Statement by

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before the

Committee on Financial Services

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Chairman Hensarling, Ranking Member Waters, other members of the committee, thank you for the opportunity to testify on the Federal Reserve's regulation and supervision of the financial system. My testimony today covers two main topics: our efforts to improve regulatory transparency, including the report accompanying my submission to the committee, and our progress in making the post-crisis regulatory framework simpler and more efficient.

The Role of Transparency in Regulation and Supervision

I am mindful that this semiannual testimony--like my position as Vice Chairman for Supervision--is grounded in Congress’s efforts to strengthen and improve the nation’s regulatory framework following the financial crisis. This testimony reflects a critical element of those efforts: the desire, and the need, for greater transparency.

Transparency is part of the foundation of public accountability and a cornerstone of due process. It is also key to a well-functioning regulatory system and an essential aspect of safety and soundness, as well as financial stability. Transparency provides financial firms clarity on the letter and spirit of their obligations; it provides supervisors with the benefit of exposure to a diversity of perspectives; and it provides markets with insight into the condition of regulated firms, fostering market discipline. Transparency increases public confidence in the role of the financial system to support credit, investment, and economic growth.

The Federal Reserve has taken a number of steps since my last testimony to further increase transparency, and to provide more information about our supervisory activities to both regulated institutions and the public.
For example, the Board recently improved its supervisory ratings system for large financial institutions.\(^1\) Ratings are an essential vehicle for supervisory feedback—a clear, concise way to convey whether a firm meets expectations, with tangible, predictable consequences for those that fall short. Our ratings system for large institutions had remained unchanged since 2004, even as our supervision of those institutions evolved significantly after the crisis. The new rating system will better align ratings for these firms with the supervisory feedback they receive, and will focus firms on the capital, liquidity, and governance issues most likely to affect safety and soundness.

The banking agencies also recently clarified that supervisory guidance is a tool to enhance the transparency of supervisory expectations, and should never be the basis of an enforcement action.\(^2\) Guidance—a valuable tool for examiners to help evaluate firms and explain supervisory findings—should always be based on concerns for safety and soundness or compliance at a particular firm. However, guidance is not legally enforceable, and Federal Reserve examiners will not treat it that way.

Finally, we expect shortly to make final a set of measures to increase visibility into the Board’s supervisory stress testing program. The enhanced disclosures will include more granular descriptions of our models; more information about the design of our scenarios; and more detail about the outcomes we project, including a range of loss rates for loans held by firms subject to the Comprehensive Capital Analysis and Review. The disclosures will provide a more complete picture of the stress testing process, and facilitate thoughtful comments from academics.

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and other members of the public, while mitigating the risk of convergence on a single model. As a result, we believe the disclosures will improve our work, making the tests more reliable, visible, and credible. We will continue our efforts toward greater transparency in stress testing over the next several years, including by disclosing descriptions of additional material models and modeled loss rate disclosures for loan and non-loan portfolios.

**Semiannual Review of the Safety and Soundness of the U.S. Banking System**

The report that accompanies my testimony today is another tool to keep Congress, and the public, informed about our work, the banking system, and the role of both in supporting the broader economy.³ The report focuses on the Federal Reserve’s prudential supervisory activities.⁴ As the report shows, the banking sector remains in strong condition, in line with strong U.S. economic performance, with lending growth, fewer nonperforming loans, and strong overall profitability.

Large institutions are well capitalized and liquid, and their capital planning and liquidity-risk-management processes are improving. Ninety-nine percent of regional and community banks are currently well capitalized, and supervisory recommendations made to smaller firms during the financial crisis have largely been closed. We are, however, very much aware of the dangers of complacency, and our report lists several priority areas of risk we will continue to monitor closely in the coming year, including cyber and information technology risks at supervised firms of all sizes.

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Improvements in Regulatory Efficiency

Improving regulatory efficiency is another core element of our current regulatory efforts. Tailoring regulation and supervision to risk has been a programmatic goal of Federal Reserve policy for more than two decades. The motivations are clear: supervisory resources are not limitless, and supervision is not costless, either to the public or to supervised institutions. Activities and firms that pose the greatest risk should receive the most scrutiny, and where the risk is lower, the regulatory burden should be lower as well.

This principle guided Congress and the federal banking agencies in designing the post-crisis regulatory framework, which imposed greater restrictions on larger, more systemically important firms and less intrusive requirements on smaller ones. It has also guided our implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRCPA, or the Act). On this front, we have made substantial progress:

- expanding eligibility of community banking firms for the Small Bank Holding Company Policy Statement, and for longer, 18-month examination cycles;6

- giving bank holding companies below $100 billion in assets immediate relief from supervisory assessments, stress testing requirements, and some additional Dodd-Frank Act prudential measures;7 and

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implementing changes to liquidity regulation of municipal securities and capital regulation of high-volatility commercial real estate exposures.8

The Board, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) have also continued the work to significantly reduce the reporting burden on community banking organizations, altering reporting frequencies, items, and thresholds, while preserving the data necessary for effective oversight.9 The agencies recently issued a proposal to reduce further reporting requirements for small depository institutions in the first and third quarters of the year. Under the proposal, around 37 percent of data items would not be required in those quarters.

Our most significant step to implement the Act came two weeks ago, when the Board issued two proposals to better align prudential standards with the risk profile of regulated institutions.10 These proposals implement changes that Congress enacted this spring in the EGRRCPA. One of the proposals addresses the Board’s enhanced prudential standards for large banking firms, and the other is an interagency proposal amending the regulatory capital and liquidity regulations that apply to large banking organizations. Both proposals separate large banking firms into four categories, using size as a relevant but not sufficient factor for increased regulatory requirements. Among the other factors that will now enter into this assessment are nonbank assets, short-term wholesale funding, and off-balance-sheet exposure. The changes

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would significantly reduce regulatory compliance requirements for firms in the lowest risk category, including most institutions with between $100 billion and $250 billion in assets. Firms with $250 billion or more in assets, or firms with assets between $100 billion and $250 billion that meet a risk threshold, will face reduced liquidity requirements. The proposals would largely maintain existing requirements for the largest and most complex firms.

These new categories represent a step forward in regulatory efficiency. They draw on our experience administering enhanced prudential requirements and other post-crisis measures. They recognize that other indicators of risk beyond size are appropriate to consider when determining if more stringent standards should apply to certain firms. They move toward a more risk-sensitive, nuanced framework, where riskier activities and a larger systemic footprint correspond to higher supervisory and regulatory requirements.

Apart from the requirements of the Act, we also recently proposed a new approach to calculating credit risk, known as the standardized approach to counterparty credit risk, or SA-CCR. The new approach would better account for the risks associated with derivatives exposures, including market practices that reduce risk, such as netting and initial margin.\(^\text{11}\) We issued a proposal simplifying and tailoring requirements under the Volcker rule, to ensure that the most stringent requirements apply to the firms with the most trading activity, and that compliance is as simple and objective as possible. We also issued a rule limiting the exposure of large firms to a single counterparty, addressing a key source of contagion during the financial crisis. We have received thoughtful input from the public that will help inform our implementation of all of these measures.

Finally, we have continued to engage with supervisors and central banks overseas. The ultimate goal of having an efficient and transparent regulatory system is to help the American economy—to enable banking organizations to offer safe, stable financial services to households and businesses around the country. But American businesses compete in a global marketplace, and as the financial crisis showed, when regulatory standards fall in other countries, Americans can pay the price. Engaging overseas, through forums like the Financial Stability Board and the Basel Committee on Banking Supervision, helps level the playing field—and it helps ensure that all countries, not just the United States, do their part to maintain and protect the global economy.

Our work to improve regulatory efficiency is not done, and we expect to make additional progress in the months ahead on a number of issues. In particular, we are working with our counterparts at the OCC and FDIC on a community bank leverage ratio proposal. We expect that this proposal would meaningfully reduce the compliance burden for community banking organizations, while preserving overall levels of capital at small banks and our ability to take prompt action when problems arise.

I look forward to continuing our efforts to make our regulatory framework simpler, more transparent, and more efficient—and I look forward to participating in the committee’s oversight of those efforts. As Chairman Powell said at his swearing-in: “As a public institution, we must be transparent about our actions so that the public, through its elected representatives, can hold us accountable.”12 We will continue to do so to the best of our ability.

Thank you, and I look forward to answering your questions.

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