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Improving the Oversight of Large Financial Institutions

Remarks by

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Thank you for the opportunity to speak to you today, it is great to be back in New York. The Citizens Budget Commission has played an important role over the years as a forum to discuss issues of interest to New Yorkers that are often also of national and even global importance. Given New York's preeminence as a center of global finance, I thought it would be appropriate to discuss just such a topic, which is how the Federal Reserve oversees the largest financial institutions, many of which are headquartered or have a major presence here, and how that oversight has strengthened since the financial crisis.¹

The Financial Crisis and Large Financial Institutions

The crisis had many causes, including the numerous factors that drove a lengthy housing boom and the expansion of a largely unregulated "shadow banking system" rivaling the traditional banking sector in size. A self-reinforcing financial panic magnified the damage from risks that had built up over many years throughout the country and across the financial system.

But to a considerable extent, large and complex financial institutions were the epicenter of the crisis. These institutions, some of which were not subject to Federal Reserve oversight at the time, were the locus for much of the excessive risk-taking that led to the crisis. Due to their primacy and interconnections with the rest of the financial system, these large institutions were also the means by which the crisis spread quickly and with devastating effect through the economy.

¹ Although the Federal Reserve supervises entities with a range of legal forms, including depository institutions and holding companies, for the purposes of my remarks today, "financial institutions," "firms," "banks," and "banking organizations" are used interchangeably unless indicated otherwise.

The financial crisis and the recession caused great hardship for millions of individuals and families in this city and in communities throughout our country. I believe all Americans share a common interest in working to make sure that our financial system is strong, resilient, and able to serve a healthy and growing economy. A critical part of our work since the crisis to promote a stable financial system has therefore involved greater effort to ensure that large institutions are operating safely and soundly and are prepared to continue serving households and businesses even when faced with stressful financial conditions.

In the run-up to the crisis, large firms failed to adequately anticipate and manage risks that grew and concentrated in their increasingly sprawling, diverse, and complex operations. Partly as a result, these firms had trouble retaining the trust of markets and creditors when the financial system came under stress. Doubts quickly mounted about whether these institutions could sustain losses in the value of many assets they held. Further doubts were raised about whether these firms had enough cash and other liquid assets to meet the immediate or potential demands of short-term creditors and large institutional customers. In the lead-up to the crisis, many large institutions had become heavily reliant on very short-term borrowing, at relatively low rates, to fund lending and other operations providing higher returns. While this approach may have appeared to be an easy source of profit, it had the disadvantage of leaving those banks exposed to devastating runs if short-term funding dried up, as it did in the crisis.

Large financial institutions, of course, were not alone in failing to see these risks. The checks and balances that were widely expected to prevent excessive risk-taking by large financial firms--regulatory oversight and market discipline--did not do so.

Government agencies, including the Fed, failed to recognize the extent of the risks or how severely they could damage the financial system and the economy. Investors failed to anticipate and understand the risks of large financial institutions' activities that materialized during the crisis.

Background on Financial Regulation and Supervision

Before I turn to the Fed's actions to improve oversight of large financial institutions, let me be clear about what I mean by "large institutions." Generally, I have in mind those firms whose financial distress would pose a significant risk to financial stability--firms that are, in that sense, "systemically important." This would include U.S. banking organizations with large, complex, and often international operations; foreign banking organizations with extensive U.S. operations; and other large and complex financial firms. Today the Federal Reserve subjects 16 of those firms to significantly higher levels of oversight than are applied to other institutions.² To put the scale and importance of these firms in perspective, the 8 U.S. bank holding companies among these 16 firms hold nearly 60 percent of all assets in the U.S. banking system.³

The Federal Reserve's oversight of large financial institutions is aimed at ensuring the safety and soundness of individual financial institutions as well as the resiliency of the financial system. The Fed expects the banks it oversees, including the largest banks, to be financially sound. Two core elements of soundness are capital and

² A current list of these firms is available on the Federal Reserve Board's webpage "Large Institution Supervision Coordinating Committee" at www.federalreserve.gov/bankinforeg/large-institution-supervision.htm. This list may evolve based on changes in firms' relative systemic importance. Financial Stability Oversight Council determinations of nonbank financial institutions subject to Federal Reserve oversight are available on the U.S. Department of Treasury's website at www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.

³ Information is based on data from the most recent FR Y-9C report, which is filed quarterly by bank holding companies and savings and loan holding companies. To access the report, see the Board's webpage "Reporting Forms" at www.federalreserve.gov/apps/reportforms/default.aspx.

liquidity. Capital is the funds provided by a bank's shareholders that serve as a buffer to enable the firm to absorb unexpected losses, including during times of economic downturn or financial stress. A bank's liquidity is its ability to meet current and future obligations to customers and others with whom it enters into financial transactions. Liquidity is the lifeblood of a financial firm, because once liquidity dries up, the firm is no longer able to operate.

Beyond focusing on capital and liquidity, the Fed also promotes safety and soundness by seeking to ensure that banks are well managed and subject to strong governance by a board of directors responsible to shareholders. It is unfortunate that I need to underscore this, but we expect the firms we oversee to follow the law and to operate in an ethical manner. Too often in recent years, bankers at large institutions have not done so, sometimes brazenly. These incidents, both individually and in their totality, raise legitimate questions of whether there may be pervasive shortcomings in the values of large financial firms that might undermine their safety and soundness.⁴

While the Federal Reserve looks closely at the individual safety and soundness of large financial firms, as I noted earlier, it is not sufficient to view each of these firms in isolation. The safety and soundness of large firms affects, and is affected by, the stability of the broader financial system. In the decades of relative financial stability leading up to the crisis, it is fair to say that the Fed focused too much on individual firms and not enough on their role in the financial system and the implications of those firms'

⁴ For more information, see Daniel K. Tarullo (2014), "Good Compliance, Not Mere Compliance," speech delivered at "Reforming Culture and Behavior in the Financial Services Industry," a conference sponsored by the Federal Reserve Bank of New York, New York, N.Y., October 20, www.federalreserve.gov/newsevents/speech/tarullo20141020a.htm.

operations for financial stability. To use an apt metaphor, we looked closely at the trees and not as intently as we should have at the forest. One of the most fundamental changes in the Fed's oversight of large institutions since the crisis, a principle that undergirds everything I will discuss today, is elevating the importance of financial stability in that oversight.

The Fed oversees financial institutions through regulation and supervision. While they are often closely related, these are two distinct activities. On the one hand, regulation refers primarily to the rules that firms must follow. Regulation starts with laws passed by Congress which are the basis for specific and detailed rules written by the Fed and other agencies. Supervision, on the other hand, involves monitoring and examining the day-to-day operations of these firms, including their financial condition, how they manage risks, and their corporate governance, to make sure they are complying with laws and regulations and operating in a safe and sound manner.

The Federal Reserve Board writes the regulations firms must follow, establishes supervisory policies and, in close collaboration with the 12 regional Reserve Banks, is deeply engaged in the supervision of large financial institutions. Much of the day-to-day work of supervision, particularly for smaller banks, occurs locally through the Reserve Banks. For systemically important firms, the Board several years ago established the Large Institution Supervision Coordinating Committee (LISCC) in order to assure well-coordinated supervision.

I consider the effective supervision of large institutions, to ensure their safety and soundness and the stability of the financial system, to be one of the Federal Reserve

Board's most important responsibilities, and one of my most important responsibilities as Chair.

In improving the oversight of large firms, the Federal Reserve has made it a top priority to ensure that we appropriately tailor our regulation and supervision of banks to their size, complexity, and risks.⁵ We will use statutory authorities to ensure that we avoid a one-size-fits-all approach as we promulgate rules and regulations. As we continue this work, we will communicate to the Congress should we identify discrete issues that may benefit from further clarification or technical changes without undermining safety and soundness, such as those addressed by Congress last year related to capital requirements for insurance companies.

Post-Crisis Regulation and Supervision of Large Financial Institutions

Regulatory Reform

Regulatory changes since the crisis have been extensive.⁶ While my emphasis today is on steps taken in the United States, I should also note that we work closely with

⁵ See Daniel K. Tarullo (2014), "A Tiered Approach to Regulation and Supervision of Community Banks," speech delivered at the Community Bankers Symposium, Chicago, Ill., November 7, www.federalreserve.gov/newsevents/speech/tarullo20141107a.htm; and Janet L. Yellen (2014), "Tailored Supervision of Community Banks," speech delivered at the Independent Community Bankers of America 2014 Washington Policy Summit, Washington, May 1, www.federalreserve.gov/newsevents/speech/yellen20140501a.htm.

⁶ Several of my colleagues on the Federal Reserve Board of Governors, as well as Board staff, have spoken extensively about the post-crisis regulatory reform agenda. See, for example, Tarullo (2014), "Liquidity Regulation," speech delivered at the Clearing House 2014 Annual Conference, New York, November 20, www.federalreserve.gov/newsevents/speech/tarullo20141120a%20.htm; Tarullo (2014), "Dodd-Frank Implementation," statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 9, www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm; Stanley Fischer (2014), "Financial Sector Reform: How Far Are We?," speech delivered as the Martin Feldstein Lecture at the National Bureau of Economic Research, Cambridge, Mass., July 10, www.federalreserve.gov/newsevents/speech/fischer20140710a.htm; Scott G. Alvarez (2014), "Regulatory Rulemakings," statement before the Committee on Financial Services, U.S. House of Representatives, April 8, www.federalreserve.gov/newsevents/testimony/alvarez20140408a.htm; Tarullo (2014), "Dodd-Frank Implementation," statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 6, www.federalreserve.gov/newsevents/testimony/tarullo20140206a.htm; and Tarullo (2013), "Evaluating Progress in Regulatory Reforms to Promote Financial Stability," speech delivered at

our international colleagues to ensure that standards for systemically important financial firms are raised globally as well. We have made significant progress on our regulatory reform agenda both domestically and internationally, but we still have work to do.

I will briefly describe five regulatory changes that have been among the most important in helping the Federal Reserve improve its oversight of the largest institutions.

First, all banks are required to hold significantly more capital, with higher standards applied to the largest, most systemically important firms. Second, large institutions have also been required to substantially increase their liquidity. The blueprint for these higher capital and liquidity standards is an international agreement known as Basel III, which establishes minimum standards for internationally active banks around the world; the United States, however, has gone even further to raise capital requirements for the largest firms. Third, large firms are now required to show that they can continue to operate safely and serve their customers in stressful conditions similar to those that occurred during the crisis, an exercise known as stress testing. Fourth, under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Congress authorized a new regime, known as “resolution,” to manage the failure of large firms in an orderly manner and reduce the chances that such a failure would threaten financial stability. The Congress empowered the Fed and the Federal Deposit Insurance Corporation (FDIC) to require large firms to develop resolution plans.

The fifth and final regulatory change I want to mention is that the Dodd-Frank Act also gave the Federal Reserve more explicit responsibilities for safeguarding financial stability. As applied to large institutions, more stringent capital requirements

and the other regulatory changes I have just described are intended to promote the stability of the financial system. In addition, to address the fragmentation of responsibility for financial stability across different agencies, the Fed is part of a new interagency body, the Financial Stability Oversight Council, which helps U.S. regulators work together more effectively to better promote the stability of the financial system.

Enhanced Supervision

Along with the additional tools provided by these regulatory changes, the Federal Reserve has fortified its supervision of large financial institutions. We significantly enhanced the manner by which we assess whether these firms have sufficient capital and liquidity and are meeting new regulatory requirements in this area. We have substantially raised our expectations for how well the firms we supervise should be managing their risks, maintaining internal controls, and exercising governance. And we have reorganized our supervision of large financial institutions to increase the quality, consistency, and range of perspectives brought to bear on supervisory strategy and decisionmaking.

One of the most important enhancements to large bank supervision since the financial crisis is our assessment of whether large institutions are holding enough capital to deal with stressful financial conditions. The program includes stress testing and a yearly review of how firms are planning their future capital needs.⁷ The latest results will be disclosed in the coming days.

⁷ The Comprehensive Capital Analysis and Review applies to a larger number of institutions than the most systemically important firms discussed in these remarks.

Capital stress testing for banks is not new but the Federal Reserve has employed it much more extensively since the crisis.⁸ Using information on a bank's finances and operations, these tests gauge how a firm's capital position would be affected by hypothetical scenarios covering a range of adverse economic and financial conditions. Such tests show the potential harm faced by individual banks in stressful conditions and thus the potential that such problems could affect the stability of the financial system. The goal is to see that large institutions have enough capital not just to survive in these conditions, but also to continue serving their customers. The Federal Reserve conducts stress tests once a year, and the firms are required to run their own tests and disclose results to the public twice a year.

Stress testing is an important tool, but it is not sufficient to provide a full picture of the capital adequacy of large firms.⁹ The Fed also looks at other aspects of large banks' capital planning, such as their risk management, internal controls, and governance. If the Federal Reserve is not satisfied with the results from capital stress tests or identifies shortcomings in a firm's capital planning, we may restrict the firm's ability to pay dividends, buy back shares, or take other actions that would reduce its capital base.

In addition to these steps related to capital, in 2012 the Federal Reserve began a comprehensive assessment of large banks' liquidity.¹⁰ We review the firms' own

⁸ In addition to ad hoc stress testing that was conducted throughout the crisis, in 2009 the Federal Reserve and the other U.S. federal banking agencies undertook the Supervisory Capital Assessment Program at the 19 largest U.S. bank holding companies. This exercise played a key role in publicly identifying capital deficiencies at the largest firms and bolstering market confidence by requiring companies to address these deficiencies.

⁹ For more information about the Comprehensive Capital Analysis and Review exercise and interagency Dodd-Frank Act stress-testing requirements, see the webpage "Stress Tests and Capital Planning" on the Board's website at www.federalreserve.gov/bankinfo/reg/stress-tests-capital-planning.htm.

¹⁰ This Federal Reserve assessment is known as the Comprehensive Liquidity Analysis and Review.

liquidity stress tests, and we conduct an independent assessment of their liquidity. These liquidity exercises provide a regular opportunity for Fed supervisors to respond to evolving liquidity risks and firm practices over time. Through this effort, we can require large firms to take specific actions to bolster their liquidity or enhance the way they manage their liquidity risks.

Through stress testing and other improvements to supervision, the Federal Reserve is requiring more of large institutions. We are also requiring more of ourselves. Before the crisis, the Fed's supervision of large institutions did not make the fullest and most effective use of the expertise of our staff across the Federal Reserve System. To improve our supervision of the largest systemically important firms, we have created the Large Institution Supervision Coordinating Committee, which I mentioned earlier. The LISCC brings together experts from around the Federal Reserve System in the areas of supervision, research, legal, financial markets, and payment systems in a centralized body led by the Federal Reserve Board.

The LISCC program enhances supervision in several ways. First, by looking at firms both individually and collectively, it helps ensure supervisors are well positioned to identify issues at individual firms as well as trends across and interconnections among firms that may pose risks to financial stability. The LISCC also promotes high standards and consistency in the supervision of large firms through a centralized yet Systemwide approach. By bringing together staff members from across the Federal Reserve System, the LISCC is designed to ensure that diverse views and perspectives are brought to bear on important decisions about the supervision of systemically important firms. Lastly, the diversity of skills among the Fed experts involved in the LISCC allows it to consider

financial stability risks from the broader economy, financial markets, and other sources. The LISCC also builds on the comprehensive analysis of financial stability by the Board's Office of Financial Stability Policy and Research, which was established after the financial crisis.

The Federal Reserve has significant responsibilities for supervising large financial institutions, but we cannot guarantee their stability on our own. It is important that we communicate and coordinate with other U.S. financial regulatory agencies with responsibilities that affect the safety and soundness of large institutions. We also need to cooperate with supervisors in other countries where these firms operate. This cooperation helps us understand developments in a complex and global financial system that have implications for individual firms or for large institutions generally. It can also provide information and perspective about firms whose supervision we may share with other agencies or governments. In addition, it facilitates a coordinated approach to ensuring that large firms are operating in a safe and sound manner.

To be effective, regulation and supervision must be independent of the entities subject to oversight. You may know or have heard the term "regulatory capture." Regulatory capture is when a regulatory agency advances the interests of the industry it is supposed to oversee rather than the broader public interest it should represent.¹¹ Regulatory capture, which may occur in the oversight of any industry, can happen in both intentional and inadvertent ways. The most blatant ways involve tangible conflicts of interest--for example the expectation government officials might have of future rewards

¹¹ A body of economic literature addresses regulatory capture, with perhaps one of the most influential works being George J. Stigler (1971), "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, vol. 2 (Spring), pp. 3-21. See also Ernesto Dal Bó (2006), "Regulatory Capture: A Review," *Oxford Review of Economic Policy*, vol. 22 (Summer), pp. 203-25.

from the industry they oversee. But experience and extensive research shows that regulatory capture also occurs in less tangible ways, when close contact and familiarity between individuals leads those enforcing the rules to sympathize with those they oversee. Whatever the source, the risk of regulatory capture is something the Federal Reserve takes very seriously and works very hard to prevent. We enforce strict ethics rules and promote strong values among our employees, among them a commitment to public service. It is important that anyone serving the Fed feel safe speaking up when they have concerns about bias toward industry, and that those concerns be addressed. The broadening of expertise and participation in supervision conducted by the LISCC, as overseen by the Board, represents yet another check to the risk of regulatory capture in the oversight of large firms.

The Results of Improved Supervision

I believe the changes I have described have significantly improved the strength and stability of large financial institutions and the financial system.

As I mentioned earlier, strong capital and liquidity are fundamental to the resiliency of large institutions. The good news is that the amount and quality of capital and the strength of liquidity positions at large firms are greatly improved since the crisis.

While some of the improvement in the capital positions of large firms is due to the regulatory changes I have described that are being phased in over the next several years, some of it has come as a direct result of the Fed's capital planning and stress-testing requirements. From early 2009 through 2014, capital held by the eight most systemically important U.S. bank holding companies more than doubled, reflecting an

increase of almost \$500 billion in the strongest form of capital held by these companies.¹² Likewise, the Federal Reserve's increased focus on liquidity has contributed to significant increases in firms' liquidity. The high-quality liquid assets held by these eight firms has increased by roughly one-third since 2012, and their reliance on short-term wholesale funding has dropped considerably.

Beyond these very tangible gains, we see some evidence of improved risk management, internal controls, and governance at large firms. But large firms still have room for improvement in this area, and supervisors will be watching closely. The compliance breakdowns in recent years that I mentioned earlier in my remarks undermine confidence in large firms' risk management and controls, which has implications for financial stability. The Fed has taken and will continue to take swift and meaningful action to ensure that firms focus on their risk-management practices and continue to strengthen them.

Both the Federal Reserve and the large firms we oversee have become more forward looking in evaluating these firms' capacity to withstand significant financial stress, which has enhanced financial stability. Much of this new perspective has come through our capital and liquidity reviews, which require both firms and supervisors to make financial projections into the future rather than simply relying on current and past performance. Likewise, requiring firms to plan for their possible demise and orderly resolution has forced them to think more carefully about the sustainability of their business models and corporate structures.

¹² Specifically, for the period from 2009 to 2013, tier 1 common equity as defined in the Board's regulatory capital regulations, and in 2014, common equity tier 1 capital, due to changes in regulatory capital regulations.

We have a more consistent and industry-wide perspective on risks and vulnerabilities than we had prior to the crisis. The focus on individual firms is still extremely important, but we now supplement this approach more systematically with reviews of issues across multiple firms simultaneously. These reviews allow us to identify common themes and unacceptable practices among large firms that will enable us to take consistent and effective action.

Lastly, I believe the resolution authority enacted by the Congress and our work with the FDIC on the orderly resolution of large institutions are reducing the problem of firms considered “too big to fail” by addressing the risks a failure of a large firm would pose to the financial system. The plans developed by the largest firms to date still have a number of shortcomings, but the Federal Reserve has asked for and expects these institutions to make substantial progress in the coming months which will leave firms and the government better positioned to manage the failure of a large institution in an orderly way.¹³

The goal, through this and other actions I have described today, is to do whatever can be done to avert the dire threat and lasting damage of a severe financial crisis. We cannot eliminate the possibility of another crisis, but we can make a crisis less likely and less damaging by limiting excessive risk-taking by firms we oversee and by helping ensure that the most systemically important firms are better prepared to weather a crisis.

We have focused our efforts on the largest firms because they were and continue to be crucial to the financial system and its ability to support the financial needs of

¹³ See Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation (2014), “Agencies Provide Feedback on Second Round Resolution Plans of ‘First-Wave’ Filers,” joint press release, August 5, www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm.

households and businesses. By working to promote the safety and soundness of large firms, the Federal Reserve is trying to ensure that these and many other banks can continue to serve the people of New York and every community in America.