

# **Board of Governors of the Federal Reserve System**

## **Response to a Congressional Request Regarding the Economic Analysis Associated with Specified Rulemakings**



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**Office of Inspector General**

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**June 2011**



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

OFFICE OF INSPECTOR GENERAL

June 13, 2011

The Honorable Richard C. Shelby  
Ranking Member  
The Honorable Michael Crapo  
The Honorable Bob Corker  
The Honorable Jim DeMint  
The Honorable David Vitter  
The Honorable Mike Johanns  
The Honorable Patrick J. Toomey  
The Honorable Mark Kirk  
The Honorable Jerry Moran  
The Honorable Roger F. Wicker

Committee on Banking, Housing, and Urban Affairs  
U.S. Senate  
534 Dirksen Senate Office Building  
Washington, DC 20510

Dear Senators:

We are pleased to provide the enclosed response to your May 4, 2011, request for us to assess the economic analysis the Board of Governors of the Federal Reserve System (Board) performed for five specified proposed rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. As part of our assessment, we interviewed Board staff who worked on each of the selected proposed rulemaking teams and reviewed documentation from each of the rulemaking teams, including materials related to economic analysis. Our response includes two recommendations designed to improve the Board's rulemaking process. We have provided a copy of our response to the Board, so it may address our recommendations. We are also providing a copy of our response to the Honorable Tim Johnson, Chairman, Committee on Banking, Housing, and Urban Affairs.

We would be pleased to brief you or members of your staff on our response or any other work under our jurisdiction. If you have any questions, please contact Mr. Anthony J. Castaldo, Associate Inspector General for Inspections and Evaluations, at (202) 973-5024 or me at (202) 973-5000.

Sincerely,

A handwritten signature in black ink, appearing to read "Elise M. Ennis". The signature is fluid and cursive, with a prominent initial "E" and a long, sweeping tail.

Elise M. Ennis  
Acting Inspector General

Enclosure

**Board of Governors of the Federal Reserve System**

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## Background, Scope, and Methodology

On May 4, 2011, the Inspector General (IG) of the Board of Governors of the Federal Reserve System (Board) received a letter from the minority members of the Senate Committee on Banking, Housing, and Urban Affairs (Committee Members) requesting that we review “the economic analysis performed” by the Board with respect to certain rulemakings.<sup>1</sup> The Committee Members recommended that we limit our review to the following five proposed rules required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act):

1. Credit Risk Retention (Risk Retention), 76 FR 24090 (April 29, 2011);
2. Risk-Based Capital Standards: Advanced Capital Adequacy Framework-Basel II; Establishment of a Risk-Based Capital Floor (Risk-Based Capital Floor), 75 FR 82317 (December 30, 2010);
3. Margin and Capital Requirements for Covered Swap Entities (Margin and Capital Requirements), 76 FR 27564 (May 11, 2011);<sup>2</sup>
4. Regulation Z; Truth in Lending (Ability to Repay), 76 FR 27390 (May 11, 2011);<sup>3</sup> and
5. Financial Market Utilities (FMUs), 76 FR 18445 (April 4, 2011).

In their letter, the Committee Members requested that we address 10 specific topics. To address these topics, we (1) developed a standard set of interview questions designed to determine the economic analysis conducted in connection with the selected proposed rules; (2) conducted interviews with Board staff who worked on each of the selected proposed rulemaking teams; (3) reviewed documentation from each of the rulemaking teams, including materials related to the economic analysis performed (as applicable); and (4) developed and circulated a standard questionnaire to Board staff engaged in the specified rulemakings to determine the qualifications of staff who performed economic analysis. We interviewed more than 30 Board employees, including the individuals identified as the team leads for each selected proposed rule. In order to ensure a complete and accurate response, we also describe rulemaking activities apart from those required by statute. We conducted our fieldwork in May 2011 in accordance with the *Quality Standards for Inspection and Evaluation*, issued by the Council of the Inspectors General on Integrity and Efficiency. In accordance with these standards, we

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<sup>1</sup> The 10 Senators serving on the Committee in the minority signed the letter. The IGs of the Department of the Treasury, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, and the Securities and Exchange Commission also received this letter, although the specific Dodd-Frank Wall Street Reform and Consumer Protection Act rulemakings to be reviewed varied.

<sup>2</sup> The Committee Members’ letter referred to the proposed rule as, “Margin and Capital Requirements for Covered Swap Entities, April 12, 2011, 76 FR \_\_\_\_\_ (2011); however, the rule was subsequently published in the Federal Register.

<sup>3</sup> The Committee Members’ letter referred to the proposed rule as Regulation Z; Truth in Lending (April 19, 2011), 76 FR \_\_\_\_\_ (2011); however, the rule was subsequently published in the Federal Register.

obtained management comments on this report from appropriate Board officials, which we have included as appendix 1.

Below are our responses to the topics in the Committee Members' request.

### **1) Describe any statutory or other requirements to perform economic analysis**

A number of key statutes related to the Board's regulatory authority, including the Federal Reserve Act and the Bank Holding Company Act of 1956, provide the Board with rulemaking authority to perform the duties, functions, or services specified in these statutes. These statutes generally do not require economic analysis as part of the agency's rulemaking activities.

Section 553 of the Administrative Procedure Act (APA) establishes the notice and comment process for rulemaking that all federal agencies, including the Board, must follow. The APA does not mandate that economic analysis occur as part of the notice and comment process.

The Dodd-Frank Act does not (1) contain a general provision requiring economic analysis as part of every rulemaking or (2) explicitly require that an "economic analysis" or "cost-benefit analysis" support any of the five rules that we reviewed. The statute does identify, however, certain considerations, assessments, policy goals, or substantive requirements that must be reflected in the applicable proposed rule. The following exemplify specific Dodd-Frank Act requirements for the five rules:

- For Risk Retention, section 941 instructed the interagency rulemaking team to consider "underwriting and product features that historical loan performance indicate result in a lower risk of default" when establishing the definition of a "qualified residential mortgage" (QRM). Section 941 also required the rulemaking team, comprised of the federal banking agencies and the Securities and Exchange Commission (SEC), to consider, among other things, the "potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms" to assess the allocation of risk retention obligations between originators and securitizers.<sup>4</sup> In addition, section 941 required the Board to complete a study, in coordination and consultation with other regulators, on credit risk retention prior to drafting the proposed rule. The study, issued in October 2010, resulted in (1) a general recommendation that a "one size fits all" approach to credit risk retention requirements would not be appropriate given the varied securitization structures for different underlying assets and (2) eight general considerations for this rulemaking.
- For Risk-Based Capital Floor, section 171 specified that the floors to be used for minimum risk-based capital requirements (1) may not be less than "generally applicable" capital requirements for insured depository institutions, and (2) may not be "quantitatively lower" than generally applicable capital requirements in effect as of the enactment of the Dodd-Frank Act.

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<sup>4</sup> For purposes of this rule, the term "federal banking agencies" means the Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

- For Margin and Capital Requirements, sections 731 and 764 stated that the capital and margin requirements imposed under the proposed rule shall help ensure the safety and soundness of the swap dealer or major swap participant and be appropriate for the risk associated with the non-cleared swaps held. The sections also indicated that the applicable prudential regulator shall permit the use of noncash collateral to satisfy margin requirements determined to be consistent with preserving the financial integrity of relevant markets and the stability of the U.S. financial system.<sup>5</sup>
- For Ability to Repay, section 1402 conveyed the purpose of the law as assuring that “consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive or abusive.” In addition, section 1412 required the Board to adjust the points and fees criteria of the “qualified mortgage” definition considering the potential impact of such rules on rural areas and other areas where home values are lower.
- For FMUs, section 805 instructed the Board to consider relevant international standards and existing prudential requirements and consult with the Financial Stability Oversight Council and the supervisory agencies, such as the SEC and the Commodity Futures Trading Commission (CFTC), in promulgating the proposed rule.

The considerations, policy goals, assessments, study, and substantive requirements mentioned above demonstrate the variability between each of the Dodd-Frank Act rulemakings. Certain provisions within the Dodd-Frank Act may leave limited agency discretion for the rulemaking, including the economic analysis necessary to support the proposed rule, while other provisions may provide broader discretion.

In addition to the rulemaking requirements imposed by the Dodd-Frank Act, the Board is subject to two laws that require specific types of analysis—the Paperwork Reduction Act (PRA) and the Regulatory Flexibility Act (RFA). The PRA and the RFA require narrowly tailored evaluations of the rulemaking’s paperwork burden and effect on small entities, respectively.

The Board is also subject to the Congressional Review Act, which requires the agency conducting the rulemaking to issue a report indicating, among other things, whether the rule will produce a \$100 million or more annual impact on the economy and, therefore, constitute a “major rule.”<sup>6</sup> The Congressional Review Act does not specifically require an economic or cost-benefit analysis. However, if a cost-benefit analysis is completed, it must be submitted to both houses of Congress and the Comptroller General, along with materials related to the rulemaking, before the rule can take effect.<sup>7</sup>

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<sup>5</sup> The term “prudential regulator” includes the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

<sup>6</sup> The agency submits the analysis to the Office of Management and Budget Administrator, who determines whether the rule constitutes a major rule.

<sup>7</sup> There are limited exceptions to the Congressional Review Act outlined in sections 804 and 807, respectively, including (1) rules related to agency management, organization, procedures, or practice, and (2) rules concerning monetary policy proposed or implemented by the Board or the Federal Open Market Committee.

The Committee Members' letter specifically asked us to describe any additional steps that the Board would have to take if it were subject to Executive Order 12866 (EO 12866); Executive Order 13563 (EO 13563); and Office of Management and Budget (OMB) Circular A-4, *Regulatory Analysis*; therefore, we have included a general discussion of those requirements below.

On September 30, 1993, the President issued EO 12866, which generally outlines the rulemaking philosophy and principles for the federal government, as follows:

Federal agencies should promulgate only such regulations as are required by law, are necessary to interpret the law, or are made necessary by compelling public need, such as material failures of private markets to protect or improve the health and safety of the public, the environment, or the well-being of the American people. In deciding whether and how to regulate, agencies should assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating. Costs and benefits shall be understood to include both quantifiable measures (to the fullest extent that these can be usefully estimated) and qualitative measures of costs and benefits that are difficult to quantify, but nevertheless essential to consider. Further, in choosing among alternative regulatory approaches, agencies should select those approaches that maximize net benefits (including potential economic, environmental, public health and safety, and other advantages; distributive impacts; and equity), unless a statute requires another regulatory approach.

The requirements outlined in EO 12866 generally do not apply to the Board because the order exempts every "independent regulatory agency" enumerated in 44 U.S.C. 3502, which includes the Board. Although section 4 of EO 12866 specifies that the unified regulatory agenda and the annual regulatory planning process requirements of the order do apply to independent regulatory agencies, section 6 of EO 12866 does not contain a similar provision mandating that independent regulatory agencies conduct cost-benefit analysis for significant regulatory actions identified during this regulatory planning process.<sup>8</sup> In September 2003, OMB issued Circular A-4 to provide guidance concerning what constitutes "good regulatory analysis" for the cost-benefit analysis required under section 6 of EO 12866. However, the cost benefit analysis requirements of Circular A-4 do not apply to the Board because these requirements, contained in section 6 of the Executive order, do not apply.

On January 18, 2011, the President issued EO 13563 to supplement EO 12866 and reaffirm the principles established in the initial order. EO 13563 also generally does not apply to the Board because the order does not alter terms previously defined in EO 12866. Nevertheless, OMB guidance encourages independent regulatory agencies to "give consideration to all of

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<sup>8</sup> Agencies must submit a Regulatory Plan to OMB's Office of Information and Regulatory Affairs on an annual basis that summarizes the rules and proposed rules that it anticipates issuing in the next year and identifies "significant regulatory actions" that will have a \$100 million or more annual effect on the economy.

[EO 13563's] provisions, consistent with their legal authority.”<sup>9</sup> The Board’s General Counsel told us that the Board conducts its rulemaking activities in a manner that is generally consistent with the philosophy and principles outlined in the Executive orders.<sup>10</sup>

**2) Describe any internal policies, procedures, and guidance that the agency uses to ensure rigor and consistency in the economic analysis of its proposed rules**

We learned that the Board routinely reviews economic data to monitor changing economic conditions that affect consumers, local communities, and businesses. The Board uses this information to gain an understanding of the state of the economy as it considers policy actions, including updates to existing rules. Interviewees mentioned that the Board typically reevaluates the effectiveness of each of its existing regulations every five years. These interviewees did not identify any associated written policy; however, in a subsequent interview, the Board’s General Counsel stated that a written policy exists. We subsequently obtained the “RULEMAKING PROCEDURES – Improving Board Regulations; Policy Statement” (Rulemaking Procedures Policy Statement).<sup>11</sup> The five-year periodic review provides the opportunity to monitor the existing regulation and identify areas where economic analysis may support a prospective change. Resultant rulemakings occur on a discretionary basis to assure that existing rules remain relevant and appropriate for existing market conditions.

For the five rules we were asked to review, we determined that the Board typically followed similar rulemaking practices for each to prepare the notice of proposed rulemaking for publication in the Federal Register, although some, but not all, of the practices were formally documented. Those practices, which have developed over time, include (1) assembling an interdivisional team and selecting a team lead, (2) obtaining public input and assessing the regulatory policy considerations, (3) conducting the economic analysis necessary to support the proposed rule, (4) drafting and discussing the proposed rule, (5) addressing PRA and RFA requirements, and (6) obtaining approval from the Board of Governors. We noted that the Board’s Rulemaking Procedures Policy Statement generally describes certain practices mentioned above; however, it has not been recently updated and no rulemaking team members interviewed cited this document.<sup>12</sup>

*Assembling an Interdivisional Team and Selecting a Team Lead*

Each of the Dodd-Frank Act rulemakings we reviewed relied on an interdivisional team ranging from 5 to 13 team members collaborating to draft the initial proposal. The practice for assembling a rulemaking team is as follows. Divisions with a subject matter connection to the rulemaking participate in drafting the proposed rule. Senior Board officials from divisions

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<sup>9</sup> The OMB guidance is a memorandum (M-11-10) issued by the Administrator of the Office of Information and Regulatory Affairs on February 2, 2011. The guidance acknowledges that EO 13563 does not apply to independent agencies like the Board, but encourages those agencies to give consideration to all of its provisions, consistent with the independent agency’s legal authority.

<sup>10</sup> Circular A-4 focuses more on specific rulemaking practices than general philosophy and principles.

<sup>11</sup> The Federal Reserve Service, Volume IV, Part 8, Subpart 8-040.

<sup>12</sup> The Rulemaking Procedures Policy Statement generally describes the Board’s efforts to obtain preliminary views of interested parties prior to drafting a proposed rule and the presentation of the proposal to the applicable Board Governors for initial analysis.

participating in the rulemaking designate the team members and determine which division should take the lead on the rulemaking given their respective interests. The lead division selects a leader for the rulemaking team based on relevant expertise and availability. The team leader shepherds the rule through the interdivisional drafting process drawing on staff expertise. In general, roles and responsibilities for assessing particular regulatory policy alternatives and completing certain aspects of the proposal are allocated within the team according to subject matter expertise. Each of the team leaders for the five proposals came from different divisions within the Board, as follows:

- a Counsel within the Legal Division managed Risk Retention;
- an Assistant Director within the Division of Banking Supervision and Regulation led Risk-Based Capital Floor;
- a Senior Associate Director within the Division of Research and Statistics supervised Margin and Capital Requirements;
- a Senior Attorney within the Division of Consumer and Community Affairs managed Ability to Repay; and
- an Assistant Director within the Division of Reserve Bank Operations and Payment Systems managed FMUs.

#### *Obtaining Public Input and Assessing the Regulatory Policy Considerations*

As appropriate, an initial step in developing a proposed rule involved seeking public input from parties who may be affected by the rule.<sup>13</sup> The rulemaking teams received preliminary feedback from particular segments of the public, including depository institutions and bank holding companies, consumer groups, government sponsored enterprises (GSEs), trade associations, and other federal and state government agencies.<sup>14</sup> We were told by rulemaking team members that the Board received this feedback during meetings and from written submissions, and that the relevant teams considered feedback in evaluating the costs and benefits associated with pursuing specific alternatives.

For Risk Retention, the Board obtained input from several sources, including representatives from trade organizations, consumer groups, financial institutions, law firms, professors, and individuals. Interviewees mentioned that Board staff attended more than 20 meetings with various stakeholders. In some instances, outside parties also submitted supporting materials to

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<sup>13</sup> These forms of public input are separate from public comments requested in the Federal Register notice for a proposed rule.

<sup>14</sup> The Board has issued a formal policy addressing the documentation standards for meetings with the public. The Board will disclose all communications related to potential or proposed rulemakings initiated by the Board. Therefore, documentation standards apply to all meetings with the public to identify participants and major issues discussed. We reviewed meeting summaries for Ability to Repay and Risk Retention and the compilation of survey responses for Margin and Capital Requirements.

the Board for its review and consideration. For example, the Federal Register notice states that the agencies considered public input in developing the proposed definition of a QRM.

For Margin and Capital Requirements, the rulemaking team surveyed entities engaged in significant swap activities regarding the use of margin in managing the counterparty risk that arises from over-the-counter (OTC) derivative transactions.<sup>15</sup> In addition to obtaining information on specific industry practices, the rulemaking team also sought input regarding the magnitude of uncleared swap activity and initial margin held. The team also received public input regarding transactions between a covered swap entity and nonfinancial counterparties, which assisted staff in developing a proposed rule that categorized nonfinancial counterparties as lower risk.

The Board also obtained public input for Ability to Repay from several sources, including representatives from government agencies, depository institutions, consumer groups, trade associations, GSEs, and others. Interviewees mentioned that Board staff attended more than 10 meetings with various stakeholders. For example, to adjust the points and fees threshold for “smaller loans,” Board staff consulted with consumer advocates and various types of creditors, including representatives of banks and credit unions in rural areas, as well as manufactured home lenders. Staff also examined recent data on loan size distributions for home purchase loans and refinances by county, among other data. The proposed rule indicated that outreach participants generally encouraged the Board to avoid an approach that would require different methods of calculating points and fees depending on the size of the loan. Based on the Board’s consideration of the above information, the proposed rule sets higher percentage caps on points and fees for loans of less than \$75,000.

Existing international standards for Risk-Based Capital Floor and FMUs limited the need to solicit initial public input for those rules. For Risk-Based Capital Floor, section 171 of the Dodd-Frank Act specified the floors to be used for minimum risk-based capital, thereby minimizing the need for public comment. For FMUs, the Board based its proposed rulemaking on the existing standards in its *Policy Statement on Payments System Risk (PSR Policy)*.<sup>16</sup>

### *Conducting the Economic Analysis Necessary to Support the Proposed Rule*

The Board’s Rulemaking Procedures Policy Statement indicates that the extent of regulatory analysis varies depending on the regulation. Our interviews revealed that the nature of the economic analysis also varied according to the applicable rule. Many elements of the Dodd-Frank Act affected the scope of the economic analysis conducted, including (1) substantive requirements contained in the statute; (2) statutory references requiring the rulemaking team to consider existing standards, applicable international standards, or prudential requirements; and

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<sup>15</sup> An OTC derivative is a security not listed or traded on an organized exchange.

<sup>16</sup> The Board had previously requested comment on these standards when it incorporated the standards into its PSR Policy. In addition, the current international standards for FMUs were subject to consultation with the public before adoption. The Board collaborated with staffs at the Federal Reserve Banks of New York and Chicago in developing the proposed rule. Finally, the Board consulted with the agencies on the Financial Stability Oversight Council in promulgating the proposed rule.

(3) a statutorily mandated report on the topic. (See topic 7 below describing the economic analysis supporting each of the rules.)

### *Drafting and Discussing the Proposed Rule*

Interviewees described the Board's collaborative process to compile the initial draft of the proposed rule. This process typically involved specific team members drafting particular sections of the rule. Once the preliminary draft had been compiled, members of the interdivisional rulemaking team and other senior staff had the opportunity to review and provide input. Prior to finalizing the draft, certain rulemaking teams briefed specific members and committees of the Board of Governors to obtain initial feedback on the direction of the proposal and consulted with other relevant agencies as appropriate. This iterative and interactive process eventually resulted in an initial draft. Interviewees explained that interagency rulemakings also followed a similar collaborative drafting process among the relevant agencies.

Initial draft proposed rules, or a summary of the major legal and policy issues, were discussed with the Board committee with responsibility for the relevant subject matter and reviewed prior to being forwarded to the Board for its consideration.<sup>17</sup> For example, the Board's Committee on Consumer and Community Affairs reviewed a summary of the major legal and policy issues for the Ability to Repay proposed rule. Designated team members from the various divisions participated in those presentations. Interviewees mentioned that, in general, the committee members routinely request team members' input during the process of discussing the analyses, various choices, assumptions, and alternatives related to the proposed rule. If differing opinions on key issues persist once the initial draft or summary has been submitted for discussion, those differences are often raised and addressed during these briefings. Committee members' comments, questions, or concerns about the proposed rule must be addressed before finalizing the draft and forwarding it for the Board's consideration.

### *Addressing PRA and RFA Requirements*

In addition to the economic analysis supporting rulemaking, the Board conducted burden assessments for purposes of the PRA and the RFA. As part of every rulemaking, a centralized staff, the Financial Reports Section within the Division of Research and Statistics, calculates the paperwork burden associated with a particular rulemaking in consultation with relevant staff on the rulemaking team. Interviewees stated that RFA assessments occur on a more decentralized basis, but generally with input from the Division of Research and Statistics in consultation with relevant staff.

### *Obtaining Approval from the Board of Governors*

As the final step in the process, the Board of Governors received a memorandum on the proposed rule, including a copy of the draft Federal Register notice. The Board of Governors voted on the proposed rules and approved the release of the proposals for public comment.

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<sup>17</sup> There are six Board committees, and a minimum of two Governors serve on each.

**3) Assess the degree to which relevant agency staff understands and follows statutory and the agency’s own requirements**

Interviewees stated, and supporting documentation demonstrated, that economic analysis contributed to the Board’s regulatory policy judgments. Staff we interviewed (1) knew that applicable rulemaking statutes generally do not require economic analysis as part of the rulemaking process; (2) acknowledged specific Dodd-Frank Act requirements concerning economic analysis, including mandated considerations for the applicable rulemaking, for example the Risk Retention study; and (3) discussed the requirements of the PRA, the RFA, and the Congressional Review Act. These interviews indicated that staff was cognizant of the Board’s rulemaking practices, although none of the rulemaking team members cited the Rulemaking Procedures Policy Statement.

Our assessment of the Board’s compliance with statutory and agency requirements is contained in topic 4 below.

**4) Assess the degree to which the agency complies with these requirements**

Our interviews and documentation reviews indicated that the Board complied with the applicable Dodd-Frank Act statutory requirements described in topic 1 for the respective rulemakings. Further, we found that each proposed rulemaking complied with the PRA and the RFA. Each of the rulemakings we reviewed were proposed rules that had not advanced to final rule status, so Congressional Review Act assessments concerning “major rule” status had not yet been performed. We determined that the five rulemakings generally followed the practices noted in topic 2 above.

**5) Describe any discretionary economic analysis the agency voluntarily undertakes on a regular or ad hoc basis in order to ensure that its rulemaking is effective and efficient**

We learned that the Board routinely reviews economic data to monitor changing economic conditions that affect consumers, local communities, and businesses. The Board uses this information to gain an understanding of the state of the economy as it considers policy actions, including updates to existing rules. Interviewees mentioned that the Board typically reevaluates the effectiveness of each of its existing regulations every five years. These interviewees did not identify any associated written policy; however, in a subsequent interview the Board’s General Counsel stated that a written policy exists. We obtained the Rulemaking Procedures Policy Statement. The five-year periodic review provides the opportunity to monitor all aspects of the existing regulation and identify areas where economic analysis may support a prospective change. Resultant rulemakings occur on a discretionary basis to assure that existing rules remain relevant and appropriate for existing market conditions.

Economists from the Division of Research and Statistics highlighted a specific example where monitoring the effectiveness of currently applicable definitions led to a rule change. In that situation, the definition of “high cost mortgages” contained a rate test referencing the yields on U.S. Treasury securities. Economic analysis revealed that a different reference point would more

closely align the rate test with the purpose of the regulation. As a result, the Board promulgated a rule to update the definition to reflect the new reference point.

All rulemaking economic analysis that the Board undertook that was not pursuant to the Dodd-Frank Act was discretionary and initiated on a voluntary basis. Topic 7 below further discusses the discretionary economic analysis that occurred to support each of the selected rulemakings.

#### **6) Assess the relevant qualifications of the staff who conduct economic analysis**

We compiled team member qualification information for each of the rulemaking teams that conducted economic analysis. That information is summarized below.

Team 1 – Risk Retention – The team had four members who conducted economic analysis: two PhD economists and two members with Master’s degrees in Business Administration with finance specializations. Three of the four members had more than 20 years of experience—two team members had more than 20 years of experience in banking policy matters. The other team member had 12 years of experience as a researcher in housing and real estate finance matters.

Team 2 – Risk-Based Capital Floor – In general, this team did not conduct quantitative economic analysis, so there were no relevant team members’ qualifications that required analysis. The team determined that maintaining existing capital standards addressed the Dodd-Frank Act requirements for the rulemaking, which provided little discretion in implementation.

Team 3 – Margin and Capital Requirements – Four team members conducted economic analysis: three PhD economists and one attorney. All 4 team members had more than 10 years of experience conducting economic analysis or developing bank regulatory policy. The 4 team members’ experience levels ranged from 10 to 17 years.

Team 4 – Ability to Repay – Four team members conducted economic analysis, all of whom are PhD economists. The team members had between 6 and 31 years of experience conducting economic analysis.

Team 5 – FMUs – In general, this team did not conduct quantitative economic analysis, so there were no relevant team members’ qualifications that required analysis. The Dodd-Frank Act required that the Board develop risk management standards for designated financial market utilities and in doing so consider international standards and existing prudential standards. To achieve these statutory goals, a qualitative determination was made to align the proposed rule with the Board’s previously issued PSR Policy. We note that the Assistant Director who led the team also worked on the Board’s existing PSR Policy and the existing and forthcoming updates to international standards.

#### **7) Review the economic analysis, if any, conducted in connection with the agency’s rulemaking**

A) *The quantitative methodologies the agency uses to evaluate the costs and benefits of proposed rules and the effects those rules could have on job creation and economic growth*

As described in topic 1 above, applicable laws, regulations, Executive orders, and relevant guidance did not require that any of the five rulemakings include a macro-level cost-benefit assessment related to the rulemaking. In addition, the Dodd-Frank Act did not require an assessment of the five rules' impact on job creation or economic growth. Documentation we reviewed indicated that the Board conducts the quantitative economic analysis necessary to satisfy statutory requirements, including "consideration" requirements. On a discretionary basis, the Board also conducts the quantitative economic analysis it deems necessary to support the rulemaking.

In general, the Board relies on qualified experts to discuss, evaluate, and identify the most appropriate quantitative methodologies to meet the demands of a rulemaking based on the available data. Interviewees indicated that the time frame permitted to promulgate the applicable rule can influence the methodologies used to conduct the economic analysis necessary to support the rulemaking. Quantitative methodologies supporting rulemaking activities may include statistical analysis, scenario analysis, or complex modeling. In other instances, the data or analysis required to address a specific aspect of rulemaking may already exist; and, therefore, an additional economic analysis may not be necessary. In those situations, the Board relies on its analysis of pre-existing economic data.

Below, we describe the quantitative methodologies used to support three of the five rulemakings. (As previously noted, Risk-Based Capital Floor and FMUs did not entail quantitative economic analysis.) The economic analysis occurred in response to statutory requirements and on a discretionary basis.

For Risk Retention, the Board performed in-depth economic analysis, in response to the statute's consideration requirements, to contribute to the interagency definition of QRM. Board staff used historical data to perform a decision-tree analysis linking mortgage loan characteristics to loan performance. In addition, the agencies considered public input in developing the proposed QRM definition.

Ability to Repay followed a similar approach even though the economic analysis that occurred was narrowly tailored to address specific questions. For example, quantitative economic analysis supported specific aspects of the rulemaking, including (1) an assessment of the costs and benefits to consumers of 30-year versus 40-year loan terms to determine a "standard loan" definition; (2) an assessment of whether a debt-to-income standard should be included in the "qualified mortgage" definition; (3) a review of Home Mortgage Disclosure Act data for loan size by county to account for smaller loan sizes and loans originated in rural areas, to establish an exception to the 3 percent points and fees requirement for qualified mortgages; and (4) a review of the Office of Thrift Supervision's Thrift Financial Report data in identifying lenders who may make balloon payment mortgages. We determined that the Board conducted the quantitative analysis outlined in examples 1, 2, and 4 above on a discretionary basis, while example 3 responded to Dodd-Frank Act considerations.<sup>18</sup>

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<sup>18</sup> For balloon mortgages, section 1412 provides the Board with the discretion to determine whether "qualified mortgages" should include balloon loans as part of the rulemaking.

For Margin and Capital Requirements, the Dodd-Frank Act required the prudential regulators, in consultation with the CFTC and the SEC, to establish margin and capital requirements for non-cleared swaps of swap dealers and major swap participants that would ensure the safety and soundness of the swap dealer or major swap participant and be appropriate for the risk associated with the non-cleared swaps held.<sup>19</sup> Members of the rulemaking team conducted economic analysis to determine the standardized minimum margin requirements for non-cleared swaps. We reviewed internal Board documentation of the economic analysis performed, which indicated that the economists (1) conducted statistical analysis of the loss rates associated with different types of swaps over two sampled periods, which included a stress period; (2) evaluated initial margin requirements based on analyzing swap maturities and the imbedded risk in the underlying assets; and (3) analyzed the liquidity impact of the potential margin requirements based on an industry impact study, which considered alternative margin levels and the costs of initial margin segregation. In addition, team members also conducted an analysis regarding the systemic risk posed by different types of swap counterparties based on the size and riskiness of their derivative exposures.

B) *The qualitative methods the agency uses to categorize or rank the effects of proposed rules*

Consistent with the expectations of section 2 of EO 13563, the Rulemaking Procedures Policy Statement, and the practices outlined in topic 2 above, the Board generally sought public input for its rulemaking activities. Among other things, this input occurred through meetings, written communications, and targeted industry surveys. Interviewees stated that the agency relies on this process to better understand any issues or potential impacts associated with a particular rulemaking. For example, an interviewee mentioned that the rulemaking identified general themes that arose from the public participation and indicated that this process afforded for a high-level “categorization” of feedback themes.

For FMUs and Risk-Based Capital Floor, the Board did not rely on public input in drafting the proposed rulemakings. The Board conducted a qualitative assessment and determined that the least burdensome alternative and best course of action involved adopting existing international standards. The Federal Register notice for FMUs indicated that the adoption of current international standards would ease the potential burden on designated financial market utilities to comply with the standards when compared with adopting a new set of standards. For Risk-Based Capital Floor, the Federal Register notice stated that the proposed rule is “unlikely to have a significant impact on banking organizations. The agencies [involved in the rulemaking] also note that the changes to the general risk-based capital rules would not impose any additional obligations, restrictions, burdens, or reporting, recordkeeping or compliance requirements on banks including small banking organizations, nor do they duplicate, overlap or conflict with other Federal rules.” The Board selected these approaches, in part, because forthcoming updates to international standards may result in future significant changes.

Risk Retention also included a qualitative assessment outlined in the Board’s study required by section 941 of the Dodd-Frank Act. Among other things, the study described (1) securitization structures according to the underlying assets, (2) the mechanisms within those structures to

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<sup>19</sup> The “prudential regulators” include the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

mitigate risk, and (3) the relative performance of the underlying assets during the financial crisis. After outlining the factors considered, the report concluded that the varied asset classes, securitization structures, and risk mitigation mechanisms specific to particular structures did not lend themselves to a “one size fits all” approach. The rulemaking addressed that recommendation by providing alternatives to satisfy the risk retention requirements. In addition, the rulemaking addressed each of the additional considerations outlined in the Dodd-Frank Act mandated study.

Topics 2 and 7A above also describe situations where public input influenced the initial rulemaking proposal.

C) *The extent to which the agency considers alternative approaches to its proposed rules*

The Rulemaking Procedures Policy Statement notes that the Board will explore alternative approaches as part of its rulemaking activities. Below we provide examples where the Board considered alternative approaches in Dodd-Frank Act rulemakings.

EO 12866 section 1(b)(3) discusses available alternatives to direct regulation.<sup>20</sup> The five rulemakings we reviewed were required by provisions of the Dodd-Frank Act; therefore, an “available alternative” to direct regulation did not exist.

EO 12866 section 1(b)(8) refers to alternative forms of regulation within the confines of the relevant proposal and encourages the relevant agency to use “performance objectives” and avoid mandating the manner in which compliance must occur.<sup>21</sup> Two of the proposed rulemakings provided regulated parties with choices for addressing the underlying performance objective. Risk Retention generally imposes a 5 percent risk retention requirement on the various participants who engage in securitization activities to assure that participants retain a vested interest in the securitization or its underlying assets. The proposed rule contains a menu of permissible forms of risk retention so that the regulated entity can then select the most suitable alternative for its circumstances. Similarly, Margin and Capital Requirements provides two alternatives for margin calculation to satisfy an overall performance objective. The initial margin requirements outlined in the rule can be satisfied by (1) referring to a look-up table that indicates the margin requirements for particular transactions or (2) using an internal model, subject to approval by the entity’s primary federal regulator, to calculate its margin requirements.

As shown in the examples below, the Board also considered alternative approaches in Margin and Capital Requirements to satisfy other Dodd-Frank Act requirements. Sections 731 and 764 require that the margin and capital requirements imposed under the proposed rule shall help ensure the safety and soundness of the swap dealer or major swap participant and be appropriate for the risk associated with the non-cleared swaps held. The rulemaking team evaluated the

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<sup>20</sup> The section states, “Each agency shall identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made by the public.”

<sup>21</sup> The section states, “Each agency shall identify and assess alternative forms of regulation and shall, to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt.” Circular A-4 describes a similar methodology for evaluating alternative approaches under the heading, “Performance Standards Rather than Design Standards.”

effect of requiring margin to be posted to, or collected by, covered swap entities and determined that requiring these entities to collect margin would be the best approach to offset the risk to the entity, as well as the financial system. Sections 731 and 764 also state that the prudential regulator shall permit the use of noncash collateral to satisfy margin requirements that the regulator determines to be consistent with preserving the financial integrity of markets trading swaps and the stability of the U.S. financial system. The rulemaking team evaluated current industry practices regarding types of collateral used for margin and determined that non-cash collateral should be limited to certain types of highly liquid, high-quality debt securities outlined in the proposed rule.

D) *The extent to which the agency examines the costs, benefits, and economic impact of reasonable alternatives to its proposed rules*

The examples referenced in the prior topic address alternative approaches in the Board's rulemakings. As mentioned previously, the Board did not impose additional regulatory burdens on the industry with respect to Risk-Based Capital Floor and FMUs. In both situations, updates to the international standards that underpin both regulations may have a significant impact concerning the need to re-examine and adjust these rules in the near future. The Board concluded that consistency with pre-existing standards or previously issued rules outweighed the potential burden to be imposed by changes.

E) *The extent to which the agency seeks public input and expertise in evaluating the costs, benefits, and economic impact of its proposed rules, and the extent to which the agency incorporates the public input into its rule proposals*

Topics 2, 7A, and 7B above addressed this question. In addition, in accordance with the APA, the Board sought public comment by publishing all five proposed rules in the Federal Register.

F) *The extent to which the economic analysis performed by the agency with respect to its proposed rulemakings is transparent and the results are reproducible*

As described in topic 1 above, the Board is not subject to the cost-benefit analysis requirements outlined in EO 12866 or the guidelines for transparency and reproducibility outlined in Circular A-4.<sup>22</sup> Nevertheless, the Board conducts the economic analysis required by statute and the discretionary economic analysis necessary to support the rulemaking. In order to respond to this topic, we analyzed this subpart as if the guidelines for transparency and reproducibility applied to the economic analysis performed.

Board staff who engaged in various economic analyses indicated that they strive to use the best information available for performing economic analysis. We learned that they frequently use publicly available data, but may also use proprietary data, depending on the economic analysis required. For the three proposed rules with economic analysis, we reviewed the Board's internal supporting documentation for selected analyses. In addition, interviewees mentioned that the Federal Register notices generally detail the sources of information used in the economic

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<sup>22</sup> Circular A-4 defines "reproducible" as a qualified third party being able to read the analysis and understand the basic elements of the analysis and the way in which the estimates were developed.

analysis and may provide insight into principles or approaches underlying these analyses. Our review of selected Federal Register notices indicated that these publications typically provide insight into the general approaches and data used in the economic analysis. Examples of analyses that we reviewed are outlined below.

For Risk Retention, the Dodd-Frank Act required the agencies to define a QRM, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default. We reviewed internal Board documentation that details the data sources, the analysis methodology, and a summary of analysis results. We also reviewed the Federal Register notice for the Risk Retention proposed rule and found that this notice describes the overall approach to defining a QRM. The notice explains the factors and principles that guided the analysis and development of the QRM definition. It also cited the data that the agencies used to assess the credit quality of a mortgage, including mortgage underwriting and performance data obtained from a third party vendor as well as data obtained from the Board's Survey of Consumer Finance. In this regard, the methodology for the proposed rule is transparent and reproducible to the extent that it provides insight into the analysis that supported the QRM definition assessment.

For Margin and Capital Requirements, we reviewed internal Board documentation of the economic analysis performed, which indicated that the economists (1) conducted statistical analysis of the loss rates associated with different types of swaps over two sampled periods, which included a stress period; (2) evaluated initial margin requirements based on analyzing swap maturities and the imbedded risk in the underlying assets; and (3) analyzed the liquidity impact of the potential margin requirements based on an industry impact study, which, among other things, considered alternative margin levels. In addition, economists conducted an analysis regarding the systemic risk posed by different types of swap counterparties based on the size and riskiness of their derivative exposures. The Federal Register notice for Margin and Capital Requirements contained a high-level discussion of the conclusions resulting from the economic analysis and also discussed the major qualitative economic considerations that interviewees noted. The Board's internal documentation provided more details on the analysis than were included in the notice and met the standards for reproducibility.

For Ability to Repay, we reviewed selected internal Board documentation of economic analyses. As an example, the Dodd-Frank Act provides for an exception to the "qualified mortgage" definition, allowing certain lenders to make balloon mortgage loans. The Board's internal documentation detailed, among other things, the asset sizes of balloon mortgage originators and mortgage origination data. The Dodd-Frank Act specifically required the Board to establish a mortgage loan origination limit above which a lender would not qualify to make balloon mortgage loans. Board staff reviewed data from the Office of Thrift Supervision's Thrift Financial Reports to review balloon payment loan originations. Our review indicated that this analysis is generally reproducible for the example mentioned above.

However, we also reviewed other examples of the Board's internal documentation associated with Ability to Repay and found that in some cases the documentation did not outline the underlying work steps. For example, the Dodd-Frank Act required the Board to prescribe rules adjusting the points and fees qualified mortgage criteria for smaller loans. Board staff used data and performed outreach to gather information on how the points and fees threshold could be

adjusted for smaller loans. The Board's internal documentation contained the data used in the analysis, but the work steps underlying this analysis were not clearly documented. While, as mentioned above, the Board is not subject to the guidance in Circular A-4, we believe that consistent documentation should support statutorily mandated and discretionary economic analysis.

We also reviewed the Federal Register notice for Ability to Repay and noted that it provided insight into the general approaches and data used in the economic analyses. For example, with regard to the balloon mortgage analysis described above, we observed that this notice (1) refers to the thrift data supporting the analysis, (2) describes data limitations encountered in reviewing the mortgage origination data, and (3) notes that these limitations resulted in the Board proposing two alternatives for public comment. The Federal Register notice describes the principles regarding the Ability to Repay analyses, which generally provides for transparency and reproducibility.

#### **8) Recommendations on how to improve the rigor and consistency of the agency's economic analysis**

Based on the work we performed to address the Committee Members' request, we have two recommendations designed to improve the Board's rulemaking activities. First, we recommend that the Board update the Rulemaking Procedures Policy Statement and broadly disseminate it to all employees involved in rulemaking activities. We suggest that this document address the Board's philosophy and principles supporting its rulemaking activities and identify preferred practices. Given the varied requirements among the rulemakings we reviewed, we understand that such a document needs to be flexible and adaptable to respond to the demands of specific rulemakings.

Second, we recommend that the Board consider establishing documentation standards for rulemaking economic analysis to help ensure reproducibility on an internal basis. We observed inconsistencies in the internal documentation of work steps for economic analysis for one of the rulemakings we reviewed.

#### **9) Additional steps that the agency would have to take if it were subject to EOs 13563 and 12866 and associated OMB guidance**

If the Board were subject to the Executive orders and the associated OMB guidance, it would generally need to perform the broad cost-benefit analysis required by EO 12866 section 6(a)(3)(C). This analysis would need to be consistent with Circular A-4, including its documentation standards for reproducibility, and EO 13563. We note, though, that EO 12866 section 6(a)(3)(D) specifically states that situations may arise when agencies subject to the cost-benefit analysis requirements contained in EO 12866 may not be able to conduct those analyses. The section indicates that to "the extent practicable," an agency should complete a cost-benefit analysis in "emergency situations or when an agency is obligated by law to act more quickly than normal review procedures allow."

## **10) The extent to which the Board is considering the cumulative burden of all Dodd-Frank rulemakings on market participants and the economy**

As noted in this report, the Dodd-Frank Act does not mandate that the Board prepare economic analyses for the five proposed rules we reviewed. According to senior officials, the Board is striving to ensure that its regulations implement the statutory requirements of the Dodd-Frank Act while carefully balancing costs and benefits. Senior Board officials noted, however, that estimating the cumulative burden of imposing Dodd-Frank Act mandated rules on the broader economy is not possible at this time since few Dodd-Frank Act provisions have taken effect. For example, the expected impact of swaps margin requirements on market participants, as required by the Dodd-Frank Act, could be significant, particularly when combined with other mandated provisions requiring (1) swaps to be cleared through a central counterparty and (2) enhanced liquidity requirements for bank holding companies with assets greater than \$50 billion. Senior Board officials also stated that data provided in comments by market participants on the proposed rules' burden is expected to be an important input into crafting a final rule. In addition, they noted that as these provisions become effective over the next few years, the Board will monitor their impact on broader economic activity as part of its general consideration of financial market developments.

### **Analysis of Comments**

In accordance with applicable standards, we provided Board officials with our draft response for their review and comment. The Board's consolidated response, included as appendix 1, stated that the Board intends to adopt both of our recommendations.



## Appendix 1 – Board’s Consolidated Response



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

SCOTT G. ALVAREZ  
GENERAL COUNSEL

June 10, 2011

Elise M. Ennis, Acting Inspector General  
Board of Governors of the Federal Reserve System  
Washington, D.C. 20551

Dear Ms. Ennis:

Thank you for the opportunity to comment on your draft report about the development of draft regulations mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the extent to which economic analysis is required or otherwise voluntarily undertaken in that process. We appreciate the report’s recognition that the Board carefully considers burdens that the rules we are required to develop may have on small banks, other affected banking organizations, consumers, local communities and businesses. The report also recognizes that the Board complied with all applicable Dodd-Frank Act statutory requirements, and that we follow the requirements of the Paperwork Reduction Act and the Regulatory Flexibility Act.

The report contains two recommendations which we intend to adopt. The first recommendation suggests that the Board update the Rulemaking Procedures Policy Statement, which encourages public participation in Board rulemakings and periodic review and streamlining of Board regulations, among other things, and disseminate it to all employees involved in rulemaking activities. The second recommendation is that the Board consider establishing documentation standards for any economic analysis relied on in the drafting of rules. We will review the Rulemaking Procedures Policy Statement and, as part of that process, will consider whether or how to address documentation standards for economic analysis. When an updated policy is finalized, we will disseminate it to those involved in rulemaking activities.

Thank you, again, for the opportunity to provide comments to this draft report.

Sincerely,

*/signed/*



## **Appendix 2 – Contributors to this Response**

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