

**STATEMENT OF**

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**on**

**OVERSIGHT OF FINANCIAL STABILITY AND DATA SECURITY**

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

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Chairman Johnson, Ranking Member Crapo and members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's (FDIC) actions to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The FDIC has made significant progress in recent months in implementing the new authorities granted by the Act.<sup>1</sup> My testimony will address several topics. First, I will discuss the recently adopted regulation implementing the Volcker Rule and the actions we have taken on the risk retention and qualified mortgage rules. I will then provide an update on our progress in implementing the authority provided to the FDIC to resolve systemically important financial institutions and proposals to improve the quantity and quality of capital. Finally, I will address data integrity issues for the banking industry.

### **The Volcker Rule**

Section 619 of the Dodd-Frank Act, also known as “the Volcker Rule,” requires the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), and the federal banking agencies to adopt regulations to prohibit banking entities from engaging in proprietary trading activities and to limit the ability of banking entities to invest in, or have certain relationships with, hedge funds and private equity funds. In general terms, proprietary trading occurs when an entity places its own capital at risk to engage in the short-term buying and selling of securities primarily to profit from short-term price movements, or enters into derivative products for similar purposes.

On December 10, 2013, the FDIC, along with the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the SEC, and the CFTC, adopted a final rule implementing Section 619. The Volcker Rule is designed to strengthen the financial system and constrain the level of risk undertaken by firms that benefit, directly or indirectly, from the federal safety net provided by federal deposit insurance or access to the Federal Reserve’s discount window. The challenge to the agencies in implementing the Volcker Rule was to prohibit the types of proprietary trading and investment activity that Congress intended to limit, while allowing banking organizations to provide legitimate intermediation in the capital markets.

In finalizing this rule, the agencies carefully reviewed more than 18,000 comments and made changes to the original proposal to address commenters’ concerns. The final rule is intended to preserve legitimate market making and hedging activities while maintaining market liquidity and vibrancy. The final rule also is designed to reduce overall burden by focusing requirements on those institutions that are more likely to engage in proprietary trading and covered fund activities.

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<sup>1</sup> A summary of the FDIC’s progress implementing the provisions of the Dodd-Frank Act is attached to this testimony.

The final rule is structured around the three main elements of Section 619: 1) the proprietary trading prohibition, 2) the covered funds prohibition, and 3) the compliance requirements.

### *Proprietary Trading Prohibition*

In general, the final rule prohibits proprietary trading by banking entities. However, consistent with Section 619, the final rule includes exemptions for underwriting, market making, and risk-mitigating hedging, among other exemptions provided in the final rule.

The underwriting exemption requires that a banking entity act as an underwriter for a distribution of securities and that the trading desk's underwriting position be related to that distribution. The underwriting position must be designed not to exceed the reasonably expected near-term demands of customers.

The exemption for market making-related activities requires that a trading desk routinely stand ready to purchase and sell one or more types of financial instruments. The trading desk's inventory of these instruments must be designed not to exceed the reasonably expected near-term demands of customers. Under the final rule, determining customer demand is based on such things as historical demand and consideration of current market factors. A market-making desk may hedge the risks of its market-making activity under this exemption, provided it is acting in accordance with certain risk management procedures required under the final rule.

The requirements of the risk-mitigating hedging exemption are generally designed to ensure that hedging activity is limited to risk-mitigating hedging in purpose and effect. For instance, hedging activity must be designed to demonstrably reduce or significantly mitigate specific, identifiable risks of individual or aggregated positions of the banking entity. In addition, the banking entity must conduct an analysis (including a correlation analysis) supporting its documented hedging strategy, and the effectiveness of hedges must be monitored and, as necessary, recalibrated on an ongoing basis.

Under the final rule, a banking entity would be allowed to hedge individual exposures or aggregate exposures—for example, a specific loan book. However, a banking entity would not be allowed to engage in so-called “macro hedging.” The result is to allow cost-effective, risk-reducing hedging while preventing banking entities from entering into speculative transactions under the guise of hedging.

The final rule allows a bank to engage in proprietary trading in certain government obligations and generally does not prohibit certain trading activities of foreign banking entities, provided the trading decisions and principal risks of the foreign banking entity occur and are held outside of the United States. Such transactions may involve U.S. entities only under particular circumstances. The final rule also clarifies other exclusions and exempts certain other permitted activities.

### *Covered Funds Prohibition*

The final rule prohibits banking entities from owning and sponsoring “hedge funds” and “private equity funds,” referred to in the final rule as “covered funds.” The final rule follows the statutory definition of covered funds and encompasses any issuer that would be an investment company under the Investment Company Act if it were not otherwise excluded by two provisions of that Act (section 3(c)(1) or 3(c)(7)). The final rule also includes in the definition of covered funds other similar funds such as certain foreign funds and commodity pools, which are defined in a more limited manner than under the proposed rule.

The final rule includes a number of exclusions from the definition of covered funds. These exclusions cover certain entities having more general corporate purposes (such as wholly owned subsidiaries or joint ventures), registered investment companies and business development companies regulated by the SEC and any issue of securities backed entirely by loans subject to certain asset restrictions.<sup>2</sup>

Consistent with the Dodd-Frank Act, the final rule designates certain activities as permissible. The final rule permits a banking entity, subject to appropriate conditions, to invest in or sponsor a covered fund in connection with organizing and offering the covered fund, underwriting or market making-related activities, certain types of risk-mitigating hedging activities, activities that occur solely outside of the United States, and insurance company activities.

The final rule places a number of limitations on permitted ownership interests in covered funds. In general, consistent with the statute, the final rule provides that a banking entity may not have any ownership in a covered fund unless it qualifies for an exemption such as organizing and offering the fund in accordance with requirements of the final rule or acting as a market maker for the fund. A banking entity that organizes and offers a covered fund must limit its total interest in each covered fund to no more than three percent of the ownership interests issued by the covered fund, and to no more than three percent of the value of the entire covered fund. However, if the covered fund is subject to risk retention requirements that must be satisfied by the banking entity, the final rule provides that the banking entity may retain additional ownership interests in the covered fund in order to satisfy any minimum risk retention requirement that may be established by the agencies by regulation. In addition, the aggregate of all interests the banking entity has in all covered funds may not exceed three percent of the banking entity’s tier 1 capital. Finally, the banking entity must deduct the value of all of its interests in covered funds and any retained earnings from its capital for purposes of applying the regulatory capital standards.

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<sup>2</sup> Accordingly, covered funds do not generally include securitizations such as residential mortgage-backed securities (including GSE exposures), commercial mortgage-backed securities, auto securitizations, credit card securitizations, and commercial paper backed by conforming asset-backed commercial paper conduits. Certain other securitizations, such as collateralized loan obligations or collateralized debt obligations, will likely meet the definition of covered funds if they are unable to divest impermissible assets during the conformance period.

Certain other securitizations, such as collateralized loan obligations, will be excluded from the definition of a covered fund if they are backed exclusively by loans. However, securitizations that currently include assets other than loans can be excluded from the definition of covered funds if they divest impermissible assets during the conformance period. For securitizations that are covered funds, the conditions for a banking entity to be permitted an ownership interest in these types of securitizations are, with one exception described below, the same conditions that apply to any other covered fund—for instance, it organizes and offers the securitization or engages in underwriting or market making-related activities.

### *Compliance Requirements*

In order to ensure compliance with the final rule, institutions engaged in covered practices will be required to have compliance programs in place commensurate with their size and level of activity. The agencies will monitor compliance through the compliance programs established by the institutions they regulate. To ensure consistent application of the final rule across all banking entities, the FDIC, FRB, OCC, SEC and CFTC have formed an interagency Volcker Rule Implementation Working Group (Working Group). The Working Group will address implementation issues on an on-going basis and will provide the industry with additional guidance or clarity as necessary. The Working Group has begun meeting and will meet regularly to address reporting, guidance and interpretation issues to facilitate compliance with the rule.

The final rule generally requires banking entities to establish an internal compliance program reasonably designed to ensure and monitor compliance with the final rule. In response to concerns raised by some commenters, the final rule provides compliance requirements that vary based on the size of the banking entity and the amount of covered activities it conducts. For example, banking entities that do not engage in activities covered by the final rule will have no compliance program requirements.

Under the final rule, larger banking entities with \$50 billion or more in total consolidated assets must establish a more detailed compliance program as described in Appendix B of the final rule, including requirements that:

- The banking entity adopt a written compliance program approved by the board of directors;
- The board of directors and senior management are responsible for setting and communicating an appropriate culture of compliance and ensuring that appropriate policies regarding the management of trading activities and covered fund activities or investments are adopted to comply with the requirements of the final rule; and

- The chief executive officer of the banking entity must annually attest in writing to its primary federal regulator that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the compliance program in a manner reasonably designed to achieve compliance with the final rule.

Banking entities with total consolidated assets between \$10 billion and \$50 billion will be subject to the minimum compliance program requirements included in section 20(b) of the final rule.

Finally, the final rule requires banking entities with significant trading operations to report certain quantitative metrics related to trading activities, in accordance with section 20(d) and Appendix A of the final rule. These metrics are designed to monitor certain trading activities and will be phased in over a period of time based on the type and size of the firm's trading activities.

### *Burden Reduction*

While the requirements of Section 619 apply to all banking entities regardless of size, the prohibited proprietary trading activities and investments in, and relationships with, hedge funds and private equity funds that are covered by the final rule are generally conducted by larger, more complex banking organizations. As a result, the final rule is designed to avoid placing needless requirements on banks that do not engage in these activities or have only limited exposure.

The final rule focuses compliance requirements on those institutions that are more likely to engage in prohibited proprietary trading and covered fund activities. Under the final rule, a bank is exempt from all of the compliance program requirements, and all of the associated costs, if it limits its covered activities to activities that are excluded from the definition of proprietary trading, such as trading in certain government, agency, state, and municipal obligations. In particular, the final rule provides that a banking entity is not required to implement a compliance program if it does not engage in activities or investments covered by the rule. This eliminates the compliance burden on banking entities that do not engage in covered activities or investments.

A banking entity with total consolidated assets of \$10 billion or less that engages in covered activities can meet the compliance requirements of the final rule simply by including in its existing compliance policies and procedures references to the requirements of section 13 of the Bank Holding Company Act and subpart D of the final rule as appropriate given the activities, size, scope and complexity of the banking entity. This significantly reduces the compliance burden on smaller banking entities that engage in a limited amount of covered activities or investments.

The final rule requires all other banking entities to establish a compliance program designed to ensure compliance with Section 619 and the requirements set forth in the final rule. Even for banking entities that must establish a compliance program, the

final rule makes changes from the NPR to reduce the burden of the metrics reporting requirements. For example, the final rule raised the threshold for metrics reporting from \$1 billion in trading assets and liabilities threshold originally proposed to \$10 billion in trading assets and liabilities, thereby capturing only firms that engage in very significant trading activity. The final rule also reduced the number of mandatory trading metrics required to be reported to the agencies from around 20 in the original proposal to 7 in the final rule. Additionally, the final rule provided for metrics reporting to be phased-in based on the size of the banking entity's trading assets and liabilities, with banks with more than \$50 billion in trading assets and liabilities reporting first, following banks with more than \$25 billion in trading assets and liabilities, and then banks with more than \$10 billion in trading assets and liabilities.

### *Treatment of TruPS CDOs*

Following the issuance of the final rule implementing section 619, a number of community banking organizations expressed concern that the final rule conflicts with the Congressional determination under section 171(b)(4)(C) of the Dodd-Frank Act to grandfather trust preferred securities (TruPS). On December 19 and December 27, 2013, the banking agencies issued joint statements providing guidance to financial institutions regarding the potential impact of the final rule on the treatment of TruPS held in collateralized debt obligations (CDOs). These statements outlined some of the issues that must be resolved in order to determine whether ownership of an interest in a securitization vehicle that holds primarily TruPS would be subject to the provisions of section 619 of the Dodd-Frank Act and the final implementing rules.<sup>3</sup>

Following additional review, the agencies determined that it is appropriate and consistent with the provisions of the Dodd-Frank Act to exempt certain collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs) from the investment prohibitions of section 619 of the Act. Section 171 of the Dodd-Frank Act provides for the grandfathering of TruPS issued before May 19, 2010, by certain depository institution holding companies with total assets of less than \$15 billion as of December 31, 2009, and by mutual holding companies established as of May 19, 2010. The TruPS CDO structure was the vehicle that gave effect to the use of TruPS as a regulatory capital instrument prior to May 19, 2010, and was part of the status quo that Congress preserved with the grandfathering provision of section 171.

The interim final rule (IFR) adopted by the agencies on January 14, 2014<sup>4</sup> is consistent with the relief the agencies believe Congress intended to provide community banking organizations under section 171(b)(4)(C) of the Dodd-Frank Act. Under the IFR, the agencies have exempted TruPS CDOs that meet specific criteria from the prohibition on the acquisition or retention of any interest in or sponsorship of covered funds by banking entities. The federal banking agencies also released a non-exclusive list

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<sup>3</sup> <http://www.fdic.gov/news/news/press/2013/pr13123.html>;  
<http://www.fdic.gov/news/news/press/2013/pr13126a.pdf>

<sup>4</sup> <http://www.fdic.gov/news/news/press/2014/pr14003a.pdf>

of issuers that meet the requirements for the exemption.<sup>5</sup> The IFR is clear that banking organizations can rely solely on this list for compliance purposes. The agencies will accept public comment on the IFR for 30 days following its publication in the Federal Register.

## **Risk Retention**

On August 28, 2013, the FDIC Board approved an NPR issued jointly with five other federal agencies to implement the credit risk retention requirement set forth in Section 941 of the Dodd-Frank Act, which seeks to ensure that securitization sponsors have appropriate incentives for prudent underwriting. The proposed rule generally requires that the sponsor of any asset-backed security (ABS) retain an economic interest equal to at least five percent of the aggregate credit risk of the collateral. This is the second proposal under Section 941; the first was issued in April 2011.

The current NPR provides the sponsors of ABSs with various options for meeting the risk retention requirements. As required by the Dodd-Frank Act, the proposed rule defines a “qualified residential mortgage” (QRM), that is, a mortgage which is statutorily exempt from risk retention requirements. The NPR would align the definition of QRM with the definition of “qualified mortgage” (QM) as prescribed by the Consumer Financial Protection Bureau (CFPB) in 2013. The NPR also includes a request for public comment on an alternative QRM definition that would add certain underwriting standards to the existing QM definition. Similar to the prior proposal, the current proposal sets forth criteria for securitizations of commercial real estate loans, commercial loans, and automobile loans that meet certain conservative credit quality standards to be exempt from risk retention requirements.

The FDIC has received approximately 150 comments on the current NPR. A number of comments relate to risk retention issues regarding open market collateralized loan obligations (CLOs).<sup>6</sup> The proposed rule considers an open market CLO manager to be a securitization sponsor and, therefore, the manager would generally be required to retain five percent of the credit risk of CLO issuances. As an alternative, managers or sponsors could satisfy the risk retention requirement if the lead arrangers of the loans (typically the main lender) purchased by the open market CLO retained the required risk. Some commenters have argued that the lead arranger option is unworkable and that the proposal would significantly affect the formation and continued operation of CLOs, and that this could reduce the volume of commercial lending. The agencies are continuing to review comments and meet with interested groups to discuss their concerns and will give full consideration to all issues raised before we issue the final rule.

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<sup>5</sup> <http://www.fdic.gov/news/news/press/2014/pr14003b.pdf>

<sup>6</sup> An open market CLO is defined as one (i) whose assets consist of senior, secured syndicated loans acquired directly from the sellers in open market transactions and of servicing assets, (ii) that is managed by a CLO manager, and (iii) that holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO.



## **Examination Treatment of Qualified Mortgages**

Recognizing that many institutions are assessing how to implement the Ability-to-Repay and QM rules issued by the CFPB, the federal financial regulators jointly issued interagency statements on their supervisory approach for residential mortgage loans. The agencies emphasize that an institution may originate both QM and non-QM residential mortgage loans. A bank's decision to offer only QM loans, absent other factors, should not elevate a supervised institution's fair lending risk and is compatible with meeting Community Reinvestment Act obligations. The interagency statements emphasize that the agencies will not subject a residential mortgage loan to regulatory criticism – either from a safety and soundness or consumer protection perspective - based solely on the loan's status as a QM or a non-QM.

## **Resolution of Systemically Important Financial Institutions**

### *Resolution Plans – “Living Wills”*

Under the framework of the Dodd-Frank Act, bankruptcy is the preferred option in the event of the failure of a SIFI. To make this objective achievable, Title I of the Dodd-Frank Act requires that all bank holding companies with total consolidated assets of \$50 billion or more, and nonbank financial companies that the Financial Stability Oversight Council (FSOC) determines could pose a threat to the financial stability of the United States, prepare resolution plans, or “living wills,” to demonstrate how the company could be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of the company's financial distress or failure. The living will process is an important new tool to enhance the resolvability of large financial institutions through the bankruptcy process.

The 165(d) Rule, jointly issued by the FDIC and the Federal Reserve Board in 2011, implemented the requirements for resolution plans and provided for staggered annual submission deadlines based on the size and complexity of the companies. Eleven of the largest, most complex institutions submitted initial plans in 2012 and revised plans in 2013. During 2013, the remaining 120 institutions submitted their initial resolution plans under the 165(d) rule. In addition, in 2013, the FSOC designated three non-bank financial institutions for Federal Reserve Board supervision. These firms are expected to submit their initial resolution plans in 2014.

### *2013 Guidance on Living Wills*

Following the review of the initial resolution plans submitted in 2012, the agencies developed Guidance for the firms to detail the information that should be included in their 2013 resolution plan submissions. The agencies identified an initial set of significant obstacles to rapid and orderly resolution which covered companies are expected to address in the plans, including the actions or steps the company has taken or proposes to take to remediate or otherwise mitigate each obstacle and a timeline for any proposed actions. These eleven institutions submitted their revised resolution plans in October 2013.

As required by the statute, the resolution plans submitted in 2013 will be subject to informational completeness reviews and reviews for resolvability under the Bankruptcy Code. The agencies are reviewing how each resolution plan addresses a set of benchmarks outlined in the Guidance which represent the key impediments to an orderly resolution. The benchmarks are as follows:

- **Multiple Competing Insolvencies:** Multiple jurisdictions, with the possibility of different insolvency frameworks, raise the risk of discontinuity of critical operations and uncertain outcomes.
- **Global Cooperation:** The risk that lack of cooperation could lead to ring-fencing of assets or other outcomes that could exacerbate financial instability in the United States and/or loss of franchise value, as well as uncertainty in the markets.
- **Operations and Interconnectedness.** The risk that services provided by an affiliate or third party might be interrupted, or access to payment and clearing capabilities might be lost;
- **Counterparty Actions.** The risk that counterparty actions may create operational challenges for the company, leading to systemic market disruption or financial instability in the United States; and
- **Funding and Liquidity.** The risk of insufficient liquidity to maintain critical operations arising from increased margin requirements, acceleration, termination, inability to roll over short term borrowings, default interest rate obligations, loss of access to alternative sources of credit, and/or additional expenses of restructuring.

The FDIC and the Federal Reserve are charged with reviewing the 165(d) plans and may jointly find that a plan is not credible or would not facilitate an orderly resolution under the Bankruptcy Code. If a plan is found to be deficient in either case, the FDIC and the Federal Reserve must notify the filer of the areas in which the plan is deficient. The filer must resubmit a revised plan that addresses the deficiencies within 90 days (or other specified timeframe). The FDIC and the Federal Reserve currently are in the process of reviewing the plans under the standards provided in the statute.

#### *Orderly Liquidation Authority*

In cases where resolution under the Bankruptcy Code may result in serious adverse effects on financial stability in the U.S., the Orderly Liquidation Authority set out in Title II of the Dodd-Frank Act serves as the last resort alternative. Upon recommendations by a two-thirds vote of the Federal Reserve Board and the FDIC Board and a determination by the Treasury Secretary in consultation with the President, a financial company whose failure is deemed to pose a risk to the financial system may be placed into an FDIC receivership. Under the Act, key findings and recommendations

must be made before the Orderly Liquidation Authority can be considered as an option. These include a determination that the financial company is in default or danger of default, that failure of the financial company and its resolution under applicable Federal or State law, including bankruptcy, would have serious adverse effects on financial stability in the United States and that no viable private sector alternative is available to prevent the default of the financial company.

In my July 11, 2013 testimony before this Committee, I described how the FDIC is developing a strategic approach, referred to as Single Point-of-Entry (SPOE), to carry out its Orderly Liquidation Authority for resolving a SIFI. Under the SPOE strategy, the FDIC would be appointed receiver of the top-tier parent holding company of the financial group following the company's failure and the completion of the recommendation, determination, and expedited judicial review process set forth in Title II of the Act. The FDIC would organize a bridge financial company into which assets from the receivership estate, including the failed holding company's investments in, and loans to subsidiaries, would be transferred.

The FDIC would oversee operations of the bridge financial company and would retain control over certain high-level key matters of the bridge financial company's governance. Shareholders would be wiped out, unsecured debt holders would have their claims written down to reflect any losses that shareholders cannot cover, and culpable senior management would be replaced. The FDIC would appoint a board of directors and nominate a new chief executive officer and other key managers to operate the bridge financial company under the FDIC's oversight. The plan for restructuring the company could include changing business, shrinking businesses, breaking the company into smaller entities, and liquidating certain assets or closing certain operations. The FDIC also would likely require the restructuring of the firm into one or more smaller non-systemic firms that could be resolved under bankruptcy.

During the operation of the bridge financial company, the healthy subsidiaries of the company would remain open, allowing them to continue business. In this manner the resolution strategy would protect against contagion in the financial system by maintaining vital linkages among critical operating subsidiaries, ensuring continuity of services, and avoiding the disruption that would likely accompany failure. At the same time, the strategy would protect against moral hazard by holding accountable the failed company's owners and management responsible for its failure.

On December 10, 2013, the FDIC Board approved publication of a Federal Register notice<sup>7</sup> which provides greater detail on the SPOE strategy and discusses the key issues that will be faced in the resolution of a SIFI. The notice seeks public comment and views as to how the policy objectives set forth in the Dodd-Frank Act could better be achieved.

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<sup>7</sup> FDIC, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (Dec. 18, 2013)

In addition, the Federal Reserve, in consultation with the FDIC, is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of unsecured debt at the holding company level. Such a requirement would ensure that there are creditors at the holding company level to absorb losses at the failed firm.

### *Cross-border Issues*

Advance planning and cross-border coordination for the resolution of globally active SIFIs will be essential to minimizing disruptions to global financial markets. Recognizing that global SIFIs create complex international legal and operational concerns, the FDIC continues to reach out to foreign regulators to establish frameworks for effective cross-border cooperation.

As part of our bilateral efforts, the FDIC and the Bank of England, in conjunction with the prudential regulators in our respective jurisdictions, have been developing contingency plans for the failure of a global SIFI that has operations in the U.S. and the U.K. Of the 28 G-SIFIs designated by the Financial Stability Board (FSB) of the G-20 countries, four are headquartered in the U.K, and another eight are headquartered in the U.S. Moreover, approximately 70 percent of the reported foreign activities of the eight U.S. G-SIFIs emanates from the U.K. The magnitude of these financial relationships makes the U.S.-U.K. bilateral relationship by far the most significant with regard to the resolution of G-SIFIs. Because of the magnitude of these institutions' operations, our two countries have a strong mutual interest in ensuring that the failure of such an institution could be resolved at no cost to taxpayers and without placing the financial system at risk.

The FDIC and U.K. authorities released a joint paper on resolution strategies in December 2012, reflecting the close working relationship between the two authorities. This joint paper focuses on the application of "top-down" resolution strategies for a U.S. or a U.K. financial group in a cross-border context and addresses several common considerations to these resolution strategies. In December 2013, the FDIC and the Bank of England, including the Prudential Regulation Authority, in conjunction with the Federal Reserve Board and the Federal Reserve Bank of New York, held a staff-level tabletop exercise exploring cross-border issues and potential mitigating actions that could be taken by regulators in the event of a resolution.

The FDIC also is coordinating with representatives from European authorities to discuss issues of mutual interest, including the resolution of European global SIFIs and ways in which we can harmonize receivership actions. The FDIC and the European Commission (E.C.) have established a joint Working Group composed of senior executives from the FDIC and the E.C. to focus on both resolution and deposit insurance issues. The agreement establishing the Working Group provides for meetings twice a year with other interim interchanges and the exchange of detailees. In 2013, the Working Group convened formally twice, and there has been ongoing collaboration at the staff level. The FDIC and the E.C. have had in-depth discussions regarding the FDIC's experience with resolution as well as the SPOE strategy that we are developing. We also

have discussed the E.C.'s proposed E.U.-wide Credit Institution and Investment Firm Recovery and Resolution Directive, the E.C.'s proposed amendment to harmonize further deposit guarantee schemes E.U.-wide, and the E.C.'s proposal for a Single Resolution Mechanism that would apply to Euro-area Member States, as well as any others that would opt-in. The FDIC and the E.C. also have exchanged staff members for short periods to enhance staff experience with respective resolution authorities. In 2014, at the request of the E.C., the FDIC is planning to conduct a training seminar on resolutions for E.C. staff.

The FDIC continues to foster its relationships with other jurisdictions that regulate global SIFIs, including Switzerland, Germany, and Japan. In 2013, the FDIC had significant principal and staff-level engagements with these countries to discuss cross-border issues and potential impediments that would affect the resolution of a global SIFI. We will continue this work in 2014 with plans to host tabletop exercises with staff from these authorities. We also have discussed developing joint resolution strategy papers, similar to the one with the U.K., as well as possible exchanges of detailees.

In a significant demonstration of cross-border cooperation on resolution issues, the FDIC signed a November 2013 joint letter with the Bank of England, the Swiss Financial Market Supervisory Authority and the German Federal Financial Supervisory Authority, to the International Swaps and Derivatives Association, Inc. (ISDA). This letter encouraged ISDA to develop provisions in derivatives contracts that would provide for short-term suspension of early termination rights and other remedies in the event of a G-SIFI resolution. The adoption of such changes would allow derivatives contracts to remain in effect throughout the resolution process following the implementation of a number of potential resolution strategies.

We anticipate continuation of our international coordination and outreach and will continue to work to resolve impediments to an orderly resolution of a global SIFI.

## **Capital and Liquidity Requirements**

### *Interagency Rulemakings on Basel III and the Supplementary Leverage Ratio*

In July 2013, the FDIC Board acted on two important regulatory capital rulemakings. First, the FDIC joined the Federal Reserve, and the OCC in issuing rulemakings that significantly revise and strengthen risk-based capital regulations through implementation of the Basel III international accord ("Basel III rulemaking"). Second, these agencies also issued an NPR that would strengthen leverage capital requirements for the eight largest U.S. bank holding companies (BHCs) and their insured banks.

The Basel III rulemaking substantially strengthens both the quality and the quantity of risk-based capital for all banks in the U.S. by placing greater emphasis on Tier 1 common equity capital. Tier 1 common equity capital is widely recognized as the most loss-absorbing form of capital, and the Basel III changes are expected to result in a

stronger, more resilient industry better able to withstand periods of economic stress in the future.

The Basel III rulemaking also includes a new supplementary leverage ratio requirement, an issue agreed in the Basel III international accord. This represents an important enhancement to the international capital framework. Prior to this rule, there was no international leverage ratio requirement. For the first time, the Basel III accord included an international minimum leverage ratio, and consistent with the agreement, the Basel III rulemaking includes a three percent minimum supplementary leverage ratio that applies only to the seventeen large banking organizations subject to the advanced approaches rule.

As noted above, the NPR would strengthen the supplementary leverage requirements encompassed in the Basel III rulemaking for the eight largest BHCs and their insured banks. The NPR would require covered insured depository institutions (IDIs) to satisfy a six percent supplementary leverage ratio to be considered well capitalized for prompt corrective action (PCA) purposes. BHCs covered by the NPR would need to maintain a supplementary leverage ratio of at least five percent (a three percent minimum plus a two percent buffer) to avoid restrictions on capital distributions and executive compensation.

As the NPR points out, maintaining a strong capital base at the largest, most systemically important institutions is particularly important because capital shortfalls at these institutions can contribute to systemic distress and have material adverse economic effects. The agencies' analysis suggests that a three percent minimum supplementary leverage ratio contained in the Basel III accord would not have appreciably mitigated the growth in leverage among systemically important institutions in the years preceding the recent crisis. The FDIC views this as problematic because one of the most important objectives of the capital reforms was to address the buildup of excessive leverage.

While the Basel III rulemaking raises risk-based capital requirements significantly, the minimum supplementary leverage ratio provided in Basel III does not raise leverage capital comparably. From a safety and soundness perspective, leverage capital requirements and risk-based capital requirements are complementary. Each offsets the potential weaknesses of the other, and the two working together – as they have in the U.S. for over 20 years – are more effective than either by itself. For example, risk-weighted asset calculations are subject to modeling error, subjectivity, and other uncertainties. These weaknesses can be offset by a more robust leverage ratio. On the other hand, risk-based capital measures are useful because they may better capture the risk posed by different kinds of assets. The NPR is intended to increase leverage capital to maintain rough comparability with the increase in risk-based capital required under Basel III.

Higher capital requirements would help offset systemic risk and would also put additional private capital at risk before the Deposit Insurance Fund (DIF) and the federal government's resolution mechanisms would be called upon. This proposed rulemaking is

one of the most important steps the banking agencies could take to strengthen the safety and soundness of the U.S. banking and financial systems.

### *Rule on the Liquidity Coverage Ratio and the Net Stable Funding Ratio Proposal*

A number of large financial institutions experienced significant liquidity problems during the financial crisis that exacerbated stress on the banking system, and more broadly, compromised financial stability. In response, the U.S. banking agencies have made a concerted effort, both domestically and internationally, to strengthen liquidity and short-term funding requirements for the largest U.S. banking organizations.

In October 2013, the FDIC, together with the OCC and the Federal Reserve, issued an interagency proposed rule to implement a quantitative liquidity requirement consistent with the Liquidity Coverage Ratio (LCR) developed by the Basel Committee on Banking Supervision on which the U.S. banking agencies serve as members. The LCR rule would apply to large, internationally active banking organizations and their consolidated subsidiary depository institutions with \$10 billion or more in total consolidated assets and is an important step in helping to bolster the resilience of these organizations during periods of financial stress. The proposal requires banks to hold a minimum level of liquid assets to withstand contingent liquidity events and provides a standard way of expressing a bank's on-balance sheet liquidity position to stakeholders and supervisors. The proposal establishes a transition schedule under which covered companies must fully meet the minimum LCR by January 1, 2017, two years earlier than the Basel deadline. The comment period on this proposal closed on January 31, 2014.

In January 2014, the Basel Committee issued a related proposal to establish a Net Stable Funding Ratio (NSFR). The NSFR proposal complements the LCR by promoting stable funding profiles over the longer term by limiting over-reliance on short-term wholesale funding, improving the assessment of funding risk for on- and off-balance sheet items, and encouraging stable sources of funding. To meet the proposed NSFR requirement, the largest U.S. banks would have to maintain a minimum level of stable funding given the liquidity characteristics of their assets and off-balance sheet exposures. The FDIC strongly supports the Basel Committee's NSFR proposal, and we anticipate that the U.S. banking agencies will develop a similar domestic rule once the Basel Committee's consultation period ends in April of this year.

### **Data Integrity**

Recent highly publicized data breaches have highlighted payment card data integrity issues at merchants. Compromised payment card data can affect millions of consumers and thousands of issuing banks globally. Consequently, payment card data integrity has been, and remains, a concern of the federal banking regulators. Although the federal banking agencies do not have the authority to regulate the payment card operations of retail merchants, such as those subject to the recent breaches in the news, the FDIC and the other federal banking regulators are able to examine merchant

acceptance and payment card issuing operations that occur under the direct control of a bank.

The FDIC treats data security as a significant risk area due to its potential to disrupt bank operations, harm consumers, and undermine confidence in the banking system and economy. The failure or misuse of technology can impact the safety and soundness of an institution with sudden and severe losses, directly harm consumers, or both.

In its role as supervisor of insured institutions, the FDIC analyzes emerging cyber threats, occurrences of bank security breaches, and other incidents. The FDIC monitors security issues in the banking industry on a regular basis through on-site examinations and regulatory reports. The FDIC, through its membership in the Financial and Banking Information Infrastructure Committee (FBIIC), works with groups such as the Financial Services Sector Coordinating Council (FSSCC), other regulatory agencies, law enforcement and others to share information regarding emerging issues and coordinate our responses.

Additionally, the Federal Financial Institutions Examination Council formed a Cybersecurity and Critical Infrastructure Working Group in June 2013. This working group will serve as a liaison with the intelligence community, law enforcement and homeland security agencies on cybersecurity and critical infrastructure protection-related issues. It also will conduct programs to create cyber risk awareness and consider additional industry guidance on specific threats. Finally, the group is pursuing an agenda for the member agencies to collaborate on cybersecurity and critical infrastructure issues related to examination policy, training, information sharing and incident communication and coordination.

The FDIC has issued guidance to financial institutions with respect to keeping data secure, protecting customers, and responding to breaches of data security. In 2001, the federal banking agencies issued Interagency Guidelines Establishing Information Security Standards, as required by Section 501(b) of the Gramm Leach Bliley Act, requiring every financial institution to have an information security program, approved by the institution's board of directors, to protect customer information.

The FDIC's most direct role in ensuring cyber security within the financial sector is through its on-site examination programs. The FDIC regularly and routinely evaluates all of its regulated financial institutions' information security programs through our information technology (IT) examinations. The federal banking agencies also conduct IT examinations of major technology service providers that provide services to financial institutions. These examinations are designed, in part, to ensure that financial institutions protect both bank and customer information. Depending on the findings from our examinations, informal or formal enforcement action may be pursued to achieve corrective actions.



The Federal Financial Institutions Examination Council (FFIEC), which includes the FDIC, publishes a series of Information Technology Examination Handbooks. Banks and their service providers are examined by their appropriate federal banking agency using the standards in the FFIEC books, which includes an assessment of their information security and protection of customer information, among other things. The handbooks address objectives, standards, resources, roles and responsibilities, best practices, and examination procedures. These handbooks are available to examiners, bankers, and the public.

With respect to retail payments in particular, the federal banking agencies' supervisory programs assess acquiring banks to ensure that appropriate payment operations risk mitigation efforts are in place. Included as part of the FFIEC IT Examination Handbook are two booklets, "Retail Payment Systems" and "Wholesale Payment Systems," to address regulatory expectations for risk management of these systems.

The federal banking agencies issued guidance in March 2005 for financial institutions to develop and implement a Response Program designed to address incidents of unauthorized access to sensitive customer information.

Recognizing that addressing cyber risks can be especially challenging for community banks, the FDIC is taking steps to assist them with planning and training. At the November 19, 2013 meeting of its Advisory Committee on Community Banking, we shared with members, an exercise that institutions can use to initiate discussions about operational risk and the potential impact of IT disruptions on common banking functions. This exercise, named "Cyber Challenge," provides financial institutions with four exercise scenarios via short videos. Each video represents a standalone scenario so users may choose to consider any number of the scenarios in any order they desire. Each video has associated challenge questions that have been developed to promote discussion on topics relevant to the specific scenarios and to assist institutions in the development of proper responses. Additionally, financial institutions may discuss how they would react to the scenario, how they would handle the situation in their respective institution, and what controls their institution has in place to prevent the situation. Cyber Challenge will be distributed to all FDIC-supervised institutions in the near future

## **Conclusion**

Thank you for the opportunity to share with the Committee the work that the FDIC has been doing to implement the Dodd-Frank Act and address systemic risk in the aftermath of the financial crisis. I would be glad to respond to your questions.

## **Status of FDIC Dodd-Frank Act Rulemakings**

### **Completed FDIC-only Rulemakings**

FDIC has met all applicable deadlines in issuing those required regulations in the Dodd-Frank Wall Street Reform and Consumer Protection Act for which it is solely responsible. These include:

- Orderly Liquidation Authority (OLA) Regulations
  - Inflation adjustment for wage claims against financial company in receivership;
  - Executive compensation clawbacks and definition of compensation; and
  - Definition of ‘predominantly engaged in activities financial in nature’ for title II purposes.
- Deposit Insurance Fund Management Regulations
  - Regulations establishing an asset-based assessment base;
  - Regulations implementing permanent \$250,000 coverage;
  - Elimination of pro-cyclical assessments; dividend regulations;
  - Restoration plan to increase the minimum reserve ratio from 1.15 to 1.35% by Sept. 30, 2020; and
  - Regulations implementing temporary full Deposit Insurance coverage for non-interest bearing transaction accounts (Program expired 12/31/12).

The FDIC has also issued several optional rules, including the following OLA rules:

- Rules governing payment of post-insolvency interest to creditors;
- Rules establishing the proper measure of actual, direct, compensatory damages caused by repudiation of contingent claims;
- Rules governing the priority of creditors and the treatment of secured creditors;
- Rules governing the administrative claims process;
- Rules governing the treatment of mutual insurance holding companies; and
- Rules providing for enforcement of contracts of subsidiaries or affiliates of a covered financial company.

### **Completed Interagency Rules:**

FDIC and its fellow agencies have issued a number of joint or interagency regulations. These include:

- Title I resolution plan requirements;
- Regulations implementing self-administered stress tests for financial companies;
- Minimum leverage capital requirements for IDIs (Collins §171(b)(1));
- Minimum risk-based capital requirements (Collins §171(b)(2));
- Capital requirements for activities that pose risks to the financial system (Collins §171(b)(7)) (as of July 9, 2013);
- Rules providing for calculation of the “maximum obligation limitation”;
- Regulations on foreign currency futures;
- Removing regulatory references to credit ratings;
- Property appraisal requirements for higher cost mortgages;
- Appraisals for higher priced mortgages supplemental rule;

- Appraisal independence requirements;
- Volcker Rule Prohibition on Proprietary Trading and Investments in Covered Funds; and
- Interim final rule authorizing Retention of Interests in CDOs backed by Bank-Issued Trust Preferred Securities

**Rulemakings in process—FDIC-only:**

A few regulations without statutory deadlines remain in process. These include:

- OLA regulations implementing post-appointment requirements and establishing eligibility requirements for asset purchasers; and
- Integration and Streamlining of adopted OTS regulations.

**Interagency Rulemakings in process:**

- Additional OLA Rules:
  - Orderly liquidation of covered brokers and dealers;
  - Regulations regarding treatment of officers and directors of companies resolved under Title II; and
  - QFC recordkeeping rules;
- Regulations implementing the credit exposure reporting requirement for large BHCs and nonbank financial companies supervised by the FRB;
- Regulations implementing the “source of strength” requirement for BHCs, S&LHCs, and other companies that control IDIs;
- Capital and margin requirements for derivatives that are not cleared OTC;
- Regulations governing credit risk retention in asset-backed securitizations, including ABS backed by residential mortgages;
- Regulations governing enhanced compensation structure reporting and prohibiting inappropriate incentive-based payment arrangements;
- Rulemaking prohibiting retaliation against an IDI or other covered person that institutes an appeal of conflicting supervisory determinations by the CFPB and the appropriate prudential regulator; and
- Additional appraisals and related regulations:
  - Minimum requirements for registration of appraisal management companies and for the reporting of the activities of appraisal management companies to Appraisal Subcommittee;
  - Regulations to implement quality controls standards for automated valuation models; and
  - Regulations providing for appropriate appraisal review.

**Other DFA Regulations and Guidance:**

- OMWI – Proposed Standards for Assessing Diversity in Regulated Entities;
- Stress Testing Guidance, including:
  - Economic Scenarios for 2014 Stress Testing;
  - Policy Statement on the Principles for Development and Distribution of Annual Stress Test Scenarios (FDIC-supervised institutions); and

- Proposed Interagency Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations With Total Consolidated Assets of More Than \$10 Billion But Less Than \$50 Billion; and
- Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans