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Chairman Shelby, Ranking Member Brown, and other members of the committee, I appreciate the opportunity to testify on the threshold in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) for application of enhanced prudential standards to bank holding companies. In my testimony this morning I will try to provide, from a regulator's perspective, some context for the committee's consideration of this subject by explaining how the Federal Reserve has differentially implemented prudential regulations based on the size, scope, and range of activities of banking organizations, as well as how we have organized our supervisory portfolios. In both our supervisory and regulatory practices, we are pursuing a tiered approach to prudential oversight.

Regulatory Differentiation in the Dodd-Frank Act

Traditionally, statutes creating prudential regulatory requirements or authorities generally took what might be termed a unitary approach. That is, the statutes simply made a particular requirement or authority applicable to banks or banking organizations generally, with few clear distinctions based on the characteristics of the regulated entities. The federal banking agencies did adopt some regulations with requirements that applied only to larger institutions. And, as I will describe a bit later, through supervisory practice they administered some statutory requirements differently based on the size of banks and the scope of their activities. But the starting point was a more or less similar set of statutory requirements.

The Dodd-Frank Act explicitly broke with this traditional approach by creating prudential requirements that vary with the size or systemic importance of banking organizations. Of particular importance is the Dodd-Frank Act emphasis on financial stability, both in markets generally and with respect to the largest financial firms, which had been associated with market perceptions that they were too big to fail. The law created some new authorities for financial regulators and instructed regulators to use authorities they already had to put in place regulations to contain systemic risk. As to regulations applicable to individual firms, the Dodd-Frank Act creates thresholds for various prudential regulations at asset sizes of $1 billion, $10 billion, and $50 billion. Of special note is that section 165 of the Dodd-Frank Act requires the Federal Reserve to establish enhanced prudential standards for bank holding companies with total assets of $50 billion or more and other financial firms designated as systemically important by the Financial Stability Oversight Council. Among other areas, these standards include capital, liquidity, risk management, resolution planning, and single-counterparty credit limits. Of particular significance is the section 165 requirement that these enhanced standards increase in stringency depending on the size, interconnectedness, role in credit intermediation, and other factors specified in the law. In addition to these enhanced, graduated standards, section 165 requires that firms with greater than $50 billion in assets be subject to annual supervisory stress tests.

The Federal Reserve has implemented the section 165 requirement of graduated stringency for enhanced prudential standards by creating what are, in effect, three categories within the universe of banking organizations with $50 billion or more in assets. As required by statute, all firms within this universe are subject to basic enhanced standards. Firms with assets of between $50 billion and $250 billion are subject only to these basic enhanced standards. Firms with at least $250 billion in assets or $10 billion in on-balance-sheet foreign assets are also subject to more stringent requirements, including the advanced approaches risk-based capital requirements, the supplementary leverage ratio, the countercyclical capital buffer, and the full-scope liquidity coverage ratio.

Finally, the eight U.S. bank holding companies that have been designated as global systemically important banking organizations will be subject to an additional set of regulatory requirements. An enhanced supplementary leverage ratio, equally applicable to all eight firms, has already been adopted. We are also working on two requirements that will vary in stringency even among these eight firms, based on their relative systemic importance. One is the set of risk-based capital surcharges for which we issued a notice of proposed rulemaking late last year. The other, on which we anticipate issuing a notice of proposed rulemaking in the coming months, is a long-term debt requirement designed to support effective orderly resolution processes.

In sum, the stringency of the Federal Reserve's prudential regulations increases in proportion to the systemic importance of the banking organizations. With this tiered approach to regulation, the Federal Reserve aims not only to achieve the Dodd-Frank Act goal of mitigating risks to U.S. financial stability, but to do so in a manner that limits regulatory costs and the expenditure of supervisory resources where not needed to promote safety, soundness, and financial stability.

Tiered Regulatory and Supervisory Experience

The Federal Reserve also takes a tiered approach to supervision. We organize the firms we supervise into portfolios based predominately, although not exclusively, on asset size. We have four such groups: (1) community banking organizations, which are generally those with $10 billion or less in total assets; (2) regional banking organizations, which have total assets between $10 billion and $50 billion; (3) large banking organizations, which have total assets over $50 billion but are not among the largest and most complex banking organizations; and

(4) firms overseen by the Large Institution Supervision Coordinating Committee (LISCC), which are the largest and most complex banking organizations.[1]

As with tiered regulation, our tiered supervision is intended to take into account differences in business models, risks, relative regulatory burdens, and other salient considerations. Where specific regulatory goals for the different portfolios vary, the supervisory programs reflect those differences. And even where the goals are similar across portfolios, supervisory programs should nevertheless take account of the differences among the firms in the four portfolios. In general, we shape our supervisory expectations for each portfolio by considering the increase in safety and soundness that we are likely to achieve through a specific practice or requirement, in light of the regulatory costs for the banking organizations in the portfolio and the impact that the stress or failure of those institutions would likely have on credit intermediation, the deposit insurance fund, and financial stability.

So, for example, there are heightened expectations with regard to corporate governance for large banking organizations that are not applied to regional or community banking organizations. Among other areas, the Federal Reserve expects the boards of directors of these larger firms to set direction and oversight for revenue and profit generation, risk management, and control functions; to ensure that senior management has the expertise and level of involvement required to manage core business lines, critical operations, banking offices, and other material entities; and to maintain a corporate culture that emphasizes the importance of compliance with laws, regulation, and consumer protection. While strong corporate governance is important at all banking organizations, it is vital at large banking organizations, given that

[1] For more information on the LISCC, see http://federalreserve.gov/bankinforeg/large-institution-supervision.htm.

their systems and operations are typically much broader and more complex than those of the smaller-scale and more localized regional and community banking organizations.

While asset size is the principal determinant of the general supervisory program for a banking organization, other factors are taken into account as appropriate. For example, if a regional banking organization were to become involved in activities typically undertaken only by larger banking organizations, we might add to that firm's supervision an expectation or practice drawn from the large banking organization portfolio. Moreover, in determining which banking organizations belong in the LISCC portfolio, the Federal Reserve has focused on the risks to the financial system posed by individual firms--size has not been the dispositive factor. For example, three large banking organizations are not in that portfolio, even though they have larger balance sheets than the processing- and custody-focused bank holding companies that are in the LISCC portfolio. The stress or failure of these large, essentially regional banking organizations could have a serious effect on credit intermediation across a significant part of the country and, in some situations of generalized stress, might have consequences for the financial system as a whole. However, we judge that the functions of the two processing- and custody-focused LISCC firms implicate systemic concerns to a greater extent than the substantial balance sheets of the larger regionals.

The Role of Statutory Thresholds

As I hope by now is apparent, the Federal Reserve has done considerable work to tailor our supervision of banking organizations by reference to their size, business model, and systemic importance. Similarly, using the statutory discretion granted us, and frequently in cooperation with other regulatory agencies, we have also tailored the application of certain statutory requirements to different groups of banks. The question of statutory thresholds is thus a fairly narrow one: Does a threshold specify a cut-off point that is appropriate for mandatory application of a particular regulatory requirement, taking into account whatever discretion is given to the implementing regulatory agencies?

In answering this question, it is first worth noting the case for establishing such statutory thresholds. In the past, Congress has at times not simply given the banking agencies authority to engage in a particular form of prudential regulation, but has required that they do so. Capital regulation and prompt correction action are two examples. Not coincidentally, I think, congressional action followed banking crises that revealed possible shortcomings in the regulatory and supervisory structures that had existed preceding the crisis. In requiring certain kinds of prudential regulation, Congress was in effect protecting against memories of those problems fading and the consequent possibility of supervisory relaxation, which might allow for a recurrence of similar banking problems in the future.

The creation of mandatory thresholds for certain enhanced prudential standards is an important advance in the traditional congressional role of specifying a set of mandatory regulations. This statutory structure recognizes the substantially divergent risks presented to the economy and the financial system by the potential stress or failure of banking organizations of different sizes and with different activities, while preserving considerable discretion for the banking agencies in implementing those regulations. Here again, statutory enactment of mandatory measures for banking organizations of a certain size or systemic importance serves as a form of safeguard against the erosion of prudential oversight that could occur were predominant reliance to be placed on the details of firm-specific supervision, which are sometimes hard for the public to discern. Removal or change of such thresholds, as with generally applicable prudential requirements, will thus require congressional action and an occasion for considered public debate on the merits of such change.

Experience to date, however, suggests that there are some statutory thresholds that might bear reexamination. One pertains to the applicability of some Dodd-Frank Act provisions to community banks. For example, the Volcker rule and the incentive compensation requirements of section 956 of the Dodd-Frank Act are directed at concerns generally present only with larger institutions, but the Volcker rule by its terms applies to all banking organizations, and the incentive compensation provisions apply by their terms to all banking organizations with $1 billion or more in assets. The banking agencies have done their best to tailor the application of these rules to smaller banks and, indeed, to make clear the limited extent to which they should affect those banks. However, some compliance effort on these rules is still needed at community banks. Raising the asset threshold for these two requirements to $10 billion would eliminate this compliance burden, the cost of which is probably not worth whatever incremental prudential benefits might be gained at these small banks. Even in the relatively unusual circumstance in which a practice at a smaller bank might raise safety and soundness concerns, the supervisory process would remain available to rectify any problems.

The second threshold that is worth discussing is the $50 billion level established by section 165 of the Dodd-Frank Act. As noted earlier, the import of this threshold is to require enhanced prudential standards and supervisory stress testing for banking organizations whose assets exceed that amount. As also noted, the Federal Reserve has tailored those standards in accordance with the increasing stringency requirement of section 165, so that they are more flexible for institutions closer to the $50 billion threshold and most demanding for the eight firms of global systemic importance. It has been somewhat more difficult to customize supervisory stress testing. While some elements of the test, such as the market shock and single-counterparty default scenarios, are applied only to larger firms, the basic requirements for the aggregation and reporting of data conforming to our supervisory model and for firms to run our scenarios through their own models do entail substantial expenditures of out-of-pocket and human resources. This can be a considerable challenge for a $60 billion or $70 billion bank. On the other side of the ledger, while we do derive some supervisory benefits from inclusion of these banks toward the lower end of the range in the supervisory stress tests, those benefits are relatively modest, and we believe we could probably realize them through other supervisory means.

These are the factors that lay behind my suggestion last year that it might be worth thinking about the level of this threshold, which I understand to be a purpose of today's hearing. That said, I want to emphasize a few points. First, consideration of potential increases in the threshold for mandatory prudential measures should not remove the discretion of the banking agencies to require additional measures--including such things as more capital or liquidity--for specific firms or groups of firms in appropriate circumstances. That is, while it is sensible to limit mandatory measures for classes of firms where most banks in that class are unlikely to present a particular kind of risk, it would be very ill-advised to preclude supervisors from requiring such measures of firms where that risk may become more of a concern.

Second, any consideration of raising the threshold to take account of the factors I mentioned earlier should not extend to removal of the application of enhanced standards and other rules to the largest banking organizations. As senators and regulators have discussed many times before in this committee, the tasks of combatting the reality and the perception of too big to fail, and of vulnerabilities in broader financial markets, are crucial and ongoing.

Conclusion

The innovation in the Dodd-Frank Act that requires tiered regulation is central to our shared goals of protecting financial stability and ensuring the availability of credit. Smaller banks do not pose risks to financial stability, though they can suffer collateral damage when stress builds throughout the financial system. And, while enhanced prudential standards are important to ensure that larger banks can continue to provide credit even in periods of stress, some of those same enhancements could actually inhibit credit extension by rendering the reasonable business models of middle-sized and smaller banks unprofitable. The Federal Reserve will continue to use statutory authorities to calibrate our regulation and supervision to the risks posed by the different classes of banks, avoiding a one-size-fits-all approach. We and, I believe, many others are committed to the dual goals of protecting systemic stability and fostering the efficient intermediation of credit by the overwhelming majority of American banks that do not pose systemic or far-reaching risks.

Thank you. I would be pleased to take any questions you may have.