Statement of
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On
Enhanced Oversight after the Financial Crisis
Wall Street Reform at One Year
before the
Committee on Banking, Housing
And
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Chairman Johnson, Ranking Member Shelby and members of the Committee, thank you for the opportunity to testify today on the one year anniversary of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

In the wake of the most severe episode of financial distress and the longest economic recession since the 1930s, the Dodd-Frank Act provides regulators with important new authorities to enhance financial stability and to respond to the regulatory challenges posed by large, complex systemically-important financial institutions (SIFIs). For example, the Dodd-Frank Act grants the Federal Deposit Insurance Corporation (FDIC) new authorities to manage the Deposit Insurance Fund (DIF) in a way that will make it more resilient in any future crisis. The Act also provides for a new SIFI resolution framework, including an Orderly Liquidation Authority and a requirement for SIFI resolution plans, which will give regulators much better tools with which to manage the failure of large, complex institutions. Finally, the Dodd-Frank Act also contains provisions that will complement the ongoing Basel III reforms that will make capital requirements more uniformly strong across the banking system.

My testimony today will focus specifically on the implementation of these Dodd-Frank provisions to enhance the future stability of our financial system.

Promoting Stability by Strengthening the Deposit Insurance Fund

The FDIC has moved quickly to implement the Dodd-Frank Act changes in the FDIC deposit insurance program. These changes will help to ensure that coverage is sufficient to preserve public confidence in a crisis, that premiums are proportional to insurance risks, and that the fund itself is restored to long-term health and maintained at levels that will withstand future periods of financial distress. The following sections highlight important developments in the financial condition of the DIF and changes to the management of the fund, assessment system, and coverage limits.

Restoring the Deposit Insurance Fund. Since year-end 2007, the failure of 377 FDIC-insured institutions has imposed total estimated losses of $84 billion on the DIF. In the recent crisis, as in the banking crisis of two decades ago, the sharp increase in bank failures caused the fund balance (the fund's net worth) to become negative. In the recent crisis, the DIF balance turned negative in the third quarter of 2009 and hit a low of negative $20.9 billion in the following quarter.

As the DIF balance declined, the FDIC adopted a statutorily required Restoration Plan and increased assessments to handle the high volume of failures and begin replenishing the fund. The FDIC increased assessment rates at the beginning of 2009, which raised regular assessment revenue from $3 billion in 2008 to over $12 billion in 2009 and almost $14 billion in 2010. In June 2009, the FDIC imposed a special assessment that brought in an additional $5.5 billion from the banking industry. Furthermore, in December 2009, to increase the FDIC's liquidity, the FDIC required that the industry prepay almost $46 billion in assessments, representing over three years of estimated assessments.

While the FDIC had to impose these measures at a very challenging time for banks, they enabled the agency to avoid borrowing from the U.S. Treasury. The measures also reaffirmed the longstanding commitment of the banking industry to fund the deposit insurance system.

Since the FDIC imposed these measures, the DIF balance has steadily improved. It increased throughout 2010 and stood at negative $1.0 billion as of March 31 of this year. We expect to report that the DIF balance is once again positive when we release second quarter results next month. Under the Restoration Plan for the DIF, the FDIC has put in place assessment rates necessary to achieve a reserve ratio (the ratio of the fund balance to estimated insured deposits) of 1.35 percent by September 30, 2020, as the Dodd-Frank Act requires.

Expanding the Assessment Base. The FDIC has also implemented the Dodd-Frank Act requirement to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. The FDIC does not expect this change to materially affect the overall amount of assessment revenue that otherwise would have been collected. However, as Congress intended, the change in the assessment base will generally shift some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions. The result will be a sharing of the assessment burden that better reflects each group's share of industry assets. The FDIC estimates that aggregate premiums paid by institutions with less than $10 billion in assets will decline by approximately 30 percent, primarily due to the assessment base change.

Raising Deposit Insurance Coverage Limits. In retrospect, it appears clear that expanding the coverage of deposit accounts during the crisis helped maintain public confidence in the banking system and particularly helped community banks maintain deposits. In the aftermath of the crisis, the Dodd-Frank Act made permanent the increase in the coverage limit to $250,000. It also provided deposit insurance coverage on the entire balance of non-interest bearing transaction accounts at all insured depository institutions until December 31, 2012. This provision extends, with some modifications, an FDIC program that provided stability to banks and their business customers during the crisis. The two-year extension of full coverage for non-interest bearing transaction accounts will especially help smaller banks retain accounts commonly used for payroll and other business transaction purposes and maintain the ability to make loans within their communities.

Long-term Changes to DIF Management. The Dodd-Frank Act provided the FDIC with substantial new flexibility in setting reserve ratio targets and paying dividends. The FDIC has used its new authority to adopt a long-term fund management plan that should maintain a positive DIF balance even during a banking crisis while preserving steady and predictable assessment rates throughout economic and credit cycles. FDIC analysis of the past two banking crises has shown that the DIF reserve ratio must be 2 percent or higher in advance of a banking crisis to avoid high deposit insurance assessment rates when banking institutions are strained and least able to pay. Consequently, the FDIC recently established a 2 percent reserve ratio target (also known as the Designated Reserve Ratio, or DRR) as a critical component of its long-term fund management strategy.

Promoting Stability by Improving Our Capacity to Address SIFI Failures

A key feature of the Dodd-Frank Act is a series of new authorities that together provide the basis for a new SIFI resolution framework that will greatly enhance the ability of regulators to address the problems of large, complex financial institutions in any future crisis.

Orderly Liquidation Authority. Title II of the Dodd-Frank Act vests the FDIC with orderly liquidation authority that is similar in many respects to the authorities it already has for insured depository institutions. If the FDIC is appointed as receiver for a covered financial company, it is required to carry out an orderly liquidation of the company in a manner than ensures that creditors and shareholders appropriately bear the losses of the financial company while maximizing the value of the company's assets, minimizing losses, mitigating risk, and minimizing moral hazard. Under this authority, common and preferred stockholders, debt holders and other unsecured creditors will know that they will bear the losses of any institution placed into receivership, and management will know that it could be replaced. In addition, management that is substantially responsible for the failure of a covered financial company will be subject to the claw-back of compensation earned during the two previous years.

Critical to the exercise of this authority is a clear and transparent process that is efficient and fair. With this in mind, the FDIC commenced the process of proposing rules implementing the Orderly Liquidation Authority immediately upon the passage of the Dodd-Frank Act. A Proposed Rule addressing a few critical elements of the Orderly Liquidation Authority was published last October. In January 2011, following consideration of comments, an Interim Final Rule was promulgated which implemented the initial Proposed Rule with appropriate changes, while continuing to solicit additional comment and feedback. That initial rulemaking addressed the treatment of similarly situated creditors, protection for employees of covered financial companies that continue to work for the company following failure, and protection for policyholders of insurance companies under the orderly liquidation process, among other things.

A second Proposed Rule addressing the implementation authority more broadly was published with request for comment last March. This Proposed Rule addressed the important topics of the recoupment of compensation of senior executives and directors who are substantially responsible for the failure of a systemically important financial institution, as well as the priority of claims and the treatment of secured and unsecured creditors. We considered all of the comments to the Interim Final Rule and the second Proposed Rule and consulted with our fellow members of the Financial Stability Oversight Council (FSOC). With appropriate changes to address those comments and concerns, a Final Rule was approved by the Board of Directors on July 6, 2011, covering all of the aspects of the Orderly Liquidation Authority addressed in these earlier rules. This Final Rule provides a framework to resolve any U.S. financial institution, no matter its size, using many of the same powers that the FDIC has long used to manage failed-bank receiverships.

While the adoption of the Final Rule Implementing Certain Orderly Liquidation Authority Provisions under Title II completes a large portion of the rulemaking required with respect to the exercise of Orderly Liquidation Authority under the Dodd-Frank Act, there is still more to do. As required by the Act, we are working with the Securities and Exchange Commission on a joint regulation implementing the Title II authority to resolve covered broker-dealers. The agencies are in agreement on the approach to the exercise of this authority, and have been meeting to finalize language of a Proposed Rule that we expect to be published in the Federal Register for public comment in the near future. Similarly, work is ongoing on a joint rule with all of the primary financial regulators regarding recordkeeping requirements for derivatives. The FDIC's experience in resolving failed financial institutions is helpful in addressing this issue, as we have a rule in place regarding recordkeeping of these qualified financial contracts with respect to insured depository institutions.

In addition, work is ongoing on other rulemakings required by Title II of the Act, including a rule governing eligibility of prospective purchasers of assets of failed financial institutions, and finalization of a Proposed Rule issued in consultation with the Department of the Treasury regarding certain key definitions for determining which organizations are financial institutions within the meaning of the Dodd-Frank Act. Work also is underway to provide additional guidance to the industry in response to questions and comments received on areas such as the creation, operation and termination of bridge financial companies, and the implementation of certain minimum recovery requirements established under the Act.

Resolution Plans. The Dodd-Frank Act also requires the FDIC and the Federal Reserve Board of Governors (FRB) jointly to issue final regulations within 18 months of enactment to implement new resolution planning and credit exposure reporting requirements. These rules will apply to bank holding companies with total assets of $50 billion or more and nonbank financial companies designated by the FSOC for enhanced supervision by the FRB. A Notice of Proposed Rulemaking for such a joint rule on resolution plans was published in April, and the comment period closed last month. Under the Proposed Rule, covered companies would be required to submit a resolution plan within a specified period after the final regulation becomes effective. The Proposed Rule provides that each covered company develop a plan for its rapid and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure. Each resolution plan is required to contain an executive summary, a strategic analysis of the plan's components, a description of the covered company's corporate governance structure for resolution planning, information regarding the covered company's overall organization structure and related information, information regarding the covered company's management information systems, a description of interconnections and interdependencies among the covered company and its material entities, and supervisory and regulatory information.

Following submission of a plan, the FDIC and FRB will review the plan to determine if it is credible and will facilitate an orderly resolution of the covered company under the Bankruptcy Code. If a resolution plan does not meet the statutory standards, after an opportunity to remedy its deficiencies, the agencies may jointly determine to impose more stringent regulatory requirements on the covered company. Further, if, after two years following the imposition of the more stringent standards, the resolution plan still does not meet the statutory standards, the FDIC and the FRB may, in consultation with the appropriate FSOC member, direct a company to divest certain assets or operations.

In connection with this rulemaking, the agencies are working to develop a deliberative process for reviewing resolution plans to determine whether a plan is both credible and would facilitate an orderly resolution of the covered company under the Bankruptcy Code. Careful consideration is being given to the need to keep proprietary information contained in the resolution plans confidential to the extent permitted by law to ensure that financial companies provide full and accurate disclosures. These important issues will be addressed in the Final Rule the agencies expect to adopt in the near future.

SIFI Designation. The SIFI resolutions framework authorized under the Dodd-Frank Act will automatically apply to bank holding companies with assets of $50 billion or more, as well as non-bank financial companies that are deemed by the FSOC to pose a risk to financial stability. The FDIC is currently working with its FSOC counterparts to jointly develop criteria for designating SIFIs under this authority. The FSOC agencies issued an Advanced Notice of Proposed Rulemaking (ANPR) last October and a Notice of Proposed Rulemaking (NPR) on January 26, 2011 describing the processes and procedures that will inform the FSOC's designation of nonbank financial companies under the Dodd-Frank Act.

In response to the FSOC's ANPR and NPR, several commenters raised concerns about the lack of detail and clarity surrounding the designation process. The industry does need clarity about which firms will be expected to provide the FSOC with this additional information. To achieve this, the FSOC will seek to establish simple and transparent metrics, such as firm size, similar to the approach used for bank holding companies under the Dodd-Frank Act, and incorporate other relevant indicators. The goal will be to establish a clear and transparent process for SIFI designation.

The FDIC Office of Complex Financial Institutions (OCFI). An important element of the FDIC's implementation effort has been the creation of a new Office of Complex Financial Institutions (OCFI) to coordinate the execution of our new SIFI resolution authorities under the Dodd-Frank Act. OCFI is already actively working with the FRB and the other agencies of FSOC to develop the capabilities needed to resolve SIFIs, if necessary, in a manner that mitigates systemic risk without reliance on taxpayer support.

OCFI is structured into three groups: monitoring, resolution planning and international outreach. Staff in the monitoring group will have responsibility to evaluate risks across the financial system and at individual entities. Unlike a prudential supervisor, the monitoring group will specifically focus on the financial, operational and execution risks that could be posed in a resolution. This group is also charged with collecting information for resolution planning and exercising the FDIC's backup authority. The resolutions group will review the resolution plans that systemically important entities develop to orderly unwind through the U.S. bankruptcy process. Additionally, staff in the resolution group will develop resolution plans for these entities using the FDIC's authority under Title II of the Dodd-Frank Act. Finally, as the name implies, the international outreach and coordination group will coordinate our efforts with those in other jurisdictions charged with similar responsibilities.

A critical component of successfully addressing a distressed SIFI is having sufficient information and clear strategic options at the time of failure to enable decision makers to reasonably foresee the outcomes of alternative scenarios. One of the FDIC's biggest challenges during the fall of 2008 was not having the information necessary to make informed decisions. Robust pre-planning – which entails understanding how and where these enterprises operate, as well as the structure of their business lines, counterparties, business risks, their role in the financial system, and their place in financial intermediation – is essential in giving regulators viable resolution options other than a bailout in the midst of a crisis. OCFI's monitoring activity of these systemic enterprises will be the principal mechanism for validating the entities' resolution plans and informing the FDIC on the development of Title II resolution plans.

OCFI's implementation of the Dodd-Frank Act SIFI resolution authorities builds on years of FDIC experience in successfully resolving failed depository institutions. While the basic framework and principles of successfull resolution apply to both small and large institutions, the resolution of large, complex and highly-interconnected institutions poses special challenges. The strategy for resolving a systemically important entity must be custom tailored to the characteristics and systemic nature of the entity, the circumstances of failure, and the overall economic environment. Business models and organizational structures change over time, as do financial and market conditions. That is why the FDIC has directed resources to approach resolution planning as an ongoing regulatory process, not as a one-time exercise.

FDIC Systemic Resolution Advisory Committee. To ensure that we have the benefit of the best thinking on complex resolution issues, the FDIC has chartered a Systemic Resolutions Advistory Commitee to provide advice and recommendations on a broad range of issues relevant to the failure and resolution of SIFIs. The Committee is composed of leading academics, prominent former policymakers, and experts from the financial industry itself. Although it has no decision-making role, Committee members will be asked to opine on topics related to the nature of systemic risk, the effects of the choice of resolution strategy on stakeholders and customers, international coordination of resolution activities, and how the market understands the new SIFI resolution authorities and how they would be applied in a future crisis.

Promoting Financial Stability by Strengthening Bank Capital

No banking system can maintain stability over the ups and downs of the business cycle without a strong capital base. Capital allows an institution to absorb large unexpected losses while maintaining the confidence of its counterparties and continuing to lend. In other words, strong capital minimizes the likelihood that large institutions will become troubled and need to be resolved in some way by the federal government during an economic downturn. Moreover, in situations where an institution does need to be resolved, a strong capital base provides regulators time to structure that resolution in an orderly manner without federal support and solicit bids from potential acquirers. In this sense, stronger bank capital requirements complement the Dodd-Frank Act resolution tools designed to prevent future bailouts of financial companies.

Insufficient capital, in contrast, heightens a banking system's exposure to periodic crises. The knowledge that capital cushions are thin compared to the magnitude of risks that abruptly and unexpectedly loom large can contribute to a panic atmosphere and feed a crisis. Thin capital cushions also contribute to the kind of abrupt deleveraging we saw in the recent crisis and its aftermath. Since the crisis, U.S. banks have contracted lending by over $750 billion and reduced their loan commitments by more than $2.7 trillion.

For all these reasons, the FDIC supports recent initiatives to strengthen bank capital requirements. While beyond the scope of this testimony, a recent initiative includes Basel III - an important initiative to strengthen the quality of capital and increase the level of minimum capital requirements. The FDIC also supports important provisions of the Dodd-Frank Act that that deal with bank capital. We believe that these provisions, contained in Section 171 and Section 165 of the Act, complement Basel III and will help promote a safe-and-sound banking system in the U.S.

Section 171 of the Dodd-Frank Act states among other things that the capital requirements for the largest banks and bank holding companies must not be less than the capital requirements that are generally applicable to insured banks. The FDIC, the FRB and Comptroller of the Currency (OCC) recently finalized a rule implementing this aspect of Section 171. Consistent with Section 171, the Final Rule states that the capital requirements computed under the agencies' general risk-based capital rules will be a floor for the capital requirements of large banks that use the Advanced Approaches of Basel II (banking organizations with assets exceeding $250 billion are required to use the Advanced Approaches). In different words, the capital requirement for a large bank using the Advanced Approaches may not be less in proportionate terms than the capital requirement for a community bank with the same exposures.

An important part of Section 171 is to ensure that regulatory capital for Bank Holding Companies (BHCs) is defined in a way that is at least as stringent as regulatory capital for insured banks. This expectation is consistent with the longstanding principle that BHCs should serve as a source of strength for their subsidiary banks. But during the crisis, we observed that BHCs were often less strongly capitalized on a consolidated basis than their subsidiary banks. This was largely a result of the widespread use of Trust Preferred Securities (TruPS), a form of subordinated debt, that are impermissible as Tier 1 capital for insured banks but have been permitted to meet a portion of a BHC's Tier 1 capital requirements since 1996. As debt instruments, TruPS cannot absorb losses while an organization operates as a going concern. This is an important reason why BHCs with heavier reliance on TruPS failed more often than other insured institutions during the crisis. Under Section 171, TruPS are phased-out of Tier 1 capital for BHCs with assets of at least $15 billion as of year-end 2009, with the phase-out occurring over a period of three years starting January 1, 2013. Important exceptions and grandfathering provisions exist for smaller BHCs.1

The FDIC considers Section 171 as an important safeguard for the capital adequacy of the U.S. banking system. Without Section 171, large U.S. banks could use their internal models to reduce their risk-based capital requirements, potentially well below the levels required for community banks, to levels that are inconsistent with safe and sound operations.

Another important capital provision is contained in Section 165 of the Dodd-Frank Act, which requires the FRB to establish heightened capital standards for BHCs with assets of at least $50 billion and designated nonbank financial companies. These requirements can be viewed as the U.S. counterparts to the so-called SIFI capital surcharges that the Basel Committee on Banking Supervision recently published for comment. We believe a requirement for additional loss absorbency at the largest institutions is appropriate given the potential impact of a failure of one of these institutions on the financial system and the broader economy.

Changes to the Regulatory Structure Under the Dodd-Frank Act

The Dodd-Frank Act also mandated important changes to the structure of the financial regulatory agencies, including the sunset of the Office of Thrift Supervision (OTS) and the creation of the Consumer Financial Protection Bureau (CFPB). These changes will have important implications for the FDIC's supervisory, policy and data collection functions.

Changes Related to OTS Sunset. The winding down of the OTS under the Dodd-Frank Act will result in the transfer of supervisory responsibility for 59 state-chartered savings associations to the FDIC.2 These institutions are located in 18 states and territories, with almost half of the total charters located in Ohio.

All of the state-chartered institutions transferring to the FDIC are small, with the largest having assets of just over $2 billion and only 3 of the 59 having total assets exceeding $1 billion. Given the small number of charters transferring to the FDIC and their relative lack of problems and complexity, the FDIC will absorb all state-chartered savings associations into our existing supervisory program. We have assigned responsibility for examinations and other supervisory activities for each state-chartered savings association to the appropriate FDIC Regional Office. FDIC and OTS supervisory personnel began coordinating early in 2011 to ensure that that there will be no gaps in supervision and that the supervisory approach for these institutions will continue to be rigorous, consistent, and balanced both during and after the transition.

We also recognize the importance of communicating regularly with the industry throughout this process. Two FDIC outreach events were held in Ohio to assist institutions in understanding the transition, and institutions in other states were contacted directly to ensure that their questions about the transition were answered.

The FDIC is fully integrating OTS staff into its current organizational structure. In addition to absorbing the supervisory responsibility for state-chartered thrifts, the FDIC will transfer approximately 95 employees from the OTS, including commissioned examiners as well as other staff. The FDIC plans to open one additional local office in southern Ohio to manage the concentration of additional examination work in that location. Since the FDIC has historically recognized and accepted professional examination credentials from other federal banking agencies, including the OTS, it will treat as commissioned FDIC examiners all OTS examiners who transfer to the FDIC with OTS accreditation. The FDIC will address any individual training gaps that emerge after the transfer date through individual training and development plans. The FDIC has also worked closely with the OCC and the OTS to ensure that all transferred OTS employees are treated in full accordance with the requirements of sections 322(e) and 322(k)(2) of the Dodd-Frank Act with respect to their status, tenure, pay, and benefits.

The agencies have determined, subject to public notice and comment and OMB approval, that it would be best to phase out the separate collection of Thrift Financial Report (TFR) data and to merge that data collection process into the Call Report process used by other FDIC-insured depository institutions beginning with the March

2012 reporting period. The FDIC will assume responsibility for TFR reporting on an interim basis beginning with the second quarter 2011 TFR.

OTS staff previously responsible for collecting and analyzing TFR data will transfer to the FDIC to support the transition of thrifts to the Call Report and the ongoing reporting process for these institutions. In addition, OTS personnel who are assigned to the FDIC will continue to process all of the existing Savings and Loan Holding Company (SLHC) reports that were previously required to be filed by the OTS until the SLHCs can be transitioned to holding company reports required by the FRB.

Changes Related to the Establishment of the CFPB. While the CFPB will be responsible for writing consumer protection rules for lenders of all types and all sizes, the current primary federal regulators will retain their enforcement responsibilities for FDIC-insured banks and thrifts with assets of less than $10 billion. This means that the FDIC will continue to examine about 4,500 state-chartered, non-member banks for compliance with consumer laws and regulations.

The FDIC has held several meetings with CFPB staff to discuss transition issues, including data sharing, hiring, and consumer complaint handling, and recently supplied the CFPB with information they requested on institutions that will be transferred to its oversight, including examination reports and consumer complaint information. We are working with the CFPB on a joint Memorandum of Understanding (MOU) to provide for the transfer to the CFPB of consumer complaints involving large financial institutions.

We are working hard to close out as many open examinations and enforcement cases as possible prior to the July 21 handover. But as part of our ongoing discussions, the CFPB has asked the FDIC to continue handling certain consumer complaints after the July 21 handover to provide for the orderly transition of complaint handling for large banks. We anticipate the possibility of ongoing work related to the transfer of consumer complaints between the FDIC and CFPB including, among other things, procedures for sharing information about complaints handled by each agency. The FDIC has also issued a solicitation of interest for experienced staff to apply for employment with the CFPB. At this point, 40 FDIC employees have accepted CFPB offers to transfer.

Conclusion

Today's testimony highlights the FDIC's progress in implementing financial reforms authorized by the Dodd-Frank Act. The Act authorized important reforms to the FDIC's deposit insurance program that will ensure that coverage is sufficient to preserve public confidence in a crisis, that premiums are proportional to insurance risks, and that the fund itself is restored to long-term health and maintained at levels that will withstand future periods of financial distress. These deposit insurance reforms are critical to both ensuring financial stability and preserving competitive balance between the largest institutions and smaller community institutions. The Act contains a number of provisions that, together, form the basis for a new SIFI resolution framework that substantially improves the ability of regulators to respond to severe financial distress on the part of a large, complex financial institution. These reforms are not a cure-all, but are designed to work in concert with the other Dodd-Frank Act reforms, including those that strengthen capital requirements and the DIF, to promote competitive balance and make financial crises less frequent and less costly in the future.

Since the Dodd-Frank Act became law one year ago, the FDIC has proceeded – on our own authority and in concert with our regulatory counterparts – to implement its provisions. We have made much progress in one year, but still have considerable work ahead of us. Throughout this process, we have sought input from the industry and the public, and we continue to report back to Congress on our progress. We believe that successful implementation of these provisions will represent a significant step forward in providing a foundation for a financial system that is more stable and less susceptible to crises in the future, and better prepared to respond to crises if and when they develop.

Thank you. I would be glad to take your questions.

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[1] Under Section 171, BHCs subject to the FRB's Small Bank Holding Company Policy Statement (generally BHCs with assets less than $500 million) are exempt from Section 171, while the existing TruPS (issued on or before May 19, 2010) of other BHCs with assets less than $15 billion may continue to be included in their Tier 1 capital.

[2] There were 61 state-chartered savings associations as of the enactment date; two institutions have since merged out of existence.

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