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THE SEMIANNUAL TESTIMONY ON THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF THE FINANCIAL SYSTEM

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE EFFORTS, ACTIVITIES, OBJECTIVES, AND PLANS OF THE FEDERAL RESERVE BOARD WITH RESPECT TO THE CONDUCT, SUPERVISION, AND REGULATION OF FINANCIAL FIRMS SUPERVISED BY THE FEDERAL RESERVE BOARD

NOVEMBER 15, 2018

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C O N T E N T S

THURSDAY, NOVEMBER 15, 2018

WITNESS

THE SEMIANNUAL TESTIMONY ON THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF THE FINANCIAL SYSTEM

THURSDAY, NOVEMBER 15, 2018

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

The Committee met at 10:01 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. The Committee will come to order.

Today we will receive testimony from Federal Reserve Vice Chairman for Supervision Randy Quarles regarding the efforts, activities, objectives, and plans of the Federal Reserve Board with respect to the conduct, supervision, and regulation of financial firms supervised by the Federal Reserve Board.

We last heard from Vice Chairman Quarles in October on the Fed's progress implementing S. 2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act.

At that time the Fed had taken actions to implement some provisions of S. 2155, including those related to the 18-month exam cycle, high-volatility commercial real estate, and the Small Bank Holding Company Policy Statement.

Since then, the Fed has taken new steps to implement key provisions of the bill.

Recently, the Fed issued proposals revising the application of enhanced prudential standards across four categories of firms to reflect each category's varying risks. These proposals are a step in the right direction, and I appreciate the Fed's work to issue them quickly.

I understand the amount of staff work that went into getting the proposals out, and thank you and your staff for your work on these proposals.

The proposals would assign banking organizations to one of four categories based on their size and other risk-based indicators, including cross-jurisdictional activity; nonbank assets; short-term wholesale funding; off-balance-sheet exposures; and status as a U.S. global systemically important bank, or a U.S. G–SIB.

The category to which an institution is assigned would determine the enhanced prudential standards and capital and liquidity requirements to which it would be subject.

I look forward to hearing how the application of certain enhanced prudential standards would address the risks associated with cross-jurisdictional activity, nonbank assets, short-term wholesale funding, and off-balance-sheet exposures.

The proposal incorporates a number of very positive changes to the current framework for regional banks, including relief from advanced approaches capital requirements; a reduced liquidity coverage ratio; changes to the frequency of supervisory and company-run stress testing, and, in some cases, the disclosure of the results.

Despite this positive step, the agencies have left a number of items unaddressed, including the treatment of foreign banking organizations; additional details on stress testing, including the Fed's Comprehensive Capital Analysis and Review, or CCAR; and resolution planning.

I encourage the regulators to revisit all regulation and guidance thresholds that were consistent with the outdated Section 165 threshold to an amount that reflects actual systemic risk.

Regulators have two options: use a systemic risk factors-based approach, or raise all thresholds to at least $250 billion in total assets to be consistent with S. 2155.

There are also other noteworthy provisions of the bill on which the Fed, working with other regulators, has yet to act, including implementation of the Community Bank Leverage Ratio and the provision that exempted cash deposits placed at central banks by custody banks from the supplemental leverage ratio. The Fed should work promptly to issue proposals to address these critical outstanding issues.

I was encouraged by Vice Chairman Quarles' speech last week, particularly the emphasis on providing more transparency around stress testing and capital planning processes.

Finally, last week all Republican Members of the Banking Committee sent a letter to the FDIC on Operation Choke Point.

Operation Choke Point is an initiative in which Federal agencies devised and relied upon a list of politically disfavored merchant categories with the intent of "choking off" these merchants' access to payment systems and banking services.

Staff at the banking agencies use verbal recommendations to encourage banks to stop doing business with disfavored but legal businesses.

I plan to look into how policy is communicated from the banking agencies to the regulated institutions more broadly.

I appreciate Vice Chairman Quarles joining us today to discuss developments in the Fed's supervision and regulation and look forward to hearing more about the Fed's pending work to implement Senate bill 2155.

Senator Brown.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman, and thanks to Vice Quarles for joining us. Good to see you again.

The Fed's responsibility and Vice Chairman Quarles' job is, as we know, to ensure that the economy works for average Americans—that if you work hard, you can get ahead; that Wall Street does not again crash the financial system and squander the pensions that families worked their whole lives to earn; and that banks cannot cheat workers out of their hard-earned savings; and that executives are held accountable when they break the law.

We know the Fed failed in its mission 10 years ago. The Fed had all the power it needed to prevent the crash. Its leaders in Washington were too complacent and too cozy with Wall Street to use their authority to rein in the largest banks and to protect American taxpayers.

That is why immediately after the crash, we put in place rules to strengthen taxpayer protections from big bank risk and to protect consumers from predatory practices.

The rules worked. Our system got safer, and the rules have not stopped banks from becoming more profitable than ever, as we see. The Fed released a report on Friday showing that two important measures of banks' profitability—return on equity and average return on assets—hit a 10-year high in the second quarter of 2018. They have reported a 30-percent growth in loan volume since 2013, while experiencing a 10-year low in the share of loans that are not performing.

But now, with legislation enacted earlier this year and the actions of this Administration, we are witnessing—piece by piece by piece—the dismantling of these protections for American workers and an undermining of the dignity of work.

Since the last time Mr. Quarles testified before this Committee, we have two new developments that underscore this point.

First, the Fed's proposal to implement the bank giveaway bill, S. 2155, goes far beyond what the authors of that legislation claimed the bill would do. The Fed's proposed rule loosens protections for banks with more than $250 billion in assets—not small community banks, the way the bill was sold. We are talking about the Nation's biggest financial institutions. Combined, these firms hold $1.5 trillion in assets.

The Fed's proposal also promises more goodies for the big banks, with rollbacks for large foreign banks expected in the next few months. This is despite the fact that the Fed's own progress report said that foreign banks continue to violate anti–money-laundering laws and skirt Dodd–Frank requirements. No need today to go down that list of foreign banks. We all know who they are. We have talked about them in this Committee. Senator Cortez Masto has brought it up. I have brought it up. A number have brought it up. Yet we are saying to these foreign banks we sort of ignore the illegal things they do and continue to deregulate them.

Vice Chair Quarles gave a speech last week announcing the Fed's plans for the very largest domestic banks—a speech, frankly, that could have easily been written by one of those banks' lobbyists.

Mr. Quarles wants to weaken capital requirements for the megabanks, eliminating any leverage capital standards in stress tests. We got a preview of what this would look like in June when the Fed gave passing grades to three banks that had clearly failed their stress tests. Now Mr. Quarles wants to make this year's giveaway permanent.

The speech outlined a series of other changes to the Fed's stress tests that would render them essentially meaningless. Mr. Quarles makes no secret of the fact he wants to ease up on the assumptions that guide the tests, wants to eliminate portions of the tests, and wants to share with the banks the Fed's internal models against which they are graded—you know, giving students the answers ahead of time.

These changes, taken alongside the weakening of the Volcker Rule, other big bank leverage standards, and an abandonment of nonbank financial oversight, these changes amount to gutting the postcrisis protections we put in place that have worked marvelously for about a decade to protect American taxpayers future bailouts. Again, repeat, the banks are doing very, very, very well with these rules and regulations in terms of profitability and return, all of those things. So why do we think weakening those rules makes sense?

It is not just I who says this. Stanley Fischer, the former Vice Chair of the Fed, called these combined rollbacks "mind boggling" and "very dangerous."

When regulators have not finished implementing Dodd–Frank, when the economy has not even gone through a full economic cycle, now is not the time to begin dismantling our postcrisis protections. It is the same story: Wall Street recovers, working families in Cleveland and Baltimore and Birmingham and Las Vegas do not. When Washington policymakers suffer from collective amnesia, as this Committee does, working families and savers and taxpayers too often end up paying the price.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Brown.

Again, Vice Chairman Quarles, we appreciate you being with us. You may now make your statement.

STATEMENT OF RANDAL K. QUARLES, VICE CHAIRMAN FOR SUPERVISION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. QUARLES. Thank you. Thank you, Chairman Crapo, Ranking Member Brown, Members of the Committee. I am grateful for the opportunity to testify on the Federal Reserve's regulation and supervision of the financial system.

My prepared remarks address two main topics: our efforts to improve regulatory transparency and our progress in making the postcrisis regulatory framework simpler and more efficient. I am mindful that this semiannual testimony, like my position as Vice Chairman for Supervision, is grounded in Congress' efforts to strengthen and improve the Nation's regulatory framework following the financial crisis, and 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 it is 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 firms clarity on the letter and spirit of their obligations. It provides supervisors with exposure to a diversity of perspectives. And it provides markets with insight into the condition of regulated firms, which fosters 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. We recently improved our supervisory ratings system for the large financial institutions, better aligning ratings with the supervisory feedback that those firms receive. With our fellow banking agencies, we clarified that supervisory guidance is a tool to enhance the transparency of supervisory expectations and should never be the basis of an enforcement action. And we expect shortly to make final a set of measures to increase visibility into the Board's supervisory stress testing program, including more granular descriptions of our models, more information about the design of our scenarios, and more detail about the outcomes we project.

The report that accompanies my testimony today and that Ranking Member Brown referred to 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. As the report shows and as my written testimony discusses, 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.

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, including cyber and IT risks at supervised firms of all sizes.

Improving regulatory efficiency is another core element of our current efforts. Tailoring regulation and supervision to risk has been a programmatic goal of the Federal Reserve for more than two decades. The motivations are clear: supervisory resources are not limitless; 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 agencies in designing the postcrisis regulatory framework, and it has guided our implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act. On this front, as my written testimony details, we have made substantial progress.

Our most significant step came 2 weeks ago when the Board issued two proposals to better align prudential standards with the risk profile of regulated institutions. These proposals 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 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 draw on our experience administering enhanced prudential requirements and other postcrisis measures, and they move toward a more risk-sensitive, nuanced framework, where riskier activities and a larger systemic footprint correspond to higher supervisory and regulatory requirements.

I have detailed several other efforts to improve regulatory efficiency in my written testimony, including simplifying and tailoring requirements under the Volcker Rule.

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. I look forward to making progress on that and other efforts and to participating in the Committee's oversight of our work.

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

Chairman CRAPO. Again, thank you, Mr. Quarles.

My first question is really just one on timing for what is coming next. I do appreciate the work the staff has gone through, truly. I know the amount of work it has taken for you to move as expeditiously as you have. I am concerned, however, that it is difficult to get a full picture of what the supervisory and regulatory landscape will look like until other proposals on foreign banks, resolution planning and capital planning, and stress testing are out. And I encourage you to keep the heat on to move quickly and would appreciate any updates you might have on timing.

Mr. QUARLES. Certainly, Mr. Chairman. So as I indicated, our implementing proposal which we are working on jointly with the OCC and the FDIC on the community bank leverage ratio proposal we expect very soon. And, again, I hope that the speed with which we put forward the main implementing proposal indicates that very soon really will be very soon.

Shortly following after that, I think we will have proposals for modernizing or bringing up to date the resolution framework and foreign banking organizations, tailoring for foreign banking organizations. I view the tailoring for foreign banking organizations as a somewhat separate question from implementation of S. 2155. We have been considering, and obviously we need to consider, and will come up with a proposal for that. But the domestic operations of foreign banking organizations I do not think are one-for-one correspondent with domestic firms of the same size because those intermediate holding companies, they interact with branches that are subject to a different regulatory regime here. They are parts of larger organizations.

So I think there is tailoring that can be done. We need to ensure that we have a level playing field, that firms that are alike are treated alike. That is very important. But I do think it is a separate implementation question than 2155 implementation.

Chairman CRAPO. All right. Thank you very much.

Are you familiar with the letter or have you seen the letter that the Republican Members of this Committee recently sent to the FDIC on Operation Choke Point?

Mr. QUARLES. I have seen that letter, yes.

Chairman CRAPO. And are you familiar with Operation Choke Point, what it is?

Mr. QUARLES. I am familiar with what I have read about it, yes.

Chairman CRAPO. OK. As I indicated in my opening statement, I am very concerned with the lack of accountability in the supervisory process. What we are finding is that many of the regulators who are verbally giving instructions to those regulated that are not actually contained in their authority or the law, and that, frankly, financial institutions, particularly a lot of our smaller financial institutions, feel an incredible pressure from things that are not coming even from regulations or guidances, but just from verbal communications.

This raises the question to me of whether those who are conducting the supervision throughout our agencies, our financial regulatory agencies, are engaging in regulatory direction and activity that is not authorized by law or regulation.

My question to you is: What are you doing to make sure that staff at the Federal Reserve is accountable to you? And is there anything Congress can do to make sure that you have the tools necessary to make staff at the agency accountable to you?

Mr. QUARLES. So I appreciate that concern, and I would share that concern. Obviously, if there were instances where examiners were communicating and requiring banks to take action that was not required by regulation and that was not transparent to those above them in the hierarchy, you know, obviously that would be extremely concerning.

We have a pretty vigorous training program at the Fed. I personally have undertaken as well to spend time in the various reserve banks in dealing with the supervisors on the ground, conferences of all the supervisory personnel, leadership conferences. We are working hard—none of that is terribly visible. All that is within the system. But we are working hard to ensure that our expectations for supervisory practice as well as our regulatory process is very clear to those who are on the ground.

Chairman CRAPO. Well, thank you. I appreciate that and I—well, I appreciate your attention to that. As the letter that some of the Members of this Committee recently sent to the FDIC, we want to assure that all of our regulatory agencies in the financial system follow their own regulations and the law of the United States rather than, frankly, social managing ideas that they have with regard to which businesses in America should be allowed to do business. It is an extremely serious concern, and I appreciate your attention to this.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Following your speech, one bank analyst told clients that your proposed changes are "a positive for the biggest banks by providing capital and compliance relief. It reinforces our deregulatory theme for the banking sector. It shows how deregulation can proceed, even with Democrats retaking the House of Representatives."

Two questions. Do you think this analysis of the Fed's actions is accurate? And, second, can you guarantee this Committee that when the Fed is done, megabank capital standards will not decrease relative to where they are today?

Mr. QUARLES. As I have indicated each time I talk about increasing transparency and improving the efficiency of that system, including our stress testing proposals, our objective is not to have any—certainly no material effect on the resiliency of the system and not to have any material effect on the loss-absorbing capacity of these largest firms. I think that there are things that we can do that improve the incentives, that reduce burden, that are more appropriate in a democracy about the transparency that is required about regulatory expectations without undermining the safety and soundness of the system and without, again, in any way reducing the loss-absorbing capacity of the system.

Senator BROWN. But does that mean no diminishing of the capital standards?

Mr. QUARLES. Capital standards are a very important element of that, but I think we also look broadly. So it is not just capital standards. It is all the cushions that are built into the capital structure.

Senator BROWN. It includes capital standards?

Mr. QUARLES. Capital standards are included in my understanding of loss absorbency that we do not intend to reduce.

Senator BROWN. So was that analysis of your speech fair and accurate?

Mr. QUARLES. I think it did not—I mean, to the extent that they believe that there would be material capital reductions for the largest firms, I do not think they were—I think they ignored the clear statement that I made, that our intention is not to——

Senator BROWN. This is a group of people that want those standards diminished, and there is, I mean, almost an arrogance to it: "Well, we know the regulators will help us do that even though those people in the House of Representatives will not."

Mr. QUARLES. So I believe that it is—I know from what it is that we are proposing that it is possible to have, again, a material improvement in the efficiency and reduction in the cost of our regulatory system without undermining what is at the core of it, which is improved resiliency and strong loss absorbency for these firms.

Senator BROWN. You outlined a lot of bold changes in your speech. Are you speaking for the whole Fed Board in speeches like that?

Mr. QUARLES. In some cases the Fed Board has made decisions resolving this. We have come out with proposals. In other cases—and I have tried to be clear about this when that was the case—I have said what it is that I would place before the Board in short order.

Senator BROWN. Thank you. Thanks for your honesty. This is short of an admonition, but we have noticed already, even though Chair Yellen—and every Chair is different. I get that. Chair Yellen wanted unanimity when the Board made decisions, and when one of the Board members, the only non–Trump Board member, voted the other way, they went ahead. I hope that—I said this is short of an admonition, but I hope that you keep that in mind, that the best way to do this is consensus. And if it means convincing a wayward or two Board member, one or two Board members to come around, be patient and try to do that, or look elsewhere.

Mr. QUARLES. So we do look for consensus, and certainly there is a process on the Board that I think each Board member would say has taken every Board member's thoughts into account and is open, and adjustments have been made even where at the end of the day the Board cannot be unanimous. I do not think that unanimity can be the sole measure of legitimacy or the whole Dodd–

Frank Act would be illegitimate. It was not passed unanimously. But we do at the Board have a very robust process to ensure that every Board member's voice is heard.

Senator BROWN. I appreciate that, but a regulatory body is very different from a politically elected—I mean, you, I assume—I think I can assume your political party, but it does not matter. You are on the Fed, and regardless of Ms. Brainard or Mr. Quarles or anybody else on that Board, political party should not really matter.

One more question. You said the Fed intended to give megabanks a cheat sheet for the stress test in the coming years, handing over details about the Fed's models, how the Fed predicts hypothetical loan performance, even letting banks comment on the Fed's scenarios that predict what economic shocks may occur over the next year.

Given the lead-up to the 2008 crisis, why are you so confident that banks will not optimize their assets to gain the models? Isn't that exactly what banks did to game credit rating agency models for mortgage-backed securities?

Mr. QUARLES. So in our transparency proposal, we have tried to strike a balance between more transparency, again, which I think is appropriate for a number of reasons—again, not just due process, but also to improve the quality of our models. The more that people understand them, not just the industry but academics, Congress, the public, the more input that we can receive on how to improve them.

But as I have said a number of times, I do think that there is a concern about the so-called mono model problem, and that if we were completely transparent, that whatever idiosyncracies there are in our model would become the locuses of risk throughout the entire system, and we could end up making the system more fragile rather than less. And so we are not being completely transparent about our models even in these increased transparency proposals that we have made for that reason.

Senator BROWN. Well, and I will close, Mr. Chairman. I appreciate the word "transparency" used at least six times in that answer, and you and I when we had breakfast talked about that, and I appreciate that view. But this is more like in some ways giving banks the teacher's edition of the textbook with the answers listed out in the back when you call giving them that transparency. We all want transparency in your deliberations, and I think the Fed has made progress under—really under Bernanke and Yellen and now. But I just caution you with the word "transparency" when it is giving information to the people that you are stress testing.

Thank you, Mr. Chairman.

Chairman CRAPO. Senator Corker.

Senator CORKER. Thank you. We welcome you here, and while I have enjoyed working with all of those who have held your position, it is good to have someone who is actually confirmed and in this role in the appropriate manner.

I know there are going to be comments based on my staff input earlier today relative to some of the tailoring issues and some concerns and people alluding to bank profits. But when we have tried to do safety and soundness, put in place safety and soundness regulations for institutions—and I think many of us here strongly support higher capital levels to make sure that they are safe and sound. But we really do not look at trying to manage bank profits when we do that, do we?

Mr. QUARLES. No.

Senator CORKER. Talk to us a little bit about what you think about when you go through those processes.

Mr. QUARLES. So I think that we have two principal concerns as regulators. We have a concern for the safety and soundness of individual institutions, and we have a concern for the safety and soundness of the system as a whole and for the efficiency of the system as a whole because all of us as citizens benefit from the efficiency of the financial sector. That is what provides the support for economic growth, provides credit for small businesses and businesses generally.

So really irrespective of bank profitability, our concern is that that system should be operating as efficiently as possible and that our regulation of that system, while achieving the objective of safety and soundness, is doing so in the most efficient way practicable, because when we do that, we support economic growth that benefits us all.

Senator CORKER. I notice the FDIC appropriately is moving down the path of making sure they have a rulemaking in place relative to private flood insurance, and I think many of us here would like to see steps taken to ensure that institutions are accepting private flood insurance. What is the status of that right now at the Fed?

Mr. QUARLES. So we share the view that private flood insurance should be acceptable, and we are working to ensure that that is understood throughout our supervisory system, so as a supervisory matter that private flood insurance will be acceptable.

Senator CORKER. So we look forward to you moving ahead with that, and hopefully that will happen very soon.

The GSEs have been something of debate here since 2008, unsuccessfully. I know that the new Congress likely will take up legislation. My sense is the Administration potentially will try to lead on that issue by putting in place some things they can do on their own accord and then coming back and talking with Congress about things that are necessary to fully implement reforms as it relates to Fannie and Freddie. Currently they are in conservatorship, as you know.

I am just curious. Some people on this Committee may disagree with the whole creation of FSOC. Some people I think would have thought maybe the Fed's responsibility was that. But we do have FSOC, and we do have some firms that are designated as systemically important.

I am just interested in why the Fed and why FSOC has not chosen to say that Fannie and Freddie themselves, with such a huge concentration and such importance systemically to the banking system itself, have not even during conservatorship chosen to designate them as systemically important.

Mr. QUARLES. Well, ultimately that is a question for the FSOC as a whole as opposed to just the Federal Reserve.

Senator CORKER. Would you all push for that, though? You have a very strong voice in that.

Mr. QUARLES. I think that the right—myself, I think that the right answer for the GSEs is to have a comprehensive solution, and FSOC designation in the context of that, I think it needs to be thought of as what is a comprehensive solution for these institutions. And so I would not want to do anything piecemeal until it was clearer what the whole solution is going to be. I know that the Treasury and the FHFA are both working hard on that, and I think as we see how that evolves——

Senator CORKER. So you look at designating someone with $3 trillion in assets as part of a reform solution, not something that you deem to be important as it relates to systemic risk? That is an odd response, just for what it is worth.

Mr. QUARLES. Well, again, I think that everything that involves——

Senator CORKER. Just for what it is worth, you know, I support you and I appreciate your being here. It feels like the Fed is taking a political look at this and not wanting themselves to be entangled in versus pushing for the fact that these institutions, if they ever survive conservatorship, certainly would need to have capital and all of those kinds of things. And it feels like you all are kind of dodging a political issue to keep yourselves from being maybe wounded by taking a step that is appropriate. Is that kind of where the Fed is today?

Mr. QUARLES. I certainly would not characterize it that way. I think it is that we are in early days of what ultimately is a very complex problem and a difficult solution, and I think we should not approach that solution piecemeal, but should look at what is a comprehensive answer.

Senator CORKER. So yes or no, are they systemically important?

Mr. QUARLES. Well, I think it is unarguable that those institutions have systemic consequence. The question is: What is the right response to that?

Senator CORKER. So they are systemically important. Thank you.

Chairman CRAPO. Senator Jones.

Senator JONES. Thank you, Mr. Chairman. And thank you, Mr. Quarles, for being here.

I would like to ask you a little bit about something that I am hearing more and more about in Alabama, and that is the current expected credit loss accounting standard, CECL, that has come in. As someone who tries to run away anytime people start talking numbers and accounting, I really appreciate what FASB has been doing, so I am not making any judgment here. But I am concerned in what I hear from our banks a little bit, the concern about unintentional consequences that may impact the ability of banks to make long-term loans, whether small business loans or residential loans. And I think and my recollection is that in recent comments at Brookings, you stated that you believe that there was some agreement that CECL was going to be procyclical, but that these issues could be addressed as you phased in those rules.

Can you just expand on those comments a little bit and what you are looking at to try to make sure that we do not have those unintended consequences and making sure particularly smaller banks are protected?

Mr. QUARLES. Certainly. So I agree with you that there is a lot that we still do not know about how CECL will really operate in practice and what the effect will be on banks of any size, but particularly smaller banks. And that is why we had proposed that we will have a 3-year phase-in period, at least a 3-year phase-in period, so that we can understand before phasing the CECL results into our capital calculations, exactly what those effects are really in operation.

We have gotten a lot of different estimates ex ante as to what the consequence will be of CECL. Will there be an immediate increase in reserves on day one? Is the real issue with CECL or the real consequence of CECL that there will be procyclicality in the event of stress? And if there is procyclicality in the event of stress, does that affect banks that are covered by our stress tests? And how does CECL work there? And it really is too early to say and I do not think we have enough data to know exactly what those consequences are going to be, the day one consequences versus the ongoing consequences and the stress consequences.

So we are going to be looking at all of that on the basis of the real operation of CECL when it is in effect by delaying our implementation of including it in our capital——

Senator JONES. All right. And I assume you will be taking the comments.

Mr. QUARLES. Absolutely.

Senator JONES. I mean, that phase-in is going to give you the opportunity to tweak, to go back and get comments from the banks and how it is going to be——

Mr. QUARLES. We will be looking for input from all sources on that.

Senator JONES. All right. Perfect. Thank you for that.

And so the other thing is the Community Reinvestment Act. I think that is going to be one of the most important items that banking regulators take up this year. I have spoken to the OCC about this. You know, if we get it right, it is going to be really important to modernize the CRA. But if we get it wrong and go in the wrong direction, I am concerned still—and I want to make sure that this is being addressed—that we are not having different regulators addressing the CRA in different ways.

So can you give me an update about the Fed's role working with the OCC about trying to modernize the Community Reinvestment Act?

Mr. QUARLES. Certainly. So we have worked with the OCC. The OCC has put out an Advance Notice of Proposed Rulemaking, and we had extensive discussions, all the banking agencies had extensive discussions together before the OCC went out with that ANPR. We will all be looking at the information that comes in as a consequence of that process. We are having a very athletic outreach process at the Federal Reserve on questions about the CRA. I think we have got 20 different seminars and events that are set up throughout the system, throughout our various reserve banks, looking for input on that. And I expect that, moving forward, our expectation is that we will have a joint NPR, Notice of Proposed Rulemaking, at the end of this outreach process that will reflect all the information that we receive.

Senator JONES. Great. Thank you.

Finally, just a couple of comments. Number one, I know that the Fed is part of a working group dealing with anti– money-laundering issues that I know this Committee is likely to take up this year. I have been hearing that law enforcement may not be as included on that. I know you have got some. But as a former U.S. Attorney, I would just encourage that working group to bring in the FBI or other Treasury criminal officials, because there is nothing like boots on the ground to really do that, and I would just encourage you to include some boots-on-the-ground law enforcement as part of that working group.

And the final thing I just want to say is I want to tell you that I appreciate very much you and your fellow Fed Board Governors for maintaining your independence during a time of recent criticism. I think the independence of the Federal Reserve is truly a core bedrock of our economy and our democracy here on both monetary and regulatory policy. It is critical that you maintain that independence, so thank you for that. And I want to tell you that for as many of us here that we can, we will do what we can to preserve that independence for you. So thank you.

Mr. QUARLES. Thank you, Senator.

Chairman CRAPO. Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman.

Vice Chair Quarles, first of all, thanks for being here. Before I get into the questions that I have got for you, I would like to make one real quick comment. I would like to echo the remarks made yesterday by my colleague from the House Financial Services Committee, Congressman Ted Budd, regarding the insurance regulation. I agree with Congressman Budd that the Fed and other American regulators should stand up for State-based insurance regulation and fight overreach from the international regulators like the IAIS, and hopefully you folks will stand strong on that.

Let me also just jump into where my questions would begin. As we conclude the 115th Congress, Americans have a lot of things to be thankful for. The postcrisis economic expansion has continued for a near record 97 months. Tax reform and the Trump administration's deregulatory efforts have pushed GDP growth to 4 percent. Unemployment remains at a low of 3.7 percent. These are all positive developments. Yet I remain very concerned about a number of troubling economic signals from back home in South Dakota with our strong reliance on an ag economy—not just South Dakota, but North Dakota, Minnesota, Nebraska, Iowa, the Upper Midwest.

More specifically, our country's ongoing trade disputes are causing significant economic problems for my State's ag economy. As an example, the retaliatory tariffs from China on American soybeans have caused soybean sales to China to plummet by 94 percent compared to last year's harvest.

Now, while the Federal Government's financial assistance has helped to offset some of these losses, the subsidy for each bushel of soybeans in some cases covers less than half of the actual loss that farmers are facing, and it is the producers that are really taking the brunt. They are on the tip of the spear in this trade dispute.

The impact, I cannot overemphasize how critical this trade impact is to the economic well-being of farmers in the Upper Midwest. In South Dakota, the farm economy is down for 5 years in a row. We are down 50 percent in net farm income, and this is not helping at this point. And while we see some relief coming, there is going to be a time—just as an example, soybeans down by 94 percent sales to China, some people say, "Big deal." China buys 60 percent—of all those that are exported, 60 percent of it goes to China. It is close to 30 percent of the entire soybean market. And so this is a real impact to farmers in the Upper Midwest.

Some of these folks, after 5 years of low commodity prices, will be coming in to ask for operating loans. The banks in the Upper Midwest, those who have survived year in and year out, have over the past understood at the local level that every year is not going to be a profitable year for an ag operator. And most of those smaller banks that do that expect that some years they are going to have to look at something and say, "You may not have performed well last year or commodity prices are down, but we understand long term this is going to be a profitable program for our bank, and if you do not survive, we do not survive either."

I am hopeful and what I am asking for is some reassurance from the Federal Reserve that the Fed and the FDIC, the regulators and the folks who are going to come in and actually audit the banks will have an understanding that this short-term trouble we are in right now is not going to cost these banks to be identifying these ag operators as nonperforming loans if they come back in looking for assistance to get by this tough time period in which they are on that tip of the spear in this trade dispute.

Could you comment on that, please?

Mr. QUARLES. Certainly. I think one of the strengths of our supervisory system is that we have people on the ground with experience both with individual institutions and different categories of institutions and a history of understanding how different markets work, and all of that should be brought to bear as they make their individual supervisory decisions.

Senator ROUNDS. I am going to go one step farther because I think this is really important. In the previous Administration, there were times in which at the upper echelons there was an attempt to get more money out into the economy, and yet at the lower echelons, where the actual audits were being done, there was a disconnect in that it was very difficult to get the money into the ag economy because in some cases specific sections of the ag economy were identified as nonperforming sectors, and even loans that had been repaid on time were still being identified as nonperforming assets.

I just want to hear once again a reassurance that there is some sort of a message out there that says that the ag economy is going through a tough time; we understand that there can be exceptions made, and that we are not going to be punishing the banks for trying to get these folks through a tough time. And that has got to come from the top down so that the folks on the front line who are doing the audits, making the reviews of the banks, have some understanding about what the banks are trying to do to make sure these producers survive and actually continue to help make those banks a profit in the future.

Mr. QUARLES. So I can absolutely commit to you that I take the supervision part of this job as important as the regulatory part of this job. For what it is worth, as I think you know, I come from an agricultural background myself and understand the issues that you are talking about, very much so, and will be engaging with the supervisors to ensure that they take reasonable decisions.

Senator ROUNDS. Thank you.

Thank you, Mr. Chairman.

Senator BROWN [presiding]. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. It is good to see you again, Governor Quarles.

I want to follow up on a letter I sent yesterday to the Fed and to several other Federal regulators. In it I raised concerns about the rapid growth of leveraged corporate lending, that is, lending to companies that already have a lot of debt.

There was a record $1.1 trillion in leveraged loans in the U.S. last year, nearly double what it was just a few years ago. In the last few weeks, former Fed officials have raised serious concerns about the growth of leveraged lending. Former Fed Governor Dan Tarullo called for more oversight and transparency because of the risks these loans pose to the economy, and former Fed Chair Yellen said she is "worried about the systemic risks associated with these loans."

So do you agree with former Fed Chair Yellen and Governor Tarullo that this is a concern?

Mr. QUARLES. Well, I agree that the framework that they are talking about it in, the systemic risk is what it is that we ought to be looking at and ensuring that we understand how systemic risk is evolving as opposed to simply the volume of leveraged lending. I think that is the right way to look at it.

Senator WARREN. OK. I understand you think it is the right way to look at it. Are you concerned about it, the amount? That is the question.

Mr. QUARLES. Yeah, again, I think the question is what are the structures that these loans are being held in. The amount itself is not what is critical. What is critical is, you know, are they being held in vulnerable structures? Do we understand how the system is evolving? And that is something that we are looking at very closely.

Senator WARREN. All I can say, even your fellow Trump appointee, OCC head Joe Otting, said recently that "there is probably a bit more leverage in this market than we as a country should be comfortable with."

So I tell you what, let me move on. In 2013, under the Obama administration, the Fed, the OCC, and the FDIC were worried about leveraged lending, so they issued joint guidance, and that guidance provided risk management and underwriting expectations for the leveraged commercial loans, and then they enforced it. The next year a dozen banks received notices that they were not following the guidance, and the Fed issued a supervisory finding that directed Credit Suisse to abide by the guidelines.

But things have shifted in the Trump administration. Earlier this year, Comptroller Otting said he did not care if the banks under his supervision violated the guidelines if it did not affect their overall safety and soundness. Is that your position as well?

Mr. QUARLES. Well, our position with respect to leveraged lending supervision is that we are actually quite athletically looking at that. That is something——

Senator WARREN. OK, so that is not your position. You are enforcing the guidelines.

Mr. QUARLES. Well, guidance is guidance. Guidance is intended to provide transparency, but it is not something that can be enforceable. It is not a rule. So what we are enforcing are——

Senator WARREN. I am sorry. The Fed directed Credit Suisse to abide by the guidelines back in 2014, so you cannot say there is nothing you can do. The Fed has done it.

Mr. QUARLES. To enforce guidance is inappropriate. That is not something that can be done.

Senator WARREN. Well, it directed them to follow the guidance. I mean, I do not want to split hairs with you. I am just asking a question. Are you still holding them to the guidance or not?

Mr. QUARLES. We are holding them to standards of safety and soundness, and I think that is an important distinction, Senator. We are not in any way abrogating or not looking at leveraged lending. That is an important part of our supervision.

Senator WARREN. Are you monitoring compliance with the 2013 guidelines?

Mr. QUARLES. We are monitoring compliance with safety and soundness.

Senator WARREN. Is that a no on the 2013 guideline?

Mr. QUARLES. The guidance is intended to provide transparency as to what it is that we will look at.

Senator WARREN. Are you monitoring compliance with that?

Mr. QUARLES. We should not monitor compliance with guidance. We should monitor compliance——

Senator WARREN. I take that as a no, then.

Mr. QUARLES. ——with safety and soundness.

Senator WARREN. I will take that as a no. There have been reports of banks offering loans that plainly violate the 2013 guidelines, so it is clear to me that at least the market does not think you are monitoring these. What concerns me, Governor Quarles, is this market looks a lot like the subprime mortgage market looked pre-2008. The loans are badly underwritten with minimal protections. Like subprime mortgages, these loans are being packaged up and sold to investors as collateralized loan obligations, or CLOs, which spread the risk throughout the system and take the lender off the hook for originating a bad loan. And these loans have adjustable rates, which means that if interest rates continue to go up, companies will owe more money just at the moment when the overall economy may be slowing down.

Now, the Fed dropped the ball before the 2008 crisis by ignoring the risks in the subprime mortgage market. What are you doing differently this time in coordination with other Federal regulators so that you are limiting the risk that leveraged loans cause serious harm to the financial system?

Mr. QUARLES. So we are—as I said, it is an important theme of our supervision and monitoring—this cycle is monitoring the underwriting standard for leveraged loans. We will be looking at that carefully in this supervisory cycle. We are also monitoring carefully how the CLO ecosystem is evolving to make sure that we understand where risks are evolving there.

Senator WARREN. OK. I am not sure that I see much distinction between what you are doing now and the Fed was doing pre-2008, and I think that is deeply worrisome. I have sent a letter, asked more questions in that letter. I hope I will be able to get a response soon to that. I am very concerned that the Fed dropped the ball before and may be dropping it one more time on this.

Thank you.

Chairman CRAPO [presiding]. Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman. Good morning, Mr. Vice Chairman.

Can you tell me what exposure, if any, the American banking system has to any instability in Italy, including but not limited to its banking system?

Mr. QUARLES. So the exposure of our banking system to Italian banks is—the direct exposure is relatively modest. We do not think that there is a particular issue there. Obviously it is a single financial sector. There are parts of the European financial sector that are exposed to Italy, and we continue to monitor whether developments there could have feedback effects into the United States. We are not—we do not view cause for particular concern there at the moment.

Senator KENNEDY. OK. What is a short form call report?

Mr. QUARLES. The intention of the short form call report is to be a form that has less burden on the institutions that fill it out, requires less cost and time, but still provides us all the information that we need to ensure that institutions that are less risky are safe and sound appropriate to the riskiness.

Senator KENNEDY. And I believe that Congress and, for lack of a better expression, our Dodd–Frank reform bill directed you to come up with a short form call report for banks $5 billion or less that would be less onerous. Is that right?

Mr. QUARLES. That is correct.

Senator KENNEDY. Why haven't you done that?

Mr. QUARLES. I know that we are in the process of implementing that. I think that——

Senator KENNEDY. You promulgated a rule. It is going to save the average bank a grand total of 1.18 hours a quarter. The stuff that you are cutting out is the stuff that most small banks always put zero on. You are not doing anything. I mean, I would like you to get in another lick and let us try to be serious about it.

Refresh my memory what banks $5 billion or less did wrong in 2008.

Mr. QUARLES. Well, overconcentration in commercial real estate, but we do not believe that they are——

Senator KENNEDY. But did they cause—they did not cause the meltdown.

Mr. QUARLES. We do not believe that they are likely to have systemic——

Senator KENNEDY. Right, but we punished the hell out of them in Dodd–Frank. OK?

Mr. QUARLES. Yeah, I do believe that it was—that the regulatory burden on the smaller banks was too much.

Senator KENNEDY. I wish you would take another look at your promulgated rule. I think it is all hat and no cattle.

Mr. QUARLES. I appreciate that, and I will go back and look at it.

Senator KENNEDY. OK. Tell me, Mr. Vice Chairman—and I really do appreciate the job that you are doing. Tell me what a community bank leverage ratio is.

Mr. QUARLES. So that is a proposal that we are working on with the other regulators to develop standards that a community bank that has a certain leverage ratio and other standards would be subject to simplified, much simplified regulation.

Senator KENNEDY. OK. Would it be fair to say that it would mean that a community bank which has a lot of capital, a lot of cushion, particularly with respect to or in comparison with the larger systemically important banks, would get less supervision?

Mr. QUARLES. Well, I——

Senator KENNEDY. Well, not less supervision.

Mr. QUARLES. Exactly.

Senator KENNEDY. Less paperwork.

Mr. QUARLES. Less paperwork, absolutely. Absolutely.

Senator KENNEDY. OK. Have you promulgated a rule?

Mr. QUARLES. We have not promulgated a rule yet, but that is one that I expect very soon, and very soon in real time, not Fed time.

Senator KENNEDY. OK. Well, let us suppose that a community bank had 6 percent capital. Would you consider that to be well capitalized?

Mr. QUARLES. Depending on the type of capital, that could be well capitalized.

Senator KENNEDY. OK, with reasonable liquidity.

Mr. QUARLES. Yeah, I think the community bank leverage ratio instruction is somewhere between 8 and 10. We are to look between 8 and 10 percent.

Senator KENNEDY. Right, 8, 10, 12. I am just saying there are a lot of small institutions out there that are very well capitalized, and if they belly up, the world is not going to spin off its axis. It may for its shareholders, but that is the way capitalism works.

Mr. QUARLES. Sure.

Senator KENNEDY. So we really ought to be trying to do everything we can to get a little Government off their back so you can concentrate your efforts on banks whose demise could threaten our banking system. Would that be fair?

Mr. QUARLES. I agree.

Senator KENNEDY. OK. I hope you will do that in developing the ratio, and I hope you will take a good second look at that rule that I mentioned. Thank you, Mr. Vice Chairman.

Mr. QUARLES. Thank you, Senator.

Senator KENNEDY. Have a Happy Thanksgiving.

Mr. QUARLES. Thank you.

Chairman CRAPO. Senator Menendez.

Senator MENENDEZ. Thank you.

Last week it was reported that more than 500 families, including 22 in New Jersey, wrongly lost their homes to foreclosure because of an error in Wells Fargo underwriting software which caused the bank to incorrectly deny mortgage modifications to homeowners. That is unacceptable, and there is no amount of remediation or apology that makes up for losing your home.

Now, I know, Mr. Vice Chair, that you have recused yourself from matters specific to Wells Fargo, but I do think this raises a more serious overarching question about the oversight of the Nation's biggest banks. I am seriously concerned that we are re-creating a world where homeowners are at the mercy of the banks and there will not be a cop on the beat when things go bad.

So what assurances can you give us that the Federal Reserve is specifically monitoring for these types of issues and in a larger sense ensuring that homeowners are not subject to the same abuses they were during the crisis?

Mr. QUARLES. So we have a large and active Division of Consumer and Community Affairs where we have regulatory authority that remains after the Dodd–Frank Act—and our authority was restricted to some extent as you know, but where we have regulatory authority, we have a very active enforcement program in ensuring that we are both examining and, where we see deficiencies, enforcing against consumer problems.

Senator MENENDEZ. And so in this case, that would have been lost in that process? Or would something like this be lost in that process?

Mr. QUARLES. So I would not think so. I mean, that is the sort of thing that we would look at. I would have to—we can get back to you with more specifics. The Fed can get back to you with more specifics about Wells Fargo since I am recused, but as a general systemic matter, we certainly—we do not underemphasize——

Senator MENENDEZ. My point is if you, in fact—I appreciate your answer. If you, in fact, are saying that you are looking at systemic issues that might affect homeowners in a way that this particular instance did, then it did not work as it relates to Wells Fargo. So we have to understand what is it that did not work. I would love to hear from the Fed the specific about Wells Fargo. But I would like to also hear what did not work at the end of the day that did not catch this.

The Federal Reserve recently proposed loosening liquidity rules for banks as large as $700 billion in assets. During the crisis these same banks received almost $60 billion in taxpayer bailouts. Liquidity standards are critical to ensuring banks have enough cash on hand to meet the demand should there be a stress in the market. The Fed's proposal, however, would slash those requirements and would result in a $77 billion decrease in liquid assets for banks with assets of $100 to $700 billion.

Fed Governor Brainard voted against the proposal saying she saw no changes in the financial environment that would require the Federal Reserve to substantially weaken such rules. Moreover, she said, this proposal comes at the "expense of an economically meaningful increase in the probability of stress at affected institutions," which, in other words, I translate into it is pretty risky.

How can you justify these changes which put taxpayers at risk of future bailouts?

Mr. QUARLES. So I do not think that they have put taxpayers at risk of future bailouts. The effect of our proposed liquidity changes would be a reduction in the overall amount of liquidity in the system of between 2 and 2.5 percent. We have since the crisis added $3 trillion of liquidity. That is multiples of liquidity than existed before the crisis. And these changes to tailor the burden of complying with regulation, according to the riskiness of firms, you know, I think are quite appropriate. The firms in that category are generally funded with much less wholesale funding. They are much less subject to liquidity risk. And yet the overall consequence of this change is only 2 to 2.5 percent available liquidity in the system.

Senator MENENDEZ. Let me talk to that 2.5 percent that you cite. My reading of that decline is that it is based on a larger consideration of all liquid assets in the system for banks with more than $100 billion in assets. What we are talking about is the decline in liquid assets for banks between $100 and $700 billion. So surely that ratio is much higher if you consider the liquid assets of the institutions who are receiving relief.

It is estimated that it is a decline of 30 percent for the banks over $250 billion in assets and 15 percent for those with assets between $100 and $250 billion. So it is not 2.5 percent.

Mr. QUARLES. Well, I think the appropriate denominator is the system. If you take a subset, you will always get a higher percentage if you take just a subset. But if you look at the system as a whole, we are not affecting in any material way the liquidity resources of the system.

We also are under a statutory instruction to tailor our regulation for all firms, and I think this is a way to do that to implement the statute without having an important systemic——

Senator MENENDEZ. I do not think that statutory instruction is one that drives you to ultimately create the potential for greater risk as part of that instruction.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Governor Quarles, that concludes the questioning. We appreciate again you taking the time to be here with us today.

For Senators wishing to submit questions for the record, those questions are due on Monday, November 26th, and, Vice Chairman Quarles, we ask that you respond promptly to those questions. And, once again, thank you for being here.

Mr. QUARLES. Thank you.

Chairman CRAPO. This Committee is adjourned.

[Whereupon, at 11:04 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN MIKE CRAPO

Today we will receive testimony from Federal Reserve Vice Chairman for Supervision Randy Quarles regarding the efforts, activities, objectives, and plans of the Federal Reserve Board with respect to the conduct, supervision and regulation of financial firms supervised by the Federal Reserve Board.

We last heard from Vice Chairman Quarles in October on the Fed's progress implementing S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act.

At that time, the Fed had taken actions to implement some provisions of S. 2155, including those related to the 18-month exam cycle, high-volatility commercial real estate and the Small Bank Holding Company Policy Statement.

Since then, the Fed has taken new steps to implement key provisions of the bill.

Recently, the Fed issued proposals revising the application of enhanced prudential standards across four categories of firms to reflect each category's varying risks.

These proposals are a step in the right direction, and I appreciate the Fed's work to issue them quickly.

I understand the amount of staff work that went into getting the proposals out, and thank you and your staff for your work on these proposals.

The proposals would assign banking organizations to one of four categories based on their size and other risk-based indicators, including: cross-jurisdictional activity; nonbank assets; short-term wholesale funding; off-balance-sheet exposures; and status as a U.S. global systemically important bank, or U.S. G–SIB.

The category to which an institution is assigned would determine the enhanced prudential standards and capital and liquidity requirements to which it would be subject.

I look forward to hearing how the application of certain enhanced prudential standards would address the risks associated with cross-jurisdictional activity, nonbank assets, short-term wholesale funding and off-balance-sheet exposures.

The proposal incorporates a number of very positive changes to the current framework for regional banks, including: relief from advanced approaches capital requirements; a reduced liquidity coverage ratio; and changes to the frequency of supervisory and company-run stress testing and, some cases, the disclosure of the results.

Despite this positive step, the agencies have left a number of items unaddressed, including: the treatment of foreign banking organizations; additional details on stress testing, including the Fed's Comprehensive Capital Analysis and Review, or CCAR; and resolution planning.

I encourage the regulators to revisit all regulation and guidance thresholds that were consistent with the outdated Section 165 threshold to an amount that reflects actual systemic risk.

Regulators have two options: use a systemic risk factors-based approach, or raise all thresholds to at least $250 billion in total assets to be consistent with S. 2155.

There are also other noteworthy provisions of the bill on which the Fed, working with other regulators, has yet to act, including implementation of the Community Bank Leverage Ratio and the provision that exempted cash deposits placed at central banks by custody banks from the supplemental leverage ratio.

The Fed should work promptly to issue proposals to address these critical outstanding issues.

I was encouraged by Vice Chairman Quarles' speech last week, particularly the emphasis on providing more transparency around stress testing and capital planning processes.

Finally, last week, all Republican Members of the Banking Committee sent the FDIC a letter on Operation Choke Point.

Operation Choke Point is an initiative in which Federal agencies devised and relied upon a list of politically disfavored merchant categories with the intent of "choking-off" these merchants' access to payment systems and banking services.

Staff at the banking agencies use verbal recommendations to encourage banks to stop doing business with disfavored, but legal businesses.

I plan to look into how policy is communicated from the banking agencies to regulated institutions more broadly.

I appreciate Vice Chairman Quarles' joining us today to discuss developments in the Fed's supervision and regulation and look forward to hearing more about the Fed's pending work to implement S. 2155.

PREPARED STATEMENT OF SENATOR SHERROD BROWN

Thank you, Mr. Chairman and thank you Vice Chairman Quarles for appearing before the Committee today.

The Federal Reserve's responsibility, and Vice Chairman Quarles' job, is to ensure that the economy works for average Americans—that if you work hard, you can get ahead.

That Wall Street doesn't again crash the financial system and squander the pensions that families worked their whole lives to earn.

That banks can't cheat workers out of their hard-earned savings.

And that executives are held accountable when they break the law.

We know the Fed failed in its mission 10 years ago. The Fed had all the power it needed to prevent the crash, and its leaders in Washington were too complacent, and too cozy with Wall Street, to use their authority to rein in the largest banks and protect American taxpayers.

That's why immediately after the crash, we put in place rules to strengthen taxpayer protections from big bank risk, and to protect consumers from predatory practices.

The rules worked—our system got safer, and the rules haven't stopped banks from becoming more profitable than ever. The Fed released a report on Friday showing that two important measures of banks' profitability—return on equity and average return on assets—hit a 10-year high in the second quarter of 2018.

Banks have also reported a 30 percent growth in loan volume since 2013, while experiencing a 10-year low in the share of loans that aren't performing.

But now, with legislation enacted earlier this year, and the actions of this Administration, we are witnessing—piece by piece—the dismantling of these protections for American workers.

Since the last time Mr. Quarles testified before this Committee, we have two new developments that underscore this point.

First, the Federal Reserve's proposal to implement the bank giveaway bill, S. 2155, goes far beyond what the authors of that legislation claimed the bill would do. The Fed's proposed rule loosens protections for banks with more than $250 billion in assets—not small community banks—we're talking about the Nation's biggest financial institutions. Combined, these firms hold $1.5 trillion in assets.

The Fed's proposal also promises more goodies for the big banks, with rollbacks for large foreign banks expected in the next few months. This is despite the fact that the Fed's own progress report said that foreign banks continue to violate anti–money laundering laws and skirt Dodd–Frank requirements.

Second, Vice Chairman Quarles gave a speech last week outlining the Fed's plans for the very largest domestic banks—a speech that could have easily been written by one of their lobbyists.

Mr. Quarles wants to weaken capital requirements for the megabanks, eliminating any leverage capital standards in stress tests. We got a preview of what this would look like in June, when the Fed gave passing grades to three banks that had clearly failed their stress tests. Now, Mr. Quarles wants to make this year's giveaway permanent.

The speech outlined a series of other changes to the Fed's stress tests that would render them essentially meaningless. Mr. Quarles makes no secret of the fact that he wants to ease up on the assumptions that guide the tests, wants to eliminate portions of the tests, and wants to share with the banks the Fed's internal models against which they are graded—that's like giving students the answers ahead of time.

These changes, taken alongside the weakening of the Volcker Rule, other big bank leverage standards, and an abandonment of nonbank financial oversight, amount to gutting the postcrisis protections we put in place to protect American taxpayers future bailouts.

It's not just me saying this. Stanley Fischer—the former Vice Chairman of the Fed—called these combined rollbacks quote, "mind boggling" and quote "very dangerous."

When regulators haven't finished implementing Dodd–Frank, and the economy hasn't even gone through a full economic cycle, now is not the time to begin dismantling our postcrisis protections. It's always the same story—Wall Street recovers, working families don't. And when Washington policymakers suffer from collective amnesia, working families, savers, and taxpayers end up paying the price.

PREPARED STATEMENT OF RANDAL K. QUARLES

VICE CHAIRMAN FOR SUPERVISION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOVEMBER 15, 2018

Chairman Crapo, Ranking Member Brown, 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 postcrisis 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 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 nonloan portfolios.

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[1] Board of Governors of the Federal Reserve System, "Federal Reserve Board Finalizes New Supervisory Rating System for Large Financial Institutions", news release, November 2, 2018, *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181102a.htm.*

[2] Board of Governors of the Federal Reserve System, Bureau of Consumer Financial Protection, Federal Deposit Insurance Corporation, National Credit Union Administration, and Office of the Comptroller of the Currency, "Agencies Issue Statement Reaffirming the Role of Supervisory Guidance", news release, September 11, 2018, *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180911a.htm.*

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.

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 postcrisis 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 (EGRRCPA, or the Act).[5] 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
- 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 re-

[3] Board of Governors of the Federal Reserve System, "Supervision and Regulation Report", November 9, 2018, *www.federalreserve.gov/publications/supervision-and-regulation-report.htm.*

[4] The Federal Reserve is also responsible for timely and effective supervision of consumer protection and community reinvestment laws and regulations. More information about the Federal Reserve's consumer-focused supervisory program can be found in the Federal Reserve's Annual Report to Congress. See section 5, "Consumer and Community Affairs", at *https://www.federalreserve.gov/publications/annual-report.htm.* The Federal Reserve also publishes the Consumer Compliance Supervision Bulletin, which shares information about examiners' supervisory observations and other noteworthy developments related to consumer protections. See *https://www.federalreserve.gov/publications/consumer-compliance-supervision-bulletin.htm.*

[5] EGRRCPA, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

[6] Board of Governors of the Federal Reserve System, "Federal Reserve Board Issues Interim Final Rule Expanding the Applicability of the Board's Small Bank Holding Company Policy Statement", news release, August 28, 2018, *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180828a.htm.*

[7] Board of Governors of the Federal Reserve System, "Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)", July 6, 2018, *https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706b1.pdf.*

[8] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Agencies Propose Rule Regarding the Treatment of High Volatility Commercial Real Estate", news release, September 18, 2018, *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180918a.htm.*

[9] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Agencies Issue Proposal To Streamline Regulatory Reporting for Qualifying Small Institutions", news release, November 7, 2018, *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181107a.htm.*

quirements 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 2 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 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 postcrisis 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.[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

[10] Board of Governors of the Federal Reserve System, "Federal Reserve Board Invites Public Comment on Framework That Would More Closely Match Regulations for Large Banking Organizations With Their Risk Profiles", news release, October 31, 2018, *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181031a.htm.*

[11] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Agencies Propose Rule To Update Calculation of Derivative Contract Exposure Amounts Under Regulatory Capital Rules", news release, October 30, 2018, *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181030a.htm.*

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.

[12] Jerome H. Powell, "Remarks at the Ceremonial Swearing-in" (speech at the Federal Reserve Board, Washington, DC, February 13, 2018), *https://www.federalreserve.gov/newsevents/speech/powell20180213a.htm.*

Supervision and Regulation Report

November 2018

Board of Governors of the Federal Reserve System

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Preface

The Board of Governors of the Federal Reserve System is pleased to present the inaugural *Supervision and Regulation Report*.[1] The report summarizes banking conditions and the Federal Reserve's supervisory and regulatory activities, in conjunction with semiannual testimony before Congress by the Vice Chairman for Supervision. While this inaugural report looks at trends going back to the financial crisis, future reports will focus primarily on developments in the period since the previous report. All financial and table data presented in this report are as of June 30, 2018, unless specified otherwise.

The report does not reflect the full extent of tailoring of regulations and supervision—required by the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)—which is in varying stages of implementation. Supervisory portfolios are described in their pre-EGRRCPA form. Changes to regulatory thresholds adopted to reflect EGRRCPA are underway and will be reflected in the next report.

In addition, this report focuses on the Federal Reserve's prudential supervisory responsibilities rather than consumer compliance supervision, which is addressed briefly in the Supervisory Developments section of this report.

This report consists of three main sections, in addition to a Summary of key developments and trends:

- The Banking System Conditions section provides an overview of trends in the banking sector based on data collected by the Federal Reserve and other federal financial regulatory agencies as well as market indicators of industry conditions.
- The Regulatory Developments section provides an overview of the current areas of focus of the Federal Reserve's regulatory policy framework, including pending rules.
- The Supervisory Developments section provides background information on supervisory programs and approaches, as well as an overview of key themes and trends, supervisory findings, and supervisory priorities. The report distinguishes between large financial institutions and regional and community banking organizations because supervisory approaches and priorities for these institutions frequently differ.

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[1] For more information about the Federal Reserve's supervisory and regulatory responsibilities and activities, see section 4, "Supervision and Regulation," of the Federal Reserve Board's *104th Annual Report 2017* at www.federalreserve.gov/publications/annual-report.htm. In addition, the *Federal Reserve System Purposes & Functions* publication provides an overview of these responsibilities and activities and clarifies the distinction between supervision and regulation: "Regulation and supervision are distinct, but complementary, activities. Regulation entails establishing the rules within which financial institutions must operate—in other words, issuing specific regulations and guidelines governing the formation, operations, activities, and acquisitions of financial institutions. Once the rules and regulations are established, supervision—which involves monitoring, inspecting, and examining financial institutions—seeks to ensure that an institution complies with those rules and regulations, and that it operates in a safe and sound manner." See www.federalreserve.gov/aboutthefed/pf.htm.

For summary information regarding the Federal Reserve's review of banking applications activity, please see the *Semiannual Report on Banking Applications Activity* at www.federalreserve.gov/publications/semiannual-report-on-banking-applications-activity.htm.

Contents

Summary

Regulatory policies implemented over the past decade have contributed significantly to improving the safety and soundness of banking organizations and the financial system so they are able to support the needs of the economy through good times and bad. Today, U.S. banking firms are significantly better capitalized and have much stronger liquidity positions. They rely less on short-term wholesale funding, which can evaporate quickly during periods of stress. The largest banking firms have also developed resolution plans that reduce the potential negative systemic impact that could result in the event of their failures.

As the regulatory framework has been strengthened, the Federal Reserve has also focused on the efficiency of financial institution supervision. Compliance burden should be minimized without compromising the safety and soundness gains that have been made in recent years. In addition, the Federal Reserve continues to tailor its regulations, ensuring that the rules vary with the risk of the institution.

In an effort to refine the post-crisis supervisory and regulatory framework, the Board promotes the principles of efficiency, transparency, and simplicity.

Efficiency involves developing and implementing regulations and supervision programs that tailor requirements and intensity appropriately based on the size and complexity of institutions. In addition, the Federal Reserve aims to minimize compliance burden while achieving regulatory and financial stability objectives.[2]

Transparency is not only a core requirement for accountability to the public, but also benefits the regulatory process by exposing ideas to a variety of perspectives. Similarly, transparent supervisory principles and guidance allow firms and the public to understand the basis on which supervisory decisions are made and allow firms the ability to respond constructively to supervisors.

Simplicity complements and reinforces transparency by promoting the public's understanding of the Board's regulatory and supervisory programs. Confusion and unnecessary compliance burden resulting from overly complex regulation do not advance the goal of a safe financial system.

Since the crisis, the Federal Reserve has substantially strengthened its supervisory programs for the largest institutions.

The financial crisis made clear that policymakers needed to address more substantially the threat to financial stability posed by the largest and most complex banking organizations, in particular those considered systemically important. As a result, the Federal Reserve has strategically shifted supervisory resources to its large bank supervision programs. For the largest, most systemically important financial institutions, the Large Institution Supervision Coordinating Committee (LISCC) was established in 2010 to oversee a national program for these

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[2] As discussed in Box 9, "State Member Bank and Consolidated Supervision," the Federal Reserve's bank holding company supervision program also involves reliance on—and extensive coordination with—the insured depository primary regulator in order to reduce burden and duplicative efforts, thereby promoting efficiency.

firms.[3] An increased number of horizontal examinations were introduced, focusing on capital, liquidity, governance and controls, and resolution planning.[4] In addition, financial and management information collections from large institutions increased, giving supervisors more timely and better insight into firms' risk profiles and activities.

The Federal Reserve also enhanced its supervision programs for smaller institutions to address lessons learned during the crisis…

During the financial crisis of 2007–09, a large number of regional and community banks failed or experienced financial stress. Accordingly, the Federal Reserve took steps to improve its regional and community bank supervision programs to enhance expectations for examinations, particularly for those conducted at banks with significant concentrations of credit risk in particular loan segments or that relied significantly on less-stable funding sources.

…and has more recently focused on tailoring its supervisory expectations to minimize regulatory burden whenever possible without compromising safety and soundness.

As banking conditions have improved and regulators have gained more experience implementing the post-crisis regulatory regime, the Federal Reserve, along with other regulatory agencies, has recalibrated supervisory programs to ensure they are effectively and efficiently achieving their goals. As a result, the agencies have implemented several burden-reducing supervisory changes, including

- reducing the volume of financial data that smaller, less-risky banks must submit to the agencies each quarter,
- increasing the loan size under which regulations require banks to obtain formal real estate appraisals for commercial loans, and
- proposing changes to simplify regulatory capital rules.

In addition, the Federal Reserve has taken steps to reduce the amount of undue burden associated with examinations, including conducting portions of examinations offsite. There has also been an increased emphasis on risk-focusing examination activities, where more in-depth examinations are conducted for banks identified as high risk or in areas with high-risk activities, and less-intensive examinations are conducted at lower-risk banks, or in lines of businesses at banks that have historically been lower in risk.

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3 See also Supervision and Regulation (SR) letter 15-7, "Governance Structure of the Large Institution Supervision Coordinating Committee (LISCC) Supervisory Program," at www.federalreserve.gov/supervisionreg/srletters/sr1507.htm.

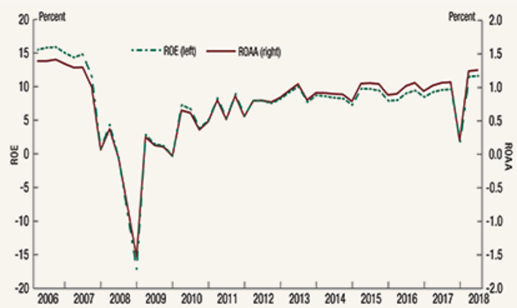
4 Horizontal examinations are exercises in which several institutions are examined simultaneously. Doing so encompasses both firm-specific supervision and the development of broader perspectives across firms.

Banking System Conditions

The financial condition of the U.S. banking system is generally strong.

The strong economy has contributed to improvements in the financial condition of banks. Two important measures of profitability—return on equity (ROE) and return on average assets (ROAA)—have seen steady gains over the past several years and attained a 10-year high in the second quarter of 2018 (figure 1).[5] Earnings for firms of all sizes have been bolstered by rising net interest income. Moderately rising interest rates have been positive for bank earnings and have helped drive increases in net interest income.

Figure 1. Bank profitability



Note: ROAA is net income/quarterly average assets; ROE is net income/average equity capital. Values are annualized.

Source: Call Report and FR Y-9C.

Firms have reported growth in loan volume coupled with lower nonperforming loan ratios.

Loan growth remains robust, with total loan volume for the industry growing over 30 percent since 2013 (figure 2). Commercial and industrial (C&I) loans and non-residential real estate loans have experienced the strongest growth. Since 2013, the volume of C&I and non-residential real estate loans has grown by over 40 percent. Residential real estate lending, which continued to experience structural changes over this period, exhibited tepid growth.

Recently, nonbank finance companies are increasing their market share in new mortgage originations, and large banks are shifting their mortgage exposures from loans to securities. As a result, the banking industry's overall loan portfolio is shifting away from residential real estate loans toward C&I loans (figure 3).

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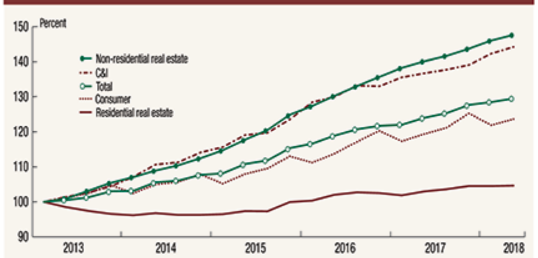
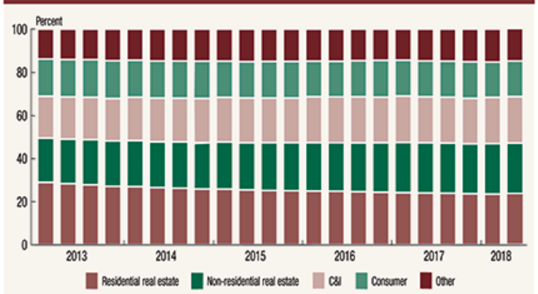
[5] The dip in ROE and ROAA in 2017 was driven by a one-time tax effect.

Figure 2. Loan growth by sector



Source: Call Report and FR Y-9C.

Figure 3. Loan composition



Note: Loan composition is individual loan categories as a share of total loans. Chart key shows bars in order from bottom to top.

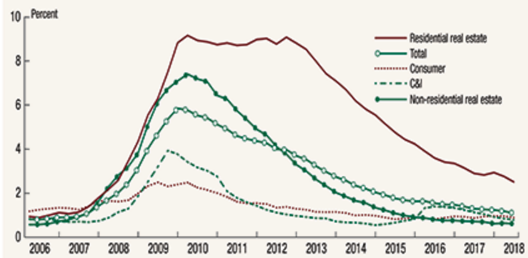
Source: Call Report and FR Y-9C.

The nonperforming loan ratio—one measure of asset quality—is generally improving or stable across the banking system (figure 4).Currently, nonperforming loans as a share of total loans and leases are at or near a 10-year low. However, nonperforming C&I loans increased in 2016 because of a slowdown in the oil and gas industry.

Firms maintain reserves to provide a cushion against losses on loans and leases they are unable to collect. One important financial metric is the ratio of allowance for loan and lease losses (ALLL, which is the amount of reserves banks set aside to absorb losses related to troubled loans) to the volume of nonperforming loans and leases held by a bank, also known as the reserve coverage ratio (figure 5). A higher ratio generally indicates a better ability to absorb future loan losses.

Since 2013, as the volume of nonperforming loans has declined, the industrywide coverage ratio has improved considerably. While the entire industry has seen an improvement in this

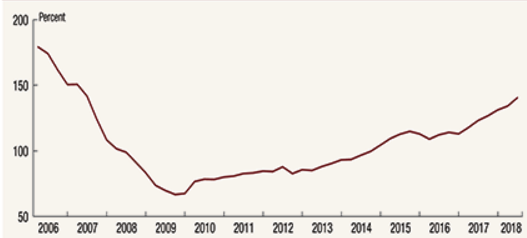
Figure 4. Non-performing loan ratio



Note: Non-performing loan ratio is the ratio of loans 90 days or more delinquent and nonaccrual loans to total loans.

Source: Call Report and FR Y-9C.

Figure 5. Reserve coverage ratio



Note: Reserve coverage ratio is the ratio of ALLL to loans 90 days or more delinquent and nonaccrual loans. Data adjusted for Ginnie Mae guaranteed loans.

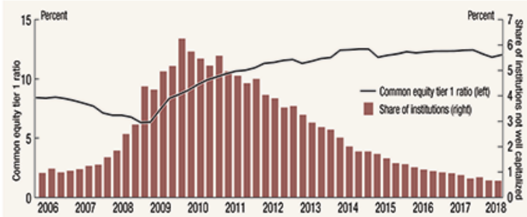
Source: Call Report and FR Y-9C.

ratio, the largest firms have seen the greatest improvement. It is important to note that non-performing loan status is a lagging indicator of loan losses and other factors are considered when estimating the allowance, such as changes in underwriting standards and changes in local or regional economic conditions.

As profitability and asset quality continue to improve, firms still maintain high levels of quality capital.

Capital provides a buffer to absorb losses that may result from unexpected operational, credit, or market events. Since the financial crisis, the Federal Reserve has implemented new rules that have significantly raised the requirements for the quantity and quality of bank capital, particularly at the largest firms. As a result of the new requirements, capital levels have increased across the industry (figure 6).

Figure 6. Common equity tier 1 ratio/share of institutions not well capitalized



Note: Common equity tier 1 is the ratio of tier 1 common equity to risk-weighted assets.

Source: Call Report and FR Y-9C.

Firms have also significantly bolstered their liquidity after coming under funding pressure during the financial crisis.

The funding stresses faced by large banks during the financial crisis heavily influenced the subsequent U.S. regulatory framework for addressing funding and liquidity risk. The financial crisis demonstrated the need to ensure that banks hold enough fundamentally sound and reliable liquid assets to survive a stress scenario. Liquidity requirements put in place since the crisis have significantly increased aggregate levels of highly liquid assets (figure 7).

Figure 7. Highly liquid assets as share of total assets

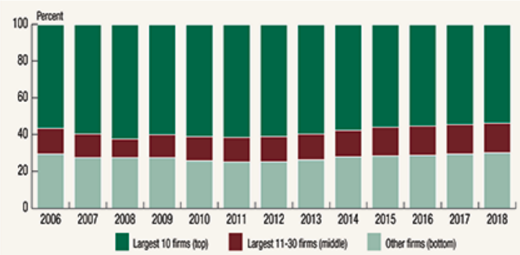
Note: Highly liquid assets (HLA) displayed here are an approximation of high-quality liquid assets (HQLA).

Source: Call Report and FR Y-9C.

The banking industry remains concentrated, while the market share of the largest banking organizations has declined.

Over the past few decades, as the banking system has grown, there has been a trend of increased bank consolidation. During the height of and immediately after the financial crisis, as the financial system was strained, many banks failed or merged with other institutions. Upon closing, their assets were sold to other, often larger, institutions, and the industry saw a wave of consolidation and growth of the largest institutions. In recent years, however, concentration has slowed by some measures. Even as the total volume of loans and leases has been growing, the distribution of those loans has spread to a broader section of the industry. The market share of loans for the 10 largest banking organizations has declined (figure 8).

Figure 8. Concentration of banking industry outstanding loans and leases



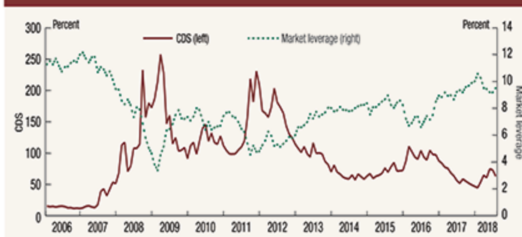
Note: Data prior to 2018 are as of year-end. The 2018 value is as of the end of 2018:Q2.

Source: Call Report and FR Y-9C.

Market indicators generally reflect stronger industry performance.

The improvements in overall banking system conditions since the crisis are reflected in market indicators of bank health, such as the market leverage ratio and credit default swap (CDS) spreads. The market leverage ratio is a market-based measure of firm capital, and a higher ratio generally indicates investor confidence in banks' financial strength. Credit default spreads are a measure of market perceptions of bank risk, and a small spread reflects investor confidence in banks' financial health. Both measures are close to pre-crisis levels (figure 9).[6]

Figure 9. Average credit default swaps (CDS) spread and market leverage ratio



Note: Market leverage ratio is the ratio of market value of equity to market value of equity plus total liabilities. CDS values are for the eight U.S. LISCC firms (Bank of America; Bank of New York Mellon; Citigroup; Goldman Sachs; JPMorgan Chase; Morgan Stanley; State Street; Wells Fargo) and four FBO LISCC firms only (Barclays; Credit Suisse; Deutsche Bank; UBS).

Source: Credit default spread—IHS Markit; market leverage—Bloomberg, Factset.

[6] Definitions of market leverage and credit default swap spreads are included in Appendix A: Data.

Box 1. Institutions Supervised by the Federal Reserve

The Federal Reserve is responsible for the supervision and regulation of bank holding companies (BHCs), savings and loan holding companies (SLHCs), state-chartered banks that are members of the Federal Reserve System (state member banks or SMBs), and the U.S. operations of foreign banking organizations (FBOs). The Federal Reserve tailors regulatory and supervisory strategies to the size and complexity of the institutions that it supervises.

For supervisory purposes, the Federal Reserve categorizes institutions into the groups in table A.

Table A. Summary of organizations supervised by the Federal Reserve

Portfolio	Definition	Number of institutions	Total assets ($ trillions)
Large Institution Supervision Coordinating Committee (LISCC)	Eight U.S. global systemically important banks (G-SIBs) and four foreign banking organizations (FBOs) with large and complex U.S. operations	12*	12.0
State member banks (SMBs)	SMBs within LISCC organizations	5	0.5
Large and foreign banking organizations (LFBOs)	Non-LISCC U.S. firms with total assets $50 billion and greater and non-LISCC FBOs	183	7.5
Large banking organizations (LBOs)	Non-LISCC U.S. firms with total assets $50 billion and greater	20	3.6
Large FBOs	Non-LISCC FBOs with combined U.S. assets $50 billion and greater	19	3.1
Small FBOs	FBOs with combined U.S. assets less than $50 billion	144	0.8
State member banks	SMBs within LFBO organizations	9	1.0
Regional banking organizations (RBOs)**	Total assets between $10 billion and $50 billion	78	1.6
State member banks	SMBs within RBO organizations	46	0.5
Community banking organizations (CBOs)	Total assets less than $10 billion	4,047	2.4
State member banks	SMBs within CBO organizations	742***	0.5
Insurance and commercial savings and loan holding companies (SLHCs)	SLHCs primarily engaged in insurance or commercial activities	11 insurance 4 commercial	1.1

Note: Data are as of June 30, 2018. The table reflects the de-designation for supervision by the Federal Reserve of Prudential Financial, Inc., by the Financial Stability Oversight Council on October 17, 2018.

* Bank of America; Bank of New York Mellon; Citigroup; Goldman Sachs; JPMorgan Chase; Morgan Stanley; State Street; Wells Fargo; Barclays; Credit Suisse; Deutsche Bank; UBS.

** In July 2018, the Federal Reserve implemented changes to its supervisory portfolio designations that raised the total asset threshold between large and regional banking organizations from $50 billion to $100 billion. These changes will be fully reflected in the next iteration of this report.

*** Includes 673 SMBs with a holding company and 69 without a holding company.

Regulatory Developments

The Federal Reserve built out a post-crisis regulatory framework based on robust capital and liquidity requirements, a strong stress-testing regime, and improved resolvability of the largest firms. The Federal Reserve is now focused on assessing whether the regulatory framework is working broadly as intended and on opportunities to simplify the framework and minimize compliance burden as appropriate without sacrificing financial stability or safety-and-soundness. The Federal Reserve is continuing to tailor and reduce burden for less-systemic firms and especially community banks.

Table 1 shows proposed and final rules, as well as Federal Reserve and interagency statements, since the beginning of the year.

Table 1. 2018 Federal Reserve or interagency rulemakings/statements (proposed and final)

Date issued	Rule/guidance
1/4/2018	Federal Reserve requests comments on proposed guidance that would clarify the Board's supervisory expectations related to risk management for large financial institutions. *Federal Register* (FR) notice: www.gpo.gov/fdsys/pkg/FR-2018-01-11/pdf/2018-00294.pdf.
2/5/2018	Agencies seek comment on proposed technical amendments to the swap margin rule. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-02-21/pdf/2018-02560.pdf.
4/2/2018	Agencies issue final rule to exempt commercial real estate transactions of $500,000 or less from appraisal requirements. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-04-09/pdf/2018-06960.pdf.
4/10/2018	Federal Reserve seeks comment on proposal to simplify capital rule for large banks while preserving strong capital levels that would maintain their ability to lend under stressful conditions. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-04-25/pdf/2018-08006.pdf.
4/11/2018	Federal Reserve and the OCC propose rule to tailor enhanced supplementary leverage ratio requirements. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-04-19/pdf/2018-08066.pdf.
4/17/2018	Agencies issue proposal to revise regulatory capital rules to address and provide an option to phase in the effects of the new accounting standard for credit losses, known as the "current expected credit loss" or CECL. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-05-14/pdf/2018-08999.pdf.
6/5/2018	Agencies ask for public comment on a proposed rule to simplify and tailor the Volcker rule. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-07-17/pdf/2018-13502.pdf.
6/14/2018	Federal Reserve approves final rule to prevent concentration of risk between large banking organizations and their counterparties from undermining financial stability. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-08-06/pdf/2018-16133.pdf.
7/6/2018	Agencies issue statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). Statement: www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf.
7/6/2018	Federal Reserve issues statement describing how, consistent with EGRRCPA, the Board will no longer subject primarily smaller, less complex banking organizations to certain Board regulations. Statement: www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706b1.pdf .
8/22/2018	Agencies issue interim final rule regarding the treatment of certain municipal securities as high-quality liquid assets, as required by EGRRCPA. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-08-31/pdf/2018-18610.pdf.

(continued)

Table 1.—*continued*

Date issued	Rule/guidance
8/23/2018	Agencies issue interim final rule expanding examination cycles for qualifying small banks and U.S. branches and agencies of foreign banks, as required by EGRRCPA. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-08-29/pdf/2018-18685.pdf.
8/28/2018	Federal Reserve issues interim final rule expanding the applicability of the Board's Small Bank Holding Company Policy Statement, as required by EGRRCPA. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-08-30/pdf/2018-18756.pdf.
9/11/2018	Agencies issue statement reaffirming the role of supervisory guidance. Statement: www.federalreserve.gov/supervisionreg/srletters/sr1805a1.pdf.
9/18/2018	Agencies issue proposed rule regarding the treatment of high-volatility commercial real estate, as required by EGRRCPA. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-09-28/pdf/2018-20875.pdf.
9/21/2018	Agencies finalize technical amendments to swap margin rule. FR notice: www.gpo.gov/fdsys/pkg/FR-2018-10-10/pdf/2018-22021.pdf.
10/3/2018	Agencies issue statement on banks and credit unions sharing resources to improve efficiency and effectiveness of Bank Secrecy Act compliance. Statement: www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181003a1.pdf.
10/30/2018	Agencies issue proposed rule to update calculation of derivative contract exposure amounts under regulatory capital rules. FR notice: www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181030a1.pdf.
10/31/2018	Federal Reserve and agencies issue proposed rules that would more closely tailor the applicability of enhanced prudential standards, as required under EGRRCPA. FR notices: www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181031a1.pdf and www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181031a2.pdf.
11/2/2018	Federal Reserve Board finalizes new supervisory rating system for large financial institutions. FR notices: www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181102a1.pdf and www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181102a2.pdf.

Box 2. The Economic Growth, Regulatory Relief, and Consumer Protection Act: Reducing Regulatory Burden

The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), enacted on May 24, 2018, changed several aspects of banking law to reduce regulatory burden on community banks and also required the federal banking agencies to further tailor their regulations to better reflect the character of the different banking firms that the agencies supervise.

On July 6, 2018, the Federal Reserve issued a statement explaining how the Board will no longer subject primarily smaller, less complex banking organizations to certain Board regulations, including those relating to stress testing and liquidity. Specifically, this statement explained how the Board would not take action to enforce certain regulations and reporting requirements for firms with less than $100 billion in total consolidated assets, such as rules implementing enhanced prudential standards and the liquidity coverage ratio requirements.

In August and September 2018, the Federal Reserve and other federal banking agencies issued three interim final rules and one proposal to implement various EGRRCPA provisions. Two of the interim final rules provide significant relief to community banking organizations.

On October 2, 2018, Vice Chairman for Supervision Randal Quarles testified before the Senate Committee on Banking, Housing, and Urban Affairs on the Federal Reserve's implementation of EGRRCPA. In his testimony, Vice Chairman Quarles noted that the Federal Reserve's implementation of EGRRCPA is underway and that progress has already been made to implement some tasks set out for the Federal Reserve in EGRRCPA. Vice Chairman Quarles highlighted that the Federal Reserve's priorities in the next few months will be to tailor regulations for firms with assets over $100 billion that are not global systemically important banks (G-SIBs) and to develop a community bank leverage ratio.

On October 31, 2018, the Federal Reserve invited public comment on two proposals (one Board-only and one jointly with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC)) that would establish a framework to further tailor regulations for large banking organizations. The proposals would establish a revised framework for applying prudential standards to large U.S. banking organizations, with four categories of standards that reflect the different risks of firms in each group.

Refer to table 1 for the complete list of rulemakings and links to those documents.

Supervisory Developments

This section provides an overview of key developments related to the supervision of institutions by the Federal Reserve, including trends and details for all large financial institutions (LISCC firms and large and foreign banking organizations) as well as trends and details regarding regional and community banking organizations.

This report focuses on the Federal Reserve's prudential supervisory responsibilities. The Federal Reserve is also responsible for timely and effective supervision of consumer protection and community reinvestment laws and regulations. This consumer-focused supervisory work is designed to promote a fair and transparent financial services marketplace and to ensure that the financial institutions under the Federal Reserve's jurisdiction comply with applicable federal consumer protection laws and regulations. The scope of the Federal Reserve's supervisory jurisdiction varies based on the particular law or regulation, and on the size of the state member bank.

More information about the Federal Reserve's consumer-focused supervisory program can be found in the Federal Reserve's *104th Annual Report 2017*.[7] The Federal Reserve also publishes the *Consumer Compliance Supervision Bulletin*, which shares information about examiners' supervisory observations and other noteworthy developments related to consumer protection.[8]

Large Financial Institutions

This section of the report discusses issues and priorities related to the supervision of firms in the LISCC and large and foreign banking organization portfolios.

The safety and soundness of large financial institutions continues to improve…

Large financial institutions are in sound financial condition. Capital levels are strong and much higher than before the financial crisis (figure 10). Recent stress test results show that the capital levels of large firms after a hypothetical severe global recession would remain above regulatory minimums (figure 11).[9] These hypothetical post-stress ratios are higher than the actual capital levels of large banks in the years leading up to the most recent recession as shown from 2006–09 in figure 10. Large financial institutions have substantially increased the percentage of high-quality liquid assets on their balance sheets, which indicates an improved ability to address any emerging liquidity needs (figure 12).

Since the crisis, large financial institutions have addressed and closed out a significant number of supervisory findings (matters requiring attention (MRAs) or matters requiring imme-

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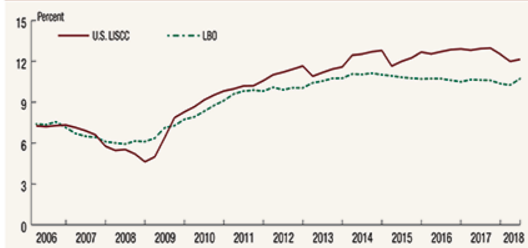
[7] See *104th Annual Report 2017*, section 5, "Consumer and Community Affairs," at www.federalreserve.gov/publications/annual-report.htm.

[8] See *The Consumer Compliance Supervision Bulletin* at www.federalreserve.gov/publications/consumer-compliance-supervision-bulletin.htm.

[9] As referenced here, the required minimum post-stress ratios for the tier 1 capital and tier 1 leverage ratio are 6.0 percent and 4.0 percent, respectively. See also the Federal Reserve's *Comprehensive Capital Analysis and Review 2018: Assessment Framework and Results* report at www.federalreserve.gov/publications/files/2018-ccar-assessment-framework-results-20180628.pdf.

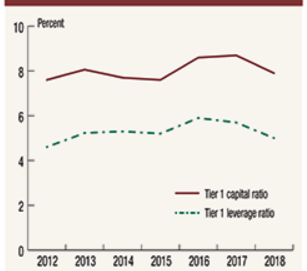
Figure 10. Large financial institution common equity tier 1 ratio



Note: Common equity tier 1 is the ratio of tier 1 common equity to risk-weighted assets.

Source: Call Report and FR Y-9C.

Figure 11. CCAR post-stress capital ratios



Note: Results of annual supervisory stress test (2012–18). Federal Reserve estimates of capital ratios in the severely adverse scenario. Regulatory minimum tier 1 capital ratio is 6.0 percent. Regulatory minimum tier 1 leverage ratio is 4.0 percent.

Source: Internal Federal Reserve supervisory databases.

diate attention (MRIAs)).[10] (See Box 3, "What Are RFI Ratings and MRAs" for more information on MRAs and MRIAs.) As a result, the number of outstanding supervisory findings have generally decreased (figure 13). However, MRAs and MRIAs have actually increased for large foreign banking operations (FBOs), reflecting changes in regulation that required substantive changes to their U.S. structures.

… but material risk-management weaknesses persist at a number of firms.

While most firms have improved in key areas of supervisory focus, such as capital planning and liquidity management, some firms continue to work to meet supervisory expectations in certain risk-management areas, which is reflected in aggregate bank holding company supervisory ratings for large financial institutions (figure 14).

Firms with less-than-satisfactory ratings generally exhibit weaknesses in one or more areas such as compliance, internal controls, model risk management, operational risk management, and/or data and information technology (IT) infrastructure. Some firms continue to exhibit weaknesses in Bank Secrecy Act (BSA) and anti-money-laundering (AML) programs. These risk-management areas sometimes have longer remediation timelines.

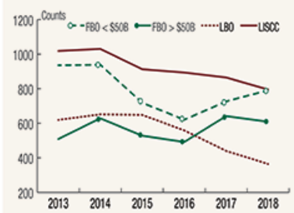
[10] For more information about MRAs and MRIAs, see SR letter 13-13, "Supervisory Considerations for the Communication of Supervisory Findings," at www.federalreserve.gov/supervisionreg/srletters/sr1313a1.pdf.

Figure 12. Large financial institution high-quality liquid assets

Note: High-quality liquidity assets (HQLA) are estimated by adding excess reserves to an estimate of securities that qualify for HQLA.

Source: FR Y-9C, FR 2900, Federal Reserve accounting system.

Figure 13. Outstanding supervisory findings, large firms and FBOs



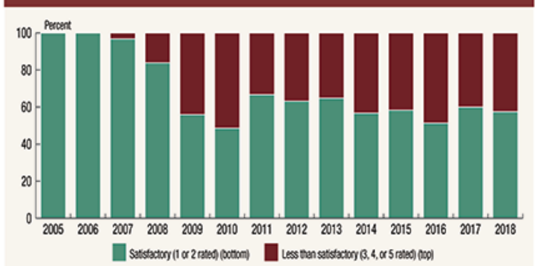
Note: Values prior to 2018 are as of year-end. The 2018 value is as of the end of 2018:Q2.

Source: Internal Federal Reserve supervisory databases.

For larger firms, supervisors will continue to conduct horizontal examinations across multiple firms.

To improve consistency and efficiency, supervisors have increased, and will continue to increase, focus on horizontal supervisory examinations within portfolios. In addition, across all programs, supervisors will also spend time reviewing emerging risks, as well as actions firms have taken to address safety-and-soundness weaknesses previously identified.

Figure 14. Holding company ratings for firms > $50 billion



Source: Internal Federal Reserve supervisory databases.

Box 3. What Are RFI Ratings and MRAs?

Examiners summarize inspection results in written reports to the senior management and board of directors of supervised holding companies. These reports describe conclusions on all factors addressed during the inspection process, including the adequacy of risk management and governance over the banking organization's activities, the consolidated financial condition of the company, and the potential adverse impact of parent and nonbanking activities on the organization.

Within these reports, examiners assign supervisory ratings using the Federal Reserve's RFI rating system, which is named for the individual components of the rating system: risk management (R), financial condition (F), and impact of parent and nonbanking activities (I).[1] Examiners assign ratings both overall in a composite form and to specific aspects of a company's performance on a five-point scale, with ratings of 1 and 2, for example, signifying "strong" or "satisfactory" assessments. A composite rating of 3 reflects "fair" status and indicates the company is vulnerable and requires more than normal supervisory attention and financial surveillance, but there is only a remote threat to its continued viability. Composite ratings of 4 and 5 reflect "marginal" or "unsatisfactory" conditions and are assigned to companies when the organization's future viability could be impaired unless prompt action is taken or the BHC's continued viability is in serious doubt. Ratings of 3, 4, or 5 are considered less-than-satisfactory. Examiners assign component and subcomponent ratings following similar rating conventions.[2] Individual company ratings are confidential supervisory information and cannot be disclosed publicly.

In many cases, holding company inspection reports will include recommendations for follow-up action on the part of the organization's management. Examiners refer to these recommendations as "matters requiring attention," or MRAs. MRAs call for action to address weaknesses in processes or controls that could lead to deterioration in a banking organization's soundness; may result in harm to consumers; or that have caused, or could lead to, noncompliance with laws and regulations. When weaknesses are acute or protracted, Federal Reserve examiners may recommend that management take action more quickly by issuing a "matter requiring immediate attention," or MRIA.

A high volume of MRAs may prompt an examiner to assign a less-than-satisfactory RFI composite rating to a holding company, but the existence of MRAs is not in and of itself an indication that a banking organization is troubled. MRAs may be issued regardless of a company's RFI rating and are not uncommon for companies deemed strong or satisfactory overall.

In the event that holding companies do not address MRAs in a timely or complete manner, examiners may determine that the related weaknesses represent a significant threat to the safety and soundness of the company or its ability to operate in compliance with law and may recommend further action. For example, the Federal Reserve could issue a formal enforcement action with a company. Formal enforcement actions derive from, and carry the full weight and enforceability of, law.

continued on next page

Box 3. What Are RFI Ratings and MRAs?—*continued*

[1] See SR letter 04-18, "Bank Holding Company Rating System," at https://fedweb.frb.gov/fedweb/bsr/srltrs/SR0418.htm. There is separate rating system for banks that is discussed in Box 9, "State Member Bank and Consolidated Supervision."

[2] On November 2, 2018, the Federal Reserve Board adopted a new rating system for large financial institutions (LFIs) that will replace the RFI rating system for those firms. See www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181102a1.pdf. The Federal Reserve will assign initial LFI ratings to firms in the LISCC portfolio in early 2019 and to other large firms in early 2020. The Federal Reserve will continue to utilize the RFI rating system in assessing U.S. bank holding companies with less than $100 billion in consolidated assets. In addition, the Federal Reserve adopted a final rule to begin applying the RFI rating system to non-insurance, non-commercial savings and loan holding companies beginning in 2019.

Box 4. Consolidated Supervision of Large Financial Institutions

Following the financial crisis, the Federal Reserve in 2012 introduced a new framework for the consolidated supervision of large financial institutions.[1] The framework applies to LISCC firms, large banking organizations, and large FBOs and consists of two primary objectives:

1. Enhance the resiliency of a firm to lower the probability of its failure or inability to continue to be able to lend to households and businesses.
2. Reduce the impact on the financial system and the broader economy in the event of a firm's failure or material weakness.

To achieve these objectives, the supervisory efforts are organized to focus on four specific components:

Capital: Assess the strength of firms' capital, or ability to absorb losses, under stressed conditions and how firms measure and use that capital on a forward-looking basis; evaluate how firms manage and control financial risks that could lead to capital reduction through losses.

Liquidity: Assess the adequacy of firms' funding and liquid assets and evaluate how firms manage risks associated with their funding and liquid assets, including under stress scenarios.

Governance and controls: Determine the adequacy of firms' practices through assessments of the effectiveness of the boards of directors' oversight of operations and risk management, the strength of risk-management practices in business lines, and the adequacy of the independent risk-management and the internal audit functions. Also, evaluate how well controls enable appropriate risk-management practices at a firm.

Recovery and resolution planning (recovery planning generally applies to certain covered firms only): Promote the resiliency of covered firms by advancing their recovery preparedness and planning and minimize the impact that distress or failure of a systemically important firm may impose on the broader financial system by furthering firms' resolvability.

[1] See SR letter 12-17, "Consolidated Supervision Framework for Large Financial Institutions," at www.federalreserve.gov/supervisionreg/srletters/sr1217.htm.

Box 5. Upcoming LISCC Supervisory Priorities

Capital

- Capital planning
- Regulatory reporting
- Counterparty risk
- Collateral management
- Wholesale credit underwriting

Liquidity

- Internal liquidity stress test assumptions
- Liquidity position
- Governance over liquidity data, contingency funding plans, and currency risk management
- Compliance with liquidity regulation

Governance and controls

- Information technology and cyber-related risks
- Internal audit
- Compliance and business conduct
- Vendor risk management
- Risk committee practices

Recovery and resolution planning

- Recovery planning
- LISCC foreign bank intermediate holding company resolution plans

Supervision of LISCC Firms

In general, LISCC firms are improving in key areas of supervisory focus.

The overall safety and soundness of LISCC firms has improved in recent years. LISCC firms meet regulatory capital requirements and have materially enhanced capital planning practices.[11] LISCC firms also generally have adequate liquid assets and funding structures. In addition, liquidity risk-management practices, including internal liquidity stress testing, have improved as has the quality of liquidity data.

LISCC firms also have improved governance practices and have strengthened aspects of how they manage compliance with internal and regulatory requirements and other operational risks. U.S. LISCC firms improved their ability to mitigate the adverse effects of a potential failure and unwinding of their operations. They have modified internal corporate structures, reviewed and positioned resources that would be needed to facilitate an orderly resolution, and improved internal shared services arrangements to support operational continuity in the event of resolution. In addition, LISCC firms have developed recovery plans and options to better prepare for severe stress.

[11] In the 2018 Comprehensive Capital Analysis and Review (CCAR) exercise, the Federal Reserve did not object to any firm's capital plan based on quantitative grounds. However, the Board of Governors did object to the capital plan of DB USA Corporation based upon qualitative grounds. The Federal Reserve also issued a conditional non-objection to the capital plans of State Street Corporation, The Goldman Sachs Group, Inc., and Morgan Stanley based on quantitative grounds. See the Federal Reserve 2018 CCAR press release at www.federalreserve.gov/newsevents/pressreleases/bcreg20180628a.htm.

The number of supervisory findings issued to LISCC firms, as well as the number of outstanding issues, has declined over the past five years.

The number of supervisory findings issued per year has steadily declined,[12] with about 45 percent fewer supervisory findings issued in 2017 as compared with 2013.[13] The average number of supervisory findings issued per firm per year declined from about 42 per firm in 2013 to about 23 in 2017. Since 2013, as firms implemented and sustained improvements in governance, risk management, and controls, more supervisory findings were closed than were issued, resulting in an overall 22 percent reduction in outstanding issues.

Box 6. Supervisory Issues at Wells Fargo

On February 2, 2018, the Federal Reserve entered into a consent order with Wells Fargo & Company that restricts the firm's growth until it implements a remediation plan that sufficiently addresses weaknesses in governance and certain areas of its risk management and internal controls. This penalty is in response to weaknesses in compliance risk management that led to widespread consumer abuses and other compliance breakdowns by the firm. The consent order requires the firm to engage a third party to review implementation of the remediation plan. The growth restriction will stay in place until both the implementation and third-party review are carried out to the satisfaction of the Federal Reserve. The Federal Reserve Board will vote on any decision to terminate the asset growth restriction on the firm.

However, some weaknesses persist, particularly related to governance and controls.

Over half of the supervisory findings issued in the past five years were related to governance and risk-management control issues, while about 28 percent were for capital-related issues and about 10 percent related to liquidity. Moreover, of the supervisory findings currently outstanding, nearly 60 percent relate to issues in governance and controls, including weaknesses in BSA/AML programs, internal audit functions, IT risk management (including cybersecurity), and model risk management (figure 15). There are also a number of outstanding supervisory findings related to how firms gather, validate, and report data for regulatory purposes.

Over the past several years, supervisory work has revealed continued weaknesses in LISCC firms' management of compliance and employee conduct risks as well as certain operational activities, including IT and the production and management of data. Some of these issues are reflected in public enforcement actions currently outstanding against LISCC firms.[14]

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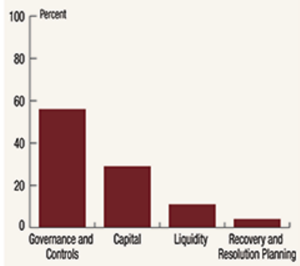
[12] Note that supervisory findings related to resolution plans are not classified as MRAs or MRIAs. Shortcomings and deficiencies found in firm specific resolution plans can be located at www.federalreserve.gov/supervisionreg/resolution-plans.htm.

[13] It should be noted that supervisory findings issued over multiple years will vary in approach and granularity as supervisory practices and policy evolve, which has an effect on the number of recommendations issued. However, the general trend in the issuance of supervisory findings indicates improved risk management at LISCC firms.

[14] Some of the outstanding enforcement actions were issued around the same time to multiple firms because of significant issues that emerged across firms, such as seven enforcement actions related to foreign exchange market abuses and related conduct issues, and several enforcement actions to address BSA/AML weaknesses.

Formal enforcement actions against entities supervised by the Federal Reserve are available on the Federal Reserve Board's website at www.federalreserve.gov/apps/enforcementactions/search.aspx.

Figure 15. Outstanding supervisory findings by category, LISCC firms



Note: As of 2018:Q2, there were 795 total outstanding supervisory findings for LISCC firms.

Source: Internal Federal Reserve supervisory databases.

Outside of governance and controls, additional areas still require improvement. With regard to capital, outstanding supervisory issues relate to methods for developing assumptions used in internal stress tests and internal governance of capital models, as well as some areas of credit risk management. Some firms have also been asked to make additional improvements in liquidity risk management to fully meet supervisory expectations. With regard to resolution planning, certain weaknesses were highlighted by the Federal Reserve in 2017, including the feasibility of selling off business units under stress, complexity in derivatives portfolios, and issues around legal entity structures.[15]

In 2018 and 2019, supervisors will continue to focus on horizontal supervisory examinations within the LISCC portfolio, including in some of the areas listed in box 5. In addition, supervisors will also review emerging risks as well as actions firms have taken to address safety-and-soundness weaknesses previously identified (including those related to existing supervisory findings and outstanding public enforcement actions).

Supervision of Large and Foreign Banking Organizations

The safety and soundness of large and foreign banking organizations is stable.

Large and foreign banking organizations generally meet supervisory expectations for capital and liquidity. Most firms continue to strengthen their capital planning processes and have mature revenue and loss estimation approaches that result in credible loss estimates. In particular, most firms have integrated their stress-testing programs with their ongoing decision-making processes, improved their data and modeling capabilities, and established robust governance practices. However, improvements are still needed at some firms as weaknesses have been identified in capturing higher-risk loans in loss projections and gaps have been identified in firms' own internal reviews of their capital planning processes.

On balance, most firms in the large and foreign banking operations (LFBOs) portfolio have established liquidity risk limit frameworks that reflect firms' risk profiles and appropriate governance processes. While firms have an independent review function in place, the role of the function continues to develop across firms. Deficiencies noted include weaknesses in some firms' liquidity risk identification processes and a lack of robust internal risk functions.

[15] For more information about resolution plans, see the Federal Reserve Board's website at www.federalreserve.gov/supervisionreg/resolution-plans.htm.

Box 7. What Are Governance and Controls?

Governance and controls are essential elements of ensuring a firm operates in a safe and sound manner. The term includes several broad activities, such as

- oversight by the board of directors,
- execution by senior management of the board's strategy,
- maintenance of effective and independent risk-management and control functions (including internal audit and policies and procedures),
- compliance with laws and regulations, and
- planning for the ongoing resiliency of the firm.

Some specific examples of governance and controls include IT and data infrastructure, cybersecurity, and BSA/AML protections. For large firms, sound governance and controls are especially important, given the increased size, complexity, and scope of operations, as well as challenges that arise from managing such large entities consistently across their various business areas.

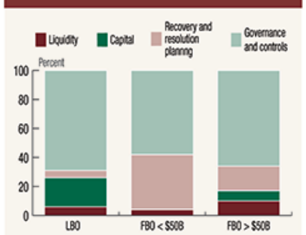
Nonfinancial risks are the most significant risks in the LFBO portfolio.

Almost 70 percent of the supervisory findings for LFBO firms are related to governance and controls (figure 16). Areas of concern include compliance control deficiencies evidenced by long-standing BSA/AML issues as well as some associated with IT risk management (including cybersecurity). The majority of public enforcement actions currently open for LFBO firms are related to BSA/AML and the Office of Foreign Assets Control (OFAC) compliance.

For FBOs, challenges remain regarding compliance with enhanced prudential standards requirements.

In 2014, the Federal Reserve finalized a rule requiring each FBO with U.S. subsidiary assets greater than $50 billion to form an intermediate holding company (IHC) to hold subsidiary assets beginning in 2016. IHCs provide the Federal Reserve a framework to apply enhanced prudential standards such as capital and liquidity requirements and to improve FBO supervision. The IHC requirement also provided a mechanism for FBOs to more effectively manage their U.S. operations. The IHC structural requirement is a material change for the supervision and regulation of foreign banks, and while FBOs continue to face challenges in implementing this requirement, the firms

Figure 16. Outstanding supervisory findings by category, LBO and non-LISCC FBO firms



Note: As of 2018:Q2, total supervisory findings, by portfolio, were: LBO–397; FBO > $50B–652; FBO < $50B–714. Chart key shows bars in order from bottom to top.

Source: Internal Federal Reserve supervisory databases.

Box 8. Upcoming LFBO Supervisory Priorities

Capital

- Loss estimation methodologies
- Capital policies and scenario design

Liquidity

- Independent review function and liquidity limits risk management
- Security dealer internal stress testing assumptions

Governance and controls

- Cyber-related risks
- Internal audit
- Compliance and business conduct
- BSA/AML and OFAC compliance program control

Recovery and resolution planning

- Resolution plans, including IHC resolution plans

have made progress in the approximately two years since the requirement took effect.

FBOs continue to strengthen risk-management and reporting systems of their respective IHCs to meet supervisory expectations. Some FBOs have established multiyear projects to address known deficiencies in their IHCs' risk-management and reporting systems.[16]

Supervisory findings for FBO branches and agencies are concentrated in compliance risk management and controls.

FBO branches and agencies often engage in BSA/AML compliance-sensitive businesses such as dollar clearing, foreign correspondent banking, and trade finance. Examiners have noted that some firms lack sufficiently strong BSA/AML compliance systems. These deficiencies have resulted in public enforcement actions and substantial penalties from bank supervisory and law enforcement agencies.

Upcoming supervisory priorities in 2018 and 2019 will include review and validation of actions by firms to address outstanding supervisory findings. For the LFBO portfolio as a whole, focus will remain on the areas listed in box 8.

Regional and Community Banking Organizations

The majority of the firms in the regional and community bank portfolios are in satisfactory condition.

The financial condition of regional and community banking organizations (RBOs and CBOs, respectively) is generally satisfactory. These institutions have maintained high common equity tier 1 capital levels over the past decade (figure 17). More than 99 percent of banking organizations in this portfolio report capital levels consistent with the "well-capitalized" designation under regulatory capital standards. Although highly liquid assets have been trending down over the past five years for these firms as lending activity has picked up, reliance on wholesale funding remains relatively low.

Supervisory recommendations issued during the financial crisis have largely been addressed and closed (figure 18).

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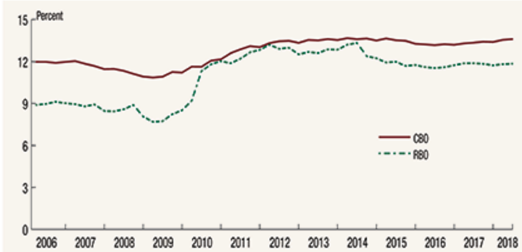
[16] These statements generally also apply to LISCC FBOs.

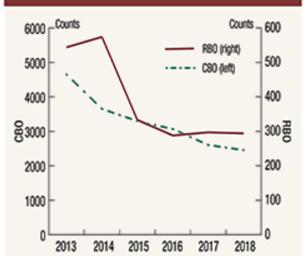
Figure 17. Common equity tier 1 ratio for RBO and CBO firms



Note: Common equity tier 1 is the ratio of tier 1 common equity to risk-weighted assets.

Source: Call Report and FR Y-9C.

Figure 18. Outstanding supervisory findings for smaller institutions



Note: Values prior to 2018 are as of year-end. The 2018 value is as of the end of 2018:Q2.

Source: Internal Federal Reserve supervisory databases.

Supervision and regulation of these institutions is aimed at tailoring requirements to match the size, risk, and complexity of each institution. As firms in these portfolios grow, merge, or enter into new markets or activities, supervisors pay close attention to ensuring that risk-management processes keep pace with their complexity and risk. The Federal Reserve completes full-scope examination or inspection activities for all CBOs, RBOs, and savings and loan holding companies (SLHCs) within each supervisory cycle. However, the scope of individual supervisory events is tailored to the size, complexity, and unique risk characteristics of each institution. To improve supervisory efficiency, Federal Reserve examiners are reducing the amount of time spent onsite at examinations, increasing the risk focus of examinations, and leveraging, where appropriate, supervisory findings from other regulators.

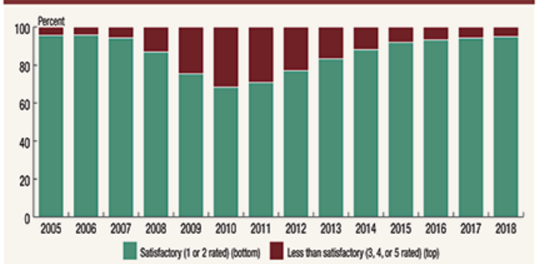
There are few RBOs or CBOs in less-than-satisfactory condition.

Supervisory ratings in these portfolios reflect the generally stable condition of the portfolio, with the vast majority of institutions rated satisfactory.[17] Less than 6 percent of all RBO and

[17] Ratings in this context refers to the composite rating of the top-tier holding company, which generally mirrors the composite rating of the subsidiary banking organization(s). See Box 3, "What Are RFI Ratings and MRAs?" See also SR letter 04-18, "Bank Holding Company Rating System," at www.federalreserve.gov/boarddocs/srletters/2004/

CBO holding companies are rated less than satisfactory, reflecting the generally strong condition of their banking subsidiaries (figure 19). The percentage of RBO and CBO companies rated satisfactory has been trending upward since the low in 2010.

Figure 19. Holding company ratings for firms < $50 billion



Source: Internal Federal Reserve supervisory databases.

Supervision of Regional Banking Organizations

The condition of the RBO portfolio has steadily improved and stabilized post-crisis.

In line with the broader industry, the quality and quantity of capital at RBO firms remain high. Currently, common equity tier 1 ratios for this portfolio are around 12 percent, and all institutions report capital ratios consistent with the "well capitalized" designation under interagency capital guidelines.

Although liquidity risk in this portfolio is considered low or moderate, examiners have observed some deterioration in RBO liquidity positions. As a result of loan growth outstripping growth in core deposits, some banking organizations have increased their reliance on riskier noncore funding sources, such as brokered and listing service deposits.

Risk management and controls at RBOs remain an area of supervisory focus.

Current risks in the portfolio are primarily the result of the consolidation of smaller firms into larger regional banks. The total number of holding companies supervised in the regional banking portfolio increased by 40 percent over the past five years, and the number of those companies that have state member lead banks has doubled. There are now 78 institutions supervised in the RBO program, with combined assets of approximately $1.6 trillion.

sr0418.htm, and SR letter 13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less," at www.federalreserve.gov/supervisionreg/srletters/sr1321.htm.

Box 9. State Member Bank and Consolidated Supervision

The Federal Reserve is responsible for the supervision and regulation of state-chartered banks that are members of the Federal Reserve System (known as state member banks or SMBs). By statute, the Federal Reserve, or chartering state banking department, must perform an onsite, full-scope examination of each SMB at least once every 12 or 18 months.

Results from the onsite examination are reported to the board of directors and management of the bank in a report of examination, which includes an assessment and ratings of the bank's capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk under the Uniform Interagency Financial Institution Rating System, also known as the CAMELS ratings system.[1]

Consolidated Supervision of Community and Regional Holding Companies

Consolidated supervision of the holding company includes an assessment of the organization's structure and condition, including nonbank subsidiaries, activities, and governance. Assessments of the holding company are conveyed through ratings of risk management, financial condition, and the impact of the holding company on the insured depository, under the RFI rating system.

The Federal Reserve's supervision of holding companies is tailored within portfolios based on the size, complexity, and risk profile of each institution. In addition, there is a significant distinction between the Federal Reserve's supervisory programs for those holding companies with SMB subsidiaries versus holding companies with non-SMB depository subsidiaries; for the latter, the Federal Reserve relies extensively on findings of the primary federal and/or state bank regulator.

Reliance on the Primary Regulators

A long-standing tenet of the Federal Reserve's CBO and RBO holding company supervisory approach is to rely on—and coordinate extensively with—the insured depository primary regulator in order to reduce burden and duplicative efforts. In the CBO portfolio, small, noncomplex holding company supervision is generally completed offsite and draws significantly on the primary regulator's assessment of the subsidiary bank or savings and loan.

Considerable efforts have been taken by the Federal Reserve in recent years to align our supervisory planning schedule with those of the OCC and FDIC to optimize coordination, resulting in a significant decline in the number of examination events led by the Federal Reserve at these companies. The Federal Reserve's Office of Inspector General (OIG) issued a report in June 2018, which concluded that "*In accordance with applicable guidance related to consolidated supervision, we determined that the Federal Reserve Banks relied on the primary federal regulator (PFR) of regional banking organizations' (RBOs) insured depository institutions to supervise the RBOs we sampled.*"[2]

continued on next page

Box 9. State Member Bank and Consolidated Supervision—*continued*

The Federal Reserve relies to the fullest extent possible on the work of primary functional state Department of Insurance (DOI) regulators as part of the overall supervisory assessment of insurance SLHCs (ISLHCs). The Federal Reserve has worked closely with the DOIs and the National Association of Insurance Commissioners to develop strategies to tailor the supervisory program for ISLHCs and address the complexities associated with insurers, maximize supervisory efficiencies, and avoid duplication.

[1] See SR letter 96-38, "Uniform Financial Institutions Rating System" at www.federalreserve.gov/boarddocs/srletters/1996/sr9638.htm.

[2] See Evaluation Report 2018-SR-B-010, June 20, 2018, on the OIG website at https://oig.federalreserve.gov/reports/board-consolidated-supervision-jun2018.htm.

Despite the growing number of RBOs, the total number of supervisory findings cited for RBO firms has declined over the past five years. Internal audit, BSA/AML, and risk-management weaknesses have been among the leading supervisory findings for RBOs for several years, reflecting the need for these capabilities to evolve commensurate with the increased size, scope, and complexity of these firms.

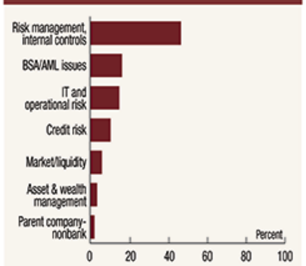
Figure 20 depicts the current breakdown of outstanding supervisory findings by category for RBO firms. Because of substantial recent growth at several firms, the RBO supervisory program has focused on assessing centralized control functions, including internal controls and audit, loan review, corporate compliance programs, IT infrastructure, and other areas impacted by merger integrations.

RBO reviews identify opportunities for risk-management improvement but not widespread safety-and-soundness concerns.

Reserve Banks recently conducted coordinated reviews of sales practices/incentive compensation and commercial credit underwriting at certain RBO state member banks (SMBs). The sales practices/incentive compensation review evaluated the range of practices for the design and implementation of incentive compensation programs; controls to prevent, detect, and report unauthorized account openings; risk-assessment processes; internal audit reviews; complaints processing; and employee terminations and separations.

Overall, the reviews identified acceptable practices and, when noted, findings were determined to be correctable in the normal course of business. Reserve Banks continue to regularly

Figure 20. Outstanding supervisory findings by category, RBO firms



Note: As of 2018:Q2, there were 294 total outstanding supervisory findings for RBO firms.

Source: Internal Federal Reserve supervisory databases.

review consumer complaints for potential issues and discuss supervisory expectations with respect to maintaining a measured and balanced incentive compensation program.

In the underwriting review, examiners reviewed a sample of recently underwritten commercial loans and concluded that the majority included acceptable structures, terms, and adequate credit analysis. Examiners provided feedback to firms so they could address weakness in some areas as needed, including policy exceptions, financial covenants, financial analysis, guarantor support, and liberal credit structures.

Box 10. Upcoming RBO Supervisory Priorities

Credit Risk

- Concentrations of credit
- Commercial real estate and construction & land development
- Underwriting practices

Operational Risk

- Merger and acquisition risks
- Information technology and cybersecurity

Other

- Sales practices and incentive compensation
- Bank Secrecy Act/anti-money-laundering

Supervisory priorities for each RBO are established during a supervisory planning process. Supervisory plans are coordinated with the subsidiary depository's primary regulator, as appropriate, and are tailored to idiosyncratic risk characteristics of each institution. Risks are also monitored across the portfolio. Some common risk focus areas that have emerged for the RBO portfolio for the current supervisory cycle are included in box 10.

Supervision of Community Banking Organizations

Community banks are currently in robust financial condition.

Capital levels at CBO firms have remained high over the past decade, following a slight drop during the financial crisis. Common equity tier 1 ratios for CBO firms average above 13 percent. More than 99 percent of the companies in this portfolio report capital ratios consistent with the "well capitalized" designation under interagency capital guidelines. Similar to the RBO portfolio, there has been a slight uptick in liquidity risks associated with this portfolio, although the majority of CBO firms are still considered to have low-to-moderate liquidity risk.

The trend of consolidation among community banks has continued. The net impact of charter conversions, mergers, and a single bank failure was a 2 percent decline in the total number of SMBs in 2017. This decline is roughly in line with trends from recent years.

CBO supervisory findings have been declining.

During 2017, the Federal Reserve led examinations at 332 CBO SMBs and conducted 2,256 holding company inspections.[18] For CBO SMBs, the vast majority exhibit a moderate-risk

[18] For noncomplex holding companies with less than $1 billion in assets (referred to as "small shell holding companies") the Federal Reserve uses an offsite inspection program that relies substantially on the work performed by the insured depository institution regulator.

Figure 21. Outstanding supervisory findings by category, CBO firms

Note: As of 2018:Q2, there were 2,460 total outstanding supervisory findings for CBO firms.

Source: Internal Federal Reserve supervisory databases.

profile, with only 27 considered high risk. Based on recent examination findings, the direction of risk at CBO SMBs is stable. The volume of supervisory findings at CBOs has steadily declined over the past five years (figure 18), as has the number of firms under enforcement actions. Figure 21 depicts the current outstanding supervisory findings by category for CBO firms.

The decline in supervisory findings over recent years is consistent with the improved ratings of the portfolios and economic conditions. In part, the decline may be attributed to changes in bank underwriting practices. Specifically, post-crisis, community banks have reduced concentrations in certain asset classes—such as construction and land development lending.

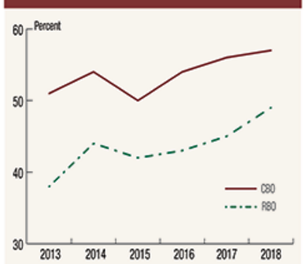
Supervisory focus remains on management of concentrations of credit, interest rate risk, and liquidity risk.

Areas of emerging risk that have received supervisory attention over the recent period include the management of concentrations of credit (specifically, commercial real estate, agriculture, and oil and gas), the impact of rising interest rates, and increased liquidity risk.

CBO supervision priorities include efforts to modernize, increase efficiencies, and reduce burden associated with the examination process.

The Federal Reserve continues to reduce unnecessary burden for community banks, including for supervisory examinations, as shown by the Bank Exams Tailored to Risk (BETR) program (see box 11). As of the first quarter of 2018, changes in loan review procedures associated with the BETR program allowed examiners the discretion to reduce the number of loan files reviewed at community banks exhibiting low credit risk. Conversely, banks with higher credit risk may see higher levels of testing or more focus on evaluating credit administration policies and practices.

Figure 22. Percent of time spent offsite



Note: Data prior to 2018 are yearly; 2018 data are as of 2018:Q2.

Source: Internal Federal Reserve supervisory databases.

Furthering efforts to reduce burden associated with examinations, examiners are now conducting the majority of community bank examinations offsite (i.e., not at a supervised bank's physical location) (figure 22).

Box 11. Bank Exams Tailored to Risk (BETR) Program: Minimizing Regulatory Burden and Optimizing Supervision Resources

In an effort to design an examination program that is more forward-looking and risk focused, the Federal Reserve developed risk metrics via the Bank Exams Tailored to Risk (BETR) program to assist with the scoping of examinations along different categories of risk.

For each risk category, BETR classifies each bank into one of three risk tiers: low, moderate, or high. In turn, these risk tiers provide examiners with a starting point for determining the scope of work to be performed during examinations. Examiners may also apply qualitative factors and their own judgment to confirm or adjust these model-driven risk tiers. For banks tiered as low risk, examiners perform limited transaction testing. In contrast, for high-risk banks, examiners apply the full extent of examination procedures.

BETR helps minimize regulatory burden and optimize the allocation of supervisory resources by directing examiners away from low-risk banks to higher-risk banks, and from low-risk areas to areas presenting heightened risk within a bank.

The BETR program has been deployed for six financial risks: credit, liquidity, interest rate, earnings, capital, and securities. These financial risk categories accounted for about half of community bank examination time in 2017. Credit risk is a key driver of community bank examinations and accounts for over one-third of all examination hours. The Federal Reserve is currently working to develop metrics for nonfinancial risks.

According to these BETR risk metrics, the share of banks tiered high risk is at, or near, historical lows for all six financial risks. As shown in figure A, continuing improvement in earnings risk is especially noticeable.

In contrast, liquidity risk is displaying some deterioration. While the share of banks tiered high risk for liquidity has not increased, the moderate-risk tier is growing. In aggregate measures, loan growth has been robust, while core deposit growth has not always kept pace. To bridge that gap, some banks have increased their reliance on noncore funding sources, such as brokered and listing service deposits.

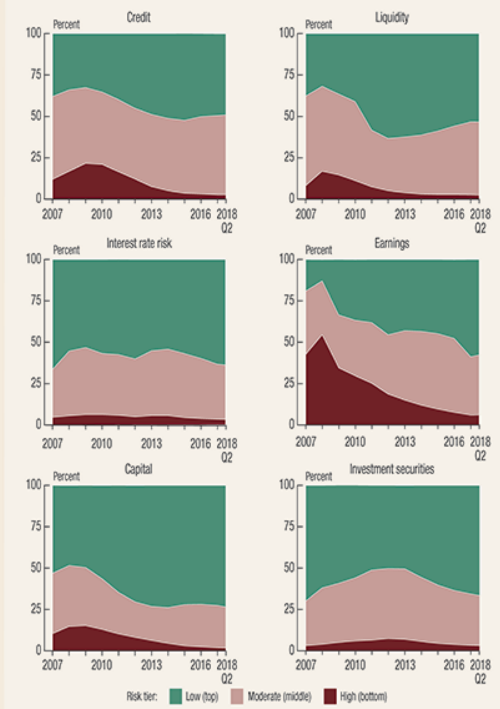
continued on next page

Finally, the Federal Reserve is actively participating with Federal Financial Institutions Examination Council (FFIEC) member agencies to review the technology platforms used to communicate with other regulators and supervised institutions and together are pursuing opportunities to further leverage technology platforms to reduce regulatory burden.

Community SMB supervision is driven by statutory mandates, and the Federal Reserve conducts a full-scope examination each supervisory cycle. Some of the emerging or higher-risk areas for CBOs for this supervisory cycle are included in box 12.

Box 11. Bank Exams Tailored to Risk (BETR) Program: Minimizing Regulatory Burden and Optimizing Supervision Resources—*continued*

Figure A. Risk tiering trends for community and regional banks based on BETR



Source: Call Report and staff calculations.

Box 12. Upcoming CBO Supervisory Priorities

Credit Risk

- Concentrations of credit
- Commercial real estate and construction & land development
- Agriculture

Operational Risk

- Information technology and cybersecurity

Other

- Bank Secrecy Act/anti-money-laundering
- Liquidity risk

Appendix A: Data

Definition of Data Sources

The *Supervision and Regulation Report* consists of data from institutions supervised in whole, or in part, by the Federal Reserve System. This appendix details these sources.

FFIEC Call Reports

The FFIEC *Consolidated Reports of Condition and Income*, also known as the Call Report, is a periodic report that is required to be completed by every national bank, state member bank, and insured nonmember bank as of the last day of each calendar quarter. The details required to be reported depend on the size of the institution, the nature of the institution's activities, and whether or not it has foreign offices. Call Report data are a widely used source of timely and accurate financial data regarding a bank's financial condition and the results of its operations. The data collected from the Call Report are used to monitor the condition, performance, and risk profiles of the institutions as individuals and as an industry.

FR Y-9C

The *Consolidated Financial Statement for Holding Companies*, also known as the FR Y-9C report, collects basic financial data from domestic BHCs, SLHCs, U.S. IHCs, and securities holding companies (SHCs). Respondent burden reduction initiatives led to the asset-sized threshold change from $500 million to $1 billion, and from $1 billion to $3 billion effective March 2015 and September 2018, respectively. In addition, BHCs, SLHCs, IHCs, and SHCs meeting certain criteria may be required to file this report, regardless of size. However, when such BHCs, SLHCs, IHCs, or SHCs own or control, or are owned or controlled by, other BHCs, SLHCs, IHCs, or SHCs, only top-tier holding companies must file this report for the consolidated holding company organization. The information contained in the report is as of the last day of each calendar quarter.

CCAR

The *Comprehensive Capital Analysis and Review*, or CCAR, evaluates the capital planning processes and capital adequacy of the largest U.S.-based holding companies on an annual basis. This includes the firms' planned capital actions, such as dividend payments and share buybacks. Strong capital levels act as a cushion to absorb losses and help ensure that banking organizations have the ability to lend to households and businesses even in times of stress. When evaluating a firm's capital plan, the Board considers both quantitative and qualitative factors. Quantitative factors include a firm's projected capital ratios under a hypothetical scenario of severe economic and financial market stress. Qualitative factors include the strength of the firm's capital planning process, which incorporates risk management, internal controls, and governance practices that support the process.

Notes on Specific Data

Top Holder

All data, unless otherwise noted, use top-holder data. This population comprises top-tier commercial bank Call Report filers and top-tier Y-9C filers. In instances where a top-tier BHC does not file the Y-9C, we combine financial data of subsidiary banks to approximate the consolidated financial data of the bank holding company. Because of data limitations, all FBOs, SLHCs, and commercial bank subsidiaries of top-tier FBOs and SLHCs are excluded from the top-holder population.

Common Equity Tier 1

The Federal Reserve's evaluation of a firm's common equity capital was initially measured using a tier 1 common capital ratio but now is evaluated using a common equity tier 1 (CET1) capital ratio, which was introduced into the regulatory capital framework with the implementation of Basel III. From 2006 through 2013, tier 1 common was used to measure common equity capital for all firms. In 2014, both tier 1 common capital (for non-advanced approaches firms) and common equity tier 1 capital (for advanced approaches firms) were used. From 2015 to present, common equity tier 1 capital was used for all firms.

Common equity tier 1 capital ratio is defined as common equity tier 1 as a percent of risk-weighted assets. While advanced approaches institutions are required to report an additional CET1 metric using an alternative calculation of risk-weighted assets, we use the standardized risk-weighted assets calculation in all cases to maintain consistency.

Matters Requiring Attention (MRAs)/Matters Requiring Immediate Attention (MRIAs)

MRAs constitute matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time but when the timing need not be "immediate."

MRIAs are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately.[19]

Well Capitalized Metric

Simplified for the purposes of this publication, firms that met or exceeded the "well capitalized" category according to the FDIC Prompt Corrective Action (PCA) guidelines as they existed in each quarter are considered well capitalized (table A.1).[20] While this standard applies to insured depositories, it is used as a proxy for holding companies in figure 6.

[19] For more information about MRAs and MRIAs, see SR letter 13-13, "Supervisory Considerations for the Communication of Supervisory Findings," at www.federalreserve.gov/supervisionreg/srletters/sr1313a1.pdf.

[20] For more information on the FDIC's PCA, see www.fdic.gov/regulations/laws/rules/1000-4000.html.

Table A.1. Prompt Corrective Action (PCA) capital ratio categories
Percent

PCA category	Total RBC ratio	Tier 1 RBC ratio	Common equity tier 1 RBC ratio	Tier 1 leverage ratio
Well capitalized	10	8	6.5	5
Adequately capitalized	8	6	4.5	4
Undercapitalized	<8	<6	<4.5	<4
Significantly undercapitalized	<6	<4	<3	<3
Critically undercapitalized	Tangible equity/total assets ≤2 percent			

Note: Values are as of the end of 2018:Q2

CAMELS Ratings

Following an examination of a commercial bank, the examiner's conclusions regarding the overall condition of the bank are summarized in a composite rating assigned in accordance with guidelines provided under the Uniform Financial Institution Rating system (CAMELS). The composite rating represents an overall appraisal of six key assessment areas (components) covered under the CAMELS rating system: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.

In addition, and separate from the interagency Uniform Financial Institutions Rating System, the Federal Reserve assigns a risk-management rating to all SMBs. The summary, or composite, rating, as well as each of the assessment areas, including risk management, is delineated on a numerical scale of 1 to 5, with 1 being the highest or best possible rating. Thus, a bank with a composite rating of 1 requires the lowest level of supervisory attention, while a 5-rated bank has the most critically deficient level of performance and therefore requires the highest degree of supervisory attention.

When appraising the six key assessment areas and assigning a composite rating, the examiner weighs and evaluates all relevant factors for downgrades and upgrades of supervisory ratings.[21]

Highly Liquid Assets

The highly liquid assets (HLA) displayed here are an approximation of the high-quality liquid assets (HQLA) used by regulators. HLAs are the sum of the following items:

- cash: includes all interest-bearing and noninterest-bearing deposits.

[21] For more information regarding composite rating considerations, see SR letters 95-51, 96-38, and 16-11 at www.federalreserve.gov/supervisionreg/srletters/srletters.htm, as well as the Commercial Bank Examination Manual appendix section A.5020.1 at www.federalreserve.gov/publications/files/cbem.pdf; with regard to CAMELS rating upgrades, see SR letter 12-4 at www.federalreserve.gov/supervisionreg/srletters/sr1204.htm.

- U.S. Treasury securities and government agency obligations
- federal funds sold in domestic offices and securities purchased under agreements to resell
- other U.S. government-guaranteed securities: includes mortgage-backed securities (MBS) issued or guaranteed by the U.S. government or a government-sponsored enterprise (GSE), and MBS collateralized by MBS issued or guaranteed by the U.S. government or GSEs. Includes held-to-maturity (amortized cost) and available-for-sale (fair value) securities.

Less the following item:

- pledged securities

Because of changes in the Call Report and FR Y-9C since the first quarter of 2006, the definition of HLA is not consistent during the entire time series. Agency commercial mortgage-backed securities are included in other U.S. government-guaranteed securities from the first quarter of 2006 until the first quarter of 2009 but are excluded from the second quarter of 2009 to the fourth quarter of 2010 before being included again in the first quarter of 2011. This is true for both banks and BHCs. Also note that the pledged securities category includes all pledged securities, including securities without government guarantees.

Allowance for Loan and Lease Losses (ALLL)

The allowance for loan and lease losses, which was originally referred to as the "reserve for bad debts," is a valuation reserve established and maintained by charges against the bank's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected.

Nonperforming Loans

Nonperforming loans, or problem loans, are those loans that are 90 days or more past due, plus loans in nonaccrual status.

Reserve Coverage Ratio

The reserve coverage ratio is the ratio of ALLL over nonperforming loans. When calculating nonperforming loans for the reserve coverage ratio, loans provided by Ginnie Mae that have been repurchased or are eligible for repurchase have been removed.

Credit Default Swap (CDS) Spread

The five-year CDS spread is reported in basis points relative to senior firm debt. Data are based on daily polls of individual broker–dealers worldwide. Note that these broker quotes are typically not transaction prices. Data provided are for LISCC (domestic and foreign) firms only.

Market Leverage

The market leverage ratio—defined as the ratio of the firm's market capitalization to the sum of market capitalization and the book value of liabilities—can be considered a market-based measure of firm capital (expressed in percentage points). Data provided are for LISCC (domestic and foreign) firms only.

High-Quality Liquid Assets (HQLA)

HQLA are estimated by adding excess reserves to an estimate of securities that qualify for HQLA. Excess reserves are estimated using balance data from internal Federal Reserve accounting records and reserve balance requirements computed based on confidential fillings of the FR 2900 Report of Transaction Accounts, Other Deposits, and Vault Cash. Securities are estimated from Form FR Y-9C. Haircuts and Level 2 asset limitations are incorporated into the estimate (Level 2 assets can represent only a limited share of the HQLA stock). Because of data availability constraints, HQLA amounts displayed in figure 12 are not based on 2052a reporting data.

Percent of Time Spent Offsite

The percent of time spent offsite measures the percentage of examination and inspection time that occurs offsite for SMB, BHC, and SLHC safety-and-soundness events. Small shell holding companies, with assets less than $1 billion, are excluded from these data.[22]

[22] For more information regarding offsite examinations, see SR letters 16-8 and 95-13 at www.federalreserve.gov/supervisionreg/srletters/srletters.htm.

Appendix B: Abbreviations

ALLL	allowance for loan and lease losses
AML	anti-money laundering
BETR	Bank Exams Tailored to Risk
BHC	bank holding company
BSA	Bank Secrecy Act
C&I	commercial and industrial
CAMELS	capital adequacy (C), asset quality (A), management (M), earnings (E), liquidity (L), and sensitivity to market risk (S) rating system
CBO	community banking organization
CCAR	Comprehensive Capital Analysis and Review
CDS	credit default swap
CECL	current expected credit loss
CET1	common equity tier 1
DOI	Department of Insurance
EGRRCPA	Economic Growth, Regulatory Relief, and Consumer Protection Act
FBO	foreign banking organization
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FR	*Federal Register*
GSE	government-sponsored enterprise
GSIB	global systemically important bank
HLA	highly liquid asset
HQLA	high-quality liquid asset
IHC	intermediate holding company
ISLHC	insurance savings and loan holding company
IT	information technology
LBO	large banking organization
LFBO	large and foreign banking organization
LFI	large financial institution
LISCC	Large Institution Supervision Coordinating Committee
MRA	matter requiring attention
MRIA	matter requiring immediate attention
OCC	Office of the Comptroller of the Currency
OFAC	Office of Foreign Assets Control
PCA	Prompt Corrective Action

RBC	risk-based capital
RBO	regional banking organization
RFI	risk management (R), financial condition (F), impact of parent and nonbanking activities (I) rating system
ROAA	return on average assets
ROE	return on equity
SLHC	savings and loan holding company
SMB	state member bank
SR	supervision and regulation

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM RANDAL K. QUARLES

Q.1. The Fed's regulation report released on November 9, 2018, said that foreign banking organizations (FBOs) still face challenges in complying with Dodd–Frank Act enhanced prudential standards (EPS). And yet your testimony noted that FBOs can expect a rule to "tailor" EPS in the coming year.

Why would the Fed alter taxpayer protections with regard to FBOs when the Fed's own report says that banks aren't fully complying with existing requirements?

A.1. The Board of Governors of the Federal Reserve System (Board) has taken, and will continue to take, a risk-based approach to supervision, focusing its resources on those institutions (both domestic and foreign) that pose the greatest risk to safety and soundness and financial stability. On October 31, 2018, the Board approved two notices of proposed rulemaking that would establish a revised framework for applying enhanced prudential standards to large U.S. banking organizations based on their risk profiles. The proposals would establish four categories of standards that reflect the different risks of firms in each group and would largely keep existing requirements in place for the riskiest and largest firms. The proposals build on the Board's existing tailoring of its rules and experience implementing those rules, and account for statutory changes enacted by the Economic Growth, Regulatory Relief, and Consumer Protection Act.

The changes proposed on October 31, 2018, do not apply to foreign banking organizations. As a part of the Board's current effort to develop a tailoring proposal for foreign banks, we are considering the appropriate way to assign foreign U.S. operations to the category of prudential standards described in the tailoring proposal for domestic firms, in light of the structures through which these firms conduct business in the Unites States.

I expect that this proposal and the two proposed rulemakings from October 31, 2018, by applying enhanced prudential standards based on risk profile, will enable the Board to continue to apply its risk-based approach to supervision in a more effective and efficient manner.

Q.2. In April, the Fed proposed weakening the enhanced supplemental leverage ratio (eSLR) by $121 billion for the insured depository institutions of the eight largest banks and proposed weakening the version of the leverage ratio used in stress tests. In a recent speech, you went further, saying that the leverage ratio should be eliminated altogether in stress tests. More than half of global systemically important banks (G–SIBs) have had their stock buybacks and dividends limited in recent years because the leverage ratio was the binding constraint on capital distributions.

How do you justify letting large banks send capital to shareholders and executives when it could otherwise be protecting taxpayers from bailouts?

A.2. Postcrisis regulatory reforms, including the supplementary leverage ratio, were designed to improve the safety and soundness and reduce the probability of failure of banking organizations, as well as to reduce the consequences to the financial system if such a failure were to occur. For large banking organizations in particular, the objective of the Federal Reserve Board (Board) has been to establish capital and other prudential requirements at a level that not only promotes resiliency at the banking organization and protects financial stability, but also maximizes long term, through-the-cycle credit availability and economic growth. In reviewing the postcrisis reforms both individually and collectively, the Board has sought ways to streamline and tailor the regulatory framework, while ensuring that such firms have adequate capital to continue to act as financial intermediaries during times of stress.

Consistent with these efforts, the Board proposed to recalibrate the enhanced supplementary leverage ratio (eSLR) to align leverage capital requirements with risk-based capital requirements for the G–SIBs. In particular, leverage capital requirements should generally act as a backstop to the risk-based requirements. If a leverage ratio is calibrated at a level that makes it generally a binding constraint, it can create incentives for firms to reduce participation in or increase costs for low-risk, low-return businesses. Over the past few years, however, concerns were raised that in certain cases the eSLR has become a binding constraint rather than a backstop to the risk-based standards. With respect to the April 2018 proposal, a decrease in capital requirements at a subsidiary depository institution does not necessarily result in its holding company being able to distribute those funds to shareholders. This happens because the capital rule and other regulatory restrictions at the holding company level, such as the Board's annual stress tests, limit the amount of capital that a holding company can distribute to shareholders. The analysis that accompanied the April 2018 proposal showed that the banking organizations that would be subject to the proposal—global systemically important banking organizations (U.S. G–SIBs)—would be able to release only up to $400 million of tier 1 capital (or approximately 0.04 percent of the amount of tier 1 capital held by these firms) to their shareholders.

With respect to the stress testing program, explicitly assigning a leverage buffer requirement to a firm on the basis of risk-sensitive poststress estimates, as the stress testing framework is intended to do, may be inconsistent with the goals of the leverage ratio.

Q.3. In a recent comment letter, the Federal Reserve Bank of Minneapolis noted that the "proposed tailoring of the eSLR and alterations to the existing stress testing that the Board is considering will weaken taxpayer protection from bailouts. Recent evidence—some of which economists from the Board of Governors itself has produced—finds that equity funding requirements for the largest banks are too low, not too high. Even measures of the credit cycle and financial stability risk indicate that it is likely prudent for banks to continue to build capital."

Please provide your perspective on this statement.

A.3. Maintaining the safety and soundness of the largest U.S. banks is critical to maintaining the stability of the U.S. financial system and the broader economy. Accordingly, postcrisis, the Board along with the other U.S. banking agencies substantially strengthened regulatory capital requirements for large banks. The Board's capital rules have been designed to significantly reduce the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure, were it to occur. Capital rules and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle, credit availability and economic growth. In general, I believe overall loss-absorbing capacity for our largest banking organizations is at about the right level.

More recently, the Board has proposed various regulatory refinements to pursue its long-standing goal of applying prudential standards based on a bank's risk profile and size. This tailoring of regulations enables the Board to supervise banking organizations in an effective and efficient manner while maintaining their safety and soundness.

Q.4. In a recent speech, you noted that the Fed is going to repropose a rule on its stress testing regime in light of comment letters it received. Then your speech goes on to list a whole host of changes the Fed may make—each of which is more favorable to the banks.

If the Fed reproposing the Stress Capital Buffer (SCB) proposal as you've outlined, would G–SIBs be required to hold more or less capital relative to the original SCB proposal?

Can you point us to an example of a proposed change, as noted in your speech, which would require G–SIBs to hold additional capital?

A.4. The Board's notice of public rulemaking entitled Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules [1] issued in April 2018 would integrate the Board's regulatory capital rules, the Board's Comprehensive Capital Analysis and Review (CCAR), and stress test rules. Under the proposal, the Board's supervisory stress test would be used to establish the size of a firm's stress capital buffer requirement. As noted in the proposal, the stress capital buffer requirement would generally maintain or in some cases increase common equity tier 1 capital requirements for global systemically important banking organizations (G–SIBs). That said, the impact of the proposal on firms would vary through the economic and credit cycle based on the risk profiles and planned capital distributions of individual firms, as well as the specific severely adverse stress scenario used in the supervisory stress test. The same potential impact on individual firms also would exist under the changes that I have outlined previously in greater detail. [2]

Board staff are currently reviewing all comments on the proposal and will carefully consider whether any changes to the proposal are appropriate.

Q.5. Does the Fed plan to incorporate the G–SIB surcharge into the Comprehensive Capital Analysis and Review (CCAR) for 2019?

A.5. In 2019, as in past CCAR cycles, the Board intends to evaluate each firm's ability to maintain capital ratios above the poststress minimum requirements. The global systemically important bank

[1] *https://www.govinfo.gov/content/pkg/FR-2018-04-25/pdf/2018-08006.pdf*

[2] See, "A New Chapter in Stress Testing", at *https://www.federalreserve.gov/newsevents/speech/guarles20181109a.htm*.

holding company surcharge is not a minimum requirement, and thus, would not be considered as part of the CCAR's quantitative assessment.

We are continuing to evaluate ways to simplify the Board's capital framework by more closely integrating the regulatory capital rules and stress testing. The Board's proposal, issued in April 2018 as noted in the response to 4(a), would introduce the concept of stress buffer requirements into the regulatory capital rules. This proposal would integrate the results of the Board's supervisory stress test into the regulatory capital rules, which already incorporates the G–SIB surcharge.

The goal of the proposal is to provide a more integrated and cohesive framework that reduces redundancies and inconsistencies across the capital rules and stress testing rules. The proposal includes other modifications as well, such as changes to the assumptions used in our stress test.

Q.6. Will you commit to making your meeting schedule transparent so that the Congress and the public can see who you're talking to before the Fed announces any proposed rules changing bank capital, leverage, liquidity, or other standards?

A.6. In my work as a Federal Reserve Board (Board) Governor, as well as the Vice Chair for Supervision and Regulation, I regularly meet with a wide range of representatives from the industry, peer domestic and foreign regulators, academics, public interest groups, and others. These meetings inform me and, in turn, the Board on a broad array of critical issues. Consistent with the practice of other Board members, I have always provided my calendar to the public upon request and will be happy to provide a copy to your staff.

Q.7. You have proposed eliminating the qualitative objection currently included in CCAR. Previously, banks such as Deutsche Bank, Santander, Citigroup, HSBC, RBS, Ally, and BB&T have received objections to their capital distribution plans based on qualitative factors.

What is your justification for eliminating the qualitative objection under CCAR?

A.7. Capital planning is a core aspect of financial and risk management that helps ensure the financial strength and resilience of a firm. Strong, forward-looking capital planning processes ensure that large firms have sufficient capital to absorb losses and continue to lend to creditworthy businesses and consumers, including during times of stress.

In 2017, the Federal Reserve eliminated the qualitative objection as part of the Comprehensive Capital Analysis and Review (CCAR) for large and noncomplex firms, which are generally firms with less than $250 billion in assets, in part because of improvements in risk management at these firms. I believe that the removal of the qualitative objection for these firms has not diminished the effectiveness of supervision.

Similarly, larger firms have also generally improved their risk management in the years since the inception of CCAR. Removing the public objection tool and continuing to evaluate firms' stress testing practices through normal supervision for all firms would align the outcome of the CCAR qualitative assessment with other supervisory programs. Firms would remain subject to the same supervisory expectations, and examiners would continue to conduct rigorous horizontal and firm specific assessments of a firm's capital positions and capital planning, tailored to the risk profile of the firm. While much of the examination work would center on a firm's capital plan submissions, examination work would continue on a year-round basis, taking into account the firm's management of other financial risks. The evaluation of the firm's capital position and capital planning would culminate in a rating of the firm's capital position and planning. Firms with deficient practices would receive supervisory findings through the examination process, and would be at risk of a ratings downgrade or enforcement action if those deficiencies were sufficiently material or not addressed in a timely manner.

Q.8. When you were asked about the Community Reinvestment Act at a recent House of Representatives hearing, you said that the law had become too "formulaic" and that it was therefore less effective.

If that's the case, would you oppose the aspect of the OCC's proposal—which would make the CRA even more formulaic by grading banks' performance according to one simple ratio?

A.8. I was referring to the fact that, over the years, practices have developed among both banks and their supervisors that result in much Community Reinvestment Act (CRA) compliance being satisfied with a single type of activity. The drafters of the CRA contemplated, and the language of the statute itself supports, a much broader potential for involvement in community development and a much wider range of qualifying investments than currently tends to result from CRA compliance. We are reviewing information the Office of the Comptroller of the Currency has received in response to its advance notice of proposed rulemaking on the CRA, as well as information gathered through the Federal Reserve's listening sessions at many of the Federal Reserve Banks around the country, to determine whether there are steps we might take as regulators to come closer to both the letter and intent of the statute. That review is ongoing, and our evaluation of any particular proposal or element of a proposal, including any potential measurement standards, will depend on a full analysis of the available information upon completion of that review.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM RANDAL K. QUARLES

Q.1. Section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act instructed bank regulators to issue a rule exempting custody banks' cash deposits placed at central banks from the Supplemental Leverage Ratio calculation.

When do you expect to implement Section 402?

A.1. As you indicate, the recent Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) legislation requires the Federal banking agencies to amend the supplementary leverage ratio as applied to custodial banks. The Federal banking agencies are actively working to issue a notice of proposed rulemaking and expect to issue it for public comment in the near future.

The April 2018 proposal to recalibrate the enhanced supplementary leverage ratio standards assumed that the components of the supplementary leverage ratio used the capital rule's existing definitions of tier 1 capital (the numerator of the ratio) and total leverage exposure (the denominator); however, the definition of total leverage exposure will change for certain banking organizations, through the implementation of section 402. As the Federal Reserve Board (Board) and the Office of the Comptroller of the Currency noted in the April 2018 proposal, significant changes to either component of the supplementary leverage ratio would likely necessitate reconsideration of the proposed recalibration, as the proposal was not intended to materially change the aggregate amount of capital in the banking system. Accordingly, staff is evaluating the April 2018 proposal in light of the statutory change, in addition to comments received on the proposal.

Q.2. Holding almost $5 trillion in U.S. banking and nonbanking assets, foreign banking organizations (FBOs) play an important role in the U.S. financial system and overall economy. FBOs operating within the U.S. and U.S. firms operating abroad should compete on a level playing field. For that reason, I was encouraged to learn that you intend to review and possibly update regulations applicable to FBOs early in 2019. Previously, you have highlighted Total Loss-Absorbing Capital (TLAC) requirements for the intermediate holding companies (IHCs) of FBOs as worthy of review.

Will TLAC requirements be a part of your 2019 efforts?

If so, what are your plans to tailor and streamline internal TLAC and long-term debt requirements?

A.2. In October 2018, the Board issued notices of proposed rulemaking (NPR) to tailor certain prudential standards for domestic banks. The Board plans to develop a separate proposal, for public comment, relating to foreign banking organizations (FBOs) and their U.S. operations. The October 2018 NPRs did not modify the Total Loss-Absorbing Capital (TLAC) requirements for U.S. firms; the specific content of a forthcoming FBO tailoring NPR remains under consideration.

Q.3. Finally, are you considering adjusting the January 1, 2019, compliance date currently in effect?

A.3. In the remarks I gave on May 16, 2018, I noted that the Board should consider whether the internal TLAC calibration for intermediate holding companies (IHCs) could be adjusted to reflect the practice of other regulators without adversely affecting resolvability and U.S. financial stability. This matter remains under consideration and the Board continues to monitor relevant developments in other jurisdictions. The Board's rule establishing TLAC, long-term debt, and clean holding company requirements for U.S. IHCs of foreign global systemically important banks became effective as of January 1, 2019. Any change to the internal TLAC requirements for IHCs, or any other aspect of the rule, would need to be adopted through the normal public rulemaking process.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR COTTON FROM RANDAL K. QUARLES

Q.1. *FINRA Rule 4210*—Two years ago, I sent a letter to the SEC expressing concern about FINRA Rule 4210, which established margin requirements on To-Be-Announced (TBA) securities such as mortgage-back bonds. The key problem here is that rule 4210 applies to broker-dealers but NOT to banks. Thus broker-dealers can use their banking arm to evade this requirement, creating an uneven playing field. Earlier this year, Federal Reserve staff confirmed this "inequity" in a call with my staff.

Last April, we spoke about this rule in a hearing with this Committee. You promised to review that rule to ensure it did not create an unequal playing field between small and medium broker-dealers and large, bank-affiliated broker-dealers. I'm sure we agree that restricting market competition isn't good for anyone except the privileged few banks that would gain business. The day after that hearing, FINRA delayed rule 4210 until March of 2019.

What steps can the Fed take to ensure that rule 4210 does not create an unequal playing field between small and medium-sized broker dealers and bank-affiliated broker dealers? Please list them.

Do you agree that as implemented, rule 4210 creates an unequal playing field for the aforementioned financial institutions?

A.1. As you noted above in your question, the Financial Industry Regulatory Authority's (FINRA) Rule 4210 To-Be-Announced (TBA) amendments are not scheduled to be implemented until spring 2019 at the earliest. In addition, recent action by FINRA suggests it is working towards reducing the rule's burden. For example, in September 2018, FINRA's Board approved revisions to its Rule 4210 TBA requirements that would eliminate the 2 percent maintenance margin requirement contained in the rule. FINRA's Board also approved revisions that would allow member firms to take a capital charge in lieu of collecting margin for mark to market losses, subject to specified limitations and conditions.[1] These changes would substantially reduce possible inequities between FINRA firms and bank dealers. FINRA has not yet sought comment on these revisions, and the Federal Reserve is monitoring FINRA's efforts. If the final result creates an unequal playing field, we will work with fellow bank regulatory agencies to address disparities between FINRA firms and bank dealers in this area, taking into account the differences between them.

Q.2. *Mortgage Servicing Assets*—As you know, many lenders prefer to keep the relationship with the customer via servicing the mortgage, even if the bank sells the mortgage itself. There has been a bipartisan view in Congress that the original rule on MSAs, which came out as part of the Basel process, was misguided and, indeed, punitive as applied to small and midsize banks. Many of us were encouraged when the regulators put out a proposal to change the existing rule. But that proposal came out over a year ago and still nothing has been done to finalize it. The current situation is driving mortgage servicing out of regulated entities and into unregulated ones, which I assume is not your objective.

[1] See *https://www.finra.org/industry/update-finra-board-governors-meeting-092618.*

When can we expect a final rule on mortgage servicing assets to be issued?

A.2. As part of the 2017 Economic Growth and Regulatory Paperwork Reduction Act report, the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies), and the National Credit Union Administration highlighted their intent to meaningfully reduce regulatory burden, especially on community banking organizations, while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system. Consistent with that objective, the agencies issued a proposal in 2017 to simplify certain aspects of the regulatory capital rules for non-advanced approaches banking organizations, including a simplified treatment for mortgage servicing assets (MSAs) (simplifications proposal).

The agencies are working jointly to implement Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA),[2] which addresses and supersedes aspects of the simplifications proposal. For example, the agencies recently issued a proposed rule to conform the regulatory capital treatment of certain acquisition, development, or construction loans to that under EGRRCPA.[3] The agencies are actively considering the comments received on the simplifications proposal in the context of the changes made by the EGRRCPA.

In addition, on November 21, 2017, the agencies finalized a rule to extend the current transition provisions in the capital rules for certain capital deductions that would be affected by the simplifications proposal.[4] Thus, while the agencies continue to evaluate comments on the simplifications proposal, for most banking organizations, MSAs not deducted under the capital rules will continue to be subject to a 100 percent risk weight rather than the fully phased-in 250 percent risk weight.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR ROUNDS FROM RANDAL K. QUARLES

Q.1. In South Dakota, many farmers use derivatives to manage the risk of price disruptions due to any number of factors in the marketplace. Given the challenges that farmers are facing on several fronts, it's important that South Dakotans are able to access tools like derivatives in a way that's as cost-effective as possible.

When our farmers do choose to access derivatives markets they're required to provide margin against their derivative contracts. Banks hold that margin in the event the farmer can't meet their obligations, thereby reducing the risk of default for the bank and for the marketplace.

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[2] See, e.g., Interagency Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (July 6, 2018), available at *https://www.fdic.gov/news/news/press/2018/pr18044a.pdf.*

[3] 83 *Fed. Reg.* 48,990 (Sept. 28, 2018).

[4] 82 *Fed. Reg.* 55,309 (Nov. 21, 2017). The final rule extended the transition provisions for banking organizations that are not subject to the capital rule's advanced approaches. Banking organizations subject to the capital rule's advanced approaches remain subject to the stricter requirements beginning on January 1, 2018.

Unfortunately the Fed's methodology for the leverage ratio doesn't recognize this reduced risk. As a result, an additional cost is imposed on farmers across the country when they hedge against price fluctuations.

When will the Fed act on this issue and provide relief on client margin? Farmers are in need of relief wherever they can get it.

I'm proud to be the Senate sponsor of S. 3577, the Financial Stability Oversight Council Improvement Act of 2018. As we continue to look at ways to make our financial system safer and more resilient, it's important that FSOC also regulates nonbanks based on the risk profile of a specific business or industry, not for the sake of regulation, and not based only on size.

Last year the Treasury Department released a report recommending how FSOC can further improve the SIFI designation process for nonbank institutions. Similar to my interest in tailoring regulations, Treasury suggested that an activities-based approach would be appropriate. I'm also pleased to hear reports that FSOC may be taking action on this front by the end of 2018.

Can you elaborate on FSOC's forthcoming proposals?

If you could, I'd like you to share some of the advantages to the activities-based approach that FSOC is considering.

How will it help the Fed's work?

And how will it help the economy more broadly?

A.1. In October 2018, the Federal Reserve Board (Board), along with the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) (collectively, the Agencies), issued a proposal that would revise the capital rule to require banking organizations to use a more risk-sensitive methodology known as the standardized approach for counterparty credit risk (SA–CCR) for reflecting derivative contracts in the supplementary leverage ratio. The Agencies believe that SA–CCR, which recognizes the shorter default risk horizon applicable to margined derivative contracts, provides a more appropriate measure of derivative contracts for leverage capital purposes than does the current approach. Analysis conducted by the Agencies indicates that, compared to the current methodology, the implementation of SA–CCR would increase covered banking organizations' supplementary leverage ratios.

As noted in the proposal, the Agencies are sensitive to impediments to banking organizations' willingness and ability to provide client-clearing services. The Agencies also are mindful of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) mandate to mitigate systemic risk and promote financial stability by, in part, developing uniform standards for the conduct of systemically important payment, clearing, and settlement activities of financial institutions. In view of these important, postcrisis reform objectives, the Agencies are inviting comment on the consequences of not recognizing collateral provided by a clearing member client banking organization in connection with a cleared transaction. The Agencies will carefully consider the comments received on the proposal.

With respect to your second question on the Financial Stability Oversight Council (FSOC), the Council has been considering revisions to the interpretive guidance on the designation of nonbanks that include taking an activities-based approach (see, for example, the minutes of the June 15, 2018, FSOC meeting).[1] Of course, any revisions to the FSOC's current guidance on the designation of nonbank financial institutions will have to be approved by the FSOC.

In principle, an activities-based approach toward the designation of individual nonbank financial institutions would shift the focus toward reviewing potential risks to U.S. financial stability from a financial system perspective by examining financial activities and products throughout various industries. This approach offers some potential advantages, including the consideration of how certain activities undertaken by nonbanks could threaten financial stability and how best these threats could be addressed. In addition, such an approach could complement the FSOC's effort to monitor broader vulnerabilities in the U.S. financial system.

In terms of helping the Federal Reserve's work, should a firm be designated and thus subject to supervision by the Federal Reserve, a clear statement from the FSOC of the particular activities of concern could help focus supervisory efforts to limit systemic risk. Further, the activities-based approach proposed in the November 2017 Treasury Department report[2] could complement the Federal Reserve's monitoring of financial stability risks. The Board provided an overview of the framework it uses to monitor financial stability in the November 2018 Financial Stability Report.[3] This framework focuses on monitoring vulnerabilities in the financial system, such as elevated valuation pressures, excessive leverage within the financial sector, excessive borrowing by businesses and households, and funding risks.

Monitoring of financial vulnerabilities and activities that could pose a threat to U.S. financial stability could help regulators design policies to reduce the likelihood of financial market disruptions or of credit crunches.

Q.2. Thank you for the ongoing dialogue on the "standardized approach for measuring counterparty credit risk" rule in derivatives markets. I appreciate regulators enacting risk-based rules in any sector of the economy.

I understand that the Fed's goal was to follow the Basel Committee's approach when it was designing the SA–CCR rule. I also understand that the SA–CCR methodology as designed by the Basel Committee recognized that margin posted by derivative users reduces the risk of default. That being said, based on my review of the Fed's SA–CCR rule, I noticed that the Fed omitted the margin exposure provisions of the Basel SA–CCR rule.

One of the purposes of implementing the Basel Committee's SA–CCR rule was to make American companies more competitive with our European counterparts, all of whom have implemented the Basel-driven version of SA–CCR.

Why did the Fed choose not to include margin exposure in the U.S. SA–CCR rule?

[1] See *https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/June152018_minutes.pdf.*

[2] See *https://www.treasury.gov/press-center/press-releases/documents/pm-fsoc-designations-memo-11-17.pdf.*

[3] See *https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf.*

Will this lack of recognition on margin perpetuate the disparities between the U.S. and Europe and put our financial institutions at a disadvantage?

A.2. The proposal is generally consistent with the Basel Committee's standards on the recognition of margin in the risk-based and leverage capital frameworks. In particular, the proposal to require use of SA–CCR in calculating the supplementary leverage ratio is generally consistent with the Basel Committee's standard on leverage capital requirements, which currently limits collateral recognition. The Agencies are sensitive to impediments to firms' willingness and ability to provide client-clearing services, and recognize the wide support for the migration of derivative contracts to central clearing frameworks. In particular, in October 2018, the Basel Committee issued a consultative document seeking views on whether to recognize collateral in their leverage capital requirement.[4] Accordingly, the Agencies are inviting comment on the consequences of not recognizing collateral provided by a clearing member client banking organization in connection with a cleared transaction. The Agencies will carefully consider each comment on the proposal.

Q.3. As you know, Section 402 of S. 2155 exempted the cash deposits of custody banks held at central banks from the supplemental leverage ratio.

Can you give us an update on when section 402 will be implemented?

And can you shed a bit more light into how this section of the law will interact with changes to the supplemental leverage ratio that the Fed announced back in April?

Balancing these two priorities is important given that regulatory changes announced in April could potentially blunt the impact of S. 2155.

A.3. As you indicate, the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) requires the Federal banking agencies to amend the supplementary leverage ratio as applied to custodial banks. The Federal banking agencies are actively working to issue a notice of proposed rulemaking and expect to issue it for public comment in the near future.

The April 2018 proposal to recalibrate the enhanced supplementary leverage ratio standards assumed that the components of the supplementary leverage ratio used the capital rule's existing definitions of tier 1 capital (the numerator of the ratio) and total leverage exposure (the denominator); however, the definition of total leverage exposure will change for certain banking organizations through the implementation of section 402. As the Board and OCC noted in the April 2018 proposal, significant changes to either component of the supplementary leverage ratio would likely necessitate reconsideration of the proposed recalibration, as the proposal was not intended to materially change the aggregate amount of capital in the banking system. Accordingly, staff is evaluating the April 2018 proposal in light of the statutory change, in addition to

[4] See Consultative Document, "Leverage Ratio Treatment of Client Cleared Derivatives", Basel Committee on Banking Supervision, October 2018, available at *https://www.bis.org/bcbs/publ/d451.pdf.*

comments received on the proposal. The Board also plans to implement the requirements of section 402 in the near-term.

Q.4. I've reviewed remarks you gave at the Brookings Institution on November 9th and appreciate efforts you're undertaking to implement S. 2155 by tailoring capital and liquidity for banks based on risk. As the Senate lead on S. 366, the TAILOR Act, I appreciate any and all steps our banking regulators take to tailor regulations to the risk profile and business model of a given institution as opposed to regulating based on arbitrary asset thresholds.

During your remarks at Brookings you stated that S. 2155 did not provide relief for large banks and that after the Fed finalizes its tailoring proposal it will turn its focus to other parts of our regulatory system.

Can you shed a bit more light into what you meant by that?

What issues will you be considering in your efforts to bring greater efficiency to our regulatory system?

A.4. The proposals approved by the Board for public comment on October 31, 2018, are designed to efficiently tailor prudential standards to the risks of large U.S. banking organizations while ensuring that firms maintain sufficient resources and risk management practices to be resilient under a range of economic conditions.[5] The proposals build on the Board's existing tailoring of its rules and experience implementing those rules, and account for changes made by the EGRRCPA to the enhanced prudential standards requirements under section 165 of the Dodd–Frank Act.

In the proposals, the Board stated its plans to propose at a later date similar amendments that would tailor capital planning and resolution planning requirements for large U.S. banking organizations. The Board also stated its plans to issue a separate proposal relating to foreign banking organizations that would implement section 401 of the EGRRCPA for these firms, take into account the structures through which these firms conduct business in the United States and reflect the principles of national treatment and equality of competitive opportunity.

In addition, the Board in general aims to reduce unnecessary costs associated with and streamline regulatory requirements based on its experience implementing the rules and consistent with the statutory provisions that motivated the rules.

Q.5. The June 2017 Treasury Report on banks and credit unions recommended, "The application of U.S. enhanced prudential standards to foreign banking organizations (FBOs) should be based on their U.S. risk profile, using the same revised threshold as is used for the application of the enhanced prudential standards to U.S. bank holding companies, rather than on global consolidated assets."

How will the Federal Reserve tailor its regulations according to this recommendation and the longstanding principle of national treatment?

A.5. The Board is in receipt of the June 2017 Department of Treasury report and has carefully reviewed its contents including its recommendations. As noted above, the Board is considering the appro-

[5] See *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181031a.htm.*

priate way to assign the U.S. operations of foreign banking organizations to the categories of prudential standards described in the Board's October 31, 2018, proposal to tailor prudential standards for domestic firms, in light of the special structures through which these firms conduct business in the United States.

Q.6. Given that foreign regulators may retaliate against American institutions for overly aggressive actions taken by U.S. regulators, what steps will the Federal Reserve take to focus its tailoring on the risk profile of intermediate holding companies and not the branch networks of international banks, which are subject to regulation by their home countries?

A.6. In developing a proposal for foreign banking organizations, the Board will consider the special structures through which these firms conduct business in the United States. The Board's current enhanced prudential standards were designed to increase the resiliency of the U.S. operations of foreign banking organizations, including the U.S. branches and agencies of these firms. In developing the proposal, the Board will continue to consider the principles of national treatment and equality of competitive opportunity along with the extent to which a foreign banking organization is subject, on a consolidated basis, to home country standards that are comparable to those applied to financial companies in the United States.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TILLIS FROM RANDAL K. QUARLES

Q.1. After Nasdaq became an exchange in 2006, it is my understanding that the Federal Reserve has not undertaken any effort to update its rules to provide a pathway to margin eligibility for companies traded over-the-counter (OTC). Margin eligibility of OTC-traded stocks can be an important part of the growth of small and emerging companies, as it helps to improve the market quality of those securities, impact an investor's willingness to purchase those securities, and as a result have a direct impact on capital formation. In addition, U.S. investors in the American depositary receipts (ADR) for Roche ($10bn yearly net income) and other large, international OTC traded firms are also negatively impacted by the Federal Reserve's inaction on this issue.

Will the Federal Reserve take action to revive the margin list for certain OTC securities? If not, please explain why.

A.1. Responding to your question above and as previously posed regarding the List of Over-the-Counter Margin Stocks (OTC List) that is no longer published by the Federal Reserve Board (Board), staff have continued to monitor OTC market developments in the years since the publication of the OTC List ceased. Any expansion of the types of securities that are margin eligible would require careful consideration by the Board of the benefits of such an approach weighed against potential increased burden on banks and other lenders.

Please know that I appreciate your concerns as noted in your questions, and we are looking into potential approaches that may be considered while ensuring any changes would not pose additional regulatory burdens. By way of background, I am including a brief summary of the history of the Board's OTC List.

In 1968, Congress amended section 7 of the Securities Exchange Act of 1934 (SEA) to allow the Board to regulate the amount of credit that may be extended on securities not registered on a national securities exchange, or those securities known as "over-the-counter" or "OTC" securities. The following year, the Board adopted criteria to identify OTC stocks that have "the degree of national investor interest, the depth and breadth of market, the availability of information respecting the security and its issuer, and the character and permanence of the issuer" to warrant treatment similar to equity securities registered on a national securities exchange. The Board's first periodically published OTC List became effective on July 8, 1969.

In 1975, Congress further amended the SEA to direct the Securities and Exchange Commission (SEC) to facilitate the development of a "national market system" (NMS) for securities to accomplish several goals, including price transparency. The SEC's criteria for NMS securities came to cover both exchange-traded stocks (which were always marginable) and a subset of stocks traded on Nasdaq, the largest and most technologically advanced over-the-counter market at that time. The majority of the securities traded on Nasdaq's NMS tier were covered by the Board's OTC margin stock criteria and appeared on the Board's OTC List. The Board's analysis, however, indicated that the liquidity and other characteristics of NMS securities generally compared favorably with those of exchange-traded securities. Accordingly, the Board amended its margin regulations in 1984 to give immediate margin status to OTC securities that qualified as NMS securities without regard to whether the stock appeared on the Board's OTC List. This action established a precedent for relying on NMS status under SEC rules as a substitute for identifying margin-eligible OTC securities through the application of Board established criteria.

The Board ceased publication of its OTC List in 1998, and provided margin status to all securities listed on the Nasdaq Stock Market, after Nasdaq raised the listing standards for non-NMS securities trading on its market, making them comparable to those traded on national securities exchanges. Indeed, Nasdaq subsequently became a national securities exchange.

Q.2. In previous reports on the state of supervision and regulation, you have stated, "the Federal Reserve relies to the fullest extent possible" on State insurance departments in the supervision of Insurance Savings & Loan Holding Companies (ISLHC) and that you have worked closely with State officials and the National Association of Insurance Commissioners (NAIC) to maximize supervisory efficiencies and avoid duplication. I continue to hear from my constituents and insurance companies in my State that "tailoring" is not occurring. It is difficult to point to a single specific action the Federal Reserve has taken to tailor for these companies, and they continue to exit the business of banking, with several exits in the last year.

Is the Federal Reserve concerned about this trend?

What specific further actions will the Federal Reserve take to make sure that ISLHCs are not being driven from the business of banking by inefficient and overly burdensome regulation?

A.2. In supervising insurance savings and loan holding companies (ISLHCs), the Federal Reserve has aimed to develop policies that are insurance-centric and appropriate for the insurance business and regulatory environment. For instance, the Board's advance notice of proposed rulemaking on insurance capital requirements set out two frameworks for capital standards that are each unlike the Board's capital rules for bank holding companies. [1] The Federal Reserve recognizes that ISLHCs have multiple functional regulators and that State insurance regulators are the primary functional supervisors of the insurance companies. In supervising the consolidated insurance organization, the Federal Reserve remains committed to working cooperatively with State insurance regulators to reduce the potential for duplication and undue burden of supervisory activities. The Federal Reserve also tailors its supervisory activities and guidance to account for the unique characteristics, organizational and regulatory structures associated with ISLHCs. Examples of tailoring for these companies include the Board's exemption of ISLHCs from Federal Reserve consolidated capital, stress testing and liquidity rules which are generally applicable to banking organizations.

Federal Reserve examination teams rely on State insurance regulators to the fullest extent possible for the assessment of insurance risks and activities. For example, supervisory evaluations and findings from State insurance regulators are incorporated into the Federal Reserve's consolidated supervision assessments. Federal Reserve examiners defer to State insurance regulators for the evaluation of insurance activities pertaining to insurance underwriting, reinsurance, reserving, market conduct, and compliance with State insurance laws.

The Federal Reserve also coordinates with State insurance regulators through information sharing agreements and supervisory colleges. Additionally, Federal Reserve examination staff meet with each ISLHC's primary State insurance regulators to share supervisory information (e.g., inspection reports, supervisory plans), coordinate supervisory activities, and identify opportunities to leverage each agency's work to complement supervisory efforts and avoid duplication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM RANDAL K. QUARLES

Q.1. You recently made a speech about the Federal Reserve's "Stress Capital Buffer" proposal, which makes significant changes to the annual supervisory Comprehensive Capital Analysis and Review (CCAR) administered by the Fed. You indicated that the Fed would make a second proposal in response to some industry comments.

[1] Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 *Fed. Reg.* 38,631 (June 14, 2016), *https://www.federalregister.gov/documents/2016/06/14/2016-14004/capital-requirements-for-supervised-institutions-significantly-engaged-in-insurance-activities.*

According your remarks, the Fed is considering allowing a firm to develop a capital distribution plan after its stress tests because "firms have told us that they would be able to engage in more thoughtful capital planning if they had knowledge of that year's stress test results before finalizing their distribution plans for the upcoming year."

What evidence has the Fed received that firms will actually be more thoughtful rather than simply plan to distribute the maximum amount permitted by the stress tests, thereby outsourcing their capital decisions to the Fed?

A.1. Currently, and under the Stress Capital Buffer proposal, a firm must decide whether to increase or decrease its planned dividends and share repurchases for the upcoming year without knowledge of a key constraint: the results of the stress test. While this practice is intended to encourage firms to think rigorously about their capital uses and needs in developing their capital plans, it also introduces significant uncertainty into a firm's capital planning process.

Adjusting the operation of the rule such that firms know their stress capital buffer before they decide on their planned distributions for the coming year would remove this uncertainty. This change would not change the expectation that firms continue to engage in meaningful capital planning and use their internal capital planning processes to set their planned capital distributions. The Federal Reserve would continue to use the supervisory process to evaluate the strength of each firm's capital planning process, including identifying its material risks and determining the capital necessary to withstand those risks during stressful conditions.

Q.2. You indicated in your speech that "reducing volatility" of stress test demands would be the goal of a future proposal. The purpose of a stress test is to determine how a firm will fare under an unanticipated shock.

How is a goal of reducing or minimizing changes in stress test results to avoid "management challenge" to banks compatible with this purpose?

A.2. The supervisory stress test allows the Federal Reserve to assess the resilience of banking organizations under various economic stress scenarios. It is essential to the continued success of the stress test as a supervisory tool that we preserve the dynamism of the stress test, and we seek to balance this objective with other supervisory objectives in evaluating future proposals.

One of these supervisory objectives is to mitigate excessive volatility in stress test results. It is typical for supervisory stress test results for a given firm to change year-over-year, as the scenarios and firms' portfolio characteristics change, and we want to maintain that feature.

However, large changes in year-over-year stress test results, particularly those not driven by portfolio changes, can make it difficult for firms to engage in responsible capital planning.

Maintaining the dynamism of the supervisory stress test need not be at odds with mitigating excessive volatility in supervisory stress test results. We are in the process of carefully considering how to achieve an appropriate balance of these two goals in future proposals.

Q.3. The 2008 crisis created financial stress because firms were not anticipating significant losses from mortgage-backed securities, which were assumed to be relatively safe assets until unanticipated losses rapidly materialized over the 2007–2008 period. Over that period banks were permitted to return about a hundred billion in capital to shareholders, which later had to be made up by taxpayers through public capital injections.

How will a low-volatility stress test effectively require banks to preserve capital during such sharp turns in the market?

A.3. Mitigating excessive volatility in loss estimates, and estimates of poststress capital, need not be synonymous with maintaining a static stress test that does not take emerging risks into the economic and financial environment into account.

Indeed, it is essential to the continued success of the stress test as a supervisory tool that we preserve the dynamism of the stress test, and we seek to balance this objective with other supervisory objectives in evaluating future proposals.

The severely adverse scenario used in the Board's annual stress test reflects a sharp deterioration in macroeconomic and market conditions, similar to what we experienced during the 2007–2008 period.

Several elements of the Federal Reserve's stress testing and scenario framework are geared toward capturing shifts in the economic environment and in firms' risk profiles. These types of shifts would continue to be captured in the supervisory stress test results. Specifically, supervisory models are regularly reestimated with newly available data, and the Board's scenario design framework allows for the incorporation of salient risks to the current economic outlook. Further, the Federal Reserve's supervisory modeling policies seek to limit reliance on past outcomes, so that supervisory models can incorporate events or outcomes outside of historical experience.

Q.4. You also indicated that the Fed would begin to "disclose additional detail about supervisory stress tests models and results . . . allow[ing] firms to benchmark the results of their own models against those of the supervisory models."

Won't a lower-volatility stress test in which details of models and assumptions are widely known result in a system where stress tests are functionally equivalent to the Basel III risk-based capital rules? If so, what would be the justification for having multiple systems of risk-based capital?

A.4. Maintaining the dynamism of the supervisory stress test—and therefore its distinction from the Basel III risk-based capital rules—is one of our key objectives, and need not be at odds with mitigating excessive volatility in supervisory stress test results. Supervisory stress test results for a given firm will continue to change year-over-year, as the scenarios and firms' portfolio characteristics change. We seek to reduce potentially excessive changes in year-over-year stress test results, which can make it difficult for firms to engage in responsible capital planning.

We believe that the additional model disclosures that we proposed late last year appropriately increase the degree of transparency into supervisory models while preserving the dynamism of the exercise.

In evaluating future proposals, we will continue to consider how best to achieve an appropriate balance of the objectives of mitigating excessive volatility in capital requirements and preserving the dynamism of the stress test exercise.

Q.5. The Fed is apparently also considering seeking the public's "input on scenarios and salient risks facing the banking system each year," providing another opportunity for interested parties to shape the stress tests. Under the current framework, the scenarios are determined by the Fed's economists, with input from the reserve banks.

Have you lost confidence in the ability of these experts to foresee risks and develop effective stress test scenarios? If not, what is the value of allowing industry actors to influence the tests they will receive?

A.5. The stress test provides a forward-looking measurement of bank capital, a view of common and systemic risks across the banking sector, and a broader understanding of the health of the financial system. By helping us ensure that the largest firms have sufficient capital to absorb losses and continue to lend in stressful conditions, the stress test helps to reduce the potential that distress from a single large firm will spill over to the broader economy. The results are valuable for markets, analysts, and ultimately, the participating firms.

The Federal Reserve Board's (Board) supervisory stress test independently assesses the resilience of the financial system under stress. I believe that our ability to provide an independent view of capital adequacy enhances the credibility of the test and of our supervisory program. Our independent assessment of poststress capital relies on models and scenarios developed by Federal Reserve staff, which is comprised of a wide range of experts that drive innovation in their fields. Across the Federal Reserve System, our diverse workforce publishes a wide range of economic and policy research and plays an active role in academic discourse.

Yet we recognize that we are not, and cannot be, a monopoly on insight and wisdom. In the past, the Board has sought and benefited from multiple and diverse perspectives on elements of its stress testing program. For example, the Board recently invited public comment on principles governing stress test model design and amendments to further clarify the scenario design framework. Through that process, we received valuable feedback which we incorporated in the finalized amendments.

We will continue to push the frontier of stress testing, through our own research and through the insights we gain from our engagement with the public. We recently announced that we will host a stress testing conference in July that will be open to the public. During the conference, we expect that a number of diverse stakeholders, including academics, public interest representatives, and financial sector representatives, will share their thoughts on certain aspects of the stress test program, including our current approach to scenario design.

Q.6. In the recent stress capital buffer (SCB) proposal, you shifted the stressed leverage ratio requirement from the supplemental leverage ratio to the less stringent Tier 1 leverage ratio. In your recent speech you then proposed to eliminate the stressed leverage ratio requirement altogether. You justified elimination of this requirement by claiming that including the leverage ratio in the stress tests made the operational effect of the leverage ratio more dependent on modeled risks.

But won't eliminating the stressed leverage ratio altogether significantly increase the role of risk modeling and risk weights in the capital system?

Could you please provide information on how many firms experienced the current stressed leverage ratio requirement to be their binding or most significant constraint in the stress test process?

A.6. The Board's notice of public rulemaking entitled Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules [1] issued in April 2018 sought comment on the introduction of a stress leverage buffer requirement in addition to the current capital rule's 4 percent minimum tier 1 leverage ratio requirement. However, the stress buffer concept would not be extended to the supplementary leverage ratio. Our analysis indicates that the stressed supplementary leverage ratio was the binding constraint for one firm based on the results of the Comprehensive Capital Analysis Review 2018.

Leverage ratios are intended to function as a backstop to traditional risk-based capital requirements. Whether or not there is an additional stress leverage buffer, global systemically important banks would continue to remain subject to the capital rule's enhanced supplementary leverage ratio standards so leverage capital requirements would continue to serve as a strong backstop. Board staff are currently reviewing all comments on the proposal and will carefully consider whether any changes to the proposed stress leverage buffer requirement or more generally are appropriate.

Q.7. Your remarks also indicated that you were motivated by the view that the "[t]ransparency of the stress test and its inputs and outputs is key to the credibility of the stress test."

Does the Fed have any evidence that firms or the market aren't taking stress tests seriously under the current regime?

A.7. The Federal Reserve's stress test remains an effective supervisory tool. We believe it is important to seek public input and to assess ways to further enhance the test's effectiveness.

Since the inception of the supervisory stress test, the Board has gradually increased the breadth of its public disclosure. By increasing the amount of information about the assessment that is available to the public, the Board has invited the public to engage and make an independent evaluation of the stress test's soundness. Since the supervisory capital assessment program exercise in 2009, incremental disclosures of supervisory models and results have benefited banking organizations and those seeking to understand

[1] *https://www.govinfo.gov/content/pkg/FR-2018-04-25/pdf/2018-08006.pdf*

the resilience of firms in times of economic stress. The December 2017 proposals to increase transparency of the supervisory stress test are the latest incremental step to increase disclosure.

In evaluating each incremental disclosure, the Board considers how to disclose information about the stress tests in a manner that appropriately balances the costs and benefits of transparency. For example, we have not disclosed the full details of our models, in large part due to the Board's concerns about convergence of stress testing, which would make them less effective and would undermine the financial stability gains we have made. We also seek to guard against the risk of firms making modifications to their businesses that change the results of the stress test without changing the risks they face. This behavior could result in the stress test giving a misleading picture of the actual vulnerabilities faced by firms. It could also result in all firms increasing their holdings of assets that perform better in the supervisory stress test, which would make the financial system as a whole less diversified and more vulnerable to shocks.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM RANDAL K. QUARLES

Q.1. *Wells Fargo*—Wells Fargo Bank admitted to creating more than 3.5 million accounts without customers' authorization. Wells Fargo forced hundreds of thousands of automobile loan customers to pay for unnecessary insurance policies, with the added expense leading some borrowers to default and lose their vehicles. Wells Fargo also admitted to charging improper fees to some mortgage borrowers. Wells Fargo did not offer help to 870 mortgage borrowers that they were entitled; 545 of those borrowers had their homes taken from them in foreclosure proceedings. Three of them were from Nevada.

In February, the Federal Reserve cited those and other issues when it ordered the bank to halt expansion until it can prove to regulators that it has systems in place to prevent consumer abuses.

What issues remain with Wells Fargo leadership's remediation plan?

Will the Fed object to Wells Fargo capital distribution plan until a remediation plan has been accepted and the consent decree released?

Why did the Federal Reserve not use the Comprehensive Capital Analysis and Review process to object to Wells Fargo's capital distribution plan?

A.1. Thank you for your question. Please note that I have recused myself from participating in official matters specific to Wells Fargo, as detailed in a press release dated December 15, 2017.

Q.2. The most recent news from Wells Fargo—870 mortgage borrowers not appropriately assisted—more than 500 wrongly foreclosed on—was reported AFTER the consent order was signed in February.

Should we expect more problems of unfair, deceptive and abuse practices harming Wells Fargo's customers in the coming year? Does the Fed and other banking regulators feel they have a handle on the harmful practices at Wells Fargo?

A.2. Please see my response to Question 1.

Q.3. Is the asset cap the Fed put in place adequate for changing Wells Fargo's behavior?

A.3. Please see my response to Question 1.

Q.4. The Supervisory Reports states that that sales practices and incentive-based compensation is an area of priority. [p.27]

What will the Fed do to change incentive pay and sales practices at banks?

A.4. As noted in the Federal Reserve Board's (Board) November 2018 Supervision and Regulation Report, the Board conducted reviews of sales and incentive compensation practices at certain State member banks with total assets between $10 billion and $50 billion. The reviews identified acceptable practices. When exceptions were noted, however, findings were determined to be correctable in the normal course of business.

Through our existing supervisory process, we will continue to monitor firms' progress towards appropriately balancing risks concerning sales and related incentive compensation practices.

Q.5. What is the status of the Incentive-based compensation rule mandated by the Dodd–Frank Wall Street Reform and Consumer Protection Act? I would note that this is a mandatory law, not discretionary.

A.5. In June 2016, the Board, Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the National Credit Union Administration (NCUA), and the Federal Housing Finance Agency (collectively, the agencies), jointly published and requested comment on a proposed rule under section 956 of the Dodd–Frank Wall Street Reform and Consumer Protection Act. This joint effort proposed several requirements to address incentive compensation arrangements. The agencies received over 100 comments on the proposed rule. Development of a final rule on an interagency basis in light of those comments is now under active work by the agencies.

The Federal Reserve continues to evaluate incentive compensation practices as a part of ongoing supervision. This supervision has focused on the design of incentive compensation arrangements; deferral and risk adjustment practices (including forfeiture and clawback mechanisms); governance; and the involvement of the firm's controls and control function groups in various aspects of incentive compensation arrangements.

The Board's supervision focuses on encouraging robust risk management and governance around incentive compensation practices rather than prescribing amounts and types of pay and compensation.

Q.6. *Bank Secrecy Act/Anti–Money Laundering*—In the Fed's Supervisory Report released last week, you note that of the supervisory findings currently outstanding, nearly 20 percent relate to weaknesses in BSA/AML programs. [p.26]

Can you be more specific about how "machine-based learning" could help banks more easily comply with the Bank Secrecy Act?

A.6. Some banks are becoming increasingly sophisticated in their approach to Bank Secrecy Act/Anti–Money Laundering (BSA/AML) compliance, and machine learning features prominently among the types of new technology that banks have been exploring in recent years. Machine learning can have many different applications, for example, some banks have experimented with this technology as a way to identify potentially suspicious patterns in transaction data at a reduced cost to the institution. While machine learning has the potential to enhance suspicious activity monitoring and other BSA/AML compliance processes, the use of this technology is at an early stage. The Federal Reserve does not advocate a particular method to comply with the BSA and believes that, as a general matter, institutions should consider a broad range of factors when considering new approaches to BSA/AML compliance such as performance, cost, and security of a particular technology. Any such processes should be transparent and reproducible so that banks and examiners understand how the system meets regulatory requirements. When developing innovative approaches, banks must continue to meet their BSA/AML compliance obligations.

Q.7. Are the banking regulators working with FinCEN on future joint guidance? What would such guidance include? What impact would the guidance have under the new decision that guidance does not have the force of law?

A.7. In December 2018, the Federal Reserve Board (Board) issued a joint statement with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Financial Crimes Enforcement Network that encourages depository institutions to explore innovative approaches to meet their BSA/AML compliance obligations and to further strengthen the financial system against illicit financial activity. [1] The statement recognizes that new technologies may help banks to more efficiently identify and report money laundering, terrorist financing, and other illicit financial activity.

While the statement encourages banks to explore new ways of using their existing tools or adopting new technologies to meet their BSA/AML compliance obligations, the statement is not itself binding and expressly recognizes that some financial institutions may not have the means or ability to innovate. In addition, the statement makes clear that the Federal Reserve will not penalize banks that maintain effective anti–money laundering programs but choose not to pursue innovative approaches.

Q.8. *Merger and Acquisition Risk*—In the Fed's Supervisory Report released last week, you note that upcoming Regional Banking Organizations Supervisory Priorities include merger and acquisition risks. A number of banking experts said that reducing the capital requirements and other rules for banks above $50 billion would lead to more bank mergers.

Do you expect to see more bank mergers this year and next year than the past few years? Can you estimate the number of bank mergers you expect in 2019?

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[1] See *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181203a.htm*.

A.8. When reviewing a bank holding company application or notice that requires approval, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, financial stability factors, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, the applicant's compliance with laws and regulations, and the applicant's ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law.

Once a merger or application has been approved, we follow merger and acquisition (M&A) activity within the regional banking portfolio[2] chiefly to assess operational risk as the acquirers integrate the new operations into their consolidated organization.

We continue to see significant M&A activity within the portfolio, and indeed the regional banking portfolio has grown as banking companies under $10 billion in assets accelerate their growth across that size threshold by performing acquisitions.

We do expect M&A activity within the regional banking portfolio to continue, but any estimate of the projected level of this activity would be pure speculation, as it will depend on many different market factors.

Q.9. How much of merger activity is due to changes from S. 2155 and bank regulator actions to reduce some rules?

A.9. The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), enacted in May 2018, raised the asset threshold at which certain prudential standards apply from $50 billion to $100 billion. The new law also changed the asset threshold for a small bank holding company from $1 billion to $3 billion. Anecdotal evidence suggests that the former thresholds may have provided a merger disincentive to banks to grow beyond that point. At this time, the Federal Reserve does not have any specific evidence to indicate that merger activity has materially increased due to changes from EGRRCPA.

Q.10. Since you note risks to regional banks arising from mergers and acquisitions, what are those risks?

A.10. As noted in my response to 5(a), when reviewing a bank holding company application or notice that requires approval, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, financial stability factors, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, the applicant's compliance with laws and regulations, and the applicant's ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law.

Once a merger or application has been approved, we follow M&A activity within the regional banking portfolio chiefly to assess operational risk as the acquirers integrate the new operations into their consolidated organization. Operational risks during integration can involve almost any aspect of running a bank, but the one that gives

[2] For supervisory purposes, the Federal Reserve generally defines regional banking organizations as those with total assets between $10 billion and $100 billion.

the greatest supervisory concern is compatibility of information technology systems. The acquiring bank needs to ensure that the transition is smooth across all balance sheet and income statement accounts, that customers are not inconvenienced or exposed to errors as the accounts are integrated, and that management information systems (MIS) used for internal reporting—MIS that generates metrics on credit, liquidity, and market risks for example—accurately capture the new consolidated entity.

Q.11. *Liquidity Coverage Ratio/Stress Tests*—Banks are required to retain enough assets they can easily convert to cash to cover 30 days of expenses. You recommend reducing this cash cushion for all but the largest banks by revisions to the Liquidity Coverage Ratio. You say the reduction is minimal. Others say it is large and significant. Your Federal Reserve colleague, Governor Lael Brainard says it "weakens the buffers that are core to the resilience of our system."

How will you know if your analysis is wrong? How will you know if banks have less capital than prudent based on these regulatory changes you propose?

A.11. The Board's liquidity framework for large banking organizations has two general components: standardized measures, such as those included in the liquidity coverage ratio rule or net stable funding ratio proposed rule, and firm-specific measures, such as liquidity risk management requirements and internal liquidity stress testing requirements.

The recent proposals to further tailor prudential standards would reduce or remove standardized liquidity requirements for some firms, but they would retain the firm-specific measures for all firms with $100 billion or more in total assets. As a result, the proposals would continue to require these firms to meet liquidity risk management standards, conduct internal liquidity stress tests, and hold a buffer of highly liquid assets sufficient to meet projected 30-day stressed cash flow needs under internal stress scenarios. The proposals would also require these firms to maintain regulatory reporting of key liquidity data, which facilitates the Board's supervision of liquidity-related risks. In addition, the Board will continue to assess the safety and soundness of firms in the normal course of supervision.

Taken together, these firm-specific standards and data reporting requirements will allow supervisors to continue to achieve regulatory objectives while improving upon the simplicity, transparency, and efficiency of the regime. In this manner, the proposals build on the Board's existing practice of tailoring regulatory requirements based on the size, complexity, and overall risk profile of banking organizations.

Q.12. If banks or their trade associations start taking the Federal Reserve to court due to their differences in how the tailoring worked, a stress test result or a cost-benefit analysis they do not agree with, will you feel your analysis was wrong?

A.12. The Board takes seriously the importance in the rulemaking process of seeking comment from the public, carefully considering those comments, and assessing the costs and benefits of its rulemaking efforts. The Board believes strongly that public comment and cost-benefit analysis can enlighten our regulatory actions and inform the implementation of our statutory responsibilities. In addition to seeking public comment on its proposals, the Board often collects impact information directly from parties that may be affected. Under the Board's current practice, consideration of costs and benefits occurs at each stage of the regulatory or policymaking process. Recent examples of the publication of quantitative analyses in connection with its rulemakings include the global systemically important bank (G–SIB) surcharge rule, the single-counterparty credit limit rule, and the long-term debt rule.

The Board has established processes that allow institutions to respond to and appeal certain types of administrative actions, such as stress test results. In addition, the Administrative Procedure Act (APA) provides for judicial review of final regulations issued by the Board. Affected firms have the legal right to challenge the actions of any administrative agency under the APA, including whether the agency has engaged in reasoned decision making. Although the Board strives to robustly support all of its supervisory and regulatory actions, these appeal and judicial review processes help to ensure fair and effective implementation of our statutory responsibilities, consistent with applicable administrative requirements.

Q.13. This isn't just one weakening of buffers. There are numerous reductions at from several rulemakings that I think collectively have a material effect in weakening safeguards. Are you concerned that this "death by a thousand cuts" will result in much less of a capital cushion for banks that may find themselves in trouble in the future?

A.13. Reforms implemented since the financial crisis have resulted in substantial gains in the resiliency of large banking organizations and the financial system as a whole. The proposals issued in October 2018 and April 2019, seek to tailor the Board's prudential requirements for certain U.S. banking organizations and foreign banking organizations in accordance with the risk profiles of these firms while still maintaining the core reforms and gains made over the past decade.

For liquidity standards, the proposals would continue to ensure that firms with the most significant risk profiles are subject to the most stringent liquidity requirements. For example, all U.S. G–SIBs and firms with very substantial size or cross-jurisdictional activity would be subject to the full liquidity coverage ratio and proposed net stable funding ratio requirements. The proposals would also require any firm with a high reliance on unstable short-term wholesale funding to meet the full requirements. This distinction would reflect these firms' elevated vulnerability to liquidity risk, and help to reduce the risk of asset fire sales that could transmit distress to other market participants and destabilize the system.

As noted in my response to question 6(a), all firms with assets greater than $100 billion will continue to be subject to firm-specific liquidity requirements. As a result, these firms will still be required to conduct internal stress tests and hold liquidity buffers sufficient to meet projected 30-day net stressed cash-flow needs.

Further, with respect to capital, the proposals do not modify capital requirements of the largest, most systemically important banking organizations (U.S. G–SIBs and banks either that are very large or have substantial cross-jurisdictional activity). The proposals may result in an adjustment of capital requirements for smaller, less-systemic firms, although the impact on capital levels for these firms could vary under different economic and market conditions. The proposals also would also lower these firms' compliance costs. As a result, the proposed requirements would reduce costs appropriately for those firms that have a limited impact on the financial system as a whole, relative to firms with more significant systemic footprints.

Q.14. While you praise transparency in regulation, some warn that providing the textbook prior to the test or describing rigorous requirements for regulation allows banks to skirt the law in areas not yet covered. For example, there was probably little oversight of cryptocurrencies yet they have become a huge problem with Initial Coin Offering frauds. How will your focus on transparency avoid giving banks the option to make an argument that they not be tested or held accountable for something not clearly defined in the rules?

A.14. Issuing clear regulations is fundamental to the legitimacy of democratically accountable institutions and is central to the Federal Reserve's mission; regulated firms have a right to know the specific requirements that apply to them. While the Board is aware that prescriptive regulation may not capture all potentially harmful activity undertaken by regulated firms, the Board's comprehensive supervisory regime is designed to identify such activity before it poses harm to a firm or to financial stability, and the Board also relies on its general safety and soundness authority [3] to address such activity.

Q.15. Standard & Poor's and Moody's stated that weakening bank requirements is a credit negative for bank bond investors. An S&P report said "the Fed's proposals are incrementally negative for bank creditors." Moody's report stated that the "reduced frequency of capital and liquidity stress testing could lead to more relaxed oversight and afford banks greater leeway in managing their capital and liquidity stress testing could lead to more relaxed oversight and afford banks greater leeway in managing their capital and liquidity, as well as reduce transparency and comparability, since fewer firms will participate in the public supervisory stress test." Do you concur with two of the Credit Rating Agencies that your proposals—reducing or recalibrating capital requirements and stress tests—are "credit negative"? Why or why not?

A.15. The proposed adjustments to the Board's capital and liquidity requirements are designed to efficiently tailor prudential standards to the risks of large banking organizations while ensuring that firms maintain sufficient resources and risk management practices to be resilient under a range of economic conditions. They are intended to maintain and support the postcrisis increases in resiliency.

In regard to capital and liquidity requirements, including capital and liquidity stress testing requirements, the Board is focused on

[3] 12 CFR part 208, subpart J, appendix D-1.

reducing the complexity of the requirements in a way that does not materially lower the aggregate amount of total loss absorbing capacity maintained by banking organizations supervised by the Board. In addition, the Board is focused on tailoring the capital and liquidity prudential standards so that they are more reflective of the variety of business models and risk profiles observed across the industry, in a manner consistent with the requirements of EGRRCPA.

Any adjustments to the Board's regulatory requirements will be coupled with the Board's continued commitment to strong supervision, and expectation that financial institutions manage their risks and maintain sufficient capital and liquidity to continue operations under stressed conditions.

Q.16. *Community Reinvestment Act and Regulatory Coordination*—In your response to my questions for the record last Spring, you neglected to answer one of my questions.

Which, if any recommendation from the Treasury Department or Comptroller Otting do you disagree with regarding the Community Reinvestment Act?

A.16. Recommendations offered by the Treasury Department and Comptroller Otting on opportunities to modernize the Community Reinvestment Act (CRA) regulations have contributed to valuable analysis and dialogue among the agencies, as well as input from the public. As I have stated previously, I support the goal of improving the current supervisory and regulatory framework for CRA based on feedback from industry and community stakeholders. We are reviewing the information the OCC has received in response to its advanced notice of proposed rulemaking on the CRA, as well as information gathered through the Federal Reserve's listening sessions at many of the Federal Reserve Banks around the country to determine whether there are steps we might take as regulators to come closer to both the letter and intent of the statute. That review is ongoing, and our evaluation of any particular proposal or element of a proposal will depend on a full analysis of the available information upon completion of that review.

Q.17. As the Vice Chair of Supervision at the Fed, can you explain why there appears to be less interagency coordination, and more controversial proposals being advanced, since you took over the Supervisory role at the Fed? What is the potential for reducing public confidence and certainty in the regulatory actions you and others are attempting to take quickly and unilaterally?

A.17. The Board consults and coordinates on a regular basis with its fellow bank regulatory agencies on a wide range of matters affecting depository institutions and their affiliates. This consultation and coordination facilitates a more cohesive regulatory framework, which is intended to promote the safety and soundness of the banking system in the most efficient and least burdensome way possible. The Board also consults regularly with the SEC, Consumer Financial Protection Bureau (CFPB), Commodity Futures Trading Commission (CFTC), OCC, FDIC, NCUA, and Treasury Department, in areas where regulatory responsibilities overlap. Coordination and cooperation with other agencies occurs at staff levels as well as through senior officers and members of the Board. In addition, the Board participates in the Federal Financial Institutions Examination Council (FFIEC) and in the Financial Stability Oversight Council, both of which facilitate interagency consultation and cooperation. These many avenues of consultation at multiple levels increase the coordination and consistency of regulation across a banking industry that has multiple regulators and charters.

Many of the proposals and final rules issued by the Board in recent months have been issued in coordination with other agencies. Recent examples of proposed or final rules issued in coordination with the OCC and FDIC include amending the definition of high-quality liquid assets under the agencies' liquidity rules; expanding eligibility for an extended examination cycle for insured banks and branches of foreign banks; raising the threshold for residential real estate transactions requiring an appraisal; and tailoring of liquidity and capital requirements for large banking organizations. Other recent examples of proposals issued in coordination with the FDIC and OCC include a proposal to establish a community bank leverage ratio, a proposal to streamline reporting requirements for small institutions, and a proposal to exclude community banks from the Volcker rule. The agencies continue to work together to implement other provisions of S. 2155 and on other matters of common interest.

Q.18. *Labor Market/Housing Market*—The U.S. has seen consistent positive private sector job growth now for more than 100 consecutive months. To what extent are these gains sustainable? What risks to the labor market do you see on the horizon?

A.18. As you noted, private sector payrolls have increased every month since the spring of 2010. The labor market remains strong, and I expect the expansion to continue, with further positive job gains.

As always, there are risks to the outlook, and admittedly, recessions are hard to foresee. But many studies demonstrate that economic expansions do not end simply because they have persisted for a long time. Rather, some shock or collection of shocks occurs that is sufficient to push the economy into recession. At present, the banking system is well capitalized and highly liquid, and the Federal Reserve is committed to do everything we can to sustain the ongoing expansion. The Federal Reserve's recently inaugurated Financial Stability Report discussed risks and the resilience of our financial system in some detail. Other risks to the outlook could come from abroad, in the form of a material downturn to some of our trading partners or from the effects of Government policies, including trade policy and Brexit.

While such downside risks are present, as reported recently in the Summary of Economic Projections, most Federal Reserve policymakers view the risks around our projections as balanced. Most importantly, policy is not on a preset course, and we will respond to changes in the economic outlook as warranted.

Q.19. More than half of renters pay more than ⅓ of their income for rent. Nearly half of Americans cannot handle a $400 emergency. What are your concerns about the housing market where prices are high and supply—both rental and home ownership—is inadequate in many communities? What should Federal policy makers do to increase the supply of affordable homes?

A.19. A healthy labor market is one of the most important factors helping families afford their housing costs. Our labor market is currently quite strong overall. The unemployment rate is at its lowest level in many decades, and the strong job market has encouraged more people to seek and hold jobs. According to aggregate statistics, however, house prices and rents have been rising well above the growth rate of aggregate disposable household income. Moreover, aggregate statistics can mask important differences across regions of the country. This is especially the case with housing markets, which have distinct geographic and local features. While an improving labor market has produced some easing in the share of households that are cost-burdened, the share of cost-burdened households remains elevated relative to the period before the financial crisis, and I share your concern over what this means for the households affected.

Housing costs have been rising because of increasing costs of labor and materials and, importantly, the availability and cost of land for residential construction, which are in turn influenced by local conditions and regulation. The Federal Reserve tracks conditions in the housing market and has noted the challenges of adding directly to the supply of affordable housing. Each of the regional Federal Reserve Banks has an active, well-staffed community development function—one of the great benefits of the Federal Reserve's structure. We get important and timely information on the state of local economic and financial conditions, including those affecting low- and moderate-income, as well as other underserved, communities. Our community development staff at the Board and several Reserve Banks have conducted research to better understand housing affordability challenges, recognizing the importance of sufficient affordable housing to a community's economic vitality. We also conduct and disseminate research on policy and practice solutions. Increasingly we have been exploring the challenges of supplying affordable rental housing and the role of local land use and zoning policies.

Q.20. *Banks Hoarding Interest Income as the Fed Raises Rates*— Since the Fed began raising interest rates, banks have seen a significant jump in net interest income and charged consumers more for loans, all while keeping the interest rate paid on customer deposits relatively flat. Why are depositors not getting higher interest rates?

A.20. Banks' profits are partly determined by the difference in interest expense they must pay on deposits and other liabilities and the interest they earn on their assets, including loans. Interest rates on bank deposits are determined by private markets, as are the interest rates on loans, bonds, and other financial savings and investment products. A significant share of banks' funding comes from customer deposits, for which banks must compete with other banks and nonbanks, such as money market mutual funds. Banks must also compete with other banks, nonbanks, and markets when setting lending rates for borrowers. Historically, we have seen that banks do not raise the rates they offer on customer deposits as much or as quickly as interest rates on other bank products, such as loans, when the Federal Reserve raises its policy rate. Moreover, the rate paid by banks on their deposit accounts does not tend to rise as much or as quickly as the yields savers earn on alternative savings investments, such as money-market mutual funds.

Of note, average advertised deposit rates are often an incomplete indicator of how banks attract and retain customer deposits. Presently, the range of rates offered by banks is wide, and many banks temporarily offer promotional rates. In addition, banks may use alternative methods to compete for deposits vis-a-vis other banks and money market mutual funds. Such alternative methods of compensating depositors include cash incentives, special rates that are not broadly advertised, and special offers on other services. We continue to study these trends and the ways in which changes in monetary policy transmit to the broader economy.

Q.21. *Cannabis Banking*—As more States begin to legalize marijuana, it becomes imperative that Congress act on offering financial services for cannabis and cannabis affiliated businesses. In its first year of legalization, the State of Nevada collected $69.8 million in tax revenue from cannabis alone—this figure indicates that there is not an insignificant amount of cash that is floating around our financial system.

Are you able to discuss whether, if any, how a lack of financial services for cannabis businesses impacts our monetary system?

A.21. We understand that cannabis business may largely be conducted via cash transactions. Although the volume (and the attendant risk) of cash transactions may be large for any individual business, the scale of these businesses relative to the scale of the United States economy is quite small. As such, any additional cash activity from these businesses does not appear to be having any impact on the Federal Reserve's ability to provide currency and coin nor on its ability to conduct monetary policy.

Q.22. Could you discuss the regulatory burden that this prohibition places on federally chartered banks?

A.22. Federal law makes it a Federal crime to possess, grow, or distribute marijuana, and prohibits an entity from knowingly engaging in a monetary transaction in criminally derived property.[4] Therefore, financial transactions that are related to marijuana are defined as money laundering under Federal law, even those related to operations that are licensed or approved under State law. The conflict between Federal and State law has created challenges for marijuana-related businesses and banks.

In 2014, the Financial Crimes Enforcement Network (FinCEN) issued guidance to "clarify how financial institutions can provide services to marijuana-related businesses (MRBs) consistent with their Bank Secrecy Act (BSA) obligations."[5] Similar to other BSA guidance, a reference to the 2014 FinCEN guidance was incorporated into the FFIEC BSA/AML Examination Manual. If there are legislative changes or if FinCEN repeals or revises its guid-

[4] See the Controlled Substances Act and 18 U.S.C. 1957.
[5] *https://www.fincen.gov/sites/default/files/shared/FIN-2014-G0011.pdf*

ance, the Board, along with the other FFIEC agencies, will evaluate whether additional steps would be appropriate.

Examiners assess whether the bank management has implemented controls that are commensurate with the bank's risks, and when those risks involve MRBs as customers, examiners assess if the bank is complying with FinCEN's 2014 marijuana guidance, including its suspicious activity report filing requirements. In general, examiners determine if the bank's controls are commensurate with the risks posed by its products, services, and customers. As a general matter, the decision to open, close, or decline a particular account or relationship is made by a depository institution, without involvement by its supervisor.