

**STATEMENT OF**

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**on**

**MITIGATING SYSTEMIC RISK THROUGH WALL STREET REFORM**

**COMMITTEE ON BANKING, HOUSING, AND  
URBAN AFFAIRS  
U.S. SENATE**

**July 11, 2013  
538 Dirksen Senate Office Building**

Chairman Johnson, Ranking Member Crapo and members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's (FDIC) actions to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

With the three-year anniversary of the Dodd-Frank Act approaching, the FDIC has made significant progress in implementing the new authorities granted by the Act,<sup>1</sup> particularly with regard to the authorities to address the issues presented by institutions that pose a risk to the financial system. We also have moved forward in our efforts to strengthen the Deposit Insurance Fund and to improve the resiliency of the capital framework for the banking industry.

My written testimony will address three key areas. First, I will provide a brief overview of the current state of the banking industry and the federal deposit insurance system. Second, I will provide an update on our progress in implementing the new authority provided to the FDIC to address the issues posed by systemically important financial institutions. Finally, I will discuss the Act's impact on our supervision of community banks.

## **Overview of the Banking Industry**

The financial condition of the banking industry in the United States has experienced three consecutive years of gradual but steady improvement. Industry

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<sup>1</sup> A summary of the FDIC's progress implementing the provisions of the Dodd-Frank Act is attached to this testimony.

balance sheets have been strengthened and capital and liquidity ratios have been greatly improved.

Industry net income has now increased on a year-over-year basis for 15 consecutive quarters. FDIC-insured commercial banks and savings institutions reported aggregate net income of \$40.3 billion in the first quarter of 2013, a \$5.5 billion (15.8 percent) increase from the \$34.8 billion in profits that the industry reported in the first quarter of 2012. Half of the 7,019 FDIC-insured institutions reporting financial results had year-over-year increases in their earnings. The proportion of banks that were unprofitable fell to 8.4 percent, down from 10.6 percent a year earlier.

Credit quality for the industry also has improved for 12 consecutive quarters. Delinquent loans and charge-offs have been steadily declining for over two years. Importantly, loan balances for the industry as a whole have now grown for six out of the last eight quarters. These positive trends have been broadly shared across the industry, among large institutions, mid-size institutions, and community banks.

The internal indicators for the FDIC also have been moving in a positive direction over this period. The number of banks on the FDIC's "Problem List" – institutions that had our lowest supervisory CAMELS ratings of 4 or 5 – peaked in March of 2011 at 888 institutions. By the end of last year, the number of problem banks stood at 651 institutions, dropping further to 612 institutions at the end of the first quarter 2013. In addition, the number of failed banks has been steadily declining. Bank failures peaked at

157 in 2010, followed by 92 in 2011, and 51 in 2012. To date in 2013, there have been 16 bank failures compared to 31 through the same period in 2012.

Despite these positive trends, the banking industry still faces a number of challenges. For example, although credit quality has been improving, delinquent loans and charge-offs remain at historically high levels. In addition, tighter net interest margins and relatively modest loan growth have created incentives for institutions to reach for yield in their loan and investment portfolios, heightening their vulnerability to interest rate risk and credit risk. Rising rates could heighten pressure on earnings at financial institutions that are not actively managing these risks. The federal banking agencies have reiterated their expectation that banks manage their interest rate risk in a prudent manner, and supervisors continue to actively monitor this risk.

#### Condition of the FDIC Deposit Insurance Fund

As the industry has recovered over the past three years, the Deposit Insurance Fund (DIF) also has moved into a stronger financial position.

#### *Restoring the DIF*

The Dodd-Frank Act raised the minimum reserve ratio for the DIF (the DIF balance as a percent of estimated insured deposits) from 1.15 percent to 1.35 percent, and required 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, and the DIF reserve ratio is recovering at a pace that remains on track under the Plan. As

of March 31, 2013, the DIF reserve ratio stood at 0.59 percent of estimated insured deposits, up from 0.44 percent at year-end 2012 and 0.22 percent at March 31 of last year. Most of the first quarter 2013 increase in the reserve ratio can be attributed to the expiration of temporary unlimited deposit insurance coverage for noninterest-bearing transaction accounts under the Act on December 31, 2012

The fund balance has grown for thirteen consecutive quarters and stood at \$35.7 billion at March 31, 2013. This is in contrast to the negative \$21 billion fund balance at its low point at the end of 2009. Assessment revenue and fewer anticipated bank failures have been the primary drivers of the growth in the DIF balance.

#### *Prepaid Assessments*

At the end of 2009, banks prepaid to the FDIC more than three years of estimated deposit insurance assessments, totaling \$45.7 billion. The prepaid assessments were successful in ensuring that the DIF had adequate liquidity to handle a high volume of bank failures without having to borrow from the Treasury. In accordance with the regulation implementing the prepaid assessment, the FDIC refunded almost \$6 billion in remaining unused balances of prepaid assessments to approximately 6,000 insured institutions at the end of June.

## **Improving Financial Stability and Mitigating Systemic Risk**

### Capital Requirements

On July 9, the FDIC Board acted on two important regulatory capital rulemakings. First, the FDIC issued an interim final rule that significantly revises and strengthens risk-based capital regulations through implementation of Basel III. This rule consolidates the proposals issued in the three separate notices of proposed rulemakings (NPRs) that the agencies issued last year and includes significant changes from the original proposals to address concerns raised by community banks. Second, the FDIC issued a joint interagency NPR to strengthen the leverage requirements for systemically important banking organizations.

### *Interim Final Rule on Basel III*

The interim final rule on Basel III would strengthen both the quality and quantity of risk-based capital for all banks by placing greater emphasis on Tier 1 common equity capital. Tier 1 common equity capital is widely recognized as the most loss-absorbing form of capital. The interim final rule adopts with revisions the three notices of proposed rulemakings or NPRs that the banking agencies proposed last year. These are the Basel III NPR, the Basel III advanced approaches NPR, and the so-called Standardized Approach NPR. These changes will create a stronger, more resilient industry better able to withstand environments of economic stress in the future.

This interim final rule is identical in substance to the final rules issued by the Federal Reserve Board and the Office of the Comptroller of the Currency (OCC) and

allows the FDIC to proceed with the implementation of these revised capital regulations in concert with our fellow regulators. Issuing the interim final rule also allows us to seek comment on the interactions between the revised risk-based capital regulations and the proposed strengthening of the leverage requirements for the largest and most systemically important banking organizations which is described in more detail below.

During the comment period on these proposals, we received a large number of comments, particularly from community banks, expressing concerns with some of the provisions of the NPRs. The interim final rule makes significant changes to aspects of the NPRs to address a number of these community bank comments. Specifically, unlike the NPR, the rule does not make any changes to the current risk-weighting approach for residential mortgages. It allows for an opt-out from the regulatory capital recognition of accumulated other comprehensive income, or AOCI, except for large banking organizations that are subject to the advanced approaches requirements. Further, the rule reflects that the Federal Reserve has adopted the grandfathering provisions of section 171 of the Dodd Frank Act for Trust Preferred Securities issued by smaller bank holding companies. Comments received on all these matters were extremely helpful to the agencies in reaching decisions on the proposals.

The interim final rule includes requirements for large banking organizations subject to the advanced approaches requirements that do not apply to community banks. For example, these advanced approach large institutions would be required to recognize

AOCI in regulatory capital and also would face strengthened capital requirements for over-the-counter derivatives.

Consistent with the Basel III international agreement, the interim final rule includes a three percent supplementary leverage ratio that applies only to the 16 large banking organizations subject to the advanced approaches requirements. This supplementary leverage ratio is more stringent than the existing U.S. leverage ratio as it would include certain off-balance sheet exposures in its denominator. Given the extensive off-balance sheet activities of many advanced approaches organizations, the supplementary leverage ratio will play an important role. Finally, the rule maintains the existing U.S. leverage requirements for all insured banks, with the minimum leverage requirements continuing to set a floor for the leverage requirements of advanced approaches banking organizations.

Although the new requirements are higher and more stringent than the old requirements, the vast majority of banks meet the requirements of the interim final rule. Going forward, the rule would have the effect of preserving and maintaining the gains in capital strength the industry has achieved in recent years. As a result, banks should be better positioned to withstand periods of economic stress and serve as a source of credit to local communities.

While much contained in these rules does not apply to community banks, we want to be certain that community banks fully understand the changes in the capital rules that



do apply to them. To that end, the FDIC is planning an extensive outreach program to assist community banks in understanding the interim final rule and the changes it makes to the existing capital requirements. We will provide technical assistance in a variety of forms, targeted specifically at community banks, including community bank guides on compliance with the rule, a video that will be available on the FDIC website, a series of regional outreach meetings, and subject matter experts at each of our regional offices whom banks can contact directly with questions.

#### *Interagency NPR on the Supplementary Leverage Ratio*

The FDIC joined the Federal Reserve and the OCC in issuing an NPR which would strengthen the supplementary leverage requirements encompassed in the interim final rule for certain large institutions and their insured banks. Using the NPR's proposed definitions of \$700 billion in total consolidated assets or \$10 trillion in assets under custody to identify large systemically significant firms, the new requirements would currently apply to eight U.S. bank holding companies and to their insured banks.

As the NPR points out, maintenance of a strong base of capital at the largest, most systemically important institutions is particularly important because capital shortfalls at these institutions can contribute to systemic distress and can have material adverse economy effects. Analysis by the agencies suggests that a three percent minimum supplementary leverage ratio would not have appreciably mitigated the growth in leverage among these organizations in the years preceding the recent crisis. Higher

capital standards for these institutions would place additional private capital at risk before calling upon the DIF and the Federal government's resolution mechanisms.

The NPR would require these insured banks to satisfy a six percent supplementary leverage ratio to be considered well capitalized for prompt corrective action (PCA) purposes. Based on current supervisory estimates of the off-balance sheet exposures of these banks, this would correspond to roughly an 8.6 percent U.S. leverage requirement. For the eight affected banks, this would currently represent \$89 billion in additional capital for an insured bank to be considered well-capitalized.

Bank Holding Companies (BHCs) covered by the NPR would need to maintain supplementary leverage ratios of a three percent minimum plus a two percent buffer for a five percent requirement in order to avoid conservation buffer restrictions on capital distributions and executive compensation. This corresponds to roughly a 7.2 percent U.S. leverage ratio, which would currently require \$63 billion in additional capital.

An important consideration in calibrating the proposal was the idea that the increase in stringency of the leverage requirements and the risk-based requirements should be balanced. Leverage capital requirements and risk-based capital requirements are complementary, with each type of requirement offsetting potential weaknesses of the other. Balancing the increase in stringency of the two types of capital requirement should make for a stronger and sounder capital base for the U.S. banking system.

## Resolution of Systemically Important Financial Institutions

In addition to these capital proposals, the FDIC has made progress on policies and strategies to build a more effective resolution framework for large, complex financial institutions. One of the most important aspects of the Dodd-Frank Act is the establishment of new authorities for regulators to use in the event of the failure of a systemically important financial institution (SIFI).

### *Resolution Plans – “Living Wills”*

Under the framework of the Dodd-Frank Act, bankruptcy is the preferred option in the event of the failure of a SIFI. To make this objective achievable, Title I of the Dodd-Frank Act requires that all bank holding companies with total consolidated assets of \$50 billion or more, and nonbank financial companies that the Financial Stability Oversight Council (FSOC) determines could pose a threat to the financial stability of the United States, prepare resolution plans, or “living wills,” to demonstrate how the company could be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of the company’s financial distress or failure. The living will process is an important new tool to enhance the resolvability of large financial institutions through the bankruptcy process.

The FDIC and the Federal Reserve Board issued a joint rule to implement Section 165(d) requirements for resolution plans (the 165(d) rule) in November 2011. The FDIC also issued a separate rule which requires all insured depository institutions (IDIs) with greater than \$50 billion in assets to submit resolution plans to the FDIC for their orderly

resolution through the FDIC's traditional resolution powers under the Federal Deposit Insurance Act (FDI Act). The 165(d) rule and the IDI resolution plan rule are designed to work in tandem by covering the full range of business lines, legal entities and capital-structure combinations within a large financial firm.

The FDIC and the Federal Reserve review the 165(d) plans and may jointly find that a plan is not credible or would not facilitate an orderly resolution under the Bankruptcy Code. If a plan is found to be deficient and adequate revisions are not made, the FDIC and the Federal Reserve may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on growth, activities, or operations of the company, including its subsidiaries. If compliance is not achieved within two years, the FDIC and the Federal Reserve, in consultation with the FSOC, can order the company to divest assets or operations to facilitate an orderly resolution under bankruptcy in the event of failure. A SIFI's plan for resolution under bankruptcy also will support the FDIC's planning for the exercise of its Title II resolution powers by providing the FDIC with a better understanding of each SIFI's structure, complexity, and processes.

### *2013 Guidance on Living Wills*

Eleven large, complex financial companies submitted initial 165(d) plans in 2012. Following the review of the initial resolution plans, the agencies developed Guidance for the firms to detail what information should be included in their 2013 resolution plan submissions. The agencies identified an initial set of significant obstacles to rapid and orderly resolution which covered companies are expected to address in the plans,

including the actions or steps the company has taken or proposes to take to remediate or otherwise mitigate each obstacle and a timeline for any proposed actions. The agencies extended the filing date to October 1, 2013, to give the firms additional time to develop resolution plan submissions that address the instructions in the Guidance.

Resolution plans submitted in 2013 will be subject to informational completeness reviews and reviews for resolvability under the Bankruptcy Code. The agencies will be looking at how each resolution plan addresses a set of benchmarks outlined in the Guidance which pose the key impediments to an orderly resolution. The benchmarks are as follows:

- **Multiple Competing Insolvencies:** Multiple jurisdictions, with the possibility of different insolvency frameworks, raise the risk of discontinuity of critical operations and uncertain outcomes.
- **Global Cooperation:** The risk that lack of cooperation could lead to ring-fencing of assets or other outcomes that could exacerbate financial instability in the United States and/or loss of franchise value, as well as uncertainty in the markets.
- **Operations and Interconnectedness.** The risk that services provided by an affiliate or third party might be interrupted, or access to payment and clearing capabilities might be lost;
- **Counterparty Actions.** The risk that counterparty actions may create operational challenges for the company, leading to systemic market disruption or financial instability in the United States; and
- **Funding and Liquidity.** The risk of insufficient liquidity to maintain critical operations arising from increased margin requirements, acceleration, termination, inability to roll over short term borrowings, default interest rate obligations, loss of access to alternative sources of credit, and/or additional expenses of restructuring.

As reflected in the Dodd-Frank Act and discussed above, the preferred option for resolution of a large failed financial firm is for the firm to file for bankruptcy just as any

failed private company would. In certain circumstances, however, resolution under the Bankruptcy Code may result in serious adverse effects on financial stability in the United States. In such cases, the Orderly Liquidation Authority set out in Title II of the Dodd-Frank Act serves as the last resort alternative and could be invoked pursuant to the statutorily prescribed recommendation, determination and expedited judicial review process.

#### *Orderly Liquidation Authority*

Prior to the recent crisis, the FDIC's receivership authorities were limited to federally insured banks and thrift institutions. The lack of authority to place the holding company or affiliates of an insured depository institution or any other non-bank financial company into an FDIC receivership to avoid systemic consequences severely constrained the ability to resolve a SIFI. Orderly Liquidation Authority provided under Title II of the Dodd-Frank Act gives the FDIC the powers necessary to resolve a failing systemic non-bank financial company in an orderly manner that imposes accountability on shareholders, creditors and management of the failed company while mitigating systemic risk and imposing no cost on taxpayers.

The FDIC has largely completed the core rulemakings necessary to carry out its systemic resolution responsibilities under Title II of the Dodd-Frank Act. For example, the FDIC approved a final rule implementing the Orderly Liquidation Authority that addressed, among other things, the priority of claims and the treatment of similarly situated creditors.

Under the Dodd-Frank Act, key findings and recommendations must be made before the Orderly Liquidation Authority can be considered as an option. These include a determination that the financial company is in default or danger of default, that failure of the financial company and its resolution under applicable Federal or State law, including bankruptcy, would have serious adverse effects on financial stability in the United States and that no viable private sector alternative is available to prevent the default of the financial company.

To implement its authority under Title II of the Dodd-Frank Act, the FDIC has developed a strategic approach to resolving a SIFI which is referred to as Single Point-of-Entry. In a Single Point-of-Entry resolution, the FDIC would be appointed as receiver of the top-tier parent holding company of the financial group following the company's failure and the completion of the recommendation, determination and expedited judicial review process set forth in Title II of the Act. Shareholders would be wiped out, unsecured debt holders would have their claims written down to reflect any losses that shareholders cannot cover, and culpable senior management would be replaced. Under the Act, officers and directors responsible for the failure cannot be retained.

During the resolution process, restructuring measures would be taken to address the problems that led to the company's failure. These could include shrinking businesses, breaking them into smaller entities, and/or liquidating certain assets or closing certain

operations. The FDIC also would likely require the restructuring of the firm into one or more smaller non-systemic firms that could be resolved under bankruptcy.

The FDIC would organize a bridge financial company into which the FDIC would transfer assets from the receivership estate, including the failed holding company's investments in and loans to subsidiaries. Equity, subordinated debt, and senior unsecured debt of the failed company would likely remain in the receivership and be converted into claims. Losses would be apportioned to the claims of former equity holders and unsecured creditors according to their order of statutory priority. Remaining claims would be converted, in part, into equity that will serve to capitalize the new operations, or into new debt instruments. This newly formed bridge financial company would continue to operate the systemically important functions of the failed financial company, thereby minimizing disruptions to the financial system and the risk of spillover effects to counterparties.

The healthy subsidiaries of the financial company would remain open and operating, allowing them to continue business and avoid the disruption that would likely accompany their closings. Critical operations for the financial system would be maintained. However, creditors at the subsidiary level should not assume that they avoid risk of loss. For example, if the losses at the financial company are so large that the holding company's shareholders and creditors cannot absorb them, then the subsidiaries with the greatest losses would have to be placed into resolution, thus exposing those subsidiary creditors to loss.



The FDIC expects the well-capitalized bridge financial company and its subsidiaries to borrow in the private markets and from customary sources of liquidity. The new resolution authority under the Dodd- Frank Act provides a back-up source for liquidity support, the Orderly Liquidation Fund (OLF). If it is needed at all, the FDIC anticipates that this liquidity facility would only be required during the initial stage of the resolution process, until private funding sources can be arranged or accessed. The law expressly prohibits taxpayer losses from the use of Title II authority.

In our view, the Single Point-of-Entry strategy holds the best promise of achieving Title II's goals of holding shareholders, creditors and management of the failed firm accountable for the company's losses and maintaining financial stability at no cost to taxpayers.

#### *Statement of Policy*

Informing capital markets, financial institutions, and the public on what to expect if the Orderly Liquidation Authority were to be invoked is an ongoing effort. While the FDIC has already been highly transparent in our planning efforts, we also are currently working on a Statement of Policy which would provide more clarity on the resolution process. We anticipate the release of a proposal for public comment before the end of the year.

In addition, the Federal Reserve, in consultation with the FDIC, is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of unsecured debt at the holding company level. Such a requirement would ensure that there are creditors at the holding company level to absorb losses at the failed firm. Questions surrounding a debt requirement are complex and include issues on the amount, seniority structure, and its relation to equity capital.

### *Cross-border Issues*

Advance planning and cross border coordination for the resolution of globally active, systemically important financial institutions (G-SIFIs) will be critical to minimizing disruptions to global financial markets. Recognizing that G-SIFIs create complex international legal and operational concerns, the FDIC is actively reaching out to foreign host regulators to establish frameworks for effective cross-border cooperation and the basis for confidential information-sharing, among other initiatives.

As part of our bilateral efforts, the FDIC and the Bank of England, in conjunction with the prudential regulators in our respective jurisdictions, have been working to develop contingency plans for the failure of G-SIFIs that have operations in both the U.S. and the U.K. Of the 28 G-SIFIs designated by the Financial Stability Board (FSB) of the G-20 countries, four are headquartered in the U.K, and another eight are headquartered in the U.S. Moreover, approximately 70 percent of the reported foreign activities of the eight U.S. G-SIFIs emanates from the U.K. The magnitude of these financial relationships makes the U.S.-U.K. bilateral relationship by far the most significant with

regard to the resolution of G-SIFIs. As a result, our two countries have a strong mutual interest in ensuring that, if such an institution should fail, it can be resolved at no cost to taxpayers and without placing the financial system at risk. The FDIC and U.K authorities released a joint paper on resolution strategies in December 2012, reflecting the close working relationship between the two authorities. This joint paper focuses on the application of “top-down” resolution strategies for a U.S. or a U.K. financial group in a cross-border context and addresses several common considerations to these resolution strategies.

In addition to the close working relationship with the U.K., the FDIC is coordinating with representatives from other European regulatory bodies to discuss issues of mutual interest including the resolution of European G-SIFIs. The FDIC and the European Commission (E.C.) have established a joint Working Group comprised of senior executives from the FDIC and the E.C. The Working Group convenes formally twice a year -- once in Washington, once in Brussels -- with on-going collaboration continuing in between the formal sessions. The first of these formal meetings took place in February 2013. Among the topics discussed at this meeting was the E.C.’s proposed Recovery and Resolution Directive, which would establish a framework for dealing with failed and failing financial institutions. The overall authorities outlined in that document have a number of parallels to the SIFI resolution authorities provided here in the U.S. under the Dodd-Frank Act. The next meeting of the Working Group will take place in Brussels later this year.

The FDIC also is engaging with Switzerland, Germany, Japan, and Canada on a bilateral basis. Among other things, the FDIC has further developed its understanding of the Swiss resolution regime for G-SIFIs, including an in-depth examination of the two Swiss-based G-SIFIs with significant operations in the U.S. During the past year, we also have participated in several productive workshops with the Federal Financial Supervisory Authority (BaFin), the German resolution authority. The FDIC anticipates a principals-level meeting with Japan later this year.

To place these working relationships in perspective, the U.S., the U.K., the European Union, Switzerland and Japan account for the home jurisdictions of 27 of the 28 G-SIFIs designated by the Financial Stability Board (FSB) of the G-20 in November 2012. Progress in these cross-border relationships is thus critical to addressing the international dimension of SIFI resolutions.

### **The Volcker Rule**

The Dodd-Frank Act requires the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), and the federal banking agencies to adopt regulations generally prohibiting proprietary trading and certain acquisitions of interest in hedge funds or private equity funds. The FDIC, jointly with the FRB, OCC, and SEC, published an NPR requesting public comment on a proposed regulation implementing the prohibition against proprietary trading. The CFTC separately approved the issuance of its NPR to implement the Volcker Rule, with a substantially identical proposed rule text.

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 are evaluating a large body of comments on whether the proposed rule represents a balanced and effective approach 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 activities that would be impacted by the proposed rule.

### **The Dodd-Frank Act and Community Banks**

While the Dodd-Frank Act has changed the regulatory framework for the financial services industry, many of the Act's reforms are geared toward larger

institutions, as discussed above. At the same time, the Act included a number of provisions that impacted community banks. Of particular relevance to the FDIC, the Act made changes to the deposit insurance system that have specific consequences for community banks.

In the aftermath of the crisis, the Dodd-Frank Act made permanent the increase in the coverage limit to \$250,000, a provision generally viewed by community banks as a helpful means to attract deposits.

The FDIC 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. As Congress intended, the 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. The result was a sharing of the assessment burden that better reflects each group's share of industry assets. Aggregate premiums paid by institutions with less than \$10 billion in assets declined by approximately one-third in the second quarter of 2011, primarily due to the assessment base change.

In the aftermath of the financial crisis and recession, as well as the enactment of the Dodd-Frank Act, many community banks had concerns about their continued viability in the U.S. financial system. Prompted by that concern, the FDIC initiated a

comprehensive review of the U.S. community banking sector covering 27 years of data and released the *FDIC Community Banking Study* in December 2012.

Our research confirms the crucial role that community banks play in the U.S. financial system. As defined by the Study, community banks represented 95 percent of all U.S. banking organizations in 2011. These institutions accounted for just 14 percent of the U.S. banking assets, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. While their share of total deposits has declined over time, community banks still hold the majority of bank deposits in rural and micropolitan counties.<sup>2</sup> The Study showed that in 629 U.S. counties (or almost one-fifth of all U.S. counties), the only banking offices operated by FDIC-insured institutions at year-end 2011 were those operated by community banks. Without community banks, many rural areas, small towns and urban neighborhoods would have little or no physical access to mainstream banking services.

The Study found that community banks that grew prudently and that maintained diversified portfolios or otherwise stuck to their core lending competencies funded by stable core deposits during the Study period exhibited relatively strong and stable performance over time. Institutions that departed from the traditional community bank business model generally underperformed over the long run. These institutions pursued higher-growth strategies – frequently through commercial real estate or construction and development lending – financed by volatile funding sources. This group encountered

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<sup>2</sup> The 3,238 U.S. counties in 2010 included 694 micropolitan counties centered on an urban core with populations between 10,000 and 50,000 people, and 1,376 rural counties with populations less than 10,000 people.

severe problems during real estate downturns and characterized the community banks that failed during the aftermath of the crisis.

As the primary federal regulator for the majority of smaller institutions (those with less than \$1 billion in total assets), the FDIC is keenly aware of the challenges facing community banks. The FDIC has tailored its supervisory approach to consider the size, complexity, and risk profile of the institutions it oversees. For example, large institutions (those with \$10 billion or more in total assets) are generally subject to continuous supervision (targeted reviews throughout the year), while smaller banks are examined periodically (every 12 to 18 months) based on their size and condition. Additionally, the frequency of our examinations of compliance with the Community Reinvestment Act can be extended for smaller, well-managed institutions. Moreover, in Financial Institution Letters issued to the industry to explain regulations and guidance, the FDIC includes a Statement of Applicability to institutions with less than \$1 billion in total assets.

In addition to the changes in the Dodd-Frank Act affecting community banks, the FDIC also reviewed its examination, rulemaking, and guidance processes during 2012 as part of our broader review of community banking challenges, with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent, while maintaining safe and sound banking practices. Based on the review, the FDIC has implemented a number of enhancements to our supervisory and rulemaking processes. First, the FDIC has restructured the pre-exam process to better scope examinations,



define expectations, and improve efficiency. Second, the FDIC is taking steps to improve communication with banks under our supervision through the use of web-based tools, regional meetings and outreach. Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities to attend training workshops and symposiums, and conference calls and training videos on complex topics of interest to community bankers. The FDIC plans to continue its review of examination and rulemaking processes, and continues to explore new initiatives to provide technical assistance to community banks.

### **Conclusion**

Thank you for the opportunity to share with the Committee the work that the FDIC has been doing to address systemic risk in the aftermath of the financial crisis. I would be glad to respond to your questions.

## **Status of FDIC Dodd-Frank Act Rulemakings**

### **Completed FDIC-only Rulemakings**

FDIC has met all applicable deadlines in issuing those required regulations in the Dodd-Frank Wall Street Reform and Consumer Protection Act for which it is solely responsible. These include:

- Orderly Liquidation Authority (OLA) Regulations
  - Inflation adjustment for wage claims against financial company in receivership;
  - Executive compensation clawbacks and definition of compensation; and
  - Definition of ‘predominantly engaged in activities financial in nature’ for title II purposes.
- Deposit Insurance Fund Management Regulations
  - Regulations establishing an asset-based assessment base;
  - Regulations implementing permanent \$250,000 coverage;
  - Elimination of pro-cyclical assessments; dividend regulations;
  - Restoration plan to increase the minimum reserve ratio from 1.15 to 1.35% by Sept. 30, 2020; and
  - Regulations implementing temporary full Deposit Insurance coverage for non-interest bearing transaction accounts (Program expired 12/31/12).

The FDIC has also issued several optional rules, including the following OLA rules:

- Rules governing payment of post-insolvency interest to creditors;
- Rules establishing the proper measure of actual, direct, compensatory damages caused by repudiation of contingent claims;
- Rules governing the priority of creditors and the treatment of secured creditors;
- Rules governing the administrative claims process;
- Rules governing the treatment of mutual insurance holding companies; and
- Rules providing for enforcement of contracts of subsidiaries or affiliates of a covered financial company.

### **Completed Interagency Rules:**

FDIC and its fellow agencies have issued a number of joint or interagency regulations.

These include:

- Title I resolution plan requirements;
- Regulations implementing self-administered stress tests for financial companies;
- Minimum leverage capital requirements for IDIs (Collins §171(b)(1));
- Minimum risk-based capital requirements (Collins §171(b)(2));
- Capital requirements for activities that pose risks to the financial system (Collins §171(b)(7)) (as of July 9, 2013);
- Rules providing for calculation of the “maximum obligation limitation”;
- Regulations on foreign currency futures;
- Removing regulatory references to credit ratings;
- Property appraisal requirements for higher cost mortgages; and
- Appraisal independence requirements.

**Rulemakings in process—FDIC-only:**

A few regulations without statutory deadlines remain in process. These include:

- OLA regulations implementing post-appointment requirements and establishing eligibility requirements for asset purchasers.

**Interagency Rulemakings in process:**

- Additional OLA Rules:
  - Orderly liquidation of covered brokers and dealers;
  - Regulations regarding treatment of officers and directors of companies resolved under Title II; and
  - QFC recordkeeping rules;
- Regulations implementing the credit exposure reporting requirement for large BHCs and nonbank financial companies supervised by the FRB;
- Regulations implementing the “source of strength” requirement for BHCs, S&LHCs, and other companies that control IDIs;
- Capital and margin requirements for derivatives that are not cleared OTC;
- The Volcker Rule prohibiting proprietary trading and acquisition of interest in hedge or private equity funds by an IDI or company that controls an IDI or affiliates;
- Regulations governing credit risk retention in asset-backed securitizations, including ABS backed by residential mortgages;
- Regulations governing enhanced compensation structure reporting and prohibiting inappropriate incentive-based payment arrangements;
- Rulemaking prohibiting retaliation against an IDI or other covered person that institutes an appeal of conflicting supervisory determinations by the CFPB and the appropriate prudential regulator; and
- Additional appraisals and related regulations:
  - Minimum requirements for registration of appraisal management companies and for the reporting of the activities of appraisal management companies to Appraisal Subcommittee;
  - Regulations to implement quality controls standards for automated valuation models; and
  - Regulations providing for appropriate appraisal review.