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Statement by

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Chairman Brown, Ranking Member Scott, and other members of the Committee, thank you for the opportunity to testify on the Federal Reserve's supervisory and regulatory activities. Accompanying my testimony is the Federal Reserve's semiannual *Supervision and Regulation Report*. Today, I will discuss current conditions in the banking sector, supervision, and some of our recent regulatory proposals.

Banking Conditions

Our banking system is sound and resilient. The acute stress that occurred in March has receded, and banking organizations continue to report capital and liquidity ratios above minimum regulatory levels. Earnings performance has remained solid and in line with pre-pandemic levels, despite recent pressure on net interest margins.

Regulatory capital ratios increased during the first half of 2023. While liquidity levels have come down from their peak in 2021, they remain above pre-pandemic levels and, as applicable, above minimum regulatory levels, leaving the banking system well positioned to mitigate liquidity pressures that may arise.

The failures of Silicon Valley Bank, Signature Bank, and First Republic Bank reflected, to varying degrees, excessive interest rate risk in their long-duration assets and an over-reliance on uninsured deposits. While the three failed banks were extreme cases, there are other banks that invested heavily in fixed-rate, long-duration assets when long-term interest rates were low. These banks have recorded sizable declines in the fair value of those assets as interest rates have increased, putting pressure on tangible capital. The banks are actively managing the resulting set of risks, but these could take some time to address. Additionally, some banks that have high reliance on uninsured deposits are using more expensive funding sources to manage their liquidity risk.

Lending has continued to grow this year, albeit at a slower pace relative to 2022, due in large part to both reduced loan demand and tighter lending standards, according to respondents to the recent Federal Reserve Senior Loan Officer Opinion Surveys. Loan delinquency rates remain low overall, and banks have increased credit loss provisions to mitigate potential future losses in response to increased delinquencies for loans related to commercial real estate (CRE) and some consumer sectors.

Looking forward, preserving a sound and resilient banking system requires continued attention to address identified vulnerabilities and vigilance to changing conditions.

Supervision

Starting with supervision, since the bank failures earlier this year, the Federal Reserve has been moving forward with ways to improve the speed, force, and agility of supervision as appropriate. Supervision must intensify at the right pace, especially as a firm grows in size or complexity, and critical issues that present safety and soundness concerns should be addressed quickly by banks and supervisors. In considering improvements to supervision, we are very mindful of the differences in size, risk, and complexity of supervised institutions and the importance of maintaining the strength and diversity of banks of all sizes that serve communities across the country.

Furthermore, supervisors have been focused on addressing material risks presented by the current economic environment as well as the rapid pace of innovation. This includes conducting targeted reviews at banks exhibiting higher interest rate and liquidity risk profiles and conducting focused training and outreach on supervisory expectations about these risks. The Federal Reserve is also monitoring for potential credit deterioration, particularly within the consumer and CRE lending segments. Additionally, the Federal Reserve has implemented a new novel bank

supervision program to improve oversight of banks engaged in nontraditional financial-technology-related activities.

However, neither banks nor supervisors can anticipate all emerging risks. That is why it is also important to help ensure that our regulatory framework sets a strong baseline for resilience, regardless of how or where the risk originates.

Capital

A key component of this resilience is capital. Banks rely on both debt (such as deposits) and capital to fund loans and other assets. Capital allows banks to absorb losses on those assets while continuing to serve households and businesses. Additionally, capital is loss-absorbing regardless of the source of the loss. That is, whatever the vulnerability or the shock, capital is able to absorb the resulting losses and, if sufficient, allows banks to keep serving their critical role in the economy.

In the Global Financial Crisis, the effects of woefully undercapitalized banks had a devastating impact on our economy and resulted in the worst recession since the Great Depression. It took six years for employment to recover, more than 10 million people fell into poverty, and 6 million families lost their homes to foreclosure. And these costs occurred even with substantial support from the government.

In the years following the Global Financial Crisis, the Federal Reserve Board (Board) adopted a set of reforms to increase the quantity and quality of capital, ran annual supervisory stress tests, and set a capital surcharge on global systemically important banks (G-SIBs) to reflect the greater risk these firms pose to U.S. financial stability. These reforms have greatly strengthened our banking system, and capital ratios of the largest banks have more than doubled since 2009. At the same time, the U.S. banking system has grown from \$12 trillion in assets in

2009 to \$23 trillion today, while showing strong profitability and overall market valuation. U.S. banks have enhanced their position as leaders in global capital markets activity. Importantly, these reforms have served the U.S. economy well. Our economy has grown substantially with the continued support of robust lending from a stronger banking system.

The reforms to the capital requirement framework we proposed earlier this year are the last stage of those post-crisis capital reforms. It has been long recognized that work remains to improve how banks measure risk, which is critically important because the riskier a bank's assets are, the more capital it needs to protect against those risks. To address these and other issues, the Board, along with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), proposed a rule in July that would further reduce the likelihood of future financial crises. The proposed rules would apply to banks with at least \$100 billion in assets, less than 40 of the over 4,000 banks in our banking system. Community banks would not be affected by this proposal.

First, for a firm's lending activities, the proposed rules would end the practice of relying on each bank's own internal estimates of its credit risk and instead use a standardized, risk-based measure of credit risk. Standardized credit risk approaches are designed to approximate observed risks through economic cycles, which internal models tend to underestimate. Such an approach also ensures consistency across banks to avoid the material variability that has been identified with internal models across institutions. Variability reduces transparency and comparability and results in the same loan being treated differently among banks. The proposed standardized approach to credit risk is generally consistent with—but more risk-sensitive than—the standardized approach the banking agencies have been using for decades.

Second, for operational losses—losses from inadequate or failed processes, such as from fraud, illegal conduct, or cyberattacks—the proposed rules would replace the use of banks’ internal models to measure operational risk with a standardized measure.

Third, for a firm’s trading activities, where modeled approaches are more reliable, the proposed rules would require more granular methods for measuring market risk, which is the risk of loss from movements in market prices, to correct for gaps in the current rules and improve risk capture. For instance, the current market-risk framework could result in capital requirements increasing during stress rather than requiring a higher amount of capital in advance of stress.

Fourth, the proposal would improve the capital requirements for the credit risk of derivatives activities by introducing a standardized, risk-sensitive measure.

Most aspects of this proposal have been under development for many years. Partly in response to the bank stress this spring, the proposal would extend the requirement of including unrealized gains and losses from available-for-sale securities in capital ratios beyond the largest, most complex banks to all large banks above \$100 billion in assets.

The proposed rules are anticipated to increase capital requirements for large banks, but the effects for each bank would vary based on its activities and risk profile. Notably, the increases would be most substantial for the largest and most complex banks, and the bulk of the estimated rise is attributable to trading and other non-lending activities.

The comment period is an important part of the rulemaking process. I want to reiterate that we are interested in public input. We have recently announced an extension of the comment period. With this extension, we are providing the public nearly six months to review the proposal, so they can provide meaningful comments. We have already heard concerns that the proposed risk-based capital treatment for mortgage lending, tax credit investments, trading

activities, and operational risk might overestimate the risk of these activities. We welcome all comments that provide the agencies with additional data and perspectives to help ensure the rules accurately reflect risk.

Long-Term Debt

I would also like to highlight our long-term debt proposal. In October of last year, the agencies issued an advance notice of proposed rulemaking requesting comments about possible extension of long-term debt requirements to more banking organizations beyond the largest and most complex. The failures of three large banks in the spring resulted in losses to the deposit insurance fund and financial stability concerns that could have been mitigated in part by requirements for additional long-term debt.

Following those events, in August, the agencies proposed a rule that would expand long-term debt and resolution planning requirements to additional large banks. The proposal's goal is to increase the potential options available for resolving depository institutions and to enhance overall financial stability. Importantly, the proposed requirements would be calibrated at a lower level relative to the largest and most complex banks in recognition of the lower systemic risk profiles of applicable banks. Additionally, because these banks already issue some long-term debt and the proposal provides for a long phase-in period, banks generally would only need to issue debt incrementally to meet the proposed requirements.

As with the capital rules I mentioned above, I would like to emphasize that these are proposed rules, and we look forward to hearing the public's comments.

Community Reinvestment Act

As for other material rulemakings, the agencies recently finalized a rule that strengthens and modernizes the regulations that implement the Community Reinvestment Act (CRA). The

revised rule will better encourage banks to help meet the credit needs of their entire communities, including low- and moderate-income neighborhoods.

The final rule is the result of many years of public engagement and several rounds of rulemaking by the Board, FDIC, and OCC. I appreciate the level of engagement from both banks and community and civil rights stakeholders. The many perspectives we have heard have assisted the agencies in further refining the approach from the proposed to final rule.

Key elements of the final rule include supporting minority depository institutions and community development financial institutions as well as adapting the rule to mobile and online banking. Fair lending is safe and sound lending. The new CRA regulations will encourage financial inclusion in important ways, helping to make the financial system safer and fairer.

Thank you. I am happy to take your questions.