Jeremy Powell: Relationship between regulation and economic growth

Speech by Mr Jerome H Powell, Member of the Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 22 June 2017.

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Chairman Crapo, Ranking Member Brown, and members of the committee, I appreciate the opportunity to testify at today's hearing on the relationship between regulation and economic growth. We need a resilient, well-capitalized, well-regulated financial system that is strong enough to withstand even severe shocks and support economic growth by lending through the economic cycle. The Federal Reserve has approached the post-crisis regulatory and supervisory reforms with that outcome in mind.

As a result of an improving economy and actions taken by both the federal regulators and the industry, the U.S. financial system is substantially stronger and more stable than it was before the financial crisis erupted nearly a decade ago. In this testimony, I will highlight the considerable gains made since the crisis and reflect on the principles that should guide us in the next phase. I will also discuss some specific actions that align with these principles that we have recently taken or expect to take that are designed to reduce regulatory burden without compromising safety and soundness and financial stability.

Post-crisis regulatory and supervisory reform

There is little doubt that the U.S. financial system is stronger today than it was a decade ago. As I will discuss, loss-absorbing capacity among banks is substantially higher. The banking industry, and the largest banking firms in particular, face far less liquidity risk than before the crisis. And progress in resolution planning by the largest firms has reduced the threat that their failure would pose. These efforts have made U.S. banking firms both more robust and more resolvable. And history shows that when U.S. banking firms are financially strong, they are able to better serve their customers.

Today I will highlight developments in the four key regulatory areas designed to improve and maintain the resiliency of the banking industry: capital, stress testing, liquidity, and resolution planning.

Regulatory capital reforms

The U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system. High-quality common equity tier 1 capital (CET1) is important because it is available under all circumstances to absorb losses.

Since the financial crisis, U.S. banks have been required to meet new minimum requirements for CET1 to ensure a base of protection against losses. U.S. banks also have been required to meet capital conservation buffers that incentivize banking firms to keep their capital levels well above the minimums in order to maintain full flexibility to allocate profits to shareholders and employees. For the U.S. global systemically important banks (G-SIBs), we have also imposed an additional capital surcharge designed to reduce the threat that a failure of any of these firms would pose to financial stability.

Stress testing

The Federal Reserve also conducts the Comprehensive Capital Analysis and Review (CCAR), a...
stress test that assesses whether large banking firms have enough capital to withstand severely adverse macroeconomic and financial market stress. We also use this process to assess the quality of the capital planning processes of large banking firms. The U.S. bank holding companies (BHCs) subject to CCAR have more than doubled the dollar amount of their CET1 from around $500 billion in 2009 to $1.2 trillion in the first quarter of 2017, and have more than doubled their CET1 risk-based capital ratios from 5.5 percent to 12.4 percent over that period.

**Liquidity regulation reforms**

The banking agencies have also required large banking firms to substantially reduce their liquidity risk. Our key reforms in this area include a liquidity coverage ratio (LCR) that requires large banking firms to keep enough high-quality liquid assets (HQLA) to meet net stressed cash outflows over a 30-day period. The Federal Reserve has also adopted the Comprehensive Liquidity Analysis and Review (CLAR) supervisory program for evaluating the liquidity of the most systemic banking firms. In addition, the banking agencies have proposed a net stable funding ratio (NSFR) regulation that would help ensure that large banking firms maintain a stable funding profile over a one-year horizon.

Liquidity positions within the U.S. banking system have improved substantially since the financial crisis. The U.S. G-SIBs increased their holdings of HQLA from about $1.5 trillion to about $2.3 trillion between 2011 and the first quarter of 2017. The same institutions have also reduced their reliance on short-term wholesale funding from approximately 35 percent of assets in 2006 to about 15 percent of assets today.

**Large bank resolvability reforms**

As required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Federal Reserve has been working with the Federal Deposit Insurance Corporation (FDIC) to improve resolution planning by banks. Through thoughtful resolution planning, firms can reduce the risk that their failure would have disruptive effects on the financial system and the economy. The resolution planning process has caused the largest U.S. banking firms to substantially improve their internal structures, governance, information collection systems, and allocation of capital and liquidity in ways that both promote resolvability. The Federal Reserve also has helped improve the resolvability of the largest banking firms by requiring U.S. G-SIBs and the U.S. intermediate holding companies of foreign G-SIBs to meet long-term debt and total loss absorbing capacity (TLAC) requirements.

**Effect of regulation on U.S. banks**

Evidence overwhelmingly shows that financial crises can cause severe and lasting damage to the economy’s productive capacity and growth potential. Post-crisis reforms to financial sector regulation and supervision have been designed to significantly reduce the likelihood and severity of future financial crises. We have sought to accomplish this goal in significant part by reducing both the probability of failure of a large banking firm and the consequences of such a failure were it to occur. We have substantially increased the capital, liquidity, and other prudential requirements for large banking firms, and these increases are not free. Stronger capital requirements increase bank costs, and at least some of those costs are passed along to bank customers. But in the longer term, stronger prudential requirements for large banking firms will produce more sustainable credit availability and economic growth. Our objective should be to set capital and other prudential requirements for large banking firms at a level that protects financial stability and maximizes long-term, through-the-cycle credit availability and economic growth.

**Guiding principles to simplify and reduce regulatory burden**

As we near completion of the major post-crisis regulatory reforms, this is a good time to assess the effectiveness and efficiency of these reforms. Several principles are guiding us in this effort.
First, we should protect the core elements of the reforms for our largest banking firms in capital regulation, stress testing, liquidity regulation, and resolvability. Second, we should continue to tailor our requirements to the size, risk, and complexity of the firms subject to those requirements. In particular, we should always be aware that community banks face higher costs to meet complex requirements. Third, we should assess whether we can adjust regulation in common-sense ways that will simplify rules and reduce unnecessary regulatory burden without compromising safety and soundness. And finally, we should strive to provide appropriate transparency to supervised firms and the public regarding our expectations.

**Areas of focus for recalibration and simplification**

**Small and medium bank regulatory simplification**

Over the course of the last year, the Federal Reserve and the other U.S. banking agencies finalized significant burden-reducing measures for smaller banks. The banking agencies significantly streamlined Call Report requirements for banks with less than $1 billion in total assets. This streamlined Call Report resulted in 24 fewer pages than the previous total of 85, and reduced data items required to be reported by small banks by 40 percent. The banking agencies also increased the number of institutions eligible for 18-month cycles for safety and soundness and Bank Secrecy Act exams. And the Federal Reserve implemented a desirable statutory change to raise the threshold of its Small Bank Holding Company Policy Statement from $500 million to $1 billion in assets.

In addition, earlier this year, the U.S. banking agencies issued a report under the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) that outlined additional measures that the agencies committed to completing to reduce regulatory burden. Perhaps most notably, the agencies committed to developing a proposal to simplify the generally applicable capital framework that applies to community banking organizations. Among other things, this proposal is being designed to simplify the current regulatory capital treatment of commercial real estate exposures, mortgage-servicing assets, and deferred tax assets. The agencies would seek industry comment on the proposal through the normal notice and comment process. The agencies also expect to further reduce burden on small banks by additional streamlining of Call Reports.

The Federal Reserve has also supported increases in various statutory thresholds in the Dodd-Frank Act to more narrowly focus financial stability reforms on larger banking firms. For example, we believe that small banking organizations could be exempted from the Volcker rule and from the incentive compensation requirements of the Dodd-Frank Act. We also would support an increase in the $10 billion Dodd-Frank Act asset threshold for company-run stress tests and risk committee requirements, and in the $50 billion threshold for enhanced prudential standards under section 165 of the Dodd-Frank Act.

**Resolution plans**

The U.S. G-SIBs have made substantial progress in improving their resolvability and have taken concrete steps to implement important organizational, governance, and operational measures developed in the course of their resolution planning exercises. These firms will be filing new plans on July 1 that should incorporate agency feedback and guidance. The Federal Reserve and FDIC will engage in a full review of these plans.

We are exploring with the FDIC ways to improve the resolution planning process. We believe it is worthwhile to consider extending the cycle for living will submissions from annual to once every two years, and focusing every other of these filings on key topics of interest and material changes from the prior full plan submission. In addition, there may be opportunities to greatly reduce the submission requirements for a large number of firms due to their relatively small, simple, and domestically focused activities. Such an approach could limit full plan filing
requirements to firms that are large, complex, or have systemically critical operations.

**Volcker rule**

The Federal Reserve is reassessing whether the Volcker rule implementing regulation most efficiently achieves its policy objectives, and we look forward to working with the other four Volcker rule agencies to find ways to improve the regulation. In our view, there is room for eliminating or relaxing aspects of the implementing regulation that do not directly bear on the Volcker rule’s main policy goals. We also believe it would be constructive for Congress to consider focusing the Volcker rule on entities with significant trading books and eliminating the requirement that smaller firms be subject to the rule. In the meantime, we believe that it is worthwhile for the agencies to consider further tailoring of the implementing rule as it applies to smaller firms and firms with small trading books, and to consider ways to streamline or reduce the paperwork and reporting burden associated with the rule.

**Enhancements to stress testing and CCAR**

The Federal Reserve is committed to increasing the transparency of the stress testing and CCAR processes. We will soon seek public feedback concerning possible forms of enhanced disclosure. One such disclosure would be a range of indicative loss rates predicted by the Federal Reserve’s models for various loan and securities portfolios. We would also disclose more information about risk characteristics that contribute to the loss-estimate ranges.

When we release CCAR results next week, we will disclose more detailed information on CCAR’s qualitative assessment. We will also publish a document later this year summarizing the performance of the industry on qualitative matters. Many of our largest banking firms have made substantial progress toward meeting supervisory expectations for capital planning. If that progress continues, I believe it will be appropriate to consider removing the qualitative objection from CCAR for those firms that achieve and sustain high-quality capital planning capabilities. We would continue to assess the capital planning practices of these firms as part of our ongoing supervisory processes. I would also see it as appropriate to adjust CCAR’s assumptions regarding the balance sheet and capital distributions. These adjustments would take place in conjunction with the integration of the stress test into a firm’s regulatory capital requirements.

**Leverage ratio**

In light of the substantial progress in the build-out of our overall regulatory capital and stress testing frameworks over the past few years, the Federal Reserve is taking a fresh look at the enhanced supplementary leverage ratio. We believe that the leverage ratio is an important backstop to the risk-based capital framework, but that it is important to get the relative calibrations of the leverage ratio and the risk-based capital requirements right. Doing so is critical to mitigating any perverse incentives and preventing distortions in money markets and other safe asset markets. Changes along these lines also could address concerns of custody banks that their business model is disproportionately affected by the leverage ratio.

**Conclusion**

U.S. banks today are as strong as any in the world, as shown by their solid profitability and healthy lending over recent years. As we consider the progress that has been achieved in improving the resiliency and resolvability of our banking industry, it is important for us to look for ways to reduce unnecessary burden. We must also be vigilant against new risks that may develop. In all of our efforts, our goal is to establish a regulatory framework that helps ensure the resiliency of our financial system, the availability of credit, economic growth, and financial market efficiency. We look forward to working with our fellow regulatory agencies and with Congress to achieve these important goals.