of the chartering foreign sovereign. This exception allows a foreign banking entity to trade in the debt of its chartering foreign sovereign in the United States, thereby facilitating compliance with these and other safety and soundness goals of the foreign home country supervisor. At the same time, because this exception is narrowly drawn to apply only to foreign banking entities, this exception does not undermine safety and soundness in the United States.

Second, the final rule permits a foreign bank or foreign broker-dealer regulated as a securities dealer and controlled by a U.S. banking entity to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign entity is organized. This exception is also narrowly drawn to permit foreign banks and foreign securities broker-dealers to trade in debt only of the chartering foreign sovereign. Without this exception, banking entities organized and chartered in the United States would be unable to own and operate foreign banks and foreign securities broker-dealers. As noted above, regulatory requirements in foreign countries typically expect these foreign firms to invest and trade in sovereign debt of the chartering foreign sovereign. Permitting U.S. banking entities to own and operate foreign banks and foreign securities firms allows U.S. banking entities to benefit from geographic diversity and opportunity and enhances the financial system in the United States.

The Federal Reserve has also provided relief to address concerns raised by banking entities that own CLOs. In keeping with the statute, the final rule excludes from the definition of covered fund any loan securitization that is backed entirely by loans. CLOs backed by assets that are not loans are covered by the prohibition in the statute, however.

Data reported to the federal banking agencies by insured depository institutions, bank holding companies and certain savings and loan holding companies in the Call Report and Y9-C forms indicate that only about 50 domestic banking organizations including a number of the largest banking entities in the U.S. held CLOs, including both conforming and nonconforming CLOs, as of December 31, 2013. The data also indicate that aggregate CLO holdings of these banking entities reflect an overall unrealized net gain, and unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income. New issuances of CLOs in late 2013 and early 2014 appear to be conforming to the final rule, and some CLOs issued before December 31, 2013 are conforming their investments to the provisions of section 13. Based on discussions with industry representatives and a review of data provided by market participants, it appears that the current volume of new CLO issuances is higher as compared to CLOs issued prior to the adoption of the final rule, with U.S. CLO issuances increasing to a post-crisis high of approximately $12 billion in April 2014, the third highest monthly total on record.

On April 7, 2014, the Federal Reserve issued a statement ("Board Statement") that it intends to grant two additional one-year extensions of the conformance period under section 13 of the BHC Act that would allow banking entities additional time to conform to the statute ownership interests in and sponsorship of CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final rule implementing section 13 of the BHC Act for loan securitizations. This would permit banking entities to retain until July 21, 2017, ownership interests in and sponsorship of CLOs that are not backed entirely by loans that were held as of December 31, 2013. This will provide the few banking entities that own non-conforming CLOs an extended period to conform their investments in a safe and sound manner.

4. There has been repeated discussion that other new entrants will step in to make up any potential disruption in market liquidity that the implementation of the Volcker rule may create. Can you specifically name some of these new entrants? Who are they? Have they stepped in? Are they only stepping in already liquid markets?

Financial markets attract a broad range of participants from various sectors of the economy and locations across the globe. Further, market participants are motivated by a number of incentives which may include earning profits by providing liquidity in markets where other participants are reducing their presence. Identifying which participants are acting in response to any single incentive or market opportunity is not generally possible as most market data provides no systematic information about trading intent.

5. Thank you for your testimony regarding the formation of an interagency working group. Can you tell us more about the structure of the group - for instance will there be a chairman? What is the timeline for identifying members of the group? What will the process be for stakeholders to communicate with the interagency group?

The interagency working group is an informal group of staff from each of the Agencies that meets regularly to discuss and make recommendations to the Agencies regarding resolution of issues raised by section 13 and the implementing rules. The group has already begun to meet and will continue to meet regularly going forward. Each of the Agencies also continues to meet with and collect questions from banking entities under their respective jurisdictions raised by the statute and implementing rules. Affected institutions have communicated with the Agencies by letter, in person, at conferences and otherwise regarding various matters of interest. The Agencies expect to respond to matters that are of common interest in public statements, including public responses to frequently asked questions, and in public guidance.

CLO: #19
CCS: 14-1322
RECVD: 2/25/14

Congressman Scott Garrett – Questions for the Record
Full Committee Volcker Hearing (2-5-14)

Process (All)

Given that the rule was out for proposal for two years and given the broad impact that it is going to have our U.S. financial markets, why was the new rule not put out for additional public comment? If it had been, would the problems associated with TruPS and CLOs been caught and been addressed instead of causing all of the problems those provisions have?

Econ Analysis (OCC, FRB, FDIC)

The Riegle Community Development and Regulatory Improvement Act ('Riegle Act,' 12 U.S.C. §4802(a)), requires all "Federal banking agencies including the OCC, the Fed, and the FDIC, to: "[i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest - (1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations."

Why did you not follow the law when promulgating this rule? How can you expect others you are regulating to follow the law when you yourself don't follow it?

Enforcement (SEC)

In regards to the SEC's requirement under the law to conduct an appropriate economic analysis of the rule, I appreciate Chair White's hyper-technical excuse for not, at the very least, following the spirit of the law. However, I find it somewhat ironic that ensuring the rule was written entirely under the Bank Holding Company Act to technically avoid the legal requirement to conduct economic analysis has led to an inability for the chief markets regulator (the SEC) to enforce what is essentially a markets-based rule.

How can you not have the statutory requirement to conduct robust economic analysis but have the statutory authority to enforce the rule?

Econ Analysis Request (SEC & CFTC)

It is extremely disappointing that, with a rule that will have the breadth and scope of the impact the Volcker rule will have that, regardless of legal requirements, our financial regulators did not feel it incumbent upon them to ensure they are properly weighing all of the potential impacts of this rule in a formal manner.

Given your past verbal support for economic analysis, will you commit to conducting a post facto formal economic analysis of the rule AND will you commit to conduct an ongoing formal public analysis and reporting of the impact the rule is having on liquidity in the bond market?

Foreign Sovereign Exemption + CLOs (FRB, OCC, FDIC)

The Volcker preamble states that the regulators are using safety and soundness authority to exempt certain foreign sovereign debt. Some of this foreign sovereign debt can be extremely risky, as we have seen with Spain, Italy, Portugal and Greece. One could easily make the case that actually means you are using safety and soundness authority to make banks less safe and less sound.

On the other hand, when it comes to addressing the problems in the CLO market, the preamble also states that you could use your safety and soundness authority to address the concerns surrounding those assets but you have refused to do so. If banks are forced to fire-sale their legacy CLO holdings, this could drive down asset prices, hurt the market, and actually make banks less safe and less sound. In fact, some banks have stated specifically that if is not addressed, the new rules will force them to collapse.

Why are you using your safety and soundness powers to allow banks to prop trade risky sovereign debt which will make banks less safe and less sound? Shouldn't you be using your safety and soundness authorities to help save little community banks like First Federal instead of putting them out of business solely based on overly aggressive interpretation of the statute, one never intended by Congress?

New Market Entrants (All)

There has been repeated discussion that other new entrants will step in to make up any potential disruption in market liquidity that the implementation of the Volcker rule may create. Can you specifically name some of these new entrants? Who are they? Have they stepped in? Are they only stepping in already liquid markets?

Enforcement (All)

Thank you for your testimony regarding the formation of an interagency working group. Can you tell us more about the structure of the group - for instance will there be a chairman? What is the timeline for identifying members of the group? What will the process be for stakeholders to communicate with the interagency group?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 30, 2014

The Honorable Stephen Fincher
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative Fincher:

1. The Volcker Rule will take effect around the same time as higher capital standards mandated under Basel III. What will be the combined impact of the Volcker Rule and Basel III on interest rates for corporate borrowers?

The regulatory capital framework mandated under Basel III increases minimum requirements for both the quantity and quality of capital held by banking organizations. These requirements are subject to a transition period, which began in January 2014 for larger institutions and begins in January 2015 for smaller, less complex banking organizations. These transition periods generally extend through December 31, 2018, and may extend longer for certain instruments. Data reported by the industry indicate that more than 90 percent of communities banking organizations already meet the Basel III rules on a fully phased-in basis and all of the larger banking organizations are on a trajectory that allows them to meet the Basel III standards before the end of the transition period.

The Federal Reserve and other agencies charged with implementing section 13 of the Bank Holding Company Act (BHC Act) issued final implementing rules for that section on December 10, 2013. By statute, the requirements of section 13 are subject to a conformance period that ends on July 21, 2014, absent action to extend the period by the Federal Reserve. The Federal Reserve exercised its statutory authority to extend this conformance period until July 21, 2015. The conformance period for section 13 may be extended for up to two, additional one-year periods if, in the judgment of the Federal Reserve, an extension is consistent with the purposes of section 13 and would not be detrimental to the public interest.

Enhanced capital improves the financial resilience of banking organizations, and is a hallmark of the Dodd-Frank Wall Street Reform and Consumer Protection Act provisions requiring enhanced prudential requirements and stronger minimum capital floors. Similarly, section 13 of the BHC Act was enacted to promote and enhance the safety and soundness of banking entities and the financial stability of the United States by prohibiting banking entities from engaging in short-term proprietary trading in financial instruments and making certain types of investments in private equity funds and hedge funds.

Because of the transition periods for Basel III and the conformance period provided for section 13 of the BHC Act, it is still too early to fully assess the impact of these requirements on interest rates for corporate borrowers.

2. How liquid is the market for the corporate debt of companies that make up the Dow Jones Industrial Average or the Russell 2000 index? How will the Volcker Rule affect the liquidity for these bonds?

Section 13 of the BHC Act was enacted to promote and enhance the safety and soundness of banking entities and the financial stability of the United States by prohibiting banking entities from engaging in short-term proprietary trading of financial instruments and making certain types of investments in private equity funds and hedge funds. Both the statute and final implementing rules incorporate a number of provisions that are designed to limit the impact of the statute on liquidity in the United States, including liquidity of corporate bonds. Most notably, the statute explicitly allows banking entities to engage in trading activities that are done in the context of market making and underwriting designed to meet the reasonably expected near term demands of a banking entity's clients, customers, and counterparties. In addition, the statute and final rule allow banking entities to trade on behalf of customers, including acting as agent and in trading financial instruments. These exemptions help to preserve liquidity in markets by allowing banking entities to continue in their traditional role in the intermediation of trades in financial instruments, including corporate bonds.

Staffs of the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Security and Exchange Commission, and Commodity Futures Trading Commission (the Agencies) have prepared a report on the current and historical liquidity conditions in the U.S. corporate bond market for the House Committee on Financial Services. Agency staff will provide periodic updates of this information.

The Federal Reserve and other implementing agencies are monitoring the effect of section 13 and the implementing rules on U.S. capital markets and U.S. commercial firms to allow Congress to determine whether the statute is achieving its intended purpose.

CLO: #22
CCS: 14- 1325
RECVD: 2/25/14

Questions for the Record
"The Impact of the Volcker Rule on Job Creators, Part II"
Congressman Stephen Fincher, Tennessee's 8th Congressional District
February 5, 2014

For SEC Chair White:
While the Volcker rule may purport to permit banks to continue to engage in market-making, you and I know that as a practical matter, given the difficulty in differentiating between market making and proprietary trading, a lot of firms are going to scale back their market-making activity to avoid running afoul of the prop trading ban. But even if we accept your proposition that banks will continue to make markets in corporate debt, the Volcker rule will by definition reduce liquidity in the market as dealers pull back from proprietary trading. If we could agree there may be an impact on liquidity in the corporate bond market, what would be the impact on businesses looking to borrow in that space? Is it fair to say that less liquid markets will likely result in higher returns demanded by investors? And who would ultimately pay for that increase – won't it be the businesses that borrow in the corporate bond markets?

The SEC's mission statement is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." Do you believe the SEC has studied this rule sufficiently to determine that it will not impact the efficiency of U.S. capital markets or impair capital formation and harm investors that hold securities impacted by the Volcker Rule?

Are investors harmed when they cannot buy or sell securities because of illiquid, inefficient or disorderly markets? Does the Volcker Rule have the potential to actually harm investors, particularly those investors invested in fixed income securities?

While there is an exemption for market-making, will asset managers direct their investable assets to products that received a Volcker Rule exemption? If certain markets benefit because of a Volcker Rule exemption and markets that did not receive a Volcker Rule exemption suffer, how has the SEC followed its mandate to promote fair, orderly and efficient markets?

For the panel:
The Volcker Rule will take effect around the same time as higher capital standards mandated under Basel III. What will be the combined impact of the Volcker Rule and Basel III on interest rates for corporate borrowers?

How liquid is the market for the corporate debt of companies that make up the Dow Jones Industrial Average or the Russell 2000 index? How will the Volcker Rule affect the liquidity for these bonds?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 30, 2014

The Honorable Scott Garrett
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative Garrett:</u>

1. Given that the rule was out for proposal for two years and given the broad impact that it is going to have our U.S. financial markets, why was the new rule not put out for additional public comment? If it had been, would the problems associated with TruPS and CLOs been caught and been addressed instead of causing all of the problems those provisions have?

The Federal Reserve, the Office of Comptroller of the Currency, the Federal Deposit Insurance Company, the Securities and Exchange Commission, and Commission Futures Trading Commission (the "Agencies") engaged in an extensive public process in the course of developing and finalizing the rules to implement section 13 of the Bank Holding Company Act ("BHC Act"). The Agencies individually and jointly, provided many opportunities for commenters to provide input on implementation of section 13 of the BHC Act and have collected substantial information in the process. Before initially proposing the implementing rules, the Agencies met with and received comment from members of the public about how to structure the proposal and issues raised by the statute. The public also provided substantial comment in response to a request for comment from the Financial Stability Oversight Committee regarding its findings and recommendations for implementing section 13 before the Agencies proposed implementing rules.

After these public interactions, the Agencies published detailed proposed implementing rules and posed numerous questions in the preamble to the proposal to solicit and explore alternative approaches in many areas. More than 18,000 written comments were submitted to the Agencies covering a wide variety of issues. The Agencies continued to receive comment letters after the extended comment period deadline, which the Agencies considered in developing the final rule. In addition, the Agencies held numerous meetings with commenters on issues raised by section 13 and the proposal. All of these comments and meetings were posted on the Agency websites to further public discussion and input. Thus, the Agencies believe interested parties had ample opportunity to review the proposed rules, as well as the comments made by others, and to provide views on the proposal.

The Agencies have been mindful of the importance of providing certainty to banking entities and financial markets and of providing sufficient time for banking entities to understand the requirements of the final rule and to design, test, and implement compliance and reporting systems. The further substantial delay that would necessarily have been entailed by reproposing the rule would extend the uncertainty that banking entities would face, which could have proved disruptive to banking entities and the financial markets.

Among other issues, the proposed rule specifically sought comment on the impact of section 13 and the proposal on securitization vehicles, which includes collateralized loan obligations ("CLOs") and collateralized debt obligations ("CDOs") like trust preferred securities (TruPS) CDOs. The proposal included a number of questions about the treatment of securitizations, as well as regarding the legal, accounting and tax treatment of interests in securitizations and how debt interests should be treated under the rules. Although comments were received on many other aspects of the proposal relating to securitizations, no comments were received on securitizations backed by trust preferred securities under the proposed rule.

To address concerns regarding TruPS CDOs, in January 2014, the Agencies approved an interim final rule to authorize the retention of interests in and sponsorship of TruPS CDOs that were acquired on or before December 10, 2013. The final rules exclude all securitizations backed entirely by loans, including CLOs backed entirely by loans. To address investments in CLOs that are backed in part by non-loan assets, the Federal Reserve issued a statement that it intends to grant two additional one-year extensions of the conformance period that would allow banking entities additional time to conform these ownership interests and sponsorship activities to the statute and implementing rules. The other Agencies support this action.[1]

2. The Riegle Community Development and Regulatory Improvement Act ('Riegle Act,' 12 U.S.C. §4802(a)), requires all "Federal banking agencies including the OCC, the Fed, and the FDIC, to: "[i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest - (1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations."

Why did you not follow the law when promulgating this rule? How can you expect others you are regulating to follow the law when you yourself don't follow it?

The Agencies carefully considered the administrative compliance requirements resulting from the requirements imposed by the rules to implement section 13 of the BHC Act. As explained in detail in the statement explaining the final rules, the Agencies have tailored the compliance requirements to reduce burden on smaller banking entities. In particular, the final rule applies data reporting requirements and comprehensive compliance program requirements only on the largest banking entities with significant trading activities. This reduces the cost of the implementing rules while achieving the benefits sought by Congress in enacting section 13. In addition, to relieve burden while also achieving the benefits sought by the statute, the Federal Reserve extended the conformance date for the implementing rules for an additional year to July 15, 2015, to allow all firms greater opportunity to meet the compliance requirements of the statute over time.

3. The Volcker preamble states that the regulators are using safety and soundness authority to exempt certain foreign sovereign debt. Some of this foreign sovereign debt can be extremely risky, as we have seen with Spain, Italy, Portugal and Greece. One could easily make the case that actually means you are using safety and soundness authority to make banks less safe and less sound.

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[1] See Letter to Chairman Hensarling re: CLOs (Apr. 7, 2014).

On the other hand, when it comes to addressing the problems in the CLO market, the preamble also states that you could use your safety and soundness authority to address the concerns surrounding those assets but you have refused to do so. If banks are forced to fire-sale their legacy CLO holdings, this could drive down asset prices, hurt the market, and actually make banks less safe and less sound. In fact, some banks have stated specifically that if is not addressed, the new rules will force them to collapse.

Why are you using your safety and soundness powers to allow banks to prop trade risky sovereign debt which will make banks less safe and less sound? Shouldn't you be using your safety and soundness authorities to help save little community banks like First Federal instead of putting them out of business solely based on overly aggressive interpretation of the statute, one never intended by Congress?

Congress determined that section 13 of the BHC Act was necessary to promote and enhance the safety and soundness of banking entities and the financial stability of the United States by prohibiting banking entities from engaging in short-term proprietary trading of financial instruments and making certain types of investments in private equity funds and hedge funds, subject to certain exemptions. The statute permits the agencies charged with implementing section 13 of the BHC Act to provide additional exemptions if the agencies determine, by rule, that the activity would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

The final rule implementing section 13 of the BHC Act contains a limited exemption to the prohibition on proprietary trading to permit trading in foreign sovereign debt in two circumstances. First, the final rule permits foreign banking entities to engage in proprietary trading in the United States in the debt of the foreign sovereign under whose laws the foreign banking entity is organized. Many foreign supervisors focus home country liquidity requirements on investment by foreign banking entities in the sovereign debt of the chartering foreign sovereign. This exception allows a foreign banking entity to trade in the debt of its chartering foreign sovereign in the United States, thereby facilitating compliance with these and other safety and soundness goals of the foreign home country supervisor. At the same time, because this exception is narrowly drawn to apply only to foreign banking entities, this exception does not undermine safety and soundness in the United States.

Second, the final rule permits a foreign bank or foreign broker-dealer regulated as a securities dealer and controlled by a U.S. banking entity to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign entity is organized. This exception is also narrowly drawn to permit foreign banks and foreign securities broker-dealers to trade in debt only of the chartering foreign sovereign. Without this exception, banking entities organized and chartered in the United States would be unable to own and operate foreign banks and foreign securities broker-dealers. As noted above, regulatory requirements in foreign countries typically expect these foreign firms to invest and trade in sovereign debt of the chartering foreign sovereign. Permitting U.S. banking entities to own and operate foreign banks and foreign securities firms allows U.S. banking entities to benefit from geographic diversity and opportunity and enhances the financial system in the United States.

The Federal Reserve has also provided relief to address concerns raised by banking entities that own CLOs. In keeping with the statute, the final rule excludes from the definition of covered fund any loan securitization that is backed entirely by loans. CLOs backed by assets that are not loans are covered by the prohibition in the statute, however.

Data reported to the federal banking agencies by insured depository institutions, bank holding companies and certain savings and loan holding companies in the Call Report and Y9-C forms indicate that only about 50 domestic banking organizations including a number of the largest banking entities in the U.S. held CLOs, including both conforming and nonconforming CLOs, as of December 31, 2013. The data also indicate that aggregate CLO holdings of these banking entities reflect an overall unrealized net gain, and unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income. New issuances of CLOs in late 2013 and early 2014 appear to be conforming to the final rule, and some CLOs issued before December 31, 2013 are conforming their investments to the provisions of section 13. Based on discussions with industry representatives and a review of data provided by market participants, it appears that the current volume of new CLO issuances is higher as compared to CLOs issued prior to the adoption of the final rule, with U.S. CLO issuances increasing to a post-crisis high of approximately $12 billion in April 2014, the third highest monthly total on record.

On April 7, 2014, the Federal Reserve issued a statement ("Board Statement") that it intends to grant two additional one-year extensions of the conformance period under section 13 of the BHC Act that would allow banking entities additional time to conform to the statute ownership interests in and sponsorship of CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final rule implementing section 13 of the BHC Act for loan securitizations. This would permit banking entities to retain until July 21, 2017, ownership interests in and sponsorship of CLOs that are not backed entirely by loans that were held as of December 31, 2013. This will provide the few banking entities that own non-conforming CLOs an extended period to conform their investments in a safe and sound manner.

4. There has been repeated discussion that other new entrants will step in to make up any potential disruption in market liquidity that the implementation of the Volcker rule may create. Can you specifically name some of these new entrants? Who are they? Have they stepped in? Are they only stepping in already liquid markets?

Financial markets attract a broad range of participants from various sectors of the economy and locations across the globe. Further, market participants are motivated by a number of incentives which may include earning profits by providing liquidity in markets where other participants are reducing their presence. Identifying which participants are acting in response to any single incentive or market opportunity is not generally possible as most market data provides no systematic information about trading intent.

5. Thank you for your testimony regarding the formation of an interagency working group. Can you tell us more about the structure of the group - for instance will there be a chairman? What is the timeline for identifying members of the group? What will the process be for stakeholders to communicate with the interagency group?

The interagency working group is an informal group of staff from each of the Agencies that meets regularly to discuss and make recommendations to the Agencies regarding resolution of issues raised by section 13 and the implementing rules. The group has already begun to meet and will continue to meet regularly going forward. Each of the Agencies also continues to meet with and collect questions from banking entities under their respective jurisdictions raised by the statute and implementing rules. Affected institutions have communicated with the Agencies by letter, in person, at conferences and otherwise regarding various matters of interest. The Agencies expect to respond to matters that are of common interest in public statements, including public responses to frequently asked questions, and in public guidance.

CLO: #19
CCS: 14-1322
RECVD: 2/25/14

Congressman Scott Garrett – Questions for the Record
Full Committee Volcker Hearing (2-5-14)

Process (All)

Given that the rule was out for proposal for two years and given the broad impact that it is going to have our U.S. financial markets, why was the new rule not put out for additional public comment? If it had been, would the problems associated with TruPS and CLOs been caught and been addressed instead of causing all of the problems those provisions have?

Econ Analysis (OCC, FRB, FDIC)

The Riegle Community Development and Regulatory Improvement Act ('Riegle Act,' 12 U.S.C. §4802(a)), requires all "Federal banking agencies including the OCC, the Fed, and the FDIC, to: "[i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest - (1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations."

Why did you not follow the law when promulgating this rule? How can you expect others you are regulating to follow the law when you yourself don't follow it?

Enforcement (SEC)

In regards to the SEC's requirement under the law to conduct an appropriate economic analysis of the rule, I appreciate Chair White's hyper-technical excuse for not, at the very least, following the spirit of the law. However, I find it somewhat ironic that ensuring the rule was written entirely under the Bank Holding Company Act to technically avoid the legal requirement to conduct economic analysis has led to an inability for the chief markets regulator (the SEC) to enforce what is essentially a markets-based rule.

How can you not have the statutory requirement to conduct robust economic analysis but have the statutory authority to enforce the rule?

Econ Analysis Request (SEC & CFTC)

It is extremely disappointing that, with a rule that will have the breadth and scope of the impact the Volcker rule will have that, regardless of legal requirements, our financial regulators did not feel it incumbent upon them to ensure they are properly weighing all of the potential impacts of this rule in a formal manner.

Given your past verbal support for economic analysis, will you commit to conducting a post facto formal economic analysis of the rule AND will you commit to conduct an ongoing formal public analysis and reporting of the impact the rule is having on liquidity in the bond market?

Foreign Sovereign Exemption + CLOs (FRB, OCC, FDIC)

The Volcker preamble states that the regulators are using safety and soundness authority to exempt certain foreign sovereign debt. Some of this foreign sovereign debt can be extremely risky, as we have seen with Spain, Italy, Portugal and Greece. One could easily make the case that actually means you are using safety and soundness authority to make banks less safe and less sound.

On the other hand, when it comes to addressing the problems in the CLO market, the preamble also states that you could use your safety and soundness authority to address the concerns surrounding those assets but you have refused to do so. If banks are forced to fire-sale their legacy CLO holdings, this could drive down asset prices, hurt the market, and actually make banks less safe and less sound. In fact, some banks have stated specifically that if is not addressed, the new rules will force them to collapse.

Why are you using your safety and soundness powers to allow banks to prop trade risky sovereign debt which will make banks less safe and less sound? Shouldn't you be using your safety and soundness authorities to help save little community banks like First Federal instead of putting them out of business solely based on overly aggressive interpretation of the statute, one never intended by Congress?

New Market Entrants (All)

There has been repeated discussion that other new entrants will step in to make up any potential disruption in market liquidity that the implementation of the Volcker rule may create. Can you specifically name some of these new entrants? Who are they? Have they stepped in? Are they only stepping in already liquid markets?

Enforcement (All)

Thank you for your testimony regarding the formation of an interagency working group. Can you tell us more about the structure of the group - for instance will there be a chairman? What is the timeline for identifying members of the group? What will the process be for stakeholders to communicate with the interagency group?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

June 4, 2014

The Honorable Robert Menendez
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the February 6, 2014, hearing before the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

<u>Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Senator Menendez:</u>

1. Are you comfortable with the extent to which the consumer payments industry currently sets its own data security standards? Currently, most standards are set by contract with the card companies playing a significant role and an industry body known as PCI determines most of the details and certifies compliance examiners. Should federal regulators be playing a greater role?

The Payment Card Industry (PCI) Security Standards Council released version 3 of the Data Security Standard in November 2013. PCI's philosophy has been to drive new compliance requirements as the risk landscape changes. Version 3 includes two new key requirements related to data flows and device inventory, which incrementally enhance the control environment and protect consumers from fraud. The industry relies on the PCI Security Standards Council to balance cost and effectiveness, which it does by assessing threats and identifying controls that most effectively address evolving payment card risks. The Federal Reserve and other financial regulators have relied on the expertise of the PCI Security Standards Council in setting technical data security standards. The regulators approach has been to identify broad, outcome-based security objectives that supervised entities are expected to meet through a mix of technical and non-technical approaches.

Regarding the role of federal regulators, the complexity of the regulatory environment mirrors the complexity of the payment processing landscape, with regulators focused within their statutory domains. However, we are aware of the considerable need for, and benefits of, coordination and collaboration across domains in order to effectively mitigate both firm and systemic risks. The Federal Reserve continues to monitor payment system risk and collaborate with the private sector and public-private partnerships such as the Financial and Banking Information Infrastructure Committee (FBIIC), Financial Services Sector Coordinating Council (FSSCC), and Financial Services Information Sharing and Analysis Center (FS-ISAC).

2a. When a financial data breach occurs with a merchant (as seems to be the case with the current wave of data breaches) or other source outside of a financial institution, financial institutions still very clearly feel the effects. Credit and debit card issuers, for example, must notify affected customers and issue new cards, and will likely end up bearing some portion of the financial losses that occur from fraudulent transactions using stolen card information. In the chain of a retail payment transaction, security is only as strong as its weakest link.

In addition to the examinations the Fed conducts regarding regulated institutions own data security, can you describe the Feds oversight with respect to the security of consumer data across the entire chain of consumer payment transactions?

Federal Reserve oversight of consumer payment transactions is limited to our role as a supervisor of financial institutions. Federal Reserve staff examine the data security programs of supervised banks for compliance with the information security standards required by section 501(b) of the Gramm-Leach-Bliley Act (15 U.S.C. 6801(b)) and the identity theft red flags rule required by section 615(e) of the Fair Credit Reporting Act (15 U.S.C. 1681m(e)), as well as with

Federal Reserve information security and payment systems guidance. The Federal Reserve's supervisory process includes an assessment of the adequacy of financial institution data security programs in supporting the security and reliability of customer data. Financial institutions are required to address deficiencies in a timely manner to mitigate risks to both the institution and its customers.

2b. Should federal regulators be taking a greater interest in the data security standards applicable to other entities that possess consumer financial data, beyond just regulated financial institutions? Are legislative changes necessary or are there legislative changes that would help?

Protecting the safe and sound operation of the nation's financial systems is a key priority for the Federal Reserve. To accomplish this, the Federal Reserve works with other regulators to promote the implementation of effective information security programs and protocols by supervised institutions. However, sensitive consumer data are frequently collected and stored by non-regulated firms, and these firms may not be held to the same level of information security expectations as financial institutions. As cyber threats become increasingly sophisticated, effective security and fraud-mitigation measures must evolve to include all players in the payment system, including financial institutions, non-financial firms, and consumers. The security of the payment system is only as strong as its weakest link and it is the weakest link that criminals will exploit. Given the broad reach of these threats, the Congress would appear to be the appropriate body to address these matters holistically. For example, a national standard that sets forth requirements for protecting sensitive consumer data and tracking and reporting incidents may help to protect consumers and financial systems more broadly. Payment system participants should be encouraged to cooperate with each other in preventing, detecting, and mitigating cyber-attacks. In addition, the Congress may consider investigating ways to leverage the technical capabilities of law enforcement and national security agencies with respect to cyber threats and attacks, and to encourage continued coordination across government agencies to ensure the safety and security of the financial system. Federal Reserve staff would be available to participate in discussions regarding these matters.

3. In our economy today, companies are collecting and storing growing amounts of consumer information, often without consumer's knowledge or consent. The financial industry is no exception. We have heard reports of lenders, for example, mining online data sources to help inform underwriting decisions on consumer loans. As companies aggregate more data, however, the consequences of a breach or improper use become greater.

The Target breach illustrates the risks consumers face not just of fraud, but also identity theft and other hardships. Compromised information included both payment card data and personal information such as names, email addresses, and phone numbers. But what if the next breach also involves account payment histories or Social Security numbers?

As the ways companies use consumer information changes, and the amount of consumer data they hold grows, how is the Feds approach evolving? Are there steps regulators are

taking or that Congress should take to require stronger protections against breaches and improper use, and to mitigate harm to consumers?

On an ongoing basis, the Federal Reserve evaluates the need for additional guidance to financial institutions, jointly with other banking regulators, to promote effective information security programs and practices in an environment characterized by rapid technological change. The Federal Reserve participates in the Federal Financial Institutions Examination Councils (FFIEC) efforts to develop and update guidance on a range of information technology topics, including information technology management, security, and payments. In December 2013, the Federal Reserve issued *Guidance on Managing Outsourcing Risk,* SR 13-19/CA 13-21, to address risks related to banks increasing reliance on third-party service providers. In this guidance, the Federal Reserve acknowledges that third-party outsourcing represents a heightened level of risk and complexity and banks must protect against loss of customer data and exploits of networks that may expose financial institutions to data breaches. The Federal Reserve is monitoring financial institution performance relative to the expectations in the newly released outsourcing risk guidance to ensure that third-party contract oversight includes: 1) an appropriate level of due diligence based on complexity and criticality; 2) business resumption and contingency plans; 3) an assessment of the third party information security programs; and, 4) incident reporting, management, and response programs.

Given the increasingly broad threats to consumer information, privacy, and security, the Congress may be the appropriate body to address this matter. Potential actions that Congress could consider are discussed above in our response to question 2b.

4a. A lot of the discussion in the aftermath of the recent data breaches has focused on credit and debit card smart chip technology, since the U.S. seems to have fallen behind other parts of the world such as Western Europe in adopting it. But while card chips help to reduce fraud for transactions where a card is physically present, and make it harder for thieves to print fake cards using stolen information, they do little to reduce fraud for online, card-not-present transactions.

Are you comfortable with the steps industry is taking to improve security and reduce fraud for card-not-present transactions?

The complex and evolving nature of technology and business processes ensures that threat and fraud environments are dynamic and that payment system participants must continue to evolve and enhance security processes over time. Tools, technologies, and procedures employed in the industry to reduce card-not-present (CNP) fraud at this point in time include:

- <u>Address verification</u> requires the customer to provide the cardholder's address on record with the card issuer.

- <u>Card security verification</u> requires the customer to provide a 3- or 4-digit CVV2 code printed on the card. Requiring this number at checkout helps to ensure that the customer is in possession of the physical card since the number is generally not encoded on a magnetic stripe or chip.

- Geolocation services provide information about a device's location during transaction processing based on an IP address (on a computer) or GPS signal (on a mobile device). The device's location can be compared to the customer's billing or shipping address.

- Neural network technologies use customer and past transaction data to assess the likelihood that a given transaction is fraudulent.

- PCI standards places controls on the storage and handling of cardholder information.

In addition to the measures listed above, the industry is developing several promising technologies to address new threats. For example, tokenization solutions could replace a card's primary account number with a proxy number that is valid for a single transaction. End-to-end encryption technologies that transmit encoded card data across the payment chain are also under development. The use of tokenization and end-to-end encryption are potential tools to combat threats, such as data breaches.

The payment card industry is a complex market, and implementing a new security technology may require investments and process changes by merchants, financial institutions, card networks, payment processors, as well as behavioral changes by consumers. These stakeholders often face different incentives when deciding to implement a new technology. Given the constantly changing threat environment, the complexity of the market, and the varying incentives among stakeholders, the Federal Reserve supports a layered, technology-neutral, guidance-based approach to CNP security. Stakeholders should implement several layers of technologies and procedures to mitigate threats. And, as the fraud environment changes, stakeholders should revise their approaches to CNP fraud and implement updated, cost-effective measures to address the latest threats. The Federal Reserve will continue to work with the institutions under its supervision, as well as with other regulators, to encourage payment system participants to improve measures to detect and prevent fraud.

4b. Banks and other industry participants need to be proactive here, rather than waiting for a major breach to happen before making protective investments. Do you feel that regulated institutions are paying sufficient attention to all areas of data security risk, and are making the necessary investments to protect consumers rather than treating fraud as simply a cost of doing business?

An effective payment system involves many participants, not just depository institutions, and all industry participants should take proactive measures to protect consumer data. The increasing sophistication of cyber threats makes it difficult to ensure that current investments provide adequate protection against new threats. Payment system participants need to employ multiple layers of security as well as non-technology-based policies and procedures (such as notifying customers of potentially fraudulent transactions) that complement technology-based solutions. Participants need to assess the robustness of their information security infrastructures, policies, and practices on an ongoing basis in light of the evolving threat environment and to make enhancements as appropriate.

The Federal Reserve expects supervised institutions to continually monitor their security systems in the face of evolving threats and to upgrade those systems when necessary. To this end, the Federal Reserve and other bank regulatory agencies have issued several interagency guidance documents that pertain to data breach prevention and incident response. The *Interagency Guidelines Establishing Information Security Standards* (12 CFR part 208, App. D-2 (2013)) summarizes the standards that financial institutions are expected to use in establishing a comprehensive, risk-based program to protect customer information. The *Interagency Supplement to Authentication in an Internet Banking Environment* (June 28, 2011; SR 11-09) sets out expectations about minimum security controls required to prevent loss of customer information by data breach, reflecting banks' increased reliance on internet-based technology and the simultaneous increase in attacker sophistication. The *Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice* (12 CFR part 208, App. D-2 (2013)) describes the incident response program that a financial institution should establish to address unauthorized access to or misuse of customer information. Supervised institutions are expected to review and assess their procedures and technologies on an ongoing basis and to make appropriate changes and investments to ensure an adequate and effective level of data protection.

Based on the results of Federal Reserve examination activities, in general, regulated financial institutions have placed a high priority on securing information, including corporate, customer, and counterparty data. Investments necessary to maintain technology, systems, and staff resources to support effective information security programs are being made. However, where necessary, the Federal Reserve leverages its supervisory processes to promote the correction of deficiencies identified at specific institutions.

CLO: #14
CCS: 14- 1114
RECVD: 2/19/14

Committee on Banking, Housing, and Urban Affairs
Oversight of Financial Stability and Data Security
February 6, 2014

<u>Questions for the Honorable Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System, from Senator Menendez:</u>

1. Are you comfortable with the extent to which the consumer payments industry currently sets its own data security standards? Currently, most standards are set by contract – with the card companies playing a significant role – and an industry body known as PCI determines most of the details and certifies compliance examiners. Should federal regulators be playing a greater role?

2. When a financial data breach occurs with a merchant (as seems to be the case with the current wave of data breaches) or other source outside of a financial institution, financial institutions still very clearly feel the effects. Credit and debit card issuers, for example, must notify affected customers and issue new cards, and will likely end up bearing some portion of the financial losses that occur from fraudulent transactions using stolen card information. In the chain of a retail payment transaction, security is only as strong as its weakest link.

   (a) In addition to the examinations the Fed conducts regarding regulated institutions' own data security, can you describe the Fed's oversight with respect to the security of consumer data across the entire chain of consumer payment transactions?

   (b) Should federal regulators be taking a greater interest in the data security standards applicable to other entities that possess consumer financial data, beyond just regulated financial institutions? Are legislative changes necessary or are there legislative changes that would help?

3. In our economy today, companies are collecting and storing growing amounts of consumer information, often without consumers' knowledge or consent. The financial industry is no exception. We have heard reports of lenders, for example, mining online data sources to help inform underwriting decisions on consumer loans. As companies aggregate more data, however, the consequences of a breach or improper use become greater.

   The Target breach illustrates the risks consumers face – not just of fraud, but also identity theft and other hardships. Compromised information included both payment card data and personal information such as names, email addresses, and phone numbers. But what if the next breach also involves account payment histories or Social Security numbers?
   As the ways companies use consumer information changes, and the amount of consumer data they hold grows, how is the Fed's approach evolving? Are there steps regulators are taking – or that Congress should take – to require stronger protections against breaches and improper use, and to mitigate harm to consumers?
4. A lot of the discussion in the aftermath of the recent data breaches has focused on credit and debit card "smart" chip technology, since the U.S. seems to have fallen behind other parts of the world such as Western Europe in adopting it. But while card chips help to reduce fraud for transactions where a card is physically present, and make it harder for thieves to print

fake cards using stolen information, they do little to reduce fraud for online, "card-not-present" transactions.

(a) Are you comfortable with the steps industry is taking to improve security and reduce fraud for "card-not-present" transactions?

(b) Banks and other industry participants need to be proactive here, rather than waiting for a major breach to happen before making protective investments. Do you feel that regulated institutions are paying sufficient attention to all areas of data security risk, and are making the necessary investments to protect consumers rather than treating fraud as simply a cost of doing business?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

May 9, 2014

The Honorable Mark Kirk
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the February 6, 2014, hearing before the Committee on Banking, Housing and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record.

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Sincerely,

Daniel K. Tarullo

Enclosure

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System from Senator Kirk:

1. FSOC has been in existence for more than 3 years. Since that time, 3 companies have been deemed systemically significant and a second round of companies appear to be under consideration. Despite the numerous calls from Congress, a number of industry and consumer groups and even the GAO for the FSOC to provide greater transparency about the process used for designation, (including the metrics OFR should measure in their analysis), the criteria followed, as well as the implications and process to be followed after a firm has been designated a SIFI. Can you provide greater details on why more transparency has not been achieved and how the FSOC plans to improve these issues?

The Financial Stability Oversight Committee (FSOC)--chaired by the Secretary of the Treasury and composed of 10 voting members--is charged by Congress with designating systemically important financial institutions. The FSOC has established a robust process, after seeking public notice and comment on an initial and revised proposal, for exercising its designation authority. The process contains three stages during which the FSOC screens companies for review and conducts an in-depth analysis of companies that pass the screen.

In developing this process, the FSOC sought to maximize transparency with respect to the Determination Process by providing a detailed description of (i) the profile of those nonbank financial companies likely to be evaluated by the FSOC for a potential determination, and (ii) the metrics that the FSOC intends to use when analyzing companies at various stages of the Determination Process. There are numerous opportunities during this process for a nonbank financial company to communicate with the FSOC and its staff and submit information regarding the company's activities and its potential to pose a threat to U.S. financial stability.

The FSOC applies quantitative metrics to a broad group of nonbank financial companies in determining whether a firm should be considered for designation. A nonbank financial company will be evaluated in Stage 2 if it meets both a size threshold ($50 billion in total consolidated assets) and any one of five thresholds that measure a company's interconnectedness, leverage, and liquidity risk and maturity mismatch. During Stage 2, a nonbank financial company is analyzed based on a wide range of quantitative and qualitative information available to the FSOC primarily through public and regulatory sources.

A nonbank financial company that is advanced to Stage 3 receives a notice that the company is under consideration for a Proposed Determination, which also may include a request that the nonbank financial company provide information relevant to the FSOC's evaluation. In addition, the nonbank financial company is provided an opportunity to submit written materials to the FSOC. Following a Proposed Determination, a nonbank financial company is provided a written notice of the Proposed Determination, which includes an explanation of the basis of the Proposed Determination. A nonbank financial company that is subject to a Proposed Determination may request a written or oral hearing to contest the Proposed Determination. If the FSOC determines to subject a company to supervision by the Board of Governors and prudential standards, the FSOC will provide the nonbank financial company with written notice of the FSOC's final determination, including an explanation of the basis for the FSOC's decision.

In 2013, the FSOC determined that material financial distress at each of three nonbank financial companies--American International Group, Inc., General Electric Capital Corporation, and Prudential Financial, Inc.--could pose a threat to U.S. financial stability and that those companies should be subject to Federal Reserve Board supervision and enhanced prudential standards. The FSOC released the bases of its determinations on its website. The FSOC evaluated these firms using the three-stage process.

The Federal Reserve Board recognizes the critical importance of transparency and will continue to pursue ways to promote further transparency that are consistent with the FSOC's central mission to monitor emerging threats to the financial system.

2. I, along with a number of other Republicans, introduced legislation to fix an unintended consequence on collateralized debt obligations (CDOs). In their January 13th interim final rule, regulators crafted a rule that largely mirrored what my bill sought to do; provide relief to a majority of community banks. While we appreciate the agencies' efforts on this issue, one issue that we included in our legislation that the regulators did not address was collateralized loan obligations (CLOs). The CLO market provides about $300 billion in financing to U.S. companies and U.S. banks currently hold between $70 and $80 billion of senior notes issued by existing CLOs and foreign banks subject to the Volcker Rule hold about another $60 billion. Because the final rules implementing the Volcker Rule improperly treat these debt securities as "ownership interests", the banks holding these notes will either have to divest or restructure these securities. Because restructuring well over $130 billion of CLO securities is neither feasible nor under the control of the banks holding these notes, divestment is the most likely result. This, in turn, could lead to a fire sale scenario that could put incredible downward pressure on CLO securities prices leading to significant losses for U.S. banks. If prices decline by only ten percent, U.S. banks would have to recognize losses of almost $8 billion driven not by the underlying securities but solely because of the overreach of the Volcker Rule. Indeed, the final rules are already wreaking havoc on the CLO market. Since the final rules were announced, new CLO formation was down nearly 90 percent in January 2014, the lowest issuance in 23 months. If this situation is not remedied and CLO issuance remains moribund, corporate borrowers could face higher credit costs. At the hearing of the House Financial Services Committee on January 15th, 2014, a number of both Democrats and Republicans asked questions about how to fix the issue with the CLO market that was not addressed in the interim final rule released on January 13, 2014. The representatives of the agencies noted that the CLO issue was at the top of the list of matters to be considered by the inter-agency working group that has been established to review issues such as this and publish guidance. The issue is urgent. Bank CFOs are struggling with how to treat their CLO debt securities. Can you commit to a tight time frame to issue guidance on CLOs?

In keeping with the statute, the final rule excludes from the definition of covered fund all securitizations backed entirely by loans, including CLOs backed entirely by loans.

Data reported by insured depository institutions, bank holding companies and certain savings and loan holding companies in the Call Report and Y9-C forms indicate that only about 50 banking organizations owned an interest in a CLO that was backed by assets that include assets that are not loans, and thus are covered by the statute and implementing rules. The data also indicate that, as of December 31, 2013, aggregate CLO holdings of these banking entities reflect an overall unrealized net gain, and unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income. Based on discussions with industry representatives and a review of data provided by market participants, it appears that new issuances of CLOs in late 2013 and early 2014 are conforming to the final rule. Moreover, the current volume of new CLO issuances is higher as compared to CLOs issued prior to the adoption of the implementing rules, with monthly U.S. CLO activity increasing to a post-crisis high of $13.3 billion in April 2014, the third highest monthly total on record.

On April 7, 2014, the Federal Reserve issued a statement that it intends to grant two additional one-year extensions of the conformance period under section 13 of the Bank Holding Company Act that would allow banking entities additional time to conform to the statute ownership interests in and sponsorship of CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final rule for loan securitizations. This would permit banking entities to retain ownership interests in and sponsorship of CLOs held as of that date until July 21, 2017. All of the agencies charged with implementing section 13 support the Federal Reserve's statement.

CLO: #13
CCS: 14- 1112
RECVD: 2/19/14

Committee on Banking, Housing, and Urban Affairs
Oversight of Financial Stability and Data Security
February 6, 2014

Questions for the Honorable Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System, from Senator Kirk:

1. FSOC has been in existence for more than 3 years. Since that time, 3 companies have been deemed systemically significant and a second round of companies appear to be under consideration. Despite the numerous calls from Congress, a number of industry and consumer groups and even the GAO for the FSOC to provide greater transparency about the process used for designation, (including the metrics OFR should measure in their analysis), the criteria followed, as well as the implications and process to be followed after a firm has been designated a SIFI. Can you provide greater details on why more transparency has not been achieved and how the FSOC plans to improve these issues?

2. I, along with a number of other Republicans, introduced legislation to fix an unintended consequence on collateralized debt obligations (CDOs). In their January 13th interim final rule, regulators crafted a rule that largely mirrored what my bill sought to do; provide relief to a majority of community banks. While we appreciate the agencies' efforts on this issue, one issue that we included in our legislation that the regulators did not address was collateralized loan obligations (CLOs). The CLO market provides about $300 billion in financing to U.S. companies and U.S. banks currently hold between $70 and $80 billion of senior notes issued by existing CLOs and foreign banks subject to the Volcker Rule hold about another $60 billion. Because the final rules implementing the Volcker Rule improperly treat these debt securities as "ownership interests", the banks holding these notes will either have to divest or restructure these securities. Because restructuring well over $130 billion of CLO securities is neither feasible nor under the control of the banks holding these notes, divestment is the most likely result. This, in turn, could lead to a fire sale scenario that could put incredible downward pressure on CLO securities prices leading to significant losses for U.S. banks. If prices decline by only ten percent, U.S. banks would have to recognize losses of almost $8 billion driven not by the underlying securities but solely because of the overreach of the Volcker Rule. Indeed, the final rules are already wreaking havoc on the CLO market. Since the final rules were announced, new CLO formation was down nearly 90 percent in January 2014, the lowest issuance in 23 months. If this situation is not remedied and CLO issuance remains moribund, corporate borrowers could face higher credit costs. At the hearing of the House Financial Services Committee on January 15th, 2014, a number of both Democrats and Republicans asked questions about how to fix the issue with the CLO market that was not addressed in the interim final rule released on January 13, 2014. The representatives of the agencies noted that the CLO issue was at the top of the list of matters to be considered by the inter-agency working group that has been established to review issues such as this and publish guidance. The

issue is urgent. Bank CFOs are struggling with how to treat their CLO debt securities. Can you commit to a tight time frame to issue guidance on CLOs?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

June 6, 2014

The Honorable Patrick Toomey
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 15, 2014, hearing before the Subcommittee on Financial Institutions and Consumer Protection. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michael S. Gibson
Director
Banking Supervision and Regulation

Enclosure

<u>Questions for The Honorable Michael S. Gibson, Director, Board of Governors of the Federal Reserve System from Senator Toomey:</u>

1. In the event banks are blocked from owning physical commodities, or participating in certain physical commodities markets, what affect will this have on the overall financial markets? Would you expect that other companies or entities will step into the role that banks currently play? Is oversight of these companies or entities greater or less than that of banks?

If large U.S. banking organizations were no longer permitted to own physical commodities, there could potentially be a reduction in liquidity and competition in commodity trading markets. However, many nonbank commodity trading firms compete in these markets and provide sophisticated, customized risk management solutions to non-financial customers seeking to manage commodity risks. These nonbank firms also provide financing, often in connection with a bank. Several large banking organizations have already announced their intention to exit the physical commodities business, with little or no apparent impact on overall financial markets. In addition, banking organizations that exit the physical commodities business could nonetheless retain their traditional client-based commodities derivatives businesses.

The most likely buyers of banks' physical commodities businesses are large commodities firms, particularly those with trading operations, or financial institutions located outside the United States. Agencies such as the U.S. Commodity Futures Trading Commission and Federal Energy Regulatory Commission would continue to oversee these physical commodities activities using their authorities as U.S. market regulators. However, these firms would not in most cases be subject to the supervisory oversight and regulations faced by U.S. banking organizations.

Subcommittee on Financial Institutions and Consumer Protection
Regulating Financial Holding Companies and Physical Commodities
January 15, 2014

<u>Questions for Mr. Michael Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Senator Toomey:</u>

1. In the event banks are blocked from owning physical commodities, or participating in certain physical commodities markets, what affect will this have on the overall financial markets? Would you expect that other companies or entities will step into the role that banks currently play? Is oversight of these companies or entities greater or less than that of banks?

CLO: #5
CCS: 14-0480
RECVD: 1/24/14

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency
Securities and Exchange Commission
Commodity Futures Trading Commission

January 31, 2014

The Honorable Sherrod Brown
United States Senate
Washington, D.C. 20510

Dear Senator Brown:

Thank you for your letter regarding the treatment of collateralized debt obligations backed by trust preferred securities ("TruPS CDOs") under the final rule implementing section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

Section 619 generally prohibits banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with a hedge fund, private equity fund, or similar fund (each a "covered fund"). These prohibitions are subject to a number of statutory exemptions, restrictions and definitions. On December 10, 2013, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, and the Securities and Exchange Commission (collectively, the "Agencies") approved a common final rule implementing section 619, which takes effect April 1, 2014 ("Final Rule").

As noted in your letter, following the issuance of the Final Rule implementing section 619, a number of community banking organizations expressed concern that the Final Rule conflicts with the congressional determination under section 171(b)(4)(C) of the Dodd-Frank Act to grandfather certain instruments issued by community banking organizations, including trust preferred securities. After carefully reviewing this matter, the Agencies issued an interim final rule on January 14, 2014, that permits banking entities to retain their existing interests in securitization vehicles primarily backed by trust preferred securities or subordinated debt instruments defined by reference to the standards in section 171(b)(4)(C) of the Dodd-Frank Act. The Federal banking agencies also released a non-exclusive list of issuers that qualify for the exemption which may be used by banking entities to determine compliance with the interim final rule. The interim final rule may be viewed on each of the Agencies' websites, and the non-exclusive list may be viewed on each of the Federal banking agencies' websites.

Although the Agencies believe the interim final rule addresses the concerns expressed related to TruPS CDOs, the interim final rule requests comment for a period of 30 days after its publication in the Federal Register. The Agencies will carefully consider all comments that relate to the interim final rule.

Sincerely,

Ben S. Bernanke
Chairman
Board of Governors of the
Federal Reserve System

Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation

Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency

Mary Jo White
Chairman
Securities and Exchange Commission

Mark P. Wetjen
Chairman
Commodity Futures Trading Commission

SHERROD BROWN
OHIO

COMMITTEES:
AGRICULTURE, NUTRITION, AND FORESTRY
BANKING, HOUSING, AND URBAN AFFAIRS
FINANCE
VETERANS' AFFAIRS
SELECT COMMITTEE ON ETHICS

United States Senate

WASHINGTON, DC 20510 - 3505

January 9, 2014

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

The Honorable Mary Jo White
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable Thomas J. Curry
Comptroller of the Currency
Administrator of National Banks
Washington, D.C. 20219

The Honorable Mark P. Wetjen
Acting Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, D.C. 20581

CLO: #B - 8
CCS: 14-0257
RECVD: 1/9/14

Dear Chairman Bernanke, Chairman Gruenberg, Chairman White, Comptroller Curry, and Acting Chairman Wetjen:

As a cosponsor of the new Section 13 of the Bank Holding Company Act, otherwise known as the "Volcker Rule," I fully support placing restrictions on banks engaging in proprietary trading and maintaining relationships with hedge funds or private equity funds. However, a number of institutions have brought to both your and my attention their concerns that your agencies' final rules, issued on December 10, 2013,[1] would designate Collateralized Debt Obligations (CDOs) backed by Trust Preferred Securities (TruPS) as "Covered Funds." As a strong supporter of the Volcker Rule, I urge you to provide equitable treatment for institutions' investments in TruPS CDOs.

Section 171 of the Dodd-Frank Act prevents institutions with more than $15 billion in assets from counting TruPS as capital, addressing some of the risks associated with these instruments. Because section 171 already addresses certain TruPS-related risk, and because the statute does not appear to allow your agencies to differentiate between institutions based upon their size for the purposes of determining who may invest in certain instruments, I urge your agencies to act in

[1] *See* Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation & Securities and Exchange Commission, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Dec 10, 2013 available at http://www.sec.gov/rules/final/2013/bhca-1.pdf; *see also* Commodities Futures Trading Commission, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Dec 10, 2013 available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister121013.pdf.

an equitable manner. While they may be larger than their community bank colleagues, regional institutions engage in traditional banking services – loans account for two-thirds of their assets, and regional banks account for less than one percent of notional derivatives contracts and about one percent of trading assets. If a practice is sound for one group of institutions, then it should be sound for the other.

Thank you for considering my views on this important matter as you consider making any revisions to your rules.

Sincerely,

Sherrod Brown

Sherrod Brown
United States Senator

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

March 18, 2014

The Honorable Sherrod Brown
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the written questions you submitted following the January 15, 2014, hearing before the Subcommittee on Financial Institutions and Consumer Protection. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Michael S. Gibson
Director
Banking Supervision and Regulation

Enclosure

Questions for Mr. Michael S. Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Senator Brown:

1. In your testimony, you stated the FRB's primary concern is the safety and soundness of individual financial institutions and the financial system as a whole, while market oversight is entirely the task of Commodity Futures Trading Commission (CFTC), Federal Energy Regulatory Commission (FERC) and other market regulators.

a. What is the specific statutory language that explicitly relieves the FRB of broader oversight responsibilities given the FRB's function as the consolidated regulator of Financial Holding Companies (FHCs) and systemic risk?

The Board's supervisory and regulatory authority regarding financial holding companies and systemic risk is limited to that granted by statute, in particular, the Bank Holding Company Act ("BHC Act") and the recently-enacted, Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] The BHC Act directs the Board to monitor through reports and examination the operations and financial condition of bank holding companies and "compliance of the bank holding company and the subsidiary with (I) [the BHC] Act; (II) Federal laws that the Board has specific jurisdiction to enforce against the company or subsidiary; and (III) other than in the case of an insured depository institution or functionally regulated subsidiary, any other applicable provisions of Federal law."[2] The BHC Act specifically includes within the definition of "functionally regulated subsidiary" "an entity that is subject to regulation by, or registration with, the Commodity Futures Trading Commission" with respect to activities subject to the CFTC's jurisdiction.[3] In addition, the BHC Act specifically provides that, in exercising its authority, the Board must, to the fullest extent possible, rely on examination reports made by other Federal or state regulatory agencies and avoid duplication of examination activities, reporting requirements, and requests for information.[4]

The authority to oversee the securities, derivatives, and commodities markets is vested in agencies such as the Commodity Futures Trading Commission, Federal Energy Regulatory Commission, and Securities and Exchange Commission, which have specific oversight authority including the jurisdiction to address market manipulation. In addition, these agencies have access to information regarding the practices of a wide range of market participants, whereas the Federal Reserve only has access to the activities of the participants that are banking firms. As a result, the agencies with direct market oversight authority are in the best position to tell whether certain practices deviate from market practices, including trading and pricing practices.

However, if Federal Reserve staff suspects a problem as a result of its review, staff would refer and cooperate with the appropriate market regulator(s).

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[1] See, e.g., Board of Governors v. Dimension Financial Corp., 474 U.S. 361 (1986); Western Bancshares, Inc. v. Board of Governors, 480 F.2d 749 (10th Cir. 1973). The Board also has authority to take supervisory actions, including enforcement actions, to prevent or address unsafe and unsound practices. 12 U.S.C. § 1818(b)(3).
[2] 12 U.S.C. § 1844.
[3] Id.
[4] Id.

b. Independent of the FRB's request for public comment on the issue of FHC ownership of physical commodities and energy assets through the Advanced Notice of Proposed Rulemaking (ANPR), does the FRB consider the ability of a FHC to combine its trading and dealing in commodity derivatives with direct ownership of the underlying physical commodity, such as ownership of the physical infrastructure to extract, store, deliver and transport commodities, as potentially systemically risky, unfair or dangerous from the viewpoint of market integrity, consumer protection, and macroeconomic stability?

Because of its concern that ownership of the physical infrastructure to extract, store, deliver and transport commodities may pose risks to the safety and soundness of bank holding companies, the Board has not approved bank holding companies to engage in these activities. Indeed, the Board's exercise of authority under section 4(k) of the BHC Act permitting financial holding companies to engage in activities that are complementary to financial activities specifically prohibited financial holding companies from using that authority to engage in extraction, storage, delivery, or transportation of physical commodities.

A limited number of financial holding companies engage in these activities under authority specifically provided by statute that does not require Board approval: grandfathering authority under section 4(o) of the BHC Act and merchant banking authority under sections 4(k)(4)(H) and (I) of the Act. These authorities are broad and place no limits on their combination with other authorities or activities.

As part of the January 2014 advance notice of proposed rulemaking ("ANPR"), the Board will consider how to address the potential risks to safety and soundness and U.S. financial stability that may be presented by the activities authorized under sections 4(o), 4(k)(4)(H), and 4(k)(4)(I) and whether additional prudential requirements such as capital, liquidity, reporting or disclosure requirements, could help ensure such activities do not pose undue risks to the safety and soundness of the bank holding company or to financial stability.

2. You stated the FRB's supervision staff held meetings to review FHCs' physical commodity activities since 2008. According to your testimony, these reviews raised a number of concerns about certain risks systemically important financial institutions' commodities activities can pose to financial stability. Many of these concerns are posed in the ANPR the FRB issued on January 14, 2014.

a. Please publically disclose the discussion minutes and any policy conclusions made at the staff-level meetings on the issue of FHC ownership of physical commodities. Specifically, elaborate on the FRB's policy concerns beyond issues associated with the institutions' safety and soundness to include a detailed list of the policy concerns discussed, and the number of meeting, with specific dates.

Since 2009, Federal Reserve staff has conducted a series of horizontal examinations of the commodities activities of certain financial holding companies, including Bank of America Corporation, JPMorgan Chase & Co., Goldman Sachs, and Morgan Stanley. In 2008, Goldman

Sachs and Morgan Stanley became bank holding companies, and Bank of America Corporation and JPMorgan Chase & Co. acquired companies with substantial commodities activities. Ongoing continuous monitoring work on the commodities activities of the firms has also been conducted.

The overall conclusions of these examinations helped to inform the ANPR, including the concerns reflected in the ANPR regarding the potential tail risk of physical commodities activities, the limitations of insurance and capital requirements to mitigate the potential risks of commodities activities, and the difficulty to quantify these risks.[5]

The content of the meetings held, and examinations conducted, by Federal Reserve staff regarding physical commodities activities involves confidential supervisory information and trade secrets. Disclosure of this information could prejudice the examination process and is subject to protections from disclosure under federal law.

b. Please describe the subsequent actions the Fed staff has taken to address each of these policy concerns, and demonstrate how the FRB communicated these concerns with the FHCs through orders granted or approval of specific activities or acquisitions in the course of supervising and monitoring FHCs' commodities and energy activities.

In cases where Federal Reserve examiners identified risk management or other weaknesses as part of the horizontal examination of the firms involved in physical commodities activities, this information was communicated to each of the firms, and examiners monitored the firms to ensure that the firms were taking appropriate steps to remediate these weaknesses. For example, Federal Reserve examiners have required:

- modification of value-at-risk calculations pertaining to commodities positions,
- more granular risk limits for commodities positions,
- consistent valuations of physical and derivative positions in the same commodity,
- divestiture of impermissible commodity assets, and
- a more robust compliance function for commodities activities.

In the case of JPMorgan Chase & Co., Federal Reserve staff notified the firm that Henry Bath & Sons Ltd ("Henry Bath") was not a bona fide merchant banking investment and consequently, JPMorgan Chase & Co. is required to divest its investment in Henry Bath.

c. Aside from the vote held by FRB Governors to approve the ANPR, are there any plans for any board-level meetings on this subject? If not, why has this issue not been considered or discussed by the Board?

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[5] See 79 Fed. Reg. 3329, 3332-34 (January 21, 2014).

A key purpose of the ANPR is to provide the Board with additional information in order to determine the appropriate course of action to address the risks of physical commodities activities. The Board will consider appropriate additional steps to address these risks after the comment period on the ANPR concludes. Currently, the comment period is scheduled to close on April 16, 2014.

3. You stated in your testimony that FHCs publically disclose in their quarterly filings with the FRB one metric directly related to their physical commodity holdings, which presents an aggregate market value of physical commodities on their balance sheet.

a. How does this metric help the FRB and the public understand the specific physical commodity activities these institutions conduct, including the commodity and energy companies they own or control, or the influence the FHCs may, or may not, have on the prices of individual commodities?

The Board's Reporting Form Y-9C and its schedules provide disclosure on commodities, including commodity and other exposures, gross fair value of commodity contracts, gross fair value of physical commodities held in inventory, commodities specified according to derivative position indicators, and the notional principal amount of commodity contracts. This information helps the Board track compliance with the limits it has placed on the commodity activities of firms relying on complementary authority, but the Board does not solely rely on this information to understand the breadth of commodities activities that these firms conduct or the risks that those activities pose. This disclosure informs the public of the size of physical commodity activities that the institutions conduct. The ANPR solicits comments on a broad array of issues concerning physical commodities' impact on safety and soundness and what additional criteria the Board should consider concerning physical commodities, including whether the public has a need for more information in this area that exceeds the burden that would be imposed on the financial holding companies to supply that information.

b. Is the FRB considering other disclosure alternatives given this line item only provides an aggregate number of all commodities activities conducted by a single FHC?

Yes, the Board inquires in its ANPR about the advantages and disadvantages of requesting additional reporting or disclosure requirements for bank holding companies and requests suggestions on how the Board should formulate such requirements. In addition, the Board specifically stated in the ANPR that it is considering a number of actions to address the potential risks associated with merchant banking investments, including enhanced reporting to the Board or public disclosures regarding merchant banking investments.

c. You also mentioned that FHCs disclose their physical commodities activities in their SEC filings. Bank holding company (BHC) disclosures are governed by Guide 3, a rule promulgated in the 1970s, well prior to the Gramm-Leach-Bliley Act. Guide 3 only requires disclosure of the securities held in a BHC's investment portfolio. Should these rules be revised to provide better disclosures of commodities activities?

The Board supports robust disclosures that result in transparency and encourage market discipline. The SEC's Guide 3 governs certain types of required disclosures and may not govern all physical commodity activities or investments. The SEC is best able to determine whether Guide 3 is consistent with the mandate in the federal securities laws.

4. The following questions address the process by which the FRB scrutinized, authorized, and continues to oversee the former investment banks', i.e., Goldman Sachs and Morgan Stanley, physical commodities and energy holdings after their conversion from investment banks to FHCs:

a. When Goldman Sachs and Morgan Stanley applied to the FRB to be registered as FHCs in the fall of 2008, did the FRB staff conduct a review of their existing commodities assets and investments?

The Board approved applications by Morgan Stanley and Goldman Sachs to become bank holding companies in September 2008. In light of the unusual and exigent circumstances affecting the financial markets at the time, the Board determined that emergency conditions existed that justified expeditious action and waiver of public notice of the applications. In approving the applications, the Board considered all of the statutory factors required under the BHC Act. In connection with its review of the Morgan Stanley and Goldman Sachs applications, the Board did not conduct a targeted review of the commodities activities and investments of the two organizations. Section 4(a)(2) of the Bank Holding Company Act permits a newly formed bank holding company to retain any otherwise impermissible activities for up to two years, with the possibility of three one-year extensions. Moreover, section 4(o) of the BHC Act permits a qualifying financial holding company to engage in physical commodity activities without seeking or obtaining Board approval. Both Morgan Stanley and Goldman Sachs are section 4(o) qualifying financial holding companies.

Morgan Stanley and Goldman Sachs also filed elections to become financial holding companies that ultimately became effective. Morgan Stanley's election was filed in August 2008, Goldman Sachs' in July 2009. These elections were considered under the factors enumerated in the Bank Holding Company Act and the Board's Regulation Y at the time, including the requirement that all of the depository institution subsidiaries of the bank holding company be well capitalized and well managed.

b. If yes, please describe the scope of the review, and explain how this review found these institutions' commodity holdings did not pose sufficient risks to the financial system?

Please see response for question 4, part a.

c. If not, why wasn't a review of these activities conducted?

Please see response for question 4, part a.

d. Please describe any discussions between the FRB supervisors and representatives from Goldman Sachs and/or Morgan Stanley held between 2008 and present with respect to their ability to continue, and to expand, their pre-2008 physical commodity activities under any legal authority after their conversion into bank holding companies. For example, was the Fed aware of, and did it approve, Goldman Sachs' acquisition of Metro International in 2010?

As discussed more fully in the response to question 4, part a, the 2008 Morgan Stanley and Goldman Sachs applications were processed using expedited procedures due to the emergency conditions that existed at the time.

Goldman Sachs has indicated that it is holding Metro International under merchant banking authority. Merchant banking investments are not subject to prior approval of the Federal Reserve. The policies and procedures that Goldman Sachs employs to ensure that its merchant banking investments conform with the Federal Reserve's merchant banking rules have been reviewed by supervision staff, as has the control framework that Goldman Sachs uses to minimize the financial and reputational risks posed by such investments. Subsequent to Goldman Sachs and Morgan Stanley becoming bank holding companies, supervision staff conducted extensive reviews of the commodities activities of both companies. The reviews catalogued the activities in which the two firms engaged, and assessed the control environment that the two firms utilize to manage their commodities business. Supervisory staff has periodic discussions with Goldman Sachs and Morgan Stanley regarding their physical commodities activities including the authorities under which they are engaging in the activities.

e. Please describe specific factors and reasoning for the FRB's decision to allow JPMorgan to acquire Henry Bath, a metal warehouse business, and other commodity assets from RBS Sempra in 2010.

The BHC Act and the Board's Regulation Y permit financial holding companies to make acquisitions of firms that engage in various activities that are financial in nature. Financial holding companies often seek to acquire firms that engage in financial activities, but are not subject to the BHC Act and its restrictions. These firms often engage in some amount of activities that are related to the firm's financial business, but are not permissible for bank holding companies to conduct under the BHC Act. To address this, the Board's Regulation Y permits a financial holding company to acquire a firm that is engaged in a mix of permissible financial activities and impermissible activities under certain conditions. In particular, at least 85 percent of the activities of the target firm (as measured by assets and revenues) must be permissible financial activities, and the acquiring financial holding company must divest or otherwise conform the impermissible activities within two years of the acquisition, unless a limited extension is granted by the Board. JPMorgan Chase & Co. acquired Henry Bath as part of the acquisition of the financial businesses and assets of RBS Sempra. The Board's Regulation Y required JPMorgan Chase to conform, terminate or divest its investment in Henry Bath within two years of its acquisition, subject to limited extensions.

In connection with the RBS Sempra acquisition, the Board approved JPMorgan Chase's request to engage in energy tolling and energy management services as complementary activities under section 4(k) of the BHC Act. The Board did not approve the retention of Henry Bath under this authority. The Board subsequently informed JPMorgan Chase that its investment in Henry Bath would not qualify as a merchant banking investment.

f. If an investment bank applied to the FRB to be registered as a FHC under normal circumstances (i.e., not under the crisis conditions when Goldman Sachs and Morgan Stanley became FHCs), what would have been the review process of these institutions physical commodity and energy activities? Please describe the types of inquiries the Fed would have made, and specific criteria it would have used, to assess whether these applicants' existing commodity activities complied with the requirements of the Bank Holding Company Act (BHCA) and were consistent with the public interest in preserving systemic financial stability in the long-term?

A company seeking to become a financial holding company must make at least two filings with the Federal Reserve, an application to become a bank holding company (as a result of either acquiring a bank or converting an existing depository institution subsidiary into a bank) and a declaration stating that the company elected, and qualified for, financial holding company status.[6] In connection with these filings, the Federal Reserve would request that the applicant describe its non-banking activities and the legal authority for conducting these activities. In approving a bank holding company application, the Federal Reserve is required to consider, among other things, the financial and managerial resources and future prospects of the companies and banks concerned. A company's commodities-related and energy-related activities, like its other activities, would be considered in this context.

A company, such as Goldman Sachs or Morgan Stanley, that meets the requirements of section 4(o) of the Bank Holding Company Act may engage in commodities-related activities without the approval of the Board. By its terms, section 4(o) authorizes certain companies that become financial holding companies to engage in physical commodity activities that are not otherwise permissible for financial holding companies and have not been authorized by the Board.

A financial holding company may also seek Board approval to engage in activities that are complementary to financial activities.[7] In connection with requests under this section, the Federal Reserve obtains information about the types and scope of the requested activities, the financial condition of the applicant, the programs for monitoring and limiting risk from the activities, and other relevant information. Based on all the information available to the Board, the Board then considers whether the proposed activity is complementary to a financial activity, would pose risk to the safety and soundness of depository institutions or the financial system, and whether the public benefits, such as greater convenience, increased competition, or gains in efficiency, outweigh the possible adverse effects, such as undue concentration of resources,

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[6] See 12 U.S.C. §§ 1842, 1843; 12 CFR 225.11, 225.82.
[7] See 12 U.S.C. § 1843(k)(1)(B).

decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the United States banking or financial system.

5. The following are questions related to the FRB's legal and supervisory interpretation and use of the Section 4(o)'s grandfather provision under the BHCA. During the hearing, you stated that you are not a lawyer and thus could not offer an interpretation of what section 4(o) means.

a. How does the FRB's legal staff interpret the scope of the commodity grandfathering provision in Section 4(o)? Does the term "any such activities" permit an institution eligible for grandfathered treatment to engage in all commodities and physical asset trading an ownership of they were engaged in the ownership or trading of a single commodity or physical asset prior to 1997?

Section 4(o) of the BHC Act provides that "a company that is not a bank holding company or foreign bank and becomes a financial holding company as of November 12, 1999, may continue to engage in, or directly or indirectly own or control shares of a company engaged in, activities related to the trading, sale, or investment in commodities and underlying physical properties that were not permissible for bank holding companies to conduct in the United States as of September 30, 1997, if the holding company, or any subsidiary of the holding company, lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States" and certain other requirements[8] are met.

Through this provision, Congress specifically authorized any company that becomes a financial holding company after November 1999 to engage in physical commodities activities (i.e., the physical commodities activities authorized by the provision) that were not otherwise permissible for bank holding companies to conduct in September, 1997. Companies that qualify for this statutory grandfather provision may continue to engage in commodities activities to the extent permitted by that provision without obtaining the Federal Reserve's approval.

Prior to September 30, 1997, bank holding companies claiming grandfather rights under section 4(o) were engaged in a broad range of commodities related activities that the Board had not authorized for bank holding companies. These included trading, mining, storing or transporting coal, oil, natural gas, fertilizer, electricity, and various metals. Thus, even under the narrowest reading of the statute, grandfathered bank holding companies are permitted by statute to engage in a broad range of commodities-related activities.

Some have argued that the statute is plain on its face that a grandfathered firm engaged in any commodity activity prior to the relevant date may engage after the relevant date in all of the commodities activities listed in the statute, namely "activities related to the trading, sale, or

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[8] Section 4(o) also limits such activities and investments to 5 percent of the financial holding company's total consolidated assets and prohibits cross-marketing activities between subsidiaries held pursuant to section 4(o) and affiliated depository institutions. 12 U.S.C. 1843(o)(2)-(3).

investment in commodities and underlying physical properties that were not permissible for bank holding companies to conduct in the United States as of September 30, 1997," in addition to the activities noted above that these firms conducted prior to the grandfather date. This reading would permit a grandfathered bank holding company to expand its commodities activities after the grandfather date.

As part of the ANPR, the Board will consider the scope of the grandfather provision in section 4(o). In addition, the Board will consider how to address the potential risks to safety and soundness and U.S. financial stability that may be presented by the activities authorized under section 4(o) and whether additional prudential requirements such as capital, liquidity, reporting or disclosure requirements, could help ensure such activities do not pose undue risks to the safety and soundness of the bank holding company or to financial stability.

b. Does that provision impose any limitations – including limitations related to the nature, volume, range – on the relevant FHC's physical commodities assets and activities? Would any such limitations help to limit potential risks presented by grandfathered commodity activities?

In addition to the scope of the grandfathered activities and investments discussed above, section 4(o) imposes two requirements: (1) the attributed aggregate consolidated assets of the company held by the financial holding company grandfathered pursuant to section 4(o), and not otherwise permitted to be held by a financial holding company, must not be more than 5 percent of the total consolidated assets of the financial holding company; and (2) the financial holding company must not permit any company, the shares of which it owns or controls pursuant to section 4(o), to offer or market any product or service of an affiliated depository institution or any affiliated depository institution to offer or market any product or service of any company, the shares of which are owned or controlled by such holding company pursuant to section 4(o).

As the Board noted in the ANPR, financial holding companies grandfathered under section 4(o) may engage in a broader set of physical commodities activities than financial holding companies may otherwise conduct. Moreover, financial holding companies that engage in physical commodities activities under section 4(k)(1)(B) ("complementary authority") or make merchant banking investments in companies engaged in physical commodities activities must conform to more restrictive prudential limitations than those of section 4(o) described above.

As noted in the ANPR, the Board is considering how to address the potential risks to safety and soundness and financial stability that may be presented by activities authorized under section 4(o). The ANPR seeks public comment on whether additional prudential requirements could help ensure that activities conducted under section 4(o) of the BHC Act do not pose undue risks to the safety and soundness of the bank holding company or its subsidiary depository institutions, or to financial stability.

c. Please describe any internal discussions among the FRB staff, between 2008 and now, on the proper interpretation of the scope and purpose of Section 4(o). Were there any competing interpretations and, if so, what was the basis for the current view to prevail?

As noted in the response to question 5, part a, there are multiple possible interpretations of section 4(o) of the BHC Act. The Board will consider this matter in connection with its review of physical commodities activities.

d. What type of research and analysis did the FRB staff conduct to arrive at its current interpretation?

The scope of section 4(o) of the BHC Act is an issue of statutory interpretation. Therefore, staff's research and analysis employed the tools associated with statutory interpretation, which included the language of section 4(o), applicable maxims of statutory construction, the legislative history of the Gramm-Leach-Bliley Act ("GLB Act"), and the purpose of the GLB Act and the BHC Act.

e. As we discussed, Section 5 of the Bank Holding Company Act authorizes the FRB to force the sale of a nonbank affiliate if it threatens the safety and soundness of an insured depository institution. If a particular grandfathered activity poses a serious risk to the safety and soundness of the FHC, its deposit-taking subsidiary, or long-term stability of the U.S. financial system, would the Fed be both justified and obligated to use its powers under Section 5 of the Bank Holding Company Act, including its power to order the relevant institution to terminate such an activity?

Section 5(e) of the BHC Act permits the Board, under limited circumstances, to require a bank holding company to either terminate an activity or terminate the company's control of its subsidiary bank(s). The Board may require action under section 5(e) "notwithstanding any other provision of [the BHC] Act," which would include section 4(o) of the BHC Act.

As noted, the circumstances under which the Board may act under section 5(e) are limited. The Board must have "reasonable cause to believe that the continuation by a bank holding company of any activity or of ownership or control of any of its nonbank subsidiaries, other than a nonbank subsidiary of a bank, [(1)] constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank and [(2)] is inconsistent with sound banking principles or with the purposes of [the BHC] Act or with the Financial Institutions Supervisory Act of 1966." Section 5(e) requires the Board to make both findings. Moreover, the first required finding (i.e., "a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank"), is focused on risk to the subsidiary bank.

Section 5(e) also includes procedural requirements; the Board must provide the bank holding company due notice and an opportunity for a hearing and consider the views of the bank's primary supervisor. Moreover, section 5(e) leaves the bank holding company, not the Board, the choice whether to divest the activity or divest the affiliated depository institution.

Finally, section 5(e) does not obligate the Board to act. Rather, section 5(e) provides an additional authority by which the Board may choose to address serious supervisory concerns with a bank holding company. The Board has successfully addressed a range of concerns related to the safety and soundness of bank holding companies and their subsidiary depository institutions, as well as financial stability concerns, through other authorities such as Board supervision, applications functions, and lesser enforcement actions.

6. The following are questions related to the FRB's legal and supervisory interpretation and use of the Section 4(k)'s complementary provisions under the BHCA:

a. Please describe how exactly the FRB monitors and supervises FHCs' physical commodity activities and investments made under the "complementary" authority.

Similar to other aspects of its program for prudential supervision, the focus of the Federal Reserve's assessment of physical commodities activities is the risk management framework that supports them. The primary goals of the Federal Reserve's supervisory oversight of commodities activities are to (1) monitor the management of risks of those activities to the financial holding company, and (2) assess the adequacy of the firms' control environments relating to commodities. The supervisory oversight, for example, includes a review of internal management reports, periodic meetings with the personnel responsible for managing and controlling the risks of the firm's commodities activities, and targeted examinations of the activities. Supervisory staff also reviews policies and procedures, risk limits, risk mitigants, and internal audit coverage at institutions relating to physical commodities activities.

The Federal Reserve has a number of supervisory staff with knowledge and expertise in physical commodities activities. These experts work to understand the exposures, risks, risk management, accounting treatment, and broader commodities markets extensively. They evaluate the different manner in which commodities could present risks to financial holding companies, including from a market, operational, legal and reputational risk perspective.

Staff has conducted horizontal reviews on physical commodities, based on the greater involvement of the largest financial holding companies in commodities activities, to better compare risks and practices across institutions, providing feedback to institutions where appropriate. During these reviews, the teams have examined exposures, valuations, and risk-management practices across all relevant firms, and conducted deeper reviews of the firms' operational risk quantification methodologies that relate to commodities.

Financial holding companies that engage in commodities activities also must hold regulatory capital to absorb potential losses from those activities. Financial holding companies have long been required to hold capital against the market risk of all commodity positions. Moreover, following the financial crisis, the Federal Reserve strengthened its capital requirements for the credit risk and market risk of these transactions. Further, under the Board's advanced approaches capital rules (12 CFR part 217, subpart E), financial holding companies subject to these rules are required to hold capital against the operational risk of their activities, including their commodities activities.

As stated previously, the Federal Reserve is seeking public comment in the ANPR on the sufficiency of its current supervisory and regulatory framework for constraining the risks in the physical commodities activities of financial holding companies.

b. How does the FRB supervisory staff ensure that such policies and procedures are, in fact, effective in addressing all of the potential risks posed by such activities?

Please see response for question 6, part a.

c. In your testimony, you stated the FRB has the authority to rescind any previously authorized "complementary" powers to any individual FHC.

d. On what grounds can the FRB rescind a 4(k) order?

Please see responses for question 6, parts c-d:

An activity is permissible under section 4(k)(1)(B) of the BHC Act only if the activity, in the Board's determination, is "complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally." As noted in its advance notice of proposed rulemaking released January 14, 2014, the Board is considering whether the physical commodities activities continue to meet the requirements of section 4(k)(1)(B). Also as noted, the Board is evaluating the potential costs and other burdens (to financial holding companies and the public generally) associated with narrowing or eliminating the authority to engage in such activities.

e. Can a 4(k) order be reversed if the terms of the order itself, as established by the FRB, are violated?

The Board noted in its orders approving certain financial holding companies to engage in specified physical commodities activities under section 4(k)(1)(B) of the BHC Act that the Board's decisions are specifically conditioned on compliance with all the commitments made in connection with each company's notice to the Board. Moreover, the commitments and conditions relied on in reaching such decisions are enforceable in proceedings under applicable law.

f. Section 4(j) requires a determination that a complementary activity "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the United States banking or financial system." Can a 4(k) order be revoked if the conditions laid out in section 4(j) no longer apply?

Section 4(j) of the Bank Holding Company Act requires, in connection with a notice under the subsection, the Board to consider whether the performance of the proposed activity by the bank holding company can reasonably be expected to produce benefits to the public that outweigh possible adverse effects. In its ANPR regarding physical commodities activities, the Board also has requested comment on this matter.

g. In light of public discussions on this issue, is the FRB considering rescinding its prior grants of "complementary" powers to engage in physical commodity activities to individual FHCs? If not, please explain public policy reasons for not ordering individual FHCs to cease some or all of their "complementary" commodity activities.

As noted in its ANPR regarding physical commodities activities, the Board is evaluating the potential costs and burdens on financial holding companies and the public associated with narrowing or eliminating the authority to engage in Complementary Commodities Activities. The ANPR specifically poses the question about the ways in which financial holding companies would be disadvantaged if they did not have authority to engage in Complementary Commodities Activities, and how the elimination of the authority might affect financial holding company customers and the relevant markets.

7. The following are questions related to the FRB's legal interpretation and use of the Section 4(k)'s merchant banking provision under the BHCA:

a. Please describe how the FRB monitors and supervises FHCs' physical commodity activities and investments made under the merchant banking authority.

The Federal Reserve's examinations of the merchant banking activity of financial holding companies focus on a firm's merchant banking risk management policies and procedures, compliance and audit, and portfolio risk ratings. Federal Reserve staff meets regularly with the largest financial holding companies to assess their merchant banking activities.

These meetings focus on the performance of merchant banking investments and on changes in business strategy that might warrant a closer examination. Federal Reserve staff also reminds the firms of their obligation to avoid involvement in the routine management of portfolio companies held under merchant banking authority.

The Federal Reserve's capital rules for bank holding companies also impose significant risk-based capital requirements on merchant banking investments.[9]

In addition, the ANPR regarding physical commodities activities seeks comment on whether the Federal Reserve should revise its implementing regulation for merchant banking authority or otherwise change its supervisory or regulatory approach to merchant banking activities of financial holding companies. The Board is interested in public comment on ways to better

[9] See 12 CFR part 225, Appendix A, section II.B.5.; 12 CFR 217.152.

constrain the risks of merchant banking activities and ways to better ensure that holding companies avoid engagement in the day-to-day operations of portfolio companies.

b. How does the FRB supervisory staff verify that such policies and procedures are effectively in compliance with the spirit and intent of the law that prohibits the use of merchant banking authority as a way for FHCs to get into impermissible commercial businesses?

Please see response for question 7, part a.

c. Does the FRB collect and analyze specific data on individual FHCs' merchant banking portfolios, other than the information on their market value?

The Federal Reserve collects the Annual Report of Merchant Banking Investments Held for an Extended Period (schedule FR Y-12A). This report collects data on merchant banking investments that are approaching the end of the holding period permissible under Regulation Y. Data collected include the name and location of company held, primary activity of company held, type of interest held by the financial holding company (e.g., common stock, preferred stock, general partner, limited partner), percent of ownership, acquisition cost, carrying value, and plan and schedule for disposition of the covered investment. A financial holding company generally has to submit an FR Y-12A if it holds shares, assets or other ownership interests of companies engaged in nonfinancial activities for longer than eight years (or 13 years in the case of an investment held through a qualifying private equity fund).

8. What are the penalties for violating the relevant provisions of section 4 of the Bank Holding Company Act?

Section 8 of the BHC Act provides civil and criminal penalties for companies and individuals that violate provisions of the act or regulations or orders issued thereunder.[10] Civil and criminal monetary penalties in amounts of up to $25,000 and $1,000,000, respectively, may be assessed for each day during which the violation continues.[11] Violations of section 8 of the BHC Act also may result in up to five years of imprisonment for criminal violations.[12] A company that fails to make, submit, or publish reports or information required under the BHC Act or the Board's regulations issued thereunder or that submits or publishes any false or misleading report or information is subject to fines ranging from $2,000 to $1,000,000 (or 1 percent of the total assets of the company, if such amount is less than $1,000,000).[13]

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[10] 12 U.S.C. § 1847.

[11] Id. Fines of more than $100,000 per violation per day only may be assessed for knowing violations made with the intent to deceive, defraud, or profit significantly. Id.

[12] Id. Imprisonment for a term of more than one year per violation only may be assessed for knowing violations made with the intent to deceive, defraud, or profit significantly. Id.

[13] Id. Section 8 of the BHC Act provides a tiered penalty structure for such actions generally based on the seriousness of the violation. Id.

CLO: #4
CCS: 14-0479
RECVD: 1/24/14

Subcommittee on Financial Institutions and Consumer Protection
Regulating Financial Holding Companies and Physical Commodities
January 15, 2014

Questions for Mr. Michael Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Senator Brown:

1. In your testimony, you stated the FRB's primary concern is the safety and soundness of individual financial institutions and the financial system as a whole, while market oversight is entirely the task of Commodity Futures Trading Commission (CFTC), Federal Energy Regulatory Commission (FERC) and other market regulators.

    a. What is the specific statutory language that explicitly relieves the FRB of broader oversight responsibilities given the FRB's function as the consolidated regulator of Financial Holding Companies (FHCs) and systemic risk?

    b. Independent of the FRB's request for public comment on the issue FHC ownership of physical commodities and energy assets through the Advanced Notice of Proposed Rulemaking (ANPR), does the FRB consider the ability of a FHC to combine its trading and dealing in commodity derivatives with direct ownership of the underlying physical commodity, such as ownership of the physical infrastructure to extract, store, deliver and transport commodities, as potentially systemically risky, unfair or dangerous from the viewpoint of market integrity, consumer protection, and macroeconomic stability?

2. You stated the FRB's supervision staff held meetings to review FHCs' physical commodity activities since 2008. According to your testimony, these reviews raised a number of concerns about certain risks systemically important financial institutions' commodities activities can pose to financial stability. Many of these concerns are posed in the ANPR the FRB issued on January 14, 2014.

    a. Please publically disclose the discussion minutes and any policy conclusions made at the staff-level meetings on the issue of FHC ownership of physical commodities. Specifically, elaborate on the FRB's policy concerns beyond issues associated with the institutions' safety and soundness to include a detailed list of the policy concerns discussed, and the number of meeting, with specific dates.

    b. Please describe the subsequent actions the Fed staff has taken to address each of these policy concerns, and demonstrate how the FRB communicated these concerns with the FHCs through orders granted or approval of specific activities or acquisitions in the course of supervising and monitoring FHCs' commodities and energy activities.

c. Aside from the vote held by FRB Governors to approve the ANPR, are there any plans for any board-level meetings on this subject? If not, why has this issue not been considered or discussed by the Board?

3. You stated in your testimony that FHCs publically disclose in their quarterly filings with the FRB one metric directly related to their physical commodity holdings, which presents an aggregate market value of physical commodities on their balance sheet.

   a. How does this metric help the FRB and the public understand the specific physical commodity activities these institutions conduct, including the commodity and energy companies they own or control, or the influence the FHCs may, or may not, have on the prices of individual commodities?

   b. Is the FRB considering other disclosure alternatives given this line item only provides an aggregate number of all commodities activities conducted by a single FHC?

   c. You also mentioned that FHCs disclose their physical commodities activities in their SEC filings. Bank holding company (BHC) disclosures are governed by Guide 3, a rule promulgated in the 1970s, well prior to the Gramm-Leach-Bliley Act. Guide 3 only requires disclosure of the securities held in a BHC's investment portfolio. Should these rules be revised to provide better disclosures of commodities activities?

4. The following questions address the process by which the FRB scrutinized, authorized, and continues to oversee the former investment banks', i.e., Goldman Sachs and Morgan Stanley, physical commodities and energy holdings after their conversion from investment banks to FHCs:

   a. When Goldman Sachs and Morgan Stanley applied to the FBR to be registered as FHCs in the fall of 2008, did the FRB staff conduct a review of their existing commodities assets and investments?

b. If yes, please describe the scope of the review, and explain how this review found these institutions' commodity holdings did not pose sufficient risks to the financial system?

c. If not, why wasn't a review of these activities conducted?

d. Please describe any discussions between the FRB supervisors and representatives from Goldman Sachs and/or Morgan Stanley held between 2008 and present with respect to their ability to continue, and to expand, their pre-2008 physical commodity activities under any legal authority after their conversion into bank holding companies. For example, was the Fed aware of, and did it approve, Goldman Sachs' acquisition of Metro International in 2010?

e. Please describe specific factors and reasoning for the FRB's decision to allow JPMorgan to acquire Henry Bath, a metal warehouse business, and other commodity assets from RBS Sempra in 2010.

f. If an investment bank applied to the FRB to be registered as a FHC under normal circumstances (i.e., not under the crisis conditions when Goldman Sachs and Morgan Stanley became FHCs), what would have been the review process of these institutions physical commodity and energy activities? Please describe the types of inquiries the Fed would have made, and specific criteria it would have used, to assess whether these applicants' existing commodity activities complied with the requirements of the Bank Holding Company Act (BHCA) and were consistent with the public interest in preserving systemic financial stability in the long-term?

5. The following are questions related to the FRB's legal and supervisory interpretation and use of the Section 4(o)'s grandfather provision under the BHCA. During the hearing, you stated that you are not a lawyer and thus could not offer an interpretation of what section 4(o) means.

a. How does the FRB's legal staff interpret the scope of the commodity grandfathering provision in Section 4(o)? Does the term "any such activities" permit an institution eligible for grandfathered treatment to engage in all commodities and physical asset trading and ownership if they were engaged in the ownership or trading of a single commodity or physical asset prior to 1997?

b. Does that provision impose any limitations – including limitations related to the nature, volume, range – on the relevant FHC's physical commodities assets and activities? Would any such limitations help to limit potential risks presented by grandfathered commodity activities?

c. Please describe any internal discussions among the FRB staff, between 2008 and now, on the proper interpretation of the scope and purpose of Section 4(o). Were there any competing interpretations and, if so, what was the basis for the current view to prevail?

d. What type of research and analysis did the FRB staff conduct to arrive at its current interpretation?

e. As we discussed, Section 5 of the Bank Holding Company Act authorizes the FRB to force the sale of a nonbank affiliate if it threatens the safety and soundness of an insured depository institution. If a particular grandfathered activity poses a serious risk to the safety and soundness of the FHC, its deposit-taking subsidiary, or long-term stability of the U.S. financial system, would the Fed be both justified and obligated to use its powers under Section 5 of the Bank Holding Company Act, including its power to order the relevant institution to terminate such an activity?

6. The following are questions related to the FRB's legal and supervisory interpretation and use of the Section 4(k)'s complementary provisions under the BHCA:

a. Please describe how exactly the FRB monitors and supervises FHCs' physical commodity activities and investments made under the "complementary" authority.

b. How does the FRB supervisory staff ensure that such policies and procedures are, in fact, effective in addressing all of the potential risks posed by such activities?

c. In your testimony, you stated the FRB has the authority to rescind any previously authorized "complementary" powers to any individual FHC.

d. On what grounds can the FRB rescind a 4(k) order?

e. Can a 4(k) order be reversed if the terms of the order itself, as established by the FRB, are violated?

f. Section 4(j) requires a determination that a complementary activity "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the United States banking or financial system." Can a 4(k) order be revoked if the conditions laid out in section 4(j) no longer apply?

g. In light of public discussions on this issue, is the FRB considering rescinding its prior grants of "complementary" powers to engage in physical commodity activities to individual FHCs? If not, please explain public policy reasons for not ordering individual FHCs to cease some or all of their "complementary" commodity activities.

7. The following are questions related to the FRB's legal interpretation and use of the Section 4(k)'s merchant banking provision under the BHCA:

a. Please describe how the FRB monitors and supervises FHCs' physical commodity activities and investments made under the merchant banking authority.

b. How does the FRB supervisory staff verify that such policies and procedures are effectively in compliance with the spirit and intent of the law that prohibits the use of merchant banking authority as a way for FHCs to get into impermissible commercial businesses?

c. Does the FRB collect and analyze specific data on individual FHCs' merchant banking portfolios, other than the information on their market value?

8. What are the penalties for violating the relevant provisions of section 4 of the Bank Holding Company Act?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DANIEL K. TARULLO
MEMBER OF THE BOARD

July 24, 2014

The Honorable Robert Hurt
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 5, 2014, hearing before the Committee on Financial Services. A copy also has been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Daniel K. Tarullo

Enclosure

Questions for The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System from Representative Hurt:

1. There are five agencies represented here today, but we cannot forget to include the self-regulatory agencies, such as FINRA and the National Futures Association (NFA), who have to build out an examination program for this massive new mandate for the entities they regulate. How engaged were the SROs in the rulemaking process?

2. What issues or problems were raised by SROs during the rulemaking process and how were they addressed?

3. What feedback have you received from FINRA and the NFA about the final rule? Please provide specific details on challenges raised and how they have been addressed.

4. Have you provided FINRA or the NFA any guidance on how to implement the Volcker Rule?

5. What happens when FINRA and the NFA flag something that they believe may not be compliant - do they contact all of you?

Response to questions 1-5

The Federal Reserve, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC) provided many opportunities for commenters to provide input on implementation of section 13 of the Banking Holding Company Act (BHC Act), and many members of the public submitted comment letters to explain issues of concern.

Comment letters submitted by self-regulatory organizations (SROs) on the proposal to implement section 13 of the BHC Act generally focused on the proprietary trading provisions of section 13, and argued that the final rule should appropriately accommodate the market making-related activities of banking entities, including primary dealer activity. The final implementing rules exempt market making-related activity and make clear that the market making exemption permits banking entities to engage in primary dealer activity.

In addition to general comments on the treatment of market making-related activities, there were concerns expressed about the proposed source of revenue requirement in the market making exemption, and whether this requirement would impede the ability of market makers to manage their inventory. In recognition of these concerns and for other reasons noted in the preamble, the final rule does not include a source of revenue requirement.[1] Other commenters requested that the Agencies confirm that market making in exchange-traded futures and options would be permitted, and that the final rule exempt all proprietary trading in derivatives on U.S. government and agency obligations. The preamble to the final rule makes clear that the market making exemption is available for market making-related activities in any financial instrument, including exchange-traded futures and options. The final rule does not contain an exemption for

[1] See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 FR 5536 at 5621-5624 (Jan. 31, 2014).

derivatives on U.S. government or agency obligations. The preamble to the final rule explains in detail the reasons for this decision and explains other exemptions in the rule that may be available for this activity, such as the exemption for market making-related activity or risk-mitigating hedging.[2]

The Securities Exchange Act of 1934 defines the scope of authority of SROs related to securities activities. The SEC has regular discussions with representatives of FINRA about various compliance issues under the jurisdiction of the SROs, and we understand has discussed implementation of the final rules under section 13 of the BHC Act with representatives of FINRA. Similarly, the Commodity Exchange Act authorized the creation of SROs related to futures. The CFTC has discussed implementation of the final rules under section 13 of the BHC Act with representatives of NFA. Should FINRA or the NFA identify potential instances of noncompliance with section 13 and the final implementing rules, they may contact the SEC, CFTC, or the relevant Agency and, the Agencies will consider what action, if any, by the Agencies is appropriate.

[2] See 79 FR at 5639-40 & 5646.

ROBERT HURT
5TH DISTRICT, VIRGINIA

125 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
PHONE: (202) 225-4711
FAX: (202) 225-5681

www.hurt.house.gov

COMMITTEE:
FINANCIAL SERVICES
VICE CHAIRMAN,
SUBCOMMITTEE ON CAPITAL MARKETS
AND GOVERNMENT SPONSORED ENTERPRISES

Congress of the United States
House of Representatives
Washington, DC 20515–4605

CLO: #24
CCS: 14- 1327
RECVD: 2/25/14

Questions for the Record of the House Committee on Financial Services Hearing on "The Impact of the Volcker Rule on Job Creators, Part II"

Questions for All Witnesses

1. There are five agencies represented here today, but we cannot forget to include the self-regulatory agencies, such as FINRA and the National Futures Association (NFA), who have to build out an examination program for this massive new mandate for the entities they regulate. How engaged were the SROs in the rulemaking process?

2. What issues or problems were raised by SROs during the rulemaking process and how they were addressed?

3. What feedback have you received from FINRA and the NFA about the final rule? Please provide specific details on challenges raised and how they have been addressed.

4. Have you provided FINRA or the NFA any guidance on how to implement the Volcker Rule?

5. What happens when FINRA and the NFA flag something that they believe may not be compliant – do they contact all of you?

Questions for Chair White and Acting Chairman Wetjen

1. Do FINRA and NFA expect a rule from the SEC and CFTC, or are they left to figure out your intent on their own?

2. How will SROs know if issues that arise are not something that the bank regulators approved, such as a risk mitigation activity for a bank?

3. How will these decisions be made on the fly, without creating more risk or slowing market activity, impacting liquidity and hurting customers who need to find affordable, and predictable financing?

CLO: #23
CCS: 14- 1326
RECVD: 2/25/14

TO:	Committee on Financial Services
FROM:	Representative Randy Hultgren
DATE:	February 12, 2014
RE:	**Questions for the Record, 2/5 Hearing on the Volcker Rule**

SEC Chair White: Firms that were subject to oversight by the SEC under the Consolidated Supervised Entities (CSE) program had onsite examiners reviewing their trading and other activities in the run-up to the 2008 crisis. Did any SEC employees embedded in one of those firms identify proprietary trading or investments in hedge funds or private equity funds as a concern?

Former SEC Chairman Christopher Cox ended the CSE program in the fall of 2008 when the two remaining investment banks (Goldman Sachs and Morgan Stanley) converted to bank holding companies. As you have investigated the SEC's implementation and operation of the CSE program, did you find any instances in which examiners questioned proprietary trading activity?

After Bear Stearns failed in March 2008, was there a post-mortem exam to determine the reasons for its failure? If so, was proprietary trading identified as a primary cause of that failure?

If Bear Stearns did fail because of proprietary trading, did the SEC deploy additional staff to the CSE program to focus on these activities at the remaining CSE program members such as Merrill Lynch or Lehman Brothers?

SEC Chair White and CFTC Acting Chairman Wetjen: SEC and CFTC Commissioners have criticized the Volcker rulemaking process, stating that they had less than one week to review a "voting draft" prior to the final vote on December 13, 2013.

- Given that it took nearly three years to complete the Volcker rule, why was a final, "voting draft" not issued until less than a week before the December 13th vote?

- Given the length and importance of this rule, would you have preferred to have some additional time for you or your fellow Commissioners to review and approve the final "voting draft" of the rule? Why the rush to judgment?

- Do you believe that the rulemaking process would have been improved by providing your fellow Commissioners with perhaps an additional month or even a couple of weeks to review and vote on the final, "voting draft," as some of them had requested?

- Given that certain members of the SEC and CFTC had asked for more time to review the final rule proposal, was there a specific reason(s) this rule had to be issued in December 2013 versus January or February 2014?

CLO: #50
CCS: 14-3783
RECVD: 5/21/14

Question for the Record
Representative Gwen Moore
Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom
House Financial Services Committee

April 8, 2014

Question for Mr. Osteerman and Alvarez:

On September 28, 2014, I was one of several Democrats that wrote Chairman Gruenberg to gain clarification regarding FDIC handling of bank examinations that do business with third-party processors and online non-bank lenders. I would appreciate further explanation of what your agencies are doing to coordinate with the Consumer Financial Protection Bureau to ensure a consistent regulatory regime of these products, given that the CFPB was given jurisdiction for these products under Dodd-Frank. I absolutely support the elimination of bad actors and unscrupulous practices that threaten the safety and soundness of banks, but I continue to believe that it is important for your agencies to work with the CFPB as not to preempt their jurisdiction over these products and to permit them to be lawfully offered consistent with CFPB regulations.

Question for Mr. Alverez and Ms. Friend:

This question is regarding the recently proposed Liquidity Coverage Ratio (LCR), RIN 1557-AD74, treatment of municipal securities as non-High-Quality Liquid Assets (HQLA). I would appreciate clarification regarding the extent that your office considered various, unique differences in the municipal market when formulating the proposal. For example, did you consider the differences in so-called "dollar bonds," or those bonds of larger, frequent issuers, versus the bonds of less frequent issuers that trade based on yield.

CLO: #48
CCS: 14-3781
RECVD: 5/21/14

Rep. Peter King - Questions for the Record
Financial Services Committee Hearing: "Who's in Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"
April 8, 2014

Questions for the FDIC, OCC and Federal Reserve on their proposed Liquidity Coverage Ratio rule:

1. I am glad that representatives from the FDIC, OCC and the Fed are all here today, because I would like you all to comment on the Liquidity Coverage Ratio proposal your agencies put out to comply with the Basel Committee's requirements. I am particularly concerned about how the treatment of municipal securities and deposits will affect municipalities – including New York City and communities affected by Superstorm Sandy – which depend heavily on muni bonds to fund critical infrastructure. Can you explain why your agencies did not grant municipal bonds status as "High Quality Liquid Assets" (HQLA), despite the Basel Committee's recommendation to do so? I understand that under your proposal corporate bonds and even sovereign debt were given HQLA treatment. Why is the debt of small nations whose sovereign securities are illiquid or even distressed, are treated as higher quality than securities from our own states and districts? Can you explain that decision?

2. Your agencies' LCR proposal also treats municipal deposits as secured transactions under the rule which means they would be subject to a 100% unwind for purposes of the ratio calculation. I am concerned this will hamper municipalities' ability to seek the banking services they need to make pay-roll and fund day-to-day activities. Can you comment on why these deposits were treated as secured transactions under the proposal?

CLO: #47
CCS: 14-3780
RECVD: 5/21/14

Congressman Scott Garrett

Date of Hearing – 4/8/14

The following questions are to the FRB regarding the Volcker Rule and its treatment of bank-held Collateralized Loan Obligations (CLOs).

1. Mr. Alvarez stated that the agencies do not have authority under the Volcker Rule statute to grant CLOs the workable relief that affected entities claim they need. Mr. Alvarez said that the statute does not contain a provision that allows grandfathering and also does not allow the agencies to issue an exemption merely because the banking entities may face losses.

(a) Please explain why the authority claimed by the agencies in their interim final rule on the treatment of TruPS CDOs (i.e., authority "under section 13 of the Bank Holding Company Act" (the Volcker Rule statute)) does not apply here. First, the interim final rule essentially grandfathers certain TruPS CDOs. Second, the interim final rule is based on a belief by the agencies that, absent relief, some banking entities would be required to dispose of their holdings of TruPS CDOs, "which, [the banking entities] contend, could have an immediate effect on their financial statements and their bank regulatory capital." That is, the interim final rule was issued to prevent losses to these banking entities. Third, the interim final rule makes no finding about safety and soundness. Please address why each of these points is not equally applicable in the case of CLOs.

(b) Please explain why the agencies could not use their general rulemaking authority under section 13(b)(2), which is what they appear to have done in the case of the interim final rule.

2. In response to a request from Congressman Stivers about the authority to grandfather CLOs, Mr. Alvarez replied *that ". . . we would have appreciated the flexibility to be different, but the statute is quite specific. It says that we can grant three one-year extensions, but no more than one at a time."* That answer, however, goes to the Federal Reserve's authority to extend the conformance period and not to its general rulemaking authority under the Volcker Rule statute. Why does section 13(b)(2) of the statute, which requires the agencies to "*adopt rules to carry out this section*" not provide the agencies with the authority to grandfather legacy CLOs?

3. In adopting the Final Rule, the agencies used their rulemaking authority under section 13(b)(2) (and not their safety and soundness exemptive authority under section 13(d)(1)(J)) to carve out a number of investment structures from the covered fund definition, such as wholly-owned subsidiaries, acquisition vehicles, and joint ventures. While we applaud the agencies' recognition that the Volcker Rule was not intended to capture them, we do not understand why the agencies could not use the same rulemaking authority to carve out legacy CLOs.

4. Are the agencies taking the position that the statute's rulemaking authority does not permit them to amend the Final Rule if it no longer makes sense, e.g., because of changes circumstances or new data or even if the agencies change their minds about how best to implement the statute? Are the agencies saying that their hands are completely tied? If so, please point to authority that establishes that proposition?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

September 26, 2014

The Honorable Gwen Moore
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

Enclosed are my responses to the written questions you submitted following the April 8, 2014, hearing before the Committee on Financial Services. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Scott G. Alvarez

Enclosure

Questions for Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System from Representative Moore:

1. On September 28, 2014, I was one of several Democrats that wrote Chairman Gruenberg to gain clarification regarding FDIC handling of bank examinations that do business with third-party processors and online non-bank lenders. I would appreciate further explanation of what your agencies are doing to coordinate with the Consumer Financial Protection Bureau to ensure a consistent regulatory regime of these products, given that the CFPB was given jurisdiction for these products under Dodd-Frank. I absolutely support the elimination of bad actors and unscrupulous practices that threaten the safety and soundness of banks, but I continue to believe that it is important for your agencies to work with the CFPB as not to preempt their jurisdiction over these products and to permit them to be lawfully offered consistent with CFPB regulations.

You have asked how the Federal Reserve coordinates with the Consumer Financial Protection Bureau (CFPB) to ensure consistent regulation of products offered by third-party processors and online non-bank lenders. We coordinate closely with the CFPB in a number of ways.

The Federal Reserve is responsible for ensuring that the financial institutions it supervises comply with applicable federal consumer financial laws. Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) transferred to the CFPB supervisory authority for insured depository institutions[1] with total assets in excess of $10 billion and their affiliates for compliance with eighteen enumerated consumer laws and their implementing regulations. Supervisory authority over these institutions for other federal consumer financial services statutes and regulations, including prohibitions on unfair and deceptive acts or practices under Section 5 of the Federal Trade Commission Act, was retained by the Federal Reserve. The Federal Reserve also retained supervisory authority for all federal consumer financial laws and regulations for financial institutions with total assets of $10 billion or less. Further, the Dodd-Frank Act generally transferred rulewriting authority under the enumerated consumer laws to the CFPB. The Board consults with the CFPB on its rulemaking activities under Section 1022(b) of the Dodd-Frank Act, which requires the CFPB to consult with the appropriate federal agencies before proposing rules and during the comment process. The Dodd-Frank Act also accorded the CFPB supervisory and rulewriting authority over non-banks, including payday lenders, under certain circumstances.

The Dodd-Frank Act requires that the Federal Reserve and the CFPB coordinate aspects of their consumer compliance supervision of insured depository institutions and their affiliates, including scheduling of examinations; providing reciprocal opportunities to comment upon reports of examination prior to issuance; and reciprocally providing final reports of examination after issuance. In May 2012, the Federal Reserve and the other prudential regulators entered into a Memorandum of Understanding on Supervisory Coordination (MOU) with the CFPB. The MOU establishes arrangements for coordination and information sharing among the parties, as required under the Dodd-Frank Act. In addition, the Federal Reserve works with the CFPB and

[1] Insured depository institutions supervised by the Federal Reserve are state member banks and insured state branches of foreign banking organizations.

other federal banking agencies through the FFIEC's Task Force on Consumer Compliance to develop interagency examination procedures.

As described above, the Dodd-Frank Act shifted certain federal consumer protection authorities and responsibilities to the CFPB, while others remained with the Federal Reserve. Further, the Federal Reserve's responsibility to ensure the safety and soundness of the U.S. banking system and of the banking organizations it supervises remained unchanged. For example, the Federal Reserve examines supervised institutions' anti-money laundering (AML) programs for compliance with the Bank Secrecy Act (BSA) and the USA PATRIOT Act. The Federal Reserve expects supervised institutions to implement appropriate BSA/AML policies and procedures, including regarding customer due diligence and transaction monitoring for suspicious activity. The FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) examination manual addresses relationships that pose higher BSA/AML risks due to the activities in which they engage, including those with businesses that use the banking organization to transfer funds. This guidance remains the policy of the Federal Reserve. It is not the Board's policy to discourage banking organizations from offering services to any class of financial service business operating within federal and state law. The Federal Reserve expects a banking organization that establishes relationships with customers engaging in higher-risk activities to identify the relevant risks and develop an effective monitoring regimen that addresses them.

Generally speaking, it is critical that all federal banking regulators work together as cooperatively and efficiently as possible. Clear lines of communication between the Federal Reserve and the CFPB have been essential to both entities in carrying out the work that ultimately impacts the other. As with other issues of mutual interest, Federal Reserve and CFPB staff have maintained an ongoing dialogue about issues relating to supervisory coordination, third-party payment processors and payday lending.

2. This question is regarding the recently proposed Liquidity Coverage Ratio (LCR), RIN 1557-AD74, treatment of municipal securities as non-High-Quality Liquid Assets (HQLA). I would appreciate clarification regarding the extent that your office considered various, unique differences in the municipal market when formulating the proposal. For example, did you consider the differences in so-called "dollar bonds," or those bonds of larger, frequent issuers, versus the bonds of less frequent issuers that trade based on yield.

The goal of the liquidity coverage ratio (LCR) is to ensure that covered companies are able to meet their short-term liquidity needs during times of stress. The inability to meet those liquidity needs proved to be a significant cause of the failure or near failure of several large financial firms during the recent financial crisis. To ensure adequate liquidity, the final rule includes as high-quality liquid assets (HQLA) only securities that historically have been readily convertible into cash with little or no loss of value during a period of stress, either by sale or through a repurchase transaction. The OCC, FDIC, and Board considered various types of assets for treatment as HQLA and evaluated relevant market data relating to the liquidity characteristics.

Under the LCR final rule issued on September 3, 2014, securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities) do not qualify as HQLA. However, the Board has reviewed market data regarding municipal securities and the information provided by commenters and is exploring the development of a new proposal for public comment to treat as HQLA for purposes of the LCR requirement municipal securities that trade readily and have liquidity characteristics that are comparable to other HQLA assets.

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Under the LCR notice of proposed rulemaking (NPR), collateralized municipal deposits would have been treated as secured funding transactions to permit the deposits to be eligible for lower outflow rate to the extent the deposits are secured by high-quality collateral. To the extent that a municipal deposit is not secured, the deposit would not be treated as a secured funding transaction. The NPR also had another feature that would have provided for a mathematical unwind of all secured funding transactions to ensure that firms did not enter into secured transactions for the purpose of manipulating their level of HQLA to avoid the liquid asset cap limitations.

The OCC, FDIC, and the Board recently finalized the LCR on September 3, 2014. In response to comments regarding the application of the unwind requirement for secured funding transactions to municipal and certain other types of secured deposits, the agencies determined in the LCR final rule not to require the unwind of secured municipal deposits.