STATEMENT OF

MARTIN J. GRUENBERG
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

WALL STREET REFORM: ASSESSING AND ENHANCING THE FINANCIAL REGULATORY SYSTEM

before the

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

September 9, 2014
538 Dirksen Senate Office Building

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).

My written testimony will address several key topics. First, I will discuss capital and liquidity rules that the bank regulatory agencies recently finalized, as well as a recently proposed margin rule on derivatives. Second, I will provide an update on our progress in implementing the authorities provided the FDIC relating to the resolution of systemically important financial institutions (SIFIs). I will then discuss an updated proposed risk retention rule for securitizations and implementation of the Volcker Rule. Finally, I will discuss our supervision of community banks, including the FDIC's efforts to address emerging cybersecurity and technology issues.

Capital, Liquidity and Derivative Margin Requirements

The new regulatory framework established under the Dodd-Frank Act augments and complements the banking agencies' existing authorities to require banking organizations to maintain capital and liquidity well above the minimum requirements for safety and soundness purposes, as well as to establish margin requirements on derivatives. The recent actions by the agencies to adopt a final rule on the leverage capital ratio, a final rule on the liquidity coverage ratio, and a proposed rule on margin requirements for derivatives address three key areas of systemic risk and, taken together, are an important step forward in addressing the risks posed particularly by the largest, most systemically important financial institutions.

Supplementary Leverage Ratio

In April 2014, the FDIC published a final rule that, in part, revises minimum capital requirements and, for advanced approaches banks,[1] introduces the supplementary leverage ratio requirement. The Office of the Comptroller of the Currency (OCC) and the Federal Reserve adopted a final rule in October 2013 that is substantially identical to the FDIC's final rule. Collectively, these rules are referred to as the Basel III capital rules.

The Basel III rulemaking includes a new supplementary leverage ratio requirement – 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. This ratio, which takes effect in 2018, applies to large, internationally active banking organizations, and requires them to maintain a minimum supplementary leverage ratio of three percent (in addition to

[1] An advanced approaches bank is an insured depository institution (IDI) that is an advanced approaches national bank or Federal savings association under 12 CFR 3.100(b)(1), an advanced approaches Board-regulated institution under 12 CFR 217.100(b)(1), or an advanced approaches FDIC-supervised institution under 12 CFR 324.100(b)(1). In general, an IDI is an advanced approaches bank if it has total consolidated assets of $250 billion or more, has total consolidated on-balance sheet foreign exposures of $10 billion or more, or elects to use or is a subsidiary of an IDI, bank holding company, or savings and loan holding company that uses the advanced approaches to calculate risk-weighted assets.

meeting other capital ratio requirements, including the agencies' long-standing Tier 1 leverage ratio).

In April 2014, the FDIC, the OCC and the Federal Reserve also finalized an Enhanced Supplementary Leverage Ratio final rule for the largest and most systemically important bank holding companies (BHCs) and their insured banks. This rule strengthens the supplementary leverage capital requirements beyond the levels required in the Basel III accord. Eight banking organizations are covered by these Enhanced Supplementary Leverage standards based on the thresholds in the final rule.

The agencies' analysis suggests that the three percent minimum supplementary leverage ratio contained in the international Basel III accord would not have appreciably mitigated the growth in leverage among SIFIs in the years leading up to the crisis. Accordingly, the Enhanced Supplementary Leverage standards that the agencies finalized in April will help achieve one of the most important objectives of the capital reforms: addressing the buildup of excessive leverage that contributes to systemic risk.

Under the Enhanced Supplementary Leverage standards, covered insured depository institutions (IDIs) will need to satisfy a six percent supplementary leverage ratio to be considered well capitalized for prompt corrective action (PCA) purposes. The supplementary leverage ratio includes off-balance sheet exposures in its denominator, unlike the longstanding U.S. leverage ratio which requires capital only for balance sheet assets. This means that more capital is needed to satisfy the supplementary leverage ratio than to satisfy the U.S. leverage ratio if both ratios were set at the same level. For example, based on recent supervisory estimates of the off-balance sheet exposures of these banks, a six percent supplementary leverage ratio would correspond to roughly an 8.6 percent U.S. leverage requirement. Covered BHCs will 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. This corresponds to roughly a 7.2 percent U.S. leverage ratio.

An important consideration in calibrating the Enhanced Supplementary Leverage ratio was the idea that the increase in stringency of the leverage requirements and the risk-based requirements should be balanced. Leverage capital requirements and risk-based capital requirements are complementary, with each type of requirement offsetting potential weaknesses of the other. In this regard, the Basel III rules strengthened risk-based capital requirements to a much greater extent than they strengthened leverage requirements. The Enhanced Supplementary Leverage ratio standard will ensure that the leverage requirement continues to serve as an effective complement to the risk-based capital requirements of the largest, most systemically important banking organizations, thereby strengthening the capital base and the stability of the U.S. banking system.

Maintaining a strong capital base at the largest, most systemically important financial institutions (SIFIs) is particularly important because capital shortfalls at these institutions can contribute to systemic distress and lead to material adverse economic effects. These higher capital requirements will also put additional private capital at risk before the Deposit Insurance Fund (DIF) and the federal government's resolution mechanisms would be called upon. The final Enhanced Supplementary Leverage ratio rule is one of the most important steps the banking agencies have taken to strengthen the safety and soundness of the U.S. banking and financial systems.

On September 3, 2014, the FDIC Board also finalized a rule originally proposed in April 2014 that revises the denominator measure for the supplementary leverage ratio and introduced related public disclosure requirements. The changes in this rule apply to all advanced approaches banking organizations, including the eight covered companies that would be subject to the Enhanced Supplementary Leverage standards. The denominator changes are consistent with those agreed upon by the Basel Committee on Banking Supervision and would, in the aggregate, result in a modest further strengthening of the supplementary leverage ratio requirement as compared to the capital rules finalized in April.

Liquidity Coverage Ratio

On September 3, 2014, the FDIC issued a joint interagency final rule with the Federal Reserve Board and the OCC implementing a liquidity coverage ratio (LCR). During the recent financial crisis, many banks had insufficient liquid assets and could not borrow to meet their liquidity needs. The LCR final rule is designed to strengthen the liquidity positon of our largest financial institutions, thereby promoting safety and soundness and the stability of the U.S. financial system.

This final rule applies to the largest, internationally active banking organizations: U.S. banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure and their subsidiary depository institutions with $10 billion or more in total assets. The Federal Reserve also finalized a separate rule that would apply a modified LCR requirement to BHCs with between $50 billion and $250 billion in total consolidated assets. Other insured banks are not subject to the rule.

The LCR final rule establishes a quantitative minimum liquidity coverage ratio that builds upon approaches already used by a number of large banking organizations to manage liquidity risk. It requires a covered company to maintain an amount of unencumbered high-quality liquid assets (HQLA) sufficient to meet the total stressed net cash outflows over a prospective 30 calendar-day period. A covered company's total net cash outflow amount is determined by applying outflow and inflow rates described in the rule, which reflect certain stressed assumptions, against the balances of a covered company's funding sources, obligations, and assets over a 30 calendar-day period.

A number of commenters have expressed concern about the exclusion of municipal securities from HQLA in the final rule. It is our understanding that banks do not generally hold municipal securities for liquidity purposes, but rather for longer term investment and other objectives. We will monitor closely the impact of the rule on municipal securities and consider adjustments if necessary.

Margin Rule for Derivatives

Before the passage of the Dodd-Frank Act, the derivatives activities of financial institutions were largely unregulated. One of the issues observed in the crisis was that some financial institutions had entered into large over-the-counter (OTC) derivatives positions with other institutions without the prudent initial exchange of collateral — a basic safety-and-soundness practice known as margin — in support of the positions. Title VII addressed this situation in part by requiring the use of central clearinghouses for certain standardized derivatives contracts, and by requiring the exchange of collateral, i.e., margin, for derivatives that are not centrally cleared.

Central clearinghouses for derivatives routinely manage their risks by requiring counterparties to post collateral at the inception of a trade. This practice is known as initial margin, in effect a type of security deposit or performance bond. Moreover, central clearinghouses routinely require a counterparty to post additional collateral if the market value of the position moves against that counterparty, greatly reducing the likelihood the clearinghouse will be unable to collect amounts due from counterparties. This type of collateral is known as variation margin.

Sections 731 and 764 of the Dodd Frank Act requires the large dealers in swaps to adopt certain prudent margining practices for their OTC derivatives activities that clearinghouses use, namely the posting and collecting of initial and variation margin. The exchange of margin between parties to a trade on OTC derivatives is an important check on the buildup of counterparty risk that can occur with OTC derivatives without margin. More generally, the appropriate exchange of margin promotes financial stability by reducing systemic leverage in the derivatives marketplace and promotes the safety and soundness of banks by discouraging the excessive growth of risky OTC derivatives positions.

The FDIC recently approved an interagency proposed rule to establish minimum margin requirements for the swaps of an insured depository institution or other entity that: (1) is supervised by the FDIC, Federal Reserve, OCC, Federal Housing Finance Administration (FHFA), or Farm Credit Administration (FCA); and (2) is also registered with the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC) as a dealer or major participant in swaps. The proposed rule will be published in the Federal Register with a 60-day public comment period.

In developing this proposal, the FDIC, along with the other banking agencies, worked closely with the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) to develop a proposed framework for margin requirements on non-cleared swaps (the "international margin framework") with the goal of creating an international standard for margin requirements on non-cleared swaps. After considering numerous comments, BCBS and IOSCO issued a final international margin framework in September 2013. The agencies' 2014 proposed rule is closely aligned with the principles and standards from the 2013 international framework. The E.U. and other jurisdictions also have issued similar proposals.

The proposed rule would require a covered swap entity (a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant) to exchange initial margin with counterparties that are: (1) registered with the CFTC or SEC as swap entities; or (2) financial end users with material swaps exposure -- that is, with more than $3 billion in notional exposure of OTC derivatives that are not cleared. The rule would not require a covered swap entity to collect initial margin from commercial end users. The agencies intend to maintain the status quo with respect to the way that banks interact with commercial end users.

The proposed rule would also require a covered swap entity to exchange variation margin on swaps with all counterparties that are: (1) swap entities; or (2) financial end users (regardless of whether the financial end user has a material swaps exposure). There is no requirement that a covered swap entity must collect or post variation margin with commercial end users.

Because community banks typically do not have more than $3 billion in notional exposure of OTC derivatives that are not cleared, the agencies expect that the proposed rule will not result in community banks being required to post initial margin. Community banks that do engage in OTC derivatives that are not cleared are likely already posting variation margin in the normal course of business, or in amounts too small to fall within the scope of the rule. As a result, the margin rule likely will have little, if any, impact on the vast majority of community banks.

<u>Resolution of Systemically Important Financial Institutions</u>

Resolution Plans – "Living Wills"

Under the framework of the Dodd-Frank Act, bankruptcy is the preferred option in the event of a SIFI's failure. To make this objective achievable, Title I of the Dodd-Frank Act requires that all BHCs 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.

In 2011, the FDIC and the FRB jointly issued a final rule (the 165(d) rule) implementing the resolution plan requirements of Section 165(d) of the Dodd-Frank Act. The 165(d) rule provided for staggered annual submission deadlines for resolution plans based on the size and complexity of the companies. Eleven of the largest, most complex institutions (collectively referred to as "first wave filers") 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. The FSOC also designated three nonbank financial institutions for Federal Reserve supervision that year. In July 2014, 13 firms that previously had submitted at least one resolution plan submitted revised resolution plans, and the 3 nonbank financial companies designated by the FSOC submitted their initial resolution plans. The Federal Reserve and the FDIC granted requests for extensions to two firms whose second resolution plan submissions would have been due July 1. Those plans are now due to the agencies by October 1, 2014. The remaining 116 firms are expected to submit their second submission revised resolution plans in December 2014.

Following the review of the initial resolution plans submitted in 2012, the Federal Reserve and the FDIC issued joint guidance in April 2013 to provide clarification and direction for developing 2013 resolution plan submissions. The Federal Reserve and the FDIC identified an initial set of obstacles to a rapid and orderly resolution that covered companies were expected to address in the plans. The five obstacles identified in the guidance—multiple competing insolvencies, potential lack of global cooperation, operational interconnectedness, counterparty actions, and funding and liquidity—represent the key impediments to an orderly resolution. The 2013 plans should have included the actions or steps the companies have taken or propose to take to remediate or otherwise mitigate each obstacle and a timeline for any proposed actions. The agencies also extended the deadline for submitting revised plans from July 1, 2013, to October 1, 2013, to give the firms additional time to develop resolution plan submissions that addressed the agencies' instructions.

Section 165(d) of the Dodd-Frank Act and the jointly issued implementing regulation[2] require the FDIC and the Federal Reserve to review the 165(d) plans. If the agencies jointly determine that a plan is not credible or would not facilitate an orderly resolution under the U. S. Bankruptcy Code, 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 have completed their reviews of the 2013 resolution plans submitted to the agencies by the eleven bank holding companies that submitted their revised resolution plans in October 2013. On August 5, 2014, the agencies issued letters to each of these first wave filers detailing the specific shortcomings of each firm's plan and the requirements for the 2015 submission.

While the shortcomings of the plans varied across the first wave firms, the agencies have identified several common features of the plans' shortcomings, including: (1) assumptions that the agencies regard as unrealistic or inadequately supported, such as assumptions about the likely behavior of customers, counterparties, investors, central clearing facilities, and regulators; and (2) the failure to make, or even to identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly resolution. The agencies will require that the annual plans submitted by the first wave filers on July 1, 2015, demonstrate that those firms are making significant progress to address all the shortcomings identified in the letters, and are taking actions to improve their resolvability under the U.S. Bankruptcy Code. These actions include:

- establishing a rational and less complex legal structure which would take into account the best alignment of legal entities and business lines to improve the firm's resolvability;

- developing a holding company structure that supports resolvability, including maintaining sufficient longer term debt;

[2] 12 CFR Part 243 and 12 CFR Part 381,

- amending, on an industry-wide and firm-specific basis, financial contracts to provide for a stay of certain early termination rights of counterparties triggered by insolvency proceedings;

- ensuring the continuity of shared services that support critical operations and core business lines throughout the resolution process; and

- demonstrating operational capabilities for resolution preparedness, such as the ability to produce reliable information in a timely manner.

Agency staff will work with each of the first wave filers to discuss required improvements in its resolution plan and the efforts, both proposed and in progress, to facilitate each firm's preferred resolution strategy. The agencies are also committed to finding an appropriate balance between transparency and confidentiality of proprietary and supervisory information in the resolution plans. As such, the agencies will be working with these firms to explore ways to enhance public transparency of future plan submissions.

Based upon its review of submissions by first wave filers, the FDIC Board of Directors determined, pursuant to section 165(d) of the Dodd-Frank Act, that the plans submitted by the first wave filers are not credible and do not facilitate an orderly resolution under the U.S. Bankruptcy Code. The FDIC and the Federal Reserve agreed that in the event that a first wave filer has not, by July 1, 2015, submitted a plan responsive to the shortcomings identified in the letter sent to that firm, the agencies expect to use their authority under section 165(d) to determine that a resolution plan does not meet the requirements of the Dodd-Frank Act.

Improvements to Bankruptcy

At the December 2013 meeting of the FDIC's Systemic Resolution Advisory Committee, the FDIC heard how the existing bankruptcy process could be improved to better apply to SIFIs. The current provisions of the U.S. Bankruptcy Code do not expressly take into account certain features of SIFIs that distinguish these firms from other entities that are typically resolvable under bankruptcy without posing risk to the U.S. financial system. Issues such as the authority to impose a stay on qualified financial contracts and the ability to move part of a bankrupt firm into a bridge entity in an expeditious and efficient fashion are left unaddressed in current law. It also is unclear whether traditional debtor-in-possession financing, which is available under bankruptcy, would be sufficient to address the significant liquidity needs arising from the failure of a SIFI. A further challenge in a U.S. bankruptcy proceeding would be how it could foster global cooperation with foreign authorities, courts, creditors, or other pertinent parties, including U.S. financial regulatory officials, to ensure that their interests will be protected.

Additionally, a number of scholars, policy analysts, and public officials have made helpful proposals for changes to the U.S. Bankruptcy Code that would facilitate the resolution of a SIFI in bankruptcy. The FDIC has been reaching out to those in the bankruptcy community to discuss ways to enhance the U.S. Bankruptcy Code to facilitate an orderly failure of a SIFI. In addition, the FDIC has been working with foreign authorities to encourage the International Swaps and Derivatives Association (ISDA) to modify its standard-form contracts to facilitate resolution in bankruptcy. The FDIC supports these efforts and is prepared to work with Congress on modifications to the U.S. Bankruptcy Code for the treatment of SIFIs in bankruptcy.

Implementation of Title II

Congress also recognized that there may be circumstances in which the resolution of a SIFI under the U.S. Bankruptcy Code would have serious adverse effects on financial stability in the U.S. Accordingly, in Title II of the Dodd-Frank Act, Congress provided the FDIC with orderly liquidation authority to resolve a failing SIFI as a last resort in the event that resolution under the U.S. Bankruptcy Code would result in systemic disruption of the financial system. This Orderly Liquidation Authority serves as a backstop to protect against the risk of systemic disruption to the U.S. financial system and allows for resolution in a manner that results in shareholders losing their investment, creditors taking a loss and management responsible for the failure being replaced, resulting in an orderly unwinding of the firm without cost to U.S. taxpayers.

In my February testimony before this Committee, I described how the FDIC is developing a strategic approach, referred to as Single Point of Entry (SPOE) strategy, to carry out its Orderly Liquidation Authority for resolving a SIFI in the event it is determined that a firm cannot be resolved under bankruptcy without posing a risk to the U.S. financial system. 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. For the SPOE strategy to be successful, it is critical that the top-tier holding company maintain a sufficient amount of unsecured debt that would be available to provide capital to manage the orderly unwinding of the failed firm. In a resolution, the holding company's debt would be used to absorb losses and keep the operating subsidiaries open and operating until an orderly wind-down could be achieved.

In support of the SPOE strategy, 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, in addition to the regulatory capital those companies already are required to maintain. Such a requirement would ensure that there is sufficient debt 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 (G-SIFIs) will be essential to minimizing disruptions to global financial markets. Recognizing that G-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 G-SIFI that has operations in the United States and the United Kingdom. Of the 28 G-SIFIs identified by the Financial Stability Board (FSB) in the G-20 countries, four are headquartered in the United Kingdom, and eight in the United States. Moreover, more than 70 percent of the reported foreign activities of the eight U.S. G-SIFIs originate in the United Kingdom. The magnitude of the cross-border financial relationships and local activity of G-SIFIs in the United States and the United Kingdom makes the U.S.-U.K. bilateral relationship by far the most significant with regard to the resolution of G-SIFIs. Therefore, 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 are continuing to work together to address the cross-border issues raised in the December 2012 joint paper on resolution strategies and the December 2013 tabletop exercise between staffs at the FDIC, the Bank of England (including the Prudential Regulation Authority), the Federal Reserve, and the Federal Reserve Bank of New York. This work is intended to identify actions that could be taken by each regulator to implement the SPOE resolution strategy in the event of a resolution.

The FDIC also has continued to coordinate with representatives from other European authorities to discuss issues of mutual interest, including the resolution of European G-SIFIs and ways in which we can harmonize receivership actions. The FDIC and the European Commission (E.C.) continue to work collaboratively through a joint Working Group composed of senior executives from the FDIC and the E.C., focusing on both resolution and deposit insurance issues. The Working Group meets twice a year, in addition to less formal meetings and exchanges of detailees. In 2014, the Working Group convened in May, 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 FDIC's SPOE strategy.

The E.U. recently adopted important legislation related to the resolution of global SIFIs, such as the E.U.-wide Credit Institution and Investment Firm Recovery and Resolution Directive, amendments that further harmonize deposit guarantee schemes E.U.-wide, and a Single Resolution Mechanism for Euro-area Member States and others that opt-in. The E.U. is now working to implement that legislation through secondary legislation, in the form of guidelines and standards, and by establishing the organizational capacity necessary to support the work of the Single Resolution Board under the Single Resolution Mechanism. FDIC and E.C. staffs continue to collaborate in exchanging information related to this implementation work. In June 2014, at the request of the E.C., the FDIC conducted a two-day seminar on resolutions for resolution authorities and a broad audience of E.C. staff involved in resolutions-related matters.

The FDIC continues to foster relationships with other jurisdictions that regulate G-SIFIs, including Switzerland, Germany, France and Japan. So far in 2014, the FDIC has 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 G-SIFI. We will continue this work during the remainder of 2014 and in 2015 and plan to host tabletop exercises with staff from these authorities. We also held preliminary discussions on developing joint resolution strategy papers, similar to the one with the United Kingdom, 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 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 authorities are now providing comments on proposed draft ISDA protocols that would contractually implement these provisions during a resolution under bankruptcy or under a special resolution regime. The adoption of the provisions would allow derivatives contracts to remain in effect throughout the resolution process under a number of potential resolution strategies. The FDIC believes that the development of a contractual solution has the potential to remove a key impediment to cross-border resolution.

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

<u>Risk Retention</u>

On August 28, 2013, the FDIC approved an NPR issued jointly with five other federal agencies to implement the credit risk retention requirement in Section 941 of the Dodd-Frank Act. The proposed rule seeks to ensure that securitization sponsors have appropriate incentives to monitor and ensure the underwriting and quality of assets being securitized. 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 was the second proposal under Section 941; the first was issued in April 2011.

The FDIC reviewed approximately 240 comments on the August 2013 NPR. Many comments addressed the proposed definition of a "qualified residential mortgage" (QRM), which is a mortgage that is statutorily exempt from risk retention requirements under the Dodd-Frank Act. The NPR proposed to align the definition of QRM with the definition of "qualified mortgage" (QM) adopted by the Consumer Financial Protection Bureau (CFPB) in 2013. The NPR also included a request for public comment on an alternative QRM definition that would add certain underwriting standards to the existing QM definition. The August 2013 proposal also sets forth criteria for securitizations of commercial real estate loans, commercial loans, and automobile loans that meet specific conservative credit quality standards to be exempt from risk retention requirements.

The issuing agencies have reviewed the comments, met with interested groups to discuss their concerns and have given careful consideration to all the issues raised. The agencies have made significant progress toward finalizing the rule and expect to complete the rule in the near term.

<u>Volcker Rule Implementation</u>

In adopting the Volcker Rule, the agencies recognized that clear and consistent application of the final rule across all banking entities would be extremely important. To help ensure this consistency, the five agencies formed an interagency Volcker Rule Implementation Working Group. The Working Group has been meeting on a weekly basis and has been able to make meaningful progress on coordinating implementation. The Working Group has been able to agree on a number of interpretive issues and has published several Frequently Asked Questions. In addition, the Working Group has been able to successfully develop a standardized metrics reporting template, which has been provided to and tested by the industry. In addition, the Working Group is developing a collaborative supervisory approach by the agencies.

Community Banks

Focus of Research

Since 2011, the FDIC has been engaged in a sustained research effort to better understand the issues related to community banks – those institutions that provide traditional, relationship-based banking services in their local communities. Our initial findings were presented in a comprehensive study published in December 2012. The study covered topics such as structural change, geography, financial performance, lending strategies and capital formation, and it highlighted the critical importance of community banks to our economy and our banking system. While the study found that community banks account for about 14 percent of the banking assets in the U.S, they also account for around 45 percent of all the small loans to businesses and farms made by all banks in the U.S. In addition, the study found that, of the more than 3,100 U.S. counties, nearly 20 percent (more than 600 counties) – including small towns, rural communities and urban neighborhoods – would have no physical banking presence if not for the community banks operating there.

The study also showed that community banks' core business model – defined around careful relationship lending, funded by stable core deposits, and focused on the local geographic community that the bank knows well – performed comparatively well during the recent banking crisis. Among the more than 500 banks that have failed since 2007, the highest rates of failure were observed among non-community banks and among community banks that departed from the traditional model and tried to grow with risky assets often funded by volatile brokered deposits.

Our community bank research agenda remains active. Since the beginning of the year, FDIC analysts have published new papers dealing with consolidation among community banks, the effects of long-term rural depopulation on community banks, and the efforts of Minority Depository Institutions to provide essential banking services in the communities they serve.

We have also instituted a new section in the FDIC *Quarterly Banking Profile*, or QBP, that focuses specifically on community banks. Although some 93 percent of FDIC-insured institutions met our community bank definition in the first quarter, they hold a relatively small portion of industry assets; as a result, larger bank trends tend to obscure community bank trends. This new quarterly report on the structure, activities and performance of community banks should help smaller institutions compare their results with those of other community banks as well as those of larger institutions. Introducing this regular quarterly report is one example of the FDICs commitment to maintain an active program of research and analysis on community banking issues in the years to come.

Subchapter S

The Basel III capital rules introduce a capital conservation buffer for all banks (separate from the supplementary leverage ratio buffer applicable to the largest and most systemically important BHCs and their insured banks). If a bank's risk-based capital ratios fall below specified thresholds, dividends and discretionary bonus payments become subject to limits. The buffer is meant to conserve capital in banks whose capital ratios are close to the minimums and encourage banks to remain well-capitalized.

In July 2014, the FDIC issued guidance clarifying how it will evaluate requests by S corporation banks to make dividend payments that would otherwise be prohibited under the capital conservation buffer. S corporation banks have expressed concern about the capital conservation buffer because of a unique tax issue their shareholders face. Federal income taxes of S corporation banks are paid by their investors. If an S corporation bank has income, but is limited or prohibited from paying dividends, its shareholders may have to pay taxes on their pass-through share of the S-corporation's income from their own resources. Relatively few S corporation banks are likely to be affected by this issue, and in any case not for several years. The buffer is phased-in starting in 2016 and is not fully in place until 2019.

As described in the guidance, if an S corporation bank faces this tax issue, the Basel III capital rules allow it (like any other bank) to request an exception from the dividend restriction that the buffer would otherwise impose. The primary regulator can approve such a request if consistent with safety and soundness. Absent significant safety and soundness concerns about the requesting bank, the FDIC expects to approve on a timely basis exception requests by well-rated S corporations to pay dividends of up to 40 percent of net income to shareholders to cover taxes on their pass-through share of the bank's earnings.

Cybersecurity

In its role as supervisor of state-chartered financial institutions that are not members of the Federal Reserve System, the FDIC works with other bank regulators to analyze emerging cyber threats, bank security breaches, and other technology incidents. An important initiative of the FFIEC is a project to assess the level of cybersecurity readiness at banks, technology service providers and our own supervisory policies. The agencies plan to review any identified gaps to enhance supervisory policies to address cyber threats.

Recognizing that addressing cyber risks can be especially challenging for community banks, the FDIC has taken a number of actions in addition to those taken by the FFIEC to further improve awareness of cyber risks and encourage practices to protect against threats. In April, the FDIC issued a press release urging financial institutions to utilize available cyber resources to identify and help mitigate potential threats. During the first quarter of 2014, the FDIC distributed a package to all FDIC supervised banks that included a variety of tools to assist them in developing cyber readiness. As part of this kit, the FDIC developed a "Cyber Challenge" resource for community banks to use in assessing their preparedness for a cyber-related incident, and videos and simulation exercises were made available on www.FDIC.gov and mailed to all FDIC-supervised banks. The Cyber Challenge is intended to assist banks in beginning a discussion of the potential impact of IT disruptions on important banking functions. In April, the FDIC also re-issued three documents on technology outsourcing that contain practical ideas for community banks to consider when they engage in technology outsourcing. The documents are: *Effective Practices for Selecting a Service Provider*; *Tools to Manage Technology Providers' Performance Risk: Service Level Agreements*; and *Techniques for Managing Multiple Service Providers*.

In addition to the FDIC's operations and technology examination program, the FDIC monitors cyber-security issues in the banking industry on a regular basis through on-site examinations, regulatory reports, and intelligence reports. The FDIC also works with a number of groups, including the Finance and Banking Information Infrastructure Committee, the Financial Services Sector Coordinating Council for Critical Infrastructure Protection and Homeland Security, the Financial Services Information Sharing and Analysis Center, other regulatory agencies and law enforcement to share information on emerging issues.

Conclusion

Thank you for the opportunity to share with the Committee the work that the FDIC has been doing to 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
August 2014

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;
    - Definition of 'predominantly engaged in activities financial in nature' for title II purposes; and
    - Rules governing asset purchaser eligibility.
- 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:

- Annual Stress Test – revisions to "as-of" dates for financial data;
- 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

    - 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