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Statement by

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Chairman Hensarling, Ranking Member Waters, and other members of the committee, I appreciate the opportunity to testify on the Federal Reserve's regulation and supervision of financial institutions.

The Federal Reserve, along with the other U.S. banking agencies, has made substantial progress in building stronger regulatory and supervisory programs since the global financial crisis, especially with respect to the largest and most systemically important firms. These improvements have helped to build a more resilient financial system, one that is well positioned to provide American consumers, businesses, and communities access to the credit they need even under challenging economic conditions. At the same time, we are mindful that--just as there is a strong public interest in the safety and soundness of the financial system--there is a strong public interest in the efficiency of the financial system. Our financial sector is the critical mechanism for directing the flow of savings and investment in our economy in ways that support economic growth, and economic growth, in turn, is the fundamental precondition for the continuing improvement in the living standards of all our citizens that has been one of the outstanding achievements of our country. As a result, our regulation of that system should support and promote the system's efficiency just as it supports its safety.

In fact, I believe that the supervisory objectives of safety, soundness, and efficiency are not incompatible, but rather are mutually reinforcing. Our job as regulators is to pursue each of these objectives. Moreover, our achievement of these objectives will be improved when we pursue them through processes that are as transparent as possible and through measures that are clear and simple, rather than needlessly complex. In doing this, we at the Federal Reserve intend to maintain the core elements of the post-crisis framework that have been put in place to protect the financial system's strength and resiliency, while also seeking ways to enhance its effectiveness.

In my testimony today I will: (1) review the current condition of the nation's banking institutions; (2) review our regulatory and supervisory agenda in light of the efficiency, transparency, and simplicity principles that enhance effectiveness; and (3) touch upon our engagement with foreign regulators.

Current Condition of Regulated Firms

Before I discuss our regulatory and supervisory agenda in more detail, let me provide an update regarding the current condition of the nation's banking institutions.

Overall, the U.S. commercial banking system has strengthened considerably over the past decade. The largest U.S. banking organizations--those the failure of which would pose the greatest risk to the financial system and that are subject to the Federal Reserve's stress testing framework--have increased the dollar amount of their loss-absorbing common equity capital by more than $700 billion since 2009, more than doubling their common equity capital ratios from approximately 5 percent to more than 12 percent. In addition, the eight U.S. global systemically important banking organizations, or G-SIBs, have developed significantly more stable funding positions as their reliance on short-term debt--including repurchase agreement, or repo, financing--has decreased by more than half since 2007 and now is equal to less than 15 percent of their total assets. The G-SIBs now also hold approximately $2.4 trillion in high-quality liquid assets, representing an increase of more than 60 percent since 2011.

The financial condition of community banks also has strengthened significantly since the financial crisis. Aggregate reporting data from the more than 5,000 community-based holding companies subject to Federal Reserve oversight show marked improvements in profitability that have contributed to a strong overall capital position. Community banks reported net income of $20.6 billion during 2017, up 4 percent from 2016. They also experienced particularly strong loan activity, as their most recent year-over-year loan growth of 7.7 percent materially exceeded that of the banking industry as a whole.

In the aggregate, banks realized profits of approximately $152 billion during 2017. While total net income fell in 2017 compared with 2016, this was largely a result of non-recurring items. Total loans held by U.S. commercial banks grew roughly 5 percent during 2017 and currently exceeds the previous peak from 2008.

While the overall position of the banking system is strong, the Federal Reserve continues to monitor ongoing risks that pose potential threats to banking firms of all sizes. It is often said that bad loans are made during good times. Therefore, more than eight years into the recovery, we continue to emphasize the need for banking organizations to maintain underwriting discipline and strong risk-management practices. We are particularly focused on banking organizations that have or are developing concentrations in loan segments vulnerable to adverse economic developments. Banks generally would also be vulnerable to an unexpected and swift change in the shape of the yield curve.

In addition, banks continue to innovate and keep pace with financial technology, or fintech, developments. These innovations can present promising opportunities, and I believe our role as regulators is to allow that innovation to develop in a responsible way. These innovations can expand access to credit, including to underserved consumers and small businesses, which in turn can benefit the real economy. We must also acknowledge that these opportunities likely are not without risk. Our supervision regarding fintech is therefore focused on ensuring that banks understand and manage these risks and that consumers remain protected.

We are also very focused on the increased risk to all financial institutions of cyberattacks and are working with key public- and private-sector entities to strengthen the cyber resiliency of the financial sector.[1] Cyber risk continues to grow, driven by unprecedented technological innovation, the interconnectivity of the financial services sector, and inadequate or incomplete defenses. We also observe, and incorporate into our own supervisory approach, the reality that many of the most serious cyber vulnerabilities are rooted in the basic challenges of managing large IT infrastructures. We continue to collaborate with other governmental agencies, and Federal Reserve supervisors are closely following each of these areas of concern.

Regulatory and Supervisory Agenda

The U.S. banking agencies' build-out of the regulatory and supervisory framework since the financial crisis has resulted in a substantially more resilient financial system, particularly at the largest firms. Stronger regulatory capital rules and the development of the Federal Reserve's stress testing regime have resulted in higher levels and quality of capital, new liquidity regulations and a heightened supervisory focus on liquidity have resulted in stronger liquidity positions, and resolution rules and living wills have contributed to improvements in the resolvability of systemically important firms.

That said, this body of regulation is broad in scope and complicated in detail. It is inevitable that there will be ways to improve the framework, especially with the benefit of experience and hindsight, and--given the public interest in the financial system's efficiency--it is important that we pursue this task as assiduously as we can. I will turn now to highlighting some

[1] See Randal K. Quarles, "Brief Thoughts on the Financial Regulatory System and Cybersecurity," speech at the Financial Services Roundtable 2018 Spring Conference, Washington, February 26, 2018), www.federalreserve.gov/newsevents/speech/quarles20180226b.htm.

of the ways we have sought to improve the effectiveness of the post-crisis framework through increased efficiency, transparency, and simplicity.

Efficiency

Efficiency of supervision and regulation means that if we have a choice between two methods that are equally effective in achieving a supervisory goal, we should strive to choose the one that is less burdensome. That can take many forms, including focusing the most stringent of supervisory standards and practices on the riskiest firms, as well as refining the calibration of specific requirements to make them more aligned with their original intent. I will briefly discuss a few recent measures that the Federal Reserve has taken designed to increase efficiency and thus improve the effectiveness of our regulation and supervision, such as the enhanced supplementary leverage ratio calibration proposal, the removal of midsized banking firms from the qualitative objection of our annual supervisory stress tests, and specific examination and supervisory process adjustments. I will also provide a few thoughts on where I believe additional improvements in efficiency can be made.

The Board and the Office of the Comptroller of the Currency last week issued a proposal that would recalibrate the enhanced supplementary leverage ratio, or eSLR, applicable to G-SIBs and most of their insured depository institution subsidiaries.[2] The proposal would help ensure that leverage capital requirements generally serve as a backstop to risk-based capital requirements. When the leverage ratio acts as a primary constraint, it can actually encourage excessive risk-taking behavior because it does not distinguish between the capital cost of safer and that of riskier assets. The eSLR's current calibration has made it the primary capital

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[2] Board of Governors of the Federal Reserve System, "Rule Proposed to Tailor 'Enhanced Supplementary Leverage Ratio' Requirements," news release, April 11, 2018, www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm.

constraint for some of the largest firms, which is inconsistent with its original purpose and provides an incentive for inappropriately risky behavior. The proposal would calibrate the eSLR so that it is less likely to act as a primary constraint while still continuing to serve as a meaningful backstop. The proposal also would enhance efficiency by making each firm's leverage surcharge a function of its individual systemic footprint.

Last year, the Board also adopted a rule that reduced the burden associated with the qualitative aspects of the Federal Reserve's Comprehensive Capital Analysis and Review, or CCAR, for midsized firms that pose less systemic risk. Under that rule, the Board will no longer object to the capital plans of firms with total consolidated assets between $50 billion and $250 billion because of deficiencies in their capital planning process; rather, any deficiencies in their capital planning processes will be addressed in the normal course of supervision.[3] Recently, we have solicited comment on whether that approach should be applied to a broader range of firms. I believe that our supervisory goal of ensuring a robust capital planning process at most firms can be achieved using our normal supervisory program combined with targeted horizontal assessments without compromising the safety and soundness of the financial system.

I also believe that there are additional tailoring opportunities with respect to large firms that are not G-SIBs to ensure that applicable regulation matches their risk. In this regard, I support congressional efforts regarding tailoring, as offered in both the House and Senate, which have proposed prudent modifications. In addition to this potential legislation, I believe there are further measures we can take to match the content of our regulation to the character and risk of

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[3] Board of Governors of the Federal Reserve System, "Federal Reserve Board Announces Finalized Stress Testing Rules Removing Noncomplex Firms from Qualitative Aspect of CCAR Effective for 2017," news release, January 30, 2017, www.federalreserve.gov/newsevents/pressreleases/bcreg20170130a.htm.

the institutions being regulated. Liquidity regulation, for example, does not have a G-SIB versus non-G-SIB gradation. In particular, the full liquidity coverage ratio requirement of enhanced prudential standards apply to large, non-G-SIB banks in the same way that they apply to G-SIBs. I believe it is time to take concrete steps toward calibrating liquidity requirements differently for non-G-SIBs than for G-SIBs.

I believe that we can also improve the efficiency of our regulation with respect to our requirements regarding living wills. In light of the substantial progress made by firms over the past few years with their resolution planning processes, I believe that we should adopt a permanent extension of submission cycles from annually to once every two years, and that we can again reduce burden for firms with less significant systemic footprints by reducing specific information requirements.

The U.S. banking agencies have also taken a number of steps to advance more efficient and effective supervisory programs. For example, in response to feedback from banks in the context of the review required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, the agencies recently increased the threshold for requiring an appraisal on commercial real estate loans from $250,000 to $500,000, determining that the increased threshold will not pose a threat to the safety and soundness of supervised financial institutions.[4]

Over the past several years, the Federal Reserve has also instituted various measures to clarify and streamline its overall approach to the supervision of community and regional banks in particular. For example, the Federal Reserve implemented a program it calls Bank Exams Tailored to Risk, or the BETR program. BETR uses financial metrics to differentiate the level of

[4] Board of Governors of the Federal Reserve System, "Federal Banking Agencies Issue Final Rule to Exempt Commercial Real Estate Transactions of $500,000 or Less from Appraisal Requirements," news release, April 2, 2017, www.federalreserve.gov/newsevents/pressreleases/bcreg20180402a.htm.

risk between banks before exams and ensure that examiners tailor examination procedures to minimize the regulatory burden for firms that engage in low-risk activities, while subjecting higher-risk activities to more testing and review. The Federal Reserve has also shifted a significant amount of its examination activity offsite to address concerns from community banks about burden.

We have also implemented less complex and burdensome examination approaches in the supervision of regional banking organizations with assets between $10 and $50 billion. For example, we have streamlined procedures to reduce the burden associated with assessing compliance with Dodd-Frank Wall Street Reform and Consumer Protection Act company-run stress testing requirements and decreased reporting burden by refining our tools for assessing liquidity positions at these banking organizations and eliminating the quarterly FR Y2052(b) liquidity report.

Finally, the Board has begun a broad review to identify ways to increase the efficiency of the applications process, which we expect to reduce processing times for certain types of applications.

Transparency

Transparency is central to the Federal Reserve's mission, in supervision no less than in monetary policy. In addition to transparency being a core requirement for accountability to the public, there are valuable, practical benefits to transparency around rulemaking: even good ideas can improve as a result of exposure to a variety of perspectives.

A prime example of the Board's efforts to increase transparency was its release for public comment of an enhanced stress testing transparency package late last year.[5] The Board issued the package in response to feedback from firms that there should be greater visibility into the supervisory models that often determine their binding capital constraints, as well as questions from analysts, investors, academics, and others who want to better understand details of how the Federal Reserve's supervisory stress tests work in practice. We are continuing to think about how we can make the stress testing process more transparent without lowering the strength of the test itself or undermining the usefulness of the supervisory stress test. I personally believe that our stress testing disclosures can go further, and that we should consider additional measures, such as putting our stress scenarios out for comment. My colleagues and I on the Board will be paying particularly close attention to comments on how we might improve the current proposal.

Looking ahead, we are also in the process of developing a revised framework for determining "control" under the Bank Holding Company Act. This framework would be more transparent, simpler to understand, easier to apply, and would liberalize some existing limitations. A clearer set of standardized rules should facilitate the raising of capital by banks, particularly community banks where control issues are generally more prevalent, and non-controlling investments by banking organizations in non-banking companies.

Simplicity

The third principle that should guide an assessment of our current framework, simplicity, is about promoting public understanding and compliance by the industry with regulation. Confusion and compliance burden that results from overly complex regulation does not advance

[5] Board of Governors of the Federal Reserve System, "Federal Reserve Board Requests Comment on Package of Proposals that Would Increase the Transparency of Its Stress Testing Program," news release, December 7, 2017, www.federalreserve.gov/newsevents/pressreleases/bcreg20171207a.htm.

the goal of a safe financial system. The Federal Reserve has worked to simplify the vast and often complex post-crisis regulatory framework in several different ways. The most recent example was the issuance of the proposed stress capital buffer rulemaking just last week.[6] The proposal would effectively integrate the results of the supervisory stress test into the Board's non-stress capital requirements. Doing so would result in a much simpler capital framework overall while maintaining its risk-sensitivity. For example, for the largest bank holding companies, the number of required loss absorbency ratios would be reduced from 24 to 14. While the proposal would result in burden reduction for both firms and supervisors, the proposed changes would generally maintain or increase the minimum risk-based capital required for G-SIBs (although no firm would be required to raise capital, since all firms currently maintain capital above these minimum levels) and generally modestly decrease the amount of risk-based capital required for most non-G-SIBs. Note, however, that a firm's stressed capital requirement is expected to vary in size throughout the economic cycle.

Let me turn to the Volcker rule. Many within and outside of the industry have said that this is an example of a complex regulation that is not working well. While the fundamental premise of the rule is simple, the implementing regulation is exceedingly complex. Our fellow regulators are working actively with the Federal Reserve in seeking ways to further tailor implementation of the Volcker rule and to reduce burden, particularly for firms that do not have large trading operations and do not engage in the sorts of activities that may give rise to proprietary trading.

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[6] Board of Governors of the Federal Reserve System, "Federal Reserve Board Seeks Comment on Proposal to Simplify Its Capital Rules for Large Banks while Preserving Strong Capital Levels that Would Maintain Their Ability to Lend under Stressful Conditions," news release, April 10, 2018, www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm.

Also with regard to large financial institutions, last year we issued for comment a proposal that would simplify the Board's ratings system by reducing the number of ratings. The proposed ratings system would be better aligned with the Board's post-crisis supervisory program for large financial institutions, which will allow us to target our supervisory messaging to those areas of greatest concern.[7]

Our simplification efforts have, of course, also extended to our supervision and regulation of smaller community banks. For example, in its continuing efforts to reduce data reporting and other burdens for small financial institutions, the U.S. banking agencies implemented a new streamlined Call Report form for small financial institutions in 2017.[8] Applicable to financial institutions with less than $1 billion in total assets, the streamlined reporting form removed approximately 40 percent of the nearly 2,400 data items previously included. The agencies have also proposed further streamlining of this Call Report. The cumulative effect would implement burden-reducing revisions to approximately 51 percent of the data items previously reported by small banks.

International Engagement

Finally, I would like to briefly touch upon the Federal Reserve's engagement with our foreign counterparts. As the supervisor of both U.S. banks operating overseas and foreign banks operating in the United States, we continue to maintain effective working relationships with our foreign supervisory counterparts, including through our participation in the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS). Our engagement with

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[7] Board of Governors of the Federal Reserve System, "Federal Reserve Board Invites Public Comment on Two Proposals; Corporate Governance and Rating System for Large Financial Institutions," news release, August 3, 2017, www.federalreserve.gov/newsevents/pressreleases/bcreg20170803a.htm.

[8] Federal Financial Institutions Examination Council (FFIEC), "FFIEC Finalizes June 2017 Proposed Revisions to Streamline the Call Report," news release, January 3, 2018, www.ffiec.gov/press/pr010318.htm.

foreign bank regulators aids in promoting global financial stability and a more level playing field for our supervised firms. Let me note that I believe transparency in these process is important, and I support the BCBS's efforts to increase the transparency of its international standard setting. With respect to more specific initiatives of each of these bodies, I also expect to implement the BCBS's recently completed package of reforms, which conclude its post-crisis capital standard reforms. I also want draw the Committee's attention to the FSB's recent statement, which I fully support, that now is the appropriate time to pivot focus from new policy development toward evaluating policies that have been implemented to ensure the reforms are efficient and effective and to address any unintended consequences.

Conclusion

The reforms we have adopted since the financial crisis represent a substantial strengthening of the Federal Reserve's regulatory framework and should help ensure that the U.S. financial system remains able to fulfill its vital role of supporting the economy. As I have outlined, the Board has already taken steps to increase the effectiveness of the framework currently in place by improving its efficiency, transparency, and simplicity. There are other areas where I believe that we can increase the framework's effectiveness, and we will look to do so where we are confident that we still have all appropriate tools needed to maintain the gains in safety and soundness made over the past several years.

At the same time, it is critical that we continue to monitor for emerging risks affecting the financial system. This calls for better analysis and more agility by supervisors in identifying emerging risks, as well as vigilance against complacency. We will do everything we can to fulfill the responsibility that has been entrusted to us by the Congress and the American people.

Thank you again for the opportunity to testify before you this morning, and I look forward to answering your questions.