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Statement by

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Chair

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before the

Committee on Financial Services

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Chairman Hensarling, Ranking Member Waters, and other members of the committee, I appreciate the opportunity to testify on the Federal Reserve's regulation and supervision of financial institutions.

One of the Federal Reserve's fundamental goals is to make sure that our regulatory and supervisory program is tailored to the risk that different financial institutions pose to the system as a whole. As we saw in 2007–08, the failure of systemically important financial institutions can destabilize the financial system and undermine the real economy. The largest, most complicated firms must therefore be subject to prudential standards that are more stringent than the standards that apply to other firms. Small and medium-sized banking organizations--whose failure would generally pose much less risk to the system--should be subject to standards that are materially less stringent.

The Federal Reserve has made substantial progress in building a regulatory and supervisory program that is consistent with these principles. We have implemented key standards designed to limit the financial stability risks posed by the largest, most complex banking firms. We continue to work on some remaining standards and to assess the adequacy of this package of measures. With respect to small and medium-sized banks, we must build on the steps we have already taken to ensure that they do not face undue regulatory burdens. Looking forward, we must continue to monitor for the emergence of new risks, since another key lesson from the crisis is that financial stability threats change over time.

Strengthening the Regulation and Supervision of the Largest Financial Institutions

The Federal Reserve's post-crisis efforts to strengthen its regulation and supervision of large banks have focused on promoting the safety and soundness of these firms and on limiting the adverse effects that their distress or failure could have on the financial system and the

broader economy. This orientation is consistent with section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which directs the Board to impose enhanced prudential standards on large banking organizations “in order to prevent or mitigate risks to financial stability.” Our efforts to mitigate financial stability risks posed by large financial institutions generally fall into one of two categories. First, we aim to make large financial institutions more resilient in order to reduce the likelihood of their failure or distress. And second, we aim to make large financial institutions more resolvable to limit the damage that their failure would have on the rest of the financial system and on the broader economy.

Resiliency

To increase the resiliency of the largest banking organizations, the Federal Reserve has established a broad set of enhanced prudential standards for large domestic and foreign banking organizations. Together with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency, we have implemented capital rules that require large banking organizations to hold substantially larger amounts of high-quality capital than they were required to hold before the 2007–08 crisis, and we have adopted a liquidity coverage ratio (LCR) that requires these organizations to hold a buffer of high-quality, liquid assets sufficient to meet liquidity outflows during a 30-day period of severe funding stress. We have also proposed single-counterparty credit limits that are designed to guard against the build-up of excessive concentrations of credit risk and, along with the other federal banking agencies, proposed a Net Stable Funding Ratio that would require banks to maintain a minimum level of stable funding relative to the liquidity of their assets over a one-year horizon.

In addition to strengthening the regulation of the largest, most complex financial institutions, we have also transformed our supervision of firms that pose elevated risk to U.S.

financial stability through the creation of the Large Institution Supervision Coordinating Committee (LISCC).¹ The LISCC is distinguished by several characteristics. First, the LISCC has implemented a centralized, multidisciplinary approach to supervision by bringing together experts from around the Federal Reserve System in the areas of supervision, research, legal counsel, financial markets, and payments systems. Second, major areas of focus for the supervision of firms in the LISCC portfolio are capital and liquidity resiliency under normal and potentially adverse conditions in the future, as well as recovery and resolution preparedness. And third, the LISCC complements traditional, firm-specific supervisory work with annual “horizontal” programs that examine these firms at the same time and on the same set of issues in order to promote better monitoring of trends and consistency of assessments across all of the LISCC firms.

With regard to capital adequacy, the introduction of capital stress testing for large banking organizations has been one of our signature innovations since the financial crisis. As events during the financial crisis demonstrated, capital buffers that seem adequate in a benign environment may turn out to be far less than adequate during periods of stress. For this reason, consistent with the stress-testing mandate in the Dodd-Frank Act, the Federal Reserve conducts supervisory stress tests each year on banking organizations with \$50 billion or more in total assets to determine whether they have sufficient capital to continue operations through periods of economic stress and market turbulence, and whether their capital planning frameworks are adequate to their risk profiles. The expectation embodied in our stress testing program that large

¹ The firms currently in the LISCC portfolio are American International Group, Inc.; Bank of America Corporation; The Bank of New York Mellon Corporation; Barclays PLC; Citigroup Inc.; Credit Suisse Group AG; Deutsche Bank AG; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; Prudential Financial, Inc.; State Street Corporation; UBS AG; and Wells Fargo & Company. Further information on the LISCC is available on the Board’s website at www.federalreserve.gov/bankinfo/large-institution-supervision.htm.

banking organizations should maintain sufficient capital buffers to withstand a period of significant stress promotes the resilience of those firms and of the financial system more generally.

While our stress testing program has been successful since it was first introduced in 2009, the crisis reinforced the need for regulators and supervisors to continually revisit the effectiveness of their tools and adjust as needed over time. We therefore launched a review of the Comprehensive Capital Analysis and Review (CCAR) program last year with the aim of re-assessing our stress testing practices on a comprehensive basis. As part of this process, we met with a wide range of stakeholders, including academics, analysts, bankers, public interest groups, and others. We are now considering making several changes to our stress testing methodology and process.

The leading idea that has emerged from our comprehensive CCAR review is to integrate CCAR with our regulatory capital framework. More specifically, the regulatory capital rules now include a firm-specific, risk-based capital surcharge for each global systemically important bank (GSIB) and a uniform capital conservation buffer requirement above the regulatory capital minimum for all firms. Under the approach we are considering, the existing capital conservation buffer would be replaced with a risk-sensitive, firm-specific buffer that is sized based on stress test results. Each firm's buffer requirement would be set equal to the decline in its common equity tier 1 capital ratio in the supervisory stress test. The buffer requirement would be floored at 2.5 percent of risk-weighted assets, the current level of the capital conservation buffer, to avoid any reduction in the stringency of the regulatory capital rules. We call this idea the "stress capital buffer," and it would effectively move the stress test to the center of our regulatory capital framework.

For the eight U.S. GSIBs, the move to the stress loss buffer--which would be similar in effect to including the GSIB capital surcharge in the CCAR post-stress minimum--would result in a significant aggregate increase in capital requirements. Thus, in addition to simplifying the capital framework by integrating CCAR with our regulatory capital rules, the stress loss buffer would advance our macroprudential goal of making GSIBs more resilient. In contrast, the move to the stress loss buffer approach generally would not entail a toughening of our requirements for the 25 large banking firms that are subject to CCAR but are not GSIBs. Nor would the move have any impact on community banks or other firms with less than \$50 billion in assets.

We are also considering making certain changes to the stress test assumptions used in CCAR. For example, under the current CCAR program, a firm's capital adequacy is assessed by assuming that the firm continues to make its baseline capital distributions over the stress test's two-year planning horizon. We are considering changing this conservative assumption, in significant part because of the advent of the capital conservation buffer in the regulatory capital rules, which limits the ability of a firm to make capital distributions when its capital ratios are lower than the buffer requirement. Instead, we are proposing that firms simply add one year of planned dividends to their stress capital buffer requirement in recognition of the fact that firms generally are more reluctant to reduce dividends than share buybacks. On this and other changes to CCAR that we are considering, we will of course seek public input before moving to adopt them.

Resolvability

During the crisis, fears about the systemic consequences that would result from the bankruptcies of systemically important firms motivated extraordinary government actions. The fears proved well-founded: The bankruptcy of Lehman Brothers significantly exacerbated the

crisis. To reduce the potential that resolution of a large financial firm in bankruptcy will be disorderly, section 165(d) of the Dodd-Frank Act requires large banking organizations to produce living wills that help these firms prepare to be resolved in an orderly way under the Bankruptcy Code. Although the Bankruptcy Code provides the default legal framework for resolving a failed bank holding company, the Dodd-Frank Act also creates a backup resolution authority that can be used if the resolution of a failed financial company under the Bankruptcy Code would have serious adverse effects on U.S. financial stability. The orderly liquidation authority in Title II of the Dodd-Frank Act has several features that could reduce the systemic impact of a firm's resolution, including an orderly liquidation fund and provisions to prevent the chaotic unwinding of a firm's derivatives, securities financing transactions, and other qualified financial contracts. In the unlikely event that the orderly liquidation fund does incur losses, these losses would be covered by assessments on major financial firms and would not be passed on to taxpayers.

The Federal Reserve has recently proposed important new rules to increase the prospects for the orderly resolution of a GSIB. Last October, the Board proposed to require the eight U.S. GSIBs to meet total loss-absorbing capacity (TLAC) and long-term debt requirements. The proposal would require these systemically important firms to maintain outstanding a large quantity of long-term debt that could be used to absorb losses and recapitalize the firm in resolution. Because, by definition, the actual equity of a bank will have been substantially depleted--if not totally eliminated--by the time it fails, a separate long-term debt requirement is essential to ensure that the resolution authority has the raw material from which to manufacture new equity in resolution to recapitalize and stabilize the failed firm. For this reason, the proposed long-term debt requirement would more assuredly enhance the prospects for successful

resolution--and thereby contribute to solving the too-big-to-fail problem--than would a TLAC requirement on its own. The proposal would also restrict the operations of GSIB holding companies, so that those legal entities could go through resolution without setting off short-term wholesale funding runs or otherwise jeopardizing financial stability.

In May this year, the Board issued another proposal to make GSIBs more resolvable. This second proposed rule would impose restrictions on GSIBs' qualified financial contracts--including derivatives and repurchase agreements (repos)--to guard against the rapid, mass unwinding of those contracts during the resolution of a GSIB. The proposed restrictions are a key step toward GSIB resolvability because rapidly unwinding these contracts could destabilize the financial system by causing asset fire sales and toppling other firms.

Acting in conjunction with the FDIC, the Board has also sought to increase GSIB resolvability through the living wills process. In April this year, the Board and the FDIC announced the results of their review of the eight U.S. GSIBs' 2015 resolution plans. During this review, the agencies evaluated the plans based on the firms' capital, liquidity, governance mechanisms, operational capabilities, legal entity rationalization, derivatives and trading activities, and responsiveness to prior agency feedback. The agencies found that five of the GSIBs' plans fell short of the resolvability standard set by the Dodd-Frank Act and required those firms to fix deficiencies in their plans by October of this year or potentially face more stringent prudential requirements. If the agencies jointly determine that a firm has failed to adequately remedy the noted deficiencies, the agencies may jointly determine that the company or its subsidiaries will be subject to more stringent capital, leverage, or liquidity requirements or to restrictions on the growth, activities, or operations of the firm. The agencies also identified

less-severe shortcomings in the plans of all eight U.S. GSIBs, which are expected to be addressed in the next round of resolution plan submissions, due in July 2017.

The resolution planning process requires firms to demonstrate that they have adequately assessed the challenges that their structure and business activities would pose during resolution and that they have taken action to address those issues. Firms must also confront the resolution consequences of their day-to-day management decisions on a continual basis, particularly those related to structure, business activities, capital and liquidity allocation, and governance. Firms are also expected to create a meaningful set of options for selling operations and business lines to generate resources and to allow for restructuring under stress, including through the sale or wind-down of discrete businesses that could further minimize the direct impact of the firm's distress or failure on the broader financial system. The deficiencies and shortcomings issued in the most recent plan review focus on steps necessary to ensure these objectives are met at each GSIB on an ongoing basis.

In addition to providing the firms with our feedback on their resolution plans, the agencies took several steps in April to improve the transparency of the resolution planning exercise. These steps included publicly releasing the firm feedback letters, a paper outlining the resolution plan assessment framework and firm determinations, and a document detailing the expectations of the agencies regarding the firms' 2017 resolution plan submissions. The expectations articulated for the 2017 plan contents build on detailed guidance previously provided to the GSIBs in 2014 and 2015.

While the five firms that received joint deficiencies are required to fix those deficiencies by October 2016, all of the firms that received agency feedback in April are required to submit a full resolution plan by July 1, 2017. In these plans, firms will be required to address all

identified shortcomings, follow all guidance provided by the agencies, and meet all statutory and regulatory requirements for their resolution plans. In meeting these expectations, the actions that firms need to take should be substantially complete by July 2017, as previously communicated by the agencies.

Regulation and Supervision of Large and Regional Banking Organizations

In supervising banking organizations with more than \$50 billion in assets but outside the LISCC program, the Board focuses on ensuring that companies are well managed, appropriately capitalized, and prepared to withstand potential adverse developments in the business environment. However, because the distress or failure of a non-LISCC firm is unlikely to have the same effect on the financial system and broader economy as that of a LISCC firm, we do not apply the full range of rules that we apply to those in the LISCC portfolio. For example, the Board's risk-based and leverage capital surcharges, as well as the recently proposed long-term debt and TLAC requirements, only apply to GSIBs. Similarly, the advanced approaches capital rules, countercyclical capital buffer, supplementary leverage ratio, and full LCR only apply to the largest and most internationally active banking organizations. We also scale our examination procedures to reflect the lower level of systemic risk presented by banks with more than \$50 billion in assets that are not LISCC companies.

As a result of the comprehensive CCAR review I described earlier, we are also considering exempting from the qualitative portions of CCAR any bank that has less than \$250 billion in total assets and that does not have significant international or nonbank activity. While we strongly believe the CCAR qualitative review produces significant safety and soundness benefits for the largest firms, we can achieve our supervisory goals at most medium-sized banking firms using our normal supervisory program combined with targeted horizontal

assessments of particular aspects of capital planning, as many of these firms are now meeting or close to meeting our supervisory expectations for capital planning processes. As required by statute, these firms would still be subject to the quantitative portion of our stress testing program. But even with respect to the quantitative portions of CCAR, we are considering reducing the amount of data that these firms are required to submit for stress testing purposes.

Regulatory and supervisory requirements are further tailored for regional banking organizations, defined as those with total assets between \$10 billion and \$50 billion. For example, while regional banking organizations must comply with capital rules, they are not subject to a supervisory stress test or CCAR. Rather, as required by the Dodd-Frank Act, regional banking organizations perform their own stress tests. Similarly, these companies are not subject to enhanced prudential standards established under section 165 of the Dodd-Frank Act, the LCR, or other related requirements. Instead, we conduct regular inspections of regional banking organizations and evaluate their safety and soundness based on each company's individual circumstances, in addition to horizontal exams we conduct of regional banking organizations. Because many regional banking organizations concentrate their assets and activities in banking subsidiaries that are supervised by other federal banking agencies, we coordinate supervisory activities closely with the other U.S. banking agencies and rely significantly on the results of their examinations, focusing our own inspections on the parent company and its ability to serve as a source of strength to the subsidiary banks.

Community Bank Supervision

I know that community banks play a vital role in many of your districts. Let me say that the experiences and challenges of community banking are not new to me. Before I became Chair of the Board of Governors and Vice Chair before that, I spent six years as president of the

Federal Reserve Bank of San Francisco. In that role, I was involved in the supervision of a substantial number of community banking organizations in the nine states of the San Francisco District. Among the lessons that experience reinforced is that when it comes to bank regulation and supervision, one size does not fit all. To effectively promote safety and soundness and to ensure that institutions comply with applicable consumer protection laws without creating undue regulatory burden, rules and supervisory approaches should be tailored to different types of institutions such as community banks.

The Federal Reserve supervises more than 800 community banks and more than 4,000 holding companies that control small depository institutions. These are banking organizations with total assets of \$10 billion or less. In supervising community banks, we follow a risk-focused approach that aims to target examination resources to higher-risk areas of each bank's operations and to ensure that banks maintain risk-management capabilities appropriate to their size and complexity. In the wake of the crisis, we have taken steps to refine this process by using the financial data we collect from banks to calibrate our examination procedures based on risk. We believe this will help us to identify and address emerging risks and to ensure that community bank examiners with specialized expertise are allocated to the institutions exhibiting the highest risks. We also implemented a risk-focused consumer compliance examination framework for community banks in 2014 that is intended to allow examiners to spend less time on low-risk compliance issues so that issues more likely to result in harm to consumers get more attention.

The Federal Reserve and the other banking agencies are currently in the process of completing the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) review. Under EGRPRA, the federal banking agencies are required to conduct a joint review of their

regulations every 10 years to identify provisions that are outdated, unnecessary, or unduly burdensome. The Federal Reserve views this review as a timely opportunity to step back and identify ways to reduce regulatory burden, particularly for smaller or less complex banks that pose less risk to the U.S. financial system. In carrying out this review, the agencies sought public comment on their regulations and held several roundtable discussions with bankers and interested parties to gather additional feedback on sources of burden. Themes emerging from these comments include streamlining the Call Report, reducing examination frequency, raising long-standing dollar-based thresholds for appraisals, and reducing the complexity of capital requirements for smaller banks. In response to public comments on examination frequency, the agencies have already approved interim rules to implement a provision of the Fixing America's Surface Transportation Act (FAST Act), which raises the asset threshold for insured depository institutions that are eligible for an 18-month examination cycle from \$500 million to \$1 billion. As a result of raising the threshold, eligible institutions will be subject to fewer safety and soundness and Bank Secrecy Act exams. The agencies are also exploring potential options for alleviating some burdens of appraisal requirements and are actively considering proposals to simplify regulatory capital requirements for community banks.

In addition, the banking agencies, under the auspices of the Federal Financial Institutions Examination Council, recently issued a proposal for a new and streamlined Call Report for community banks. The proposal would eliminate certain data items and reduce the reporting frequency of many other data items. As a result, banks with less than \$1 billion in total assets would submit a Call Report with about 40 percent fewer data items than the existing Call Report. The proposal incorporates comments the banking agencies received from community banks

during several outreach events used to gather information on the challenges faced by community banks in preparing Call Reports.

Congress may also wish to consider carving out community banks from two sets of Dodd-Frank Act requirements: the Volcker rule and the incentive compensation limits in section 956. The risks addressed by these statutory provisions are far more significant at larger institutions than they are at community banks. In the event that a community bank engages in practices in either of these areas that raise heightened concerns, we would be able to address these concerns as part of the normal safety-and-soundness supervisory process. While the banking agencies have tailored the Volcker rule and have proposed significant tailoring of incentive compensation rules, community banks and supervisors would benefit from not having to focus on regulatory compliance for matters that are unlikely to pose problems at smaller banks.

Current Conditions

Having reviewed some of the major elements of our regulatory and supervisory programs, let me offer a few brief remarks about the current state of the firms we regulate.

In response to regulatory and supervisory pressures, the financial condition of the U.S. GSIBs has strengthened considerably since the crisis. Common equity capital at the eight U.S. GSIBs alone has more than doubled since 2008, representing an increase to almost \$800 billion. Moreover, these firms generally have developed much more stable funding positions. The largest banking organizations have increased their holdings of high-quality liquid assets by over \$1 trillion over the past five years, at the same time as they have substantially reduced their reliance on run-prone sources of funding. Reducing run-risk is a central goal of post-crisis regulation and supervision.

Our examinations have found large and regional banks to be well capitalized. Both large and regional banking organizations have shown improved profitability since the depths of the financial crisis, although these banks have also faced challenges in recent years because of weak growth in interest and noninterest income. Both large and regional institutions have seen robust growth in commercial and industrial lending, which supports sustainable job creation.

Finally, community banks are significantly healthier. More than 95 percent are now profitable, and capital lost during the crisis has been largely replenished. Loan growth is picking up, and problem loans are now at levels last seen early in the financial crisis.

Conclusion

In conclusion, our post-crisis approach to regulation and supervision is both forward-looking and tailored to the level of risk that firms pose to financial stability and the broader economy. Standards for the largest, most complex banking organizations are now significantly more stringent than standards for small and medium-sized banks, which is appropriate given the impact that the failure or distress of those firms could have on the economy. As I have discussed, we anticipate taking additional actions in the near term to further tailor our regulatory and supervisory framework.

Yet even as we finalize the major elements of post-crisis reform, our work is not complete. We must carefully monitor the impact of the regulatory changes we have made and remain vigilant regarding the potential emergence of new risks to financial stability. We must stand ready to adjust our regulatory approach where changes are warranted. The work we do to ensure the financial system remains strong and stable is designed to protect and support the real economy that sustains the businesses and jobs on which American households rely.