Janet L Yellen: Supervision and regulation

Testimony by Ms Janet L Yellen, Chair of the Board of Governors of the Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 4 November 2015.

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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 our most fundamental goals is to promote a financial system that is strong, resilient, and able to serve a healthy and growing economy. We work to ensure the safety and soundness of the firms we supervise and also to ensure that they comply with applicable consumer protection laws, so that they may, even when faced with stressful financial conditions, continue serving consumers, businesses, and communities.

At today's hearing, I would like to discuss the lessons of the financial crisis and how we have transformed our regulatory and supervisory approach. Before the crisis, our primary goal was to ensure the safety and soundness of individual financial institutions. A key shortcoming of that approach was that we did not focus sufficiently on shared vulnerabilities across firms or the systemic consequences of the distress or failure of the largest, most complex firms. In the fall of 2008, the failure or near-failure of several of these firms – many of which we did not supervise at the time – sparked a panic that engulfed the financial system and much of the economy.

Today we aim to regulate and supervise financial firms in a manner that promotes the stability of the financial system as a whole. This shift in focus has led to a comprehensive change in our regulation and supervision of large financial institutions. As I will discuss in more detail, we have introduced a series of requirements for large banking organizations that reduce the risks to the system and our economy that could result from the failure or distress of these institutions. In addition, we have made changes in our supervision that now allow us to supervise large financial institutions on a more coordinated, forward-looking basis.

At the same time, we have been careful to make more-measured changes in our approach to regulating and supervising firms at the other end of the spectrum. Smaller institutions did not emerge from the financial crisis unscathed, and we have identified several areas in which the supervision of these institutions can be strengthened. At the same time, we are well aware that regulatory and compliance costs can impose a burden that is disproportionate to the risks these institutions pose to taxpayers and financial stability. We are committed to ensuring that the supervision of smaller institutions is tailored appropriately to their risk.

Strengthening the regulation and supervision of the largest financial institutions

Regulatory framework

The regulatory reforms we have adopted since the crisis have been designed to address the risks posed by large financial institutions in one of two ways. First, our reforms are designed to reduce the probability that large financial institutions will fail by requiring those institutions to make themselves more resilient to stress. However, we recognize that we cannot eliminate the possibility of a large financial institution's failure. Therefore, a second aim of our post-crisis reforms has been to limit the systemic damage that would result if a large financial institution does fail. This effort has involved taking steps to help ensure that authorities would have the ability to resolve a failed firm in an orderly manner while its critical operations continue to function.

To reduce the probability of a large financial institution's failure, we and the other federal banking agencies have implemented a series of reforms that strengthen the firms we regulate. We have implemented capital rules that require large banking organizations to hold substantially larger amounts of high-quality capital. Working with the other federal banking agencies, we also have adopted a liquidity coverage ratio (LCR) rule that requires large banking organizations to hold a buffer of high-quality liquid assets sufficient to meet net liquidity outflows during a period of severe stress. In addition, the Board has established a broader set of enhanced prudential standards for large domestic and foreign banking organizations pursuant to section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which includes risk-based and leverage capital requirements, liquidity standards, risk-management requirements, and stress testing.[1]

We have also adopted risk-based and leverage capital surcharges for the handful of U.S. firms that we have identified as global systemically important banking organizations (GSIBs), which require these firms to hold larger amounts of loss-absorbing capital than other firms.[2] The U.S. GSIBs are central intermediaries in U.S. financial markets, and their failure or distress would thus likely cause the most harm to the financial system. Under the framework that the Board adopted this summer, a GSIB's risk-based capital surcharge would reflect the effect that its failure would have on the financial system. In effect, the risk-based capital surcharge confronts each U.S. GSIB with a choice: It can hold more capital, or it can reduce its systemic footprint. Although similar to the international risk-based capital surcharge framework that we helped design, the rule adopted by the Board is calibrated at a level that requires U.S. GSIBs to hold significantly more capital than would be required under the international framework. A second important difference between the Board's rule and the international framework is that the Board's rule incorporates a measure of each GSIB's use of short-term wholesale funding, which is a key determinant of a GSIB's systemic footprint.

To limit the systemic effect of a large financial institution's failure, the Board and the Federal Deposit Insurance Corporation (FDIC) have adopted a resolution plan rule that requires large banking organizations to show how they could be resolved in an orderly manner under the bankruptcy code.

Last week the Board proposed another reform that would establish long-term debt and total loss-absorbing capacity (TLAC) requirements for U.S. GSIBs. We see these requirements as critical to avoiding the choice that authorities faced in the most recent crisis between bailing out large financial firms and allowing those firms to fail in a manner that would impose large costs on the broader economy. With the new requirements, if losses were to wipe out a firm's capital and push a firm into resolution, a sufficient amount of long-term unsecured debt would provide a mechanism for absorbing additional losses and recapitalizing the firm without generating contagion across the financial system and damaging the economy. In effect, this requirement provides a means for "bailing in" a firm's long-term debt holders so that a taxpayer bailout will be unnecessary. These requirements also should improve market discipline by ensuring that each GSIB has a class of creditors with clear incentive to monitor the firm's risk-taking.

Supervisory approach

In addition to strengthening the regulation of the largest, most complex financial institutions, we have also transformed our supervision of these firms. Our work is now more forward looking and multidisciplinary, drawing on a wide range of staff expertise. We put this new

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[1] The enhanced prudential standards we have established require foreign banking organizations with large U.S. operations to organize their U.S. subsidiaries under an intermediate holding company. This intermediate holding company requirement provides a basis for regulating and supervising the U.S. operations of foreign banking organizations on a more robust and consistent basis.

[2] The firms currently identified as U.S. GSIBs are Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup, Inc.; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; State Street Corporation; and Wells Fargo & Company.

approach into operation with the creation of the Large Institution Supervision Coordinating Committee (LISCC). The LISCC is charged with the supervision of the firms that pose elevated risk to U.S. financial stability. Those firms include the eight U.S. banking organizations that have been identified as GSIBs, four foreign banking organizations with large and complex U.S. operations, and the four nonbank financial institutions that have been designated as systemically important by the Financial Stability Oversight Council (FSOC).[3] The supervisory approach embodied in the LISCC differs from our more traditional approach to supervision in that it is oriented toward both the safety and soundness of the individual firms, and the stability of the financial system as a whole.[4]

The LISCC program is distinguished by several characteristics. First, the LISCC, led by the Board's director of the Division of Banking Supervision and Regulation, has implemented a more centralized, multidisciplinary supervisory approach by bringing together experts from around the Federal Reserve System in the areas of supervision, research, legal counsel, financial markets, and payments systems. Second, the LISCC takes a forward-looking approach by focusing on capital and liquidity resiliency under normal and potentially adverse conditions in the future as well as governance and recovery and resolution preparedness. And, third, the LISCC complements traditional, firm-specific supervisory work with annual "horizontal" programs that examine the same 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. The Federal Reserve conducts three major horizontal reviews of the LISCC banking firms each year that are focused on capital adequacy, liquidity resiliency, and preparedness for recovery and resolution.

With regard to capital adequacy, the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) is designed to ensure that large U.S. bank holding companies, including the LISCC firms, have rigorous, forward-looking capital planning processes and have sufficient levels of capital to operate through times of stress, as defined by the Federal Reserve's supervisory stress scenario. The program enables us to make a quantitative and qualitative assessment of the resilience and capital planning abilities of the largest banking firms on an annual basis and to limit capital distributions for firms that exhibit weaknesses.

With regard to liquidity resiliency, under the Federal Reserve's Comprehensive Liquidity Analysis and Review (CLAR), LISCC firms are subject to a comprehensive review of their liquidity positions and liquidity risk management, including internal stress-testing practices. Firms with weak liquidity positions or practices are directed to improve those practices and augment their liquidity positions as needed. Similar to CCAR, CLAR is designed to ensure that LISCC firms have rigorous, forward-looking liquidity stress testing and risk-management practices that account for unique risks, and that the LISCC firms maintain sufficient liquidity to continue to operate through a period of acute stress. The program allows the Federal Reserve to compare the range of practices across firms and form a view on liquidity vulnerabilities and funding concentrations in the system as a whole. Unlike CCAR, which currently applies to all firms with $50 billion or more in total assets, only firms within the LISCC portfolio are required to participate in CLAR.

LISCC firms are also subject to an annual review of their recovery and resolution preparedness. The program evaluates progress in implementing operational capabilities and legal entity rationalization that would facilitate recovery or resolution under a range of scenarios and provides the Federal Reserve with the ability to compare progress on recovery

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3 The foreign banking organizations whose U.S. operations are currently supervised as part of the LISCC program are Barclays PLC, Credit Suisse Group AG, Deutsche Bank AG, and UBS AG. The firms designated by the FSOC for supervision by the Federal Reserve are American International Group, Inc.; General Electric Capital Corporation, Inc.; MetLife, Inc.; and Prudential Financial, Inc.

4 Further information on the LISCC, including a full list of the supervised firms, is available on the Board's website at www.federalreserve.gov/bankinforeg/large-institution-supervision.htm.

and resolution planning across firms. We are working with the FDIC to evaluate the GSIBs' most recent resolution plans, which were submitted in July.

As I noted, the LISCC is also responsible for the supervision of nonbank financial companies that have been designated by the FSOC. The Federal Reserve currently conducts active, on-site supervision of all four of the designated firms. We are tailoring our supervisory framework to the specific business lines, risk profiles, and systemic footprints of these firms. Our supervisory efforts to date have focused on strengthening the firms' risk identification, measurement, and management; internal controls; and corporate governance. Our objectives for the designated holding companies are to ensure that the consolidated firms operate safely and soundly and to mitigate risks to financial stability. We coordinate our consolidated supervision of the three designated insurance companies, as well as the other insurance holding companies we supervise, with state insurance regulators, who continue their established oversight of insurance legal entities within the consolidated firms. We do not regulate the manner in which insurance is provided by these companies or the types of insurance they provide. Those important aspects of the firms' activities are the province of state insurance supervisors.

Regulation and supervision of large and regional companies

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 financial stability 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 internationally active banking organizations.[5] We also scale our examination procedures to reflect the lower level of systemic risk presented by non-LISCC companies.

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 recently implemented changes that strengthened the risk-based 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 and evaluate their safety and soundness based on each company's individual circumstances. 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 our regulatory colleagues 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 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

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[5] An "internationally active banking organization" is defined as a banking organization with more than $250 billion in total assets or $10 billion in on-balance-sheet foreign exposure.

the Federal Reserve Bank of San Francisco. In that role, I was responsible for 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 ensure consumer compliance 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 830 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 these institutions, 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 are taking 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 be more forward looking in addressing emerging risks and to ensure that community bank examiners with specialized expertise and experience are allocated to the institutions exhibiting the highest risks. We have also implemented a new risk-focused consumer compliance examination framework 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. And we continue to improve our examiner commissioning training program to ensure that it fully reflects the lessons of the recent crisis.

With the Congress's support, we have also taken action to relieve small holding companies of certain requirements by raising the asset threshold for the Board's Small Bank Holding Company Policy Statement from $500 million to $1 billion, and by applying this statement to small savings and loan holding companies. The Small Bank Holding Company Policy Statement promotes local control of community banking organizations by acknowledging that smaller companies have less access to the capital markets and allowing them to fund acquisitions with a higher level of debt than would otherwise be allowed. We also relieved small holding companies of requirements to comply with consolidated capital requirements, recognizing that their bank subsidiaries make up most of their assets and are already subject to capital rules. In addition, in conjunction with this change, we eliminated quarterly and more detailed consolidated financial reporting requirements for holding companies with less than $1 billion in assets, and instead require parent-only financial statements on a semiannual basis.[6]

Consistent with the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA), the Board is also working with the other federal banking agencies to identify banking regulations that are outdated, unnecessary, or unduly burdensome. As part of the EGRPRA review, the agencies have held several public outreach meetings with bankers, consumer groups, and other stakeholders.[7] Several themes have emerged during the discussions. For example, community bankers in rural areas have noted that it can be difficult to find an appraiser with knowledge about the local housing market at a reasonable fee. Bankers have asked the agencies to consider increasing the dollar threshold for requiring appraisals, which could allow them to use a less formal valuation of collateral for a larger number of mortgage loans. In addition, bankers have raised concerns about the extent of the financial reporting requirements established by the banking agencies. In response, the banking agencies have already taken steps under the auspices of the Federal Financial Institutions Examination

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[6] See Board of Governors of the Federal Reserve System (2015), "Federal Reserve Board Issues Final Rule to Expand Applicability of Small Bank Holding Company Policy Statement and Apply It to Certain Savings and Loan Holding Companies," press release, April 9.

[7] An additional EGRPRA outreach meeting is scheduled to be held in Washington, D.C., on December 2, 2015.

Council to consider options to eliminate or revise Call Report data items and to develop a streamlined reporting form for community banks.[8]

Bankers have also asked whether the agencies could review the statutorily mandated safety-and-soundness examination frequency for banks, which varies based on a bank's asset size and condition, as a way to ease the burden of frequent on-site examinations. Other bankers have commented on the burden associated with recently implemented changes to the capital guidelines and have encouraged the agencies to consider simplifying requirements for community banking organizations.

The Federal Reserve is giving all of these suggestions careful consideration and will be working closely with the other banking agencies in developing a report to the Congress at the conclusion of the EGRPRA review. Given the important role that community banks play in their communities and the economic support they provide across the country, we recognize that our supervision of community banks must be balanced and avoid unnecessarily constraining their activities.

Current conditions

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

The financial condition of the firms in the LISCC portfolio 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 of almost $500 billion. Moreover, these firms generally have much more stable funding positions: The amount of high-quality liquid assets held by the eight U.S. GSIBs has increased by roughly two-thirds since 2012, and their reliance on short-term wholesale funding has dropped considerably. Our new regulatory and supervisory approaches are aimed at helping ensure these firms remain strong. Requiring these firms to plan for an orderly resolution has forced them to think more carefully about the sustainability of their business models and corporate structures.

Nevertheless, while we have seen some evidence of improved risk management, internal controls, and governance at the LISCC firms, they continue to have substantial compliance and risk-management issues. Compliance breakdowns in recent years have undermined confidence in the LISCC firms' risk management and controls and could have implications for financial stability, given the firms' size, complexity, and interconnectedness. The LISCC firms must address these issues directly and comprehensively.

Our examinations have found large and regional banks to be well capitalized. Both large and regional banking organizations experienced dramatic improvements in profitability since the financial crisis, although these banks have also faced challenges in recent years due to weak growth in interest and noninterest income. Both large and regional institutions have seen robust growth in commercial and industrial lending.

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

While more work remains to be done, I hope you will take away from my testimony just how much has changed. Taken as a whole, the reforms we have adopted since the crisis, including those mandated by the Dodd-Frank Act, represent a substantial strengthening of

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8 See Federal Financial Institutions Examination Council (2015), "FFIEC Announces Initiative to Streamline Reporting Requirements for Community Banks," press release, September 8.

the regulatory framework for the largest financial institutions and should help ensure that the U.S. financial system remains able to fulfill its vital role of supporting the economy. Our supervisory approach is more comprehensive and forward looking while also tailored to fit the level of oversight to the risks and scope of the institution.

We know our work is not complete. In the coming year we anticipate moving forward on other rulemaking initiatives that will complement the steps we have already taken. The Federal Reserve is committed to remaining vigilant, diligent, and forward looking as a regulator and supervisor of the financial institutions that serve our economy. We will do everything we can to fulfill the responsibility that has been entrusted to us by the Congress and the American public.

Thank you. I would be pleased to respond to your questions.