STATEMENT OF

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on

IMPLEMENTING WALL STREET REFORM:
ENHANCING BANK SUPERVISION AND REDUCING SYSTEMIC RISK

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
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Chairman Johnson, Ranking Member Shelby and members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's efforts to enhance bank supervision and reduce systemic risk. I will summarize the FDIC's progress in implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), with a particular emphasis on the FDIC's implementation of the Title II Orderly Liquidation Authority, as well as how new rules promulgated under the Act affect community banking institutions. Before concluding, I will also briefly address the implications of the recent trading losses at JPMorgan Chase.

Implementation of the Dodd-Frank Act: Measures to Address Systemic Risk

The economic dislocations we have experienced in recent years, which have far exceeded those associated with any recession since the 1930s, were the direct result of the financial crisis of 2007-08. The reforms enacted under the Dodd-Frank Act were aimed at addressing the root causes of the crisis. Foremost among these reforms were measures to curb excessive risk-taking at large, complex banks and non-bank financial companies, where the crisis began. Title I of the Dodd-Frank Act includes new provisions that enhance prudential supervision and capital requirements for systemically-important financial institutions (SIFIs), while Title II authorizes a new orderly liquidation authority that significantly enhances the ability to resolve a failed SIFI without contributing to additional financial market distress.

SIFI Resolution Authorities The most important new FDIC authorities under the Dodd-Frank Act are those that provide for enhanced resolution planning and, if needed, the orderly resolution of SIFIs. Prior to the recent crisis, the FDIC's receivership authorities were limited to federally insured banks and thrift institutions. There was no authority to place the holding company or affiliates of an insured institution or any other non-bank financial company into an FDIC receivership to avoid systemic consequences. The lack of this authority severely constrained the ability of the government to resolve a SIFI and contributed to the excessive risk taking that led to the crisis.

Since passage of the Dodd-Frank Act, the FDIC has taken a number of steps to carry out its new systemic resolution responsibilities. First, the FDIC established a new Office of Complex Financial Institutions (OCFI) to carry out three core functions:

- monitor risk within and across these large, complex financial firms from the standpoint of resolutions and risk to the Deposit Insurance Fund;
- conduct resolution planning and develop strategies to respond to potential crises; and
- coordinate with regulators overseas regarding the significant challenges associated with cross-border resolution.

For the past year, the OCFI has been developing internal resolution plans in order to be ready to resolve a failing systemic financial company. These internal FDIC resolution plans, developed pursuant to the Orderly Liquidation Authority provided under Title II of the Dodd-Frank Act, apply many of the same powers that the FDIC has long used to manage failed-bank receiverships to a failing SIFI. This internal resolution planning work is the foundation of the FDIC's implementation of its new resolution responsibilities under the Dodd-Frank Act.

The FDIC has largely completed the basic rulemaking necessary to carry out its responsibilities under the Dodd-Frank Act. In July of last year, the FDIC Board approved a final rule implementing the Title II Orderly Liquidation Authority. This rulemaking addressed, among other things, the priority of claims and the treatment of similarly situated creditors. Last September, the FDIC Board adopted two rules regarding resolution plans that systemically important financial institutions themselves will be required to prepare – the so-called "living wills." The first resolution plan rule, jointly issued with the Federal Reserve Board, requires bank holding companies with total consolidated assets of $50 billion or more, and certain nonbank financial companies that the Financial Stability Oversight Council (FSOC) designates as systemic, to develop, maintain and periodically submit resolution plans to regulators.

Complementing this joint rulemaking, the FDIC also issued another rule requiring any FDIC-insured depository institution with assets over $50 billion to develop, maintain and periodically submit plans outlining how the FDIC would resolve the institution through the traditional resolution powers under the Federal Deposit Insurance Act. These two resolution plan rulemakings are designed to work in tandem and complement each other by covering the full range of business lines, legal entities and capital-structure combinations within a large financial firm. Both of these resolution plan requirements will improve efficiencies, risk management and contingency planning at the institutions themselves. Importantly, they will supplement the FDIC's own resolution planning work with information that would help facilitate an orderly resolution in the event of failure. With the joint rule final, the FDIC and the Federal Reserve Board have started the process of engaging with individual companies on the preparation of their resolution plans. The first plans, for companies with non-bank assets over $250 billion, are due in July.

Section 210 of the Dodd-Frank Act requires the FDIC to "coordinate, to the maximum extent possible" with appropriate foreign regulatory authorities in the event of a resolution of a covered financial company with cross-border operations. The FDIC has been working diligently on both multilateral and bilateral bases with our foreign counterparts in supervision and resolution to address these crucial cross-border issues.

The FDIC has participated in the work of the Financial Stability Board through its membership on the Resolution Steering Group, the Cross-border Crisis Management Group and a number of technical working groups. The FDIC also has co-chaired the Basel Committee's Cross-border Bank Resolution Group since its inception in 2007. Since the internationally active SIFIs (termed Global- or G-SIFIs) present complex international legal and operational issues, the FDIC is also actively reaching out on a bilateral basis to the foreign supervisors and resolution authorities with jurisdiction over the foreign operations of key U.S. firms. The goal is to be prepared to address issues regarding cross-border regulatory requirements and to gain an in-depth understanding of cross-border resolution regimes and the concerns that face our international counterparts in approaching the resolution of these large international organizations. As we evaluate the opportunities for cooperation in any future resolution, and the ways that such cooperation will benefit creditors in all countries, we are forging a more collaborative process as well as laying the foundation for more reliable cooperation based on mutual interests in national and global financial stability.

Although U.S. SIFIs have foreign operations in dozens of countries around the world, those operations tend to be concentrated in a relatively small number of key foreign jurisdictions, particularly the United Kingdom (U.K.). While the challenges to cross-border resolution are formidable, they may be more amenable than is commonly thought to effective management through bilateral cooperation.

The focus of our bilateral discussions is to: (i) identify impediments to orderly resolution that are unique to specific jurisdictions and discuss how to mitigate such impediments through rule changes or bilateral cooperation and (ii) examine possible resolution strategies and practical issues related to implementation of such strategies with respect to particular jurisdictions. This work entails gaining a clear understanding of how U.S. and foreign laws governing cross-border companies will interact in any crisis. Our initial work with foreign authorities has been encouraging. In particular, the U.S. financial regulatory agencies have made substantial progress with authorities in the U.K. in understanding how possible U.S. resolution structures might be treated under existing U.K. legal and policy frameworks. We have engaged in in-depth examinations of potential impediments to efficient resolutions and are, on a cooperative basis, in the process of exploring methods of resolving them.

To facilitate bilateral discussions and cooperation, the FDIC is negotiating the terms of memoranda of understanding pertaining to resolutions with regulators in various countries. These memoranda of understanding will provide a formal basis for information sharing and cooperation relating to our resolution planning and implementation functions under the legal framework of the Dodd-Frank Act.

Financial Stability Oversight Council (FSOC) The FSOC, chaired by the Secretary of the Treasury and comprising all of the key federal financial regulatory bodies, was designed to fill the gaps in oversight between existing regulatory jurisdictions and create common accountability for identifying and constraining risks to the financial system as a whole. Among other requirements, the Dodd-Frank Act directs the FSOC to facilitate regulatory coordination and information sharing among its members regarding policy development, rulemaking, supervisory information, and reporting requirements. The FSOC is also responsible for determining whether a nonbank financial company should be supervised by the Federal Reserve Board and subject to prudential standards, and for designating financial market utilities and payment, clearing, or settlement activities that are, or are likely to become, systemically important. On April 3, 2012, the FSOC unanimously approved a final rule and interpretive guidance that details the process and analytical framework for evaluating whether a nonbank financial company should be subject to supervision by the Federal Reserve Board and be subject to enhanced prudential standards (including the requirement to prepare resolution plans). On May 22, 2012, the FSOC adopted procedures governing the conduct of hearings in connection with proposed determinations and other related actions under Titles I and VIII of the Act. Additionally, on May 22, the FSOC voted to propose the preliminary designation of an initial set of financial market utilities. After those entities are provided with an opportunity for a hearing, the FSOC will be asked to vote on the final designation of those entities.

The Volcker Rule The Dodd-Frank Act requires the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission and the federal banking agencies to adopt regulations generally prohibiting proprietary trading and certain acquisitions of interest in hedge funds or private equity funds.

Last November, the FDIC, jointly with the Federal Reserve Board, the OCC, and the SEC, published a notice of proposed rulemaking (NPR) requesting public comment on a proposed regulation implementing the Volcker Rule requirements of the Dodd-Frank Act. In December, the comment period was extended to allow interested persons more time to analyze the issues and prepare their comments, and to facilitate coordination of the rulemaking among the responsible agencies.

The proposed rule also requires banking entities with significant covered trading activities to furnish periodic reports with quantitative measurements designed to help differentiate permitted market-making-related activities from prohibited proprietary trading. Under the proposed rule these requirements contain important exclusions for banking organizations with trading assets and liabilities less than $1 billion, and reduced reporting requirements for organizations with trading assets and liabilities of less than $5 billion. These thresholds are designed to reduce the burden on smaller, less complex banking entities, which generally engage in limited market-making and other trading activities.

The Agencies have requested comments on whether the proposed rule represents a balanced and effective approach in implementing the Volcker provision or whether alternative approaches exist that would provide greater benefits or implement the statutory requirements with fewer costs. The FDIC is committed to developing a final rule that meets the objectives of the statute while preserving the ability of banking entities to perform important underwriting and market-making functions, including the ability to effectively carry out these functions in less-liquid markets. Most community banks do not engage in trading activities that would be subject to the proposed rule.

Implementation of the Dodd-Frank Act: Community Banks

In addition to the provisions relevant to systemic risk, the Dodd-Frank Act also contains a number of other provisions that may have a more direct effect on community institutions. For example, the Dodd-Frank Act made changes to the FDIC's deposit insurance program, which were implemented soon after enactment, that generally work to the benefit of community institutions. The first of these was the rule to implement the Act's provision to permanently increase the insurance coverage limit to $250,000, the level that had already been introduced on a temporary basis during the crisis. The FDIC has also implemented the Dodd-Frank Act requirement to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. This change in the assessment base shifted some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions - but did so without affecting the overall amount of assessment revenue collected. The result has been a sharing of the assessment burden that better reflects each group's share of industry assets. When this provision was implemented in the second quarter of last year, aggregate premiums paid by institutions with less than $10 billion in assets declined by approximately 33 percent, primarily as a result of the base change.

As of March 31, 2012, the Deposit Insurance Fund (DIF) reserve ratio stood at 0.22 percent of estimated insured deposits, up from -0.02 percent a year earlier. The Dodd-Frank Act raised the minimum reserve ratio for the DIF from 1.15 percent to 1.35 percent, and requires that the reserve ratio reach 1.35 percent by September 30, 2020. The FDIC is currently operating under a DIF Restoration Plan that is designed to meet this deadline. However, the Dodd-Frank Act also specifically requires the FDIC to provide an offset to institutions with total consolidated assets of less than $10 billion to relieve them of the extra cost of increasing the reserve ratio from 1.15 percent to 1.35 percent.

A number of community bankers have expressed specific concerns about certain Dodd-Frank Act requirements that they believe would particularly impact them. For example, a number of community bankers have expressed concerns about the provisions of Title XIV that deal with real estate appraisal activities. The Federal Reserve Board implemented these provisions by an interim rule in late 2010 that prohibits coercion or conflicts of interest that could compromise the independent judgment of appraisers and prohibits the extension of credit if coercion or conflicts of interest are suspected to have influenced an appraisal. The banking agencies followed by issuing joint guidance describing supervisory expectations for appraisals under the new rules. The guidelines clarify standards for the appropriate use of analytical methods, the criteria for selecting appraisers, and the independence of the appraisal process. Under the guidelines, institutions also are responsible for monitoring and periodically updating valuations of collateral for existing real estate loans and for transactions, such as modifications and workouts.

The banking agencies have received a number of formal and informal communications from bankers citing concerns about the new appraisal guidelines. Of particular concern are the requirements to update valuations for existing real estate loans. This is deemed a best practice for evaluating and monitoring the risk of loans. However, the agencies clarified in the guidance that working with the borrower, particularly as the recovery takes hold, is encouraged. To that end, if no new funds are advanced in a modification, a formal appraisal is not required.

The agencies are still in the process of writing proposed rules for higher risk mortgages and proposed rules for automated loan valuations and registration requirements for the appraisal management companies. The agencies are aware of the potential impact these rulemakings could have on the industry and have met with small business representatives and other industry segments in advance of writing the rules to hear their concerns firsthand. The agencies strongly encourage the public to comment on the proposed rules when they are issued for comment.

Another area of concern for community bankers is the new mortgage escrow requirement. The wave of subprime and nontraditional mortgage lending that led to the crisis frequently included loans where escrow accounts for property taxes and insurance were not maintained. The failure to set aside funds in escrow has been cited as contributing to the financial distress of borrowers when their loans became delinquent. Accordingly, the Dodd-Frank Act directed the Federal Reserve Board to issue new proposed rules that require the establishment of escrow accounts for many closed-end first and second mortgage loans, expand the minimum mandatory period for escrow accounts, and establish new disclosure requirements in this area.

While the new rule directly addresses one of the structural weaknesses in the risky loans that led to the crisis, community bankers have expressed concerns about applying these same requirements to what they say are lower-risk mortgage loans that they hold in portfolio. In many cases, bankers say they hold too few such loans or loans of such small size that the fixed cost of setting up an escrow account would be prohibitive - and they would cease originating such loans for their customers. We have shared the concerns we have heard from community bankers with the Consumer Financial Protection Bureau and they are expected to issue a final rule on this topic later this year.

FDIC Community Banking Initiatives

During a period with significant economic challenges and many regulatory changes, it is natural for community bankers to reflect on their future role in the financial marketplace. As noted above, many community bankers have expressed concerns that the Dodd-Frank Act reforms will adversely affect their ability to compete with larger banks and non-bank competitors. The FDIC takes these concerns seriously. As the lead federal regulator for the majority of community banks in the United States and the insurer of all, it is incumbent on us to better understand the role of community banks in our economy and the particular challenges they face in the financial marketplace.

This is why the FDIC is undertaking a series of initiatives related to the future of community banks. We began this effort with a conference at our Arlington, Virginia training facility in February, where we received a great deal of useful input on the regulatory and competitive challenges currently facing the industry. We are also in the process of holding a series of roundtables with groups of community bankers in each of the FDIC's six regions around the country. At these roundtables, I am joined by the FDIC's senior executives for supervision so that we can hear first-hand about the concerns of bankers and what the FDIC can do to respond to those concerns. The roundtables are proving to be productive and frank discussions. In my experience, community bankers are not shy about expressing their views, and we appreciate receiving their ideas and input.

Even with all the attention community banking issues have received in recent years, there remains a need for more thoughtful and careful research and analysis about the role that community banks play in the U.S. financial system. As part of our initiative, the FDIC's Division of Insurance and Research also is undertaking a comprehensive review of the evolution of community banking in the United States over the past twenty-five years. Our hope is that this study will identify the key challenges facing community banks as well as stories of successful community bank business models and will provide an analysis that may be useful for community banks going forward.

Additionally, I have asked the Directors of the FDIC's Division of Risk Management Supervision and Division of Depositor and Consumer Protection to review the examination process for both risk management and compliance supervision, as well as to review how we promulgate and release rulemakings and guidance, to see if we can improve our processes and communications in ways that benefit community banks, while maintaining our supervisory standards.

Amid the challenging economic conditions of the past few years, the FDIC's examination program has continued to strive for a balanced approach. During each bank examination, our supervisory staff conducts a fact-based review of an institution's financial risk, the quality of its assets, and conformance with bank regulations. Care is taken to ensure national consistency. We make sure that examiners follow prescribed procedures and FDIC policy through our national training program and commissioning process, through internal quality reviews, and with ongoing communication at every level of our supervision staff.

In addition, we also strive to ensure that our examiners understand and follow the FDIC's policies with regard to lending to creditworthy borrowers. The FDIC has adopted supervisory policies and issued several directives that encourage the institutions to lend to creditworthy borrowers. We recognize that safe and sound banking is not an end in itself but a means to an end, which is to ensure that FDIC-insured institutions can be consistent sources of credit for our economy across the business cycle.

Trading Losses at JPMorgan Chase

The recent losses at JPMorgan Chase revealed certain risks that reside within large and complex financial institutions. They also highlighted the significance of effective risk controls and governance at these institutions. As the deposit insurer and backup supervisor of JPMorgan Chase, the FDIC staff work through the primary federal regulators to obtain information necessary to monitor the risk within the institution. The FDIC is currently working with JPMorgan Chase's primary federal regulators, the OCC and the Federal Reserve System, as well as the institution itself, to investigate both the circumstances that led to the losses and the institution's ongoing efforts to manage the risks at the firm. Following this review, we expect to work with the primary regulators to address inadequate risk management practices that are identified.

Conclusion

Significant progress has been made in implementing the financial reforms authorized by the Dodd-Frank Act. The FDIC has completed the core rulemakings for carrying out its lead responsibilities under the Act regarding deposit insurance and systemic resolution.

Successful implementation of the Act will provide a foundation for a financial system that is more stable and less susceptible to crises, and a regulatory system that is better able to respond to future crises.