

**Statement of  
Sheila C. Bair, Chairman,  
Federal Deposit Insurance Corporation  
On  
Implementation of the Dodd-Frank Wall Street Reform  
And  
Consumer Protection Act  
to the  
Committee on Banking, Housing, and  
Urban Affairs, U.S. Senate; 538 Dirksen  
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Chairman Johnson, Ranking Member Shelby and members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's (FDIC) progress in implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The recent financial crisis exposed grave shortcomings in our framework for regulating the financial system. Insufficient capital at many financial institutions, misaligned incentives in securitization markets and the rise of a largely unregulated shadow banking system bred excess and instability in our financial system that led directly to the crisis of September 2008. When the crisis hit, regulatory options for responding to distress in large, non-bank financial companies left policymakers with a no-win dilemma: either prop up failing institutions with expensive bailouts or allow destabilizing liquidations through the normal bankruptcy process. The bankruptcy of Lehman Brothers Holdings Inc. (Lehman) in September 2008 triggered a liquidity crisis at AIG and other institutions that froze our system of intercompany finance and made the 2007-09 recession the most severe since the 1930s.

The landmark Dodd-Frank Act enacted last year created a comprehensive new regulatory and resolution regime that is designed to protect the American people from the severe economic consequences of financial instability. The Dodd-Frank Act gave regulators tools to limit risk in individual financial institutions and transactions, enhance the supervision of large non-bank financial companies, and facilitate the orderly closing and liquidation of large banking organizations and non-bank financial companies in the event of failure. Recognizing the urgent need for reform and the importance of a deliberative process, the Act directed the FDIC and the other regulatory agencies to promulgate implementing regulations under a notice and comment process and to do so within specified timeframes. The FDIC is required or authorized to implement some 44 regulations, including 18 independent and 26 joint rulemakings. The Dodd-Frank Act also grants the FDIC new or enhanced enforcement authorities, new reporting requirements, and responsibility for numerous other actions.

We are now in the process of implementing the provisions of the Dodd-Frank Act as expeditiously and transparently as possible. The lessons of history – recent and distant

– remind us that financial markets cannot function for long in an efficient and stable manner without strong, clear regulatory guidelines. We know all too well that the market structures in place prior to the crisis led to misaligned incentives, a lack of transparency, insufficient capital, and excessive risk taking. As a result, the U.S. and global economies suffered a grievous blow. Millions of Americans lost their jobs, their homes, or both, even as almost all of our largest financial institutions received assistance from the government that enabled them to survive and recover. Memories of such events tend to be short once a crisis has passed, but we as regulators must never forget the enormous economic costs of the inadequate regulatory framework that allowed the crisis to occur in the first place. At the same time, our approach must also account for the potential high cost of needless or ill-conceived regulation – particularly to those in the vital community banking sector whose lending to creditworthy borrowers is necessary for a sustained economic recovery.

My testimony will review the FDIC's efforts to date to implement the provisions of Dodd-Frank and highlight what we see as issues of particular importance.

## **Implementing the Resolution Authority and Ending Too Big To Fail**

A significant number of the FDIC's rulemakings stem from the Dodd-Frank Act's mandate to end "Too Big to Fail." This includes our Orderly Liquidation Authority under Title II of the Act, our joint rulemaking with the Board of Governors of the Federal Reserve System (FRB) on requirements for resolution plans (or living wills) that will apply to systemically important financial institutions (SIFIs), and the development of criteria for determining which firms will be designated as SIFIs by the Financial Stability Oversight Council (FSOC).

### **Orderly Liquidation Authority**

The Lehman bankruptcy in September 2008 demonstrated the confusion and chaos that can result when a large, highly complex financial institution collapses into bankruptcy. The Lehman bankruptcy had an immediate and negative effect on U.S. financial stability and has proven to be a disorderly, time-consuming, and expensive process. Unfortunately, bankruptcy cannot always provide the basis for an orderly resolution of a SIFI or preserve financial stability. To overcome these problems, the Dodd-Frank Act provides for an Orderly Liquidation Authority with the ability to: plan for a resolution and liquidation, provide liquidity to maintain key assets and operations, and conduct an open bidding process to sell a SIFI and its assets and operations to the private sector as quickly as possible.

While Title I of the Dodd-Frank Act significantly enhances regulators' ability to conduct advance resolution planning for SIFIs, Title II vests the FDIC with legal resolution authorities similar to those that it already applies to insured depository institutions (IDIs).

If the FDIC is appointed as receiver, it is required to carry out an orderly liquidation of the financial company. Title II also requires that creditors and shareholders "bear the

losses of the financial company" and instructs the FDIC to liquidate a failing SIFI in a manner that maximizes the value of the company's assets, minimizes losses, mitigates risk, and minimizes 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.

The new requirements will ensure that the largest financial companies can be wound down in an orderly fashion without taxpayer cost. Under Title II of the Dodd-Frank Act, there are no more bailouts. In implementing the Act's requirements, our explicit goal is that all market players should share this firm expectation and that financial institution credit ratings should, over time, fully reflect this fact. By developing a credible process for resolving a troubled SIFI, market discipline will be reinforced and moral hazard reduced.

From the FDIC's more than 75 years of bank resolution experience, we have found that clear legal authority and transparent rules on creditor priority are important elements of an orderly resolution regime. To that end, the FDIC issued an interim final rule implementing certain provisions of our Orderly Liquidation Authority on January 25, 2011. In the interim rule, the FDIC posed questions to solicit public comment on such issues as reducing moral hazard and increasing market discipline. We also asked for comment on guidelines that would create increased certainty in establishing fair market value of various types of collateral for secured claims. The rule makes clear that similarly situated creditors would never be treated in a disparate manner except to preserve essential operations or to maximize the value of the receivership as a whole. Importantly, this discretion will not be used to favor creditors based on their size or interconnectedness. In other words, there is no avenue for a backdoor bailout.

Comments on the interim rule and the accompanying questions will help us further refine the rule and bring more certainty to the industry as it navigates the recalibrated regulatory environment. This summer we expect to finalize other rules under our Title II authority that will govern the finer details of how the FDIC will wind down failed financial companies in receivership.

## **Resolution Plans**

Even with the mechanism of the Orderly Liquidation Authority in place, ending "Too Big to Fail" requires that regulators obtain critical information and shape the structure and behavior of SIFIs before a crisis occurs. This is why the Dodd-Frank Act mandated in Title I that the FDIC and the FRB jointly establish requirements for these firms to maintain credible, actionable resolution plans that will facilitate their orderly resolution if they should fail. Without access to critical information contained in credible resolution plans, the FDIC's ability to implement an effective and orderly liquidation process could be significantly impaired.

As noted in my September testimony, the court-appointed trustee overseeing the liquidation of Lehman Brothers Inc. found that the lack of a disaster plan "contributed to the chaos" of the Lehman bankruptcy and the liquidation of its U.S. broker-dealer. Recognizing this, the Dodd-Frank Act created critical authorities designed to give the FDIC, the FRB, and the FSOC information from the largest potentially systemic financial companies that will allow for extensive advance planning both by regulators and by the companies themselves.

The Dodd-Frank Act requires the FDIC and the FRB jointly to issue regulations within 18 months of enactment to implement new resolution planning and reporting requirements that apply to bank holding companies with total assets of \$50 billion or more and non-bank financial companies designated for FRB supervision by the FSOC.

Importantly, the statute requires both periodic reporting of detailed information by these financial companies and the development and submission of resolution plans that allow "for rapid and orderly resolution in the event of material financial distress or failure." The resolution plan requirement in the Dodd-Frank Act appropriately places the responsibility on financial companies to develop their own resolution plans in coordination with the FDIC and the FRB.

The Dodd-Frank Act lays out steps that must be taken with regard to the resolution plans. First, the FRB and the FDIC must review each company's plan to determine whether it is both credible and useful for facilitating an orderly resolution under the Bankruptcy Code. Making these determinations will necessarily involve the agencies having access to the company and relevant information. This new resolution plan regulation will require financial companies to look critically at the often highly complex and interconnected corporate structures that have emerged within the financial sector.

If a plan is found to be deficient, the company will be asked to submit a revised plan to correct any identified deficiencies. The revised plan could include changes in business operations and corporate structure to facilitate implementation of the plan. If the company fails to resubmit a plan that corrects the identified deficiencies, the Dodd-Frank Act authorizes the FRB and the FDIC jointly to impose more stringent capital, leverage or liquidity requirements. In addition, the agencies may impose restrictions on growth, activities, or operations of the company or any subsidiary. In certain cases, divestiture of portions of the financial company may be required. Just last month, Neil Barofsky, the Special Inspector General for the Troubled Asset Relief Program, recognized that this regulatory authority, including the ability to require divestiture, provides an avenue to convincing the marketplace that SIFIs will not receive government assistance in a future crisis.<sup>1</sup> The FDIC is working with the FRB to develop requirements for these resolution plans. It is essential that we complete this joint rule as soon as possible.

## **SIFI Designation**

The Dodd-Frank Act created the FSOC to plug important gaps between existing regulatory jurisdictions where financial risks grew in the years leading up to the recent crisis. An important responsibility of the FSOC is to develop criteria for designating SIFIs that will be subject to enhanced FRB supervision and the requirement to maintain resolution plans. To protect the U.S. financial system, it is essential that we have the means to identify which firms in fact qualify as SIFIs so we do not find ourselves with a troubled firm that is placed into a Title II liquidation without having a resolution plan in place.

Since enactment of the Dodd-Frank Act, experienced and capable staff from each of the member agencies have been collaborating in implementing the FSOC's responsibilities, including establishing the criteria for identifying SIFIs. The Dodd-Frank Act specifies a number of factors that can be considered when designating a non-bank financial company for enhanced supervision, including: leverage; off-balance-sheet exposures; and the nature, scope, size, scale, concentration, interconnectedness and mix of activities. The FSOC will develop a combination of qualitative and quantitative measures of potential risks posed by an individual nonbank institution to U.S. financial stability.

The nonbank financial sector encompasses a multitude of financial activities and business models, and potential systemic risks vary significantly across the sector. A staff committee working under the FSOC has segmented the nonbank sector into four broad categories: 1) the hedge fund, private equity firm, and asset management industries; 2) the insurance industry; 3) specialty lenders; and 4) broker-dealers and futures commission merchants. The Council has begun developing measures of potential risks posed by these firms. Once these measures are agreed upon, the FSOC may need to request data or information that is not currently collected or otherwise available in public filings.

Recognizing the need for accurate, clear, and high quality information, Congress granted the FSOC the authority to gather and review financial data and reports from nonbank financial companies and bank holding companies, and if appropriate, request that the FRB conduct an exam of the company for purposes of making a systemic designation. By collecting more information in advance of designation, the FSOC can be much more judicious in determining which firms it designates as SIFIs. This will minimize both the threat of an unexpected systemic failure and the number of firms that will be subject to additional regulatory requirements under Title I.

Last October, the FSOC issued an Advance Notice of Proposed Rulemaking regarding the criteria that should inform the FSOC's designation of nonbank financial companies. The FSOC received approximately 50 comments from industry trade associations, individual firms, and individuals. On January 26, the FSOC issued a Notice of Proposed Rulemaking, with a 30-day comment period, describing the criteria that will inform – and the processes and procedures established under the Dodd-Frank Act – the FSOC's designation of nonbank financial companies. The FDIC would welcome comments particularly on whether the rule can offer more specificity on criteria for SIFI designation.

The FSOC is committed to adopting a final rule on this issue later this year, with the first designations to occur shortly thereafter.

### **Strengthening and Reforming the Deposit Insurance Fund**

Prior to 2006, statutory restrictions prevented the FDIC from building up the Deposit Insurance Fund (DIF) balance when conditions were favorable in order to withstand losses under adverse conditions without sharply increasing premiums. The FDIC was also largely unable to charge premiums according to risk. In fact, it was unable to charge most institutions any premium as long as the DIF balance exceeded \$1.25 per \$100 of insured deposits. Congress enacted reforms in 2006 that permitted the FDIC to charge all banks a risk-based premium and provided additional, but limited, flexibility to the FDIC to manage the size of the DIF. The FDIC changed its risk-based pricing rules to take advantage of the new law, but the onset of the recent crisis prevented the FDIC from increasing the DIF balance. In this crisis, as in the previous one, the balance of the DIF became negative, hitting a low of negative \$20.9 billion in December 2009. The DIF balance has improved in each subsequent quarter, and stood at negative \$8.0 billion as of last September. Through a special assessment and the prepayment of premiums, the FDIC took the necessary steps to ensure that it did not have to rely on taxpayer funds during the crisis to protect insured depositors.

In the Dodd-Frank Act, Congress revised the statutory authorities governing the FDIC's management of the DIF. The FDIC now has the ability to achieve goals for deposit insurance fund management that it has sought to achieve for decades but has lacked the tools to accomplish. The FDIC has increased flexibility to manage the DIF to maintain a positive fund balance even during a banking crisis while maintaining steady and predictable assessment rates throughout economic and credit cycles.

Specifically, the Dodd-Frank Act raised the minimum level for the Designated Reserve Ratio (DRR) from 1.15 percent to 1.35 percent and removed the requirement that the FDIC pay dividends of one-half of any amount in the DIF above a reserve ratio of 1.35 percent. The legislation allows the FDIC Board to suspend or limit dividends when the reserve ratio exceeds 1.50 percent.

FDIC analysis has shown that the dividend rule and the reserve ratio target are among the most important factors in maximizing the probability that the DIF will remain positive during a crisis, when losses are high, and in preventing sharp upswings in assessment rates, particularly during a crisis. This analysis has also shown that at a minimum the DIF reserve ratio (the ratio of the DIF balance to estimated insured deposits) should be about 2 percent in advance of a banking crisis in order to avoid high deposit insurance assessment rates when banking institutions are strained and least able to pay.

Consequently, the FDIC Board completed two rulemakings, one in December 2010, and one earlier this month, that together form the basis for a long-term strategy for DIF management and achievement of the statutorily required 1.35 percent DIF reserve ratio by September 30, 2020. The FDIC Board adopted assessment rates that will take effect

on April 1, 2011. The Board also adopted lower rates that will take effect when the DIF reserve ratio reaches 1.15 percent, which we expect will approximate the long-term moderate, steady assessment rate that would have been needed to maintain a positive fund balance throughout past crises. The DRR was set at 2 percent, consistent with our analysis of a long-term strategy for the DIF, and dividends were suspended indefinitely. In lieu of dividends, the rules set forth progressively lower assessment rate schedules when the reserve ratio exceeds 2 percent and 2.5 percent.

These actions increase the probability that the fund reserve ratio will reach a level sufficient to withstand a future crisis, while maintaining moderate, steady, and predictable assessment rates. Indeed, banking industry participants at an FDIC Roundtable on deposit insurance last year emphasized the importance of stable, predictable assessments in their planning and budget processes. Moreover, actions taken by the FDIC's current Board of Directors as a result of the Dodd-Frank Act should make it easier for future Boards to resist inevitable calls to reduce assessment rates or pay larger dividends at the expense of prudent fund management and counter-cyclical assessment rates.

The Dodd-Frank Act also requires the FDIC to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. Earlier this month, the FDIC Board issued a final rule implementing this requirement. The rule establishes measures for average consolidated total assets and average tangible equity that draw on data currently reported by institutions in their Consolidated Report of Condition and Income or Thrift Financial Report. In this way, the FDIC has implemented rules that minimize the number of new reporting requirements needed to calculate deposit insurance assessments. As provided by the Dodd-Frank Act, the FDIC's rule adjusted the assessment base for banker's banks and custodial banks.

Using the lessons learned from the most recent crisis, our rule changed the large bank pricing system to better differentiate for risk and better take into account losses from large institution failures that the FDIC may incur. This new system goes a long way toward reducing the pro-cyclicality of the risk-based assessment system by calculating assessment payments using more forward-looking measures. The system also removes reliance on long-term debt issuer ratings consistent with the Dodd-Frank Act.

The FDIC projects that the change to a new, expanded assessment base will not materially change the overall amount of assessment revenue that the FDIC would have collected prior to adoption of these rules. However, the change in the assessment base, in general, will result in shifting more of the overall assessment burden away from community banks and toward the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions, as Congress intended.

Under the new assessment base and large bank pricing system, the share of the assessment base held by institutions with assets greater than \$10 billion will increase from 70 percent to 78 percent, and their share of overall dollar assessments will

increase commensurately from 70 percent to 79 percent. However, because of the combined effect of the change in the assessment base and increased risk differentiation among large banks in the new large bank pricing system, many large institutions will experience significant changes in their overall assessments. The combined effect of changes in this final rule will result in 59 large institutions paying lower dollar assessments and 51 large institutions paying higher dollar assessments (based upon September 30, 2010 data). In the aggregate, small institutions will pay 30 percent less, due primarily to the change in the assessment base, thus fewer than 100 of the 7,600 plus small institutions will pay higher assessments.

## **Strengthening Capital Requirements**

One of the most important mandates of the Dodd Frank Act is Section 171—the Collins Amendment—which we believe will do more to strengthen the capital of the U.S. banking industry than any other section of the Act.

Under Section 171 the capital requirements that apply to thousands of community banks will serve as a floor for the capital requirements of our largest banks, bank holding companies and nonbanks supervised by the FRB. This is important because in the years before the crisis, U.S. regulators were embarking down a path that would allow the largest banks to use their own internal models to set, in effect, their own risk-based capital requirements, commonly referred to as the "Basel II Advanced Approach."

The premise of the Advanced Approach was that the largest banks, because of their sophisticated internal-risk models and superior diversification, simply did not need as much capital in relative terms as smaller banks. The crisis demonstrated the fallacy of this thinking as the models produced results that proved to be grossly optimistic.

Policymakers from the Basel Committee to the U.S. Congress have determined that this must not happen again. Large banks need the capital strength to stand on their own. The Collins Amendment assures that whatever advances in risk modeling may come to pass, they will not be used to allow the largest banks to operate with less capital than our nation's Main Street banks.

The federal banking agencies currently have out for comment a Notice of Proposed Rulemaking to implement Section 171 by replacing the transitional floor provisions of the Advanced Approach with a permanent floor equal to the capital requirements computed under the agencies' general risk-based capital requirements. The proposed rule would also amend the general risk-based capital rules in way designed to give additional flexibility to the FRB in crafting capital requirements for designated nonbank SIFIs.

The Collins Amendment, moreover, does more than this. While providing significant grandfathering and exemptions for smaller banking organizations, the amendment also mandates that the holding company structure for larger organizations not be used to weaken consolidated capital below levels permitted for insured banks. That aspect of



the Collins Amendment, which ensures that bank holding companies will serve as a source of strength for their insured banks, will be addressed in a subsequent rulemaking.

The Dodd-Frank Act also required regulators to eliminate reliance on credit ratings in our regulations. As you know, our regulatory capital rules and Basel II currently rely extensively on credit ratings. Last year, the banking agencies issued an Advance Notice of Proposed Rulemaking seeking industry comment on how we might design an alternative standard of credit worthiness. Unfortunately, the comments we received, for the most part, lacked substantive suggestions on how to approach this question. While we have removed any reliance on credit ratings in our assessment regulation, developing an alternative standard of creditworthiness for regulatory capital purposes is proving more challenging. The use of credit ratings for regulatory capital covers a much wider range of exposures; we cannot rely on non-public information, and the alternative standard should be usable by banks of all sizes. We are actively exploring a number of alternatives for dealing with this problem.

Separately and parallel to the Dodd-Frank Act rulemakings, the banking agencies are also developing rules to implement Basel III proposals for raising the quality and quantity of regulatory capital and setting new liquidity standards. The agencies issued a Notice of Proposed Rulemaking in January that proposes to implement the Basel Committee's 2009 revisions to the Market Risk Rule. We expect to issue a Notice of Proposed Rulemaking that will seek comment on our plans to implement Basel III later this year.

### Reforming Asset-backed Securitization

The housing bust and the financial crisis arose from a historic breakdown in U.S. mortgage markets. While emergency policies enacted at the height of the crisis have helped to stabilize the financial system and plant the seeds for recovery, mortgage markets remain deeply mired in credit distress and private securitization markets remain largely frozen. Moreover, serious weaknesses identified with mortgage servicing and foreclosure are now introducing further uncertainty into an already fragile market.

It is clear that the mortgage underwriting practices that led to the crisis, which frequently included loans with low or no documentation in addition to other risk factors such as impaired credit histories or high loan-to-value ratios, must be significantly strengthened. To this point, this has largely been accomplished through the heightened risk aversion of lenders, who have significantly tightened standards, and investors, who have largely shunned private securitization deals. Going forward, however, risk aversion will inevitably decline and there will be a need to ensure that lending standards do not revert to the risky practices that led to the last crisis.

In the case of portfolio lenders, underwriting policies are subject to scrutiny by federal and state regulators. While regulators apply standards of safe and sound lending, they typically do not take the form of pre-specified guidelines for the structure or underwriting

of the loans. For these portfolio lenders, the full retention of credit risk by the originating institution tends to act as a check on the incentive to take risks. Provided that the institution is otherwise well capitalized, well run, and well regulated, the owners and managers of the institution will bear most of the consequences for risky lending practices. By contrast, the crisis has illustrated how the mortgage securitization process is somewhat more vulnerable to the misalignment of incentives for originators and securities issuers to limit risk taking, because so much of the credit risk is passed along to investors who may not exercise due diligence over loan quality.

The excessive risk-taking inherent in the originate-to-distribute model of lending and securitization was specifically addressed in the Dodd-Frank Act by two related provisions. One provision, under Section 941 of the Act, mandates that the FSOC agencies write rules that require the securitizers (and, in certain circumstances, originators) of asset-backed securities to retain not less than 5 percent of the credit risk of those securities. The purpose of this provision is to encourage more careful lending behavior by preventing securitizers from avoiding the consequences of their risk-taking. Section 941 also mandates that the agencies define standards for Qualifying Residential Mortgages (QRMs) that will be exempt from risk retention when they are securitized. An interagency committee is working to define both the mechanism for risk retention and standards for QRMs.

Defining an effective risk retention mechanism and QRM requirements are somewhat complex tasks that have required extensive deliberation among the agencies. Because securitization structures and the compensation of securitizers can take many alternate forms, it is important that the rule be structured in a way that will minimize the ability of issuers to circumvent its intent. While we continue to work to move these rules forward without delay, we are also determined to get them right the first time. The confidence of the marketplace in these rules may well determine the extent to which private securitization will return in the wake of the crisis.

Long-term confidence in the securitization process cannot be restored unless the misalignment of servicing incentives that contributed to the present crisis is also addressed through these rules. There is ample research showing that servicing practices are critically important to mortgage performance and risk.<sup>2</sup> Regulators must use both their existing authorities and the new authorities granted under the Dodd-Frank Act to establish standards for future securitizations to help assure that, as the private securitization market returns, incentives for loss mitigation and value maximization in mortgage servicing are appropriately aligned.

The FDIC took a significant step in this regard when updating our rules for safe harbor protection with regard to the treatment of securitized assets in failed bank receiverships. Our final rule, approved in September, established standards for loan level disclosure, loan documentation, compensation and oversight of servicers. It includes incentives to assure that loans are made and managed in a way that achieves sustainable lending and maximizes value for all investors. There is already evidence of market acceptance

of these guidelines in the \$1.2 billion securitization issue by Ally Bank earlier this month, which fully conformed to the FDIC safe harbor rules for risk retention.

In short, the desired effect of the risk retention and QRM rules will be to give both loan underwriting and administration and loan servicing much larger roles in credit risk management. Lenders and regulators need to embrace the lessons learned from this crisis and establish a prudential framework for extending credit and servicing loans on a sounder basis. Servicing provisions that should be part of the QRM rule include disclosure of ownership interests in second-liens by servicers of a first mortgage and appropriate compensation incentives.

Better alignment of economic incentives in the securitization process will not only address key safety-and-soundness and investor concerns, but will also provide a stronger foundation for the new Consumer Financial Protection Bureau (CFPB) as it works to improve consumer protections for troubled borrowers in all products and by all servicers.

### **Additional Implementation Activities**

While we have focused on the important ongoing reforms where the Dodd-Frank Act assigned a significant role to the FDIC, we have been pleased to work closely with the other regulators on several other critical aspects of the Act's implementation.

Earlier this month, the FDIC Board approved a draft interagency rule to implement Section 956 of the Dodd-Frank Act, which sets forth rules and procedures governing the awarding of incentive compensation in covered financial institutions. Implementing this section will help address a key safety-and-soundness issue that contributed to the recent financial crisis – namely, that poorly designed compensation structures and poor corporate governance can misalign incentives and induce excessive risk taking within financial organizations. The proposed rule is proportionate to the size and complexity of individual banks and does not apply to banks with less than \$1 billion in assets. For the largest firms, those with over \$50 billion in assets, the proposal requires deferral of a significant portion of the incentive compensation of identified executive officers for at least three years and board-level identification and approval of the incentive compensation of employees who can expose the firm to material loss.

Another important reform under the Dodd-Frank Act is the Volcker Rule, which prohibits proprietary trading and acquisition of an interest in hedge or private equity funds by IDIs. The FSOC issued its required study of proprietary trading in January of this year, and joint rules implementing the prohibition on such trading are due by October of this year. The federal banking agencies will be working together, with the FSOC coordinating, to issue a final rule by the statutory deadline.

In addition to these rulemakings, the FDIC has a number of other implementation responsibilities, including new reporting requirements and mandated studies. Among the latter is a study to evaluate the definitions of core and brokered deposits. As part of

this study, we are hosting a roundtable discussion next month to gather valuable input from bankers, deposit brokers, and other market participants.

### Preparation for Additional Responsibilities

The FDIC Board of Directors has recently undertaken a number of organizational changes to ensure the effective implementation of our responsibilities pursuant to the Dodd-Frank Act.

As I previously described in my September testimony before this Committee, the FDIC has made organizational changes in order to enhance our ability to carry out the Dodd-Frank Act responsibilities, as well as our core responsibilities for risk management supervision of insured depository institutions and consumer protection. The new Office of Complex Financial Institutions (OCFI) will be responsible for orderly liquidation authority, resolution plans, and monitoring risks in the SIFIs. The Division of Depositor and Consumer Protection will focus on the FDIC's many responsibilities for depositor and consumer protection.

In response to the Committee's request for an update about the transfer of employees to the new CFPB, I can report that we continue to work with the Treasury Department and the other banking agencies on the transfer process of employees to ensure a smooth transition. The number of FDIC employees detailed to the CFPB will necessarily be limited since the FDIC retains the compliance examination and enforcement responsibilities for most FDIC-regulated institutions with \$10 billion or less in assets. Nonetheless, there are currently seven FDIC employees being detailed to the Treasury Department and the CFPB to work on a wide range of examination and legal issues that will confront the CFPB at its inception. There are also several more employees who have expressed interest in assisting the CFPB and are being evaluated by the Treasury Department. Recognizing that FDIC employees have developed expertise, skills, and experience in a number of areas of benefit to the CFPB, our expectation has been that a number of employees would actively seek an opportunity to assist the CFPB in its earliest stages, or on a more permanent basis.

Finally, consistent with the requirements of Section 342, the FDIC in January established a new Office of Minority and Women Inclusion (OMWI). Transferring the existing responsibilities and employees of the FDIC's former Office of Diversity and Economic Opportunity into the new OMWI has allowed for a smooth transition and no disruption in the FDIC's ongoing diversity and outreach efforts. Our plans for the OMWI include the addition of a new Senior Deputy Director and other staff as needed to ensure that the new responsibilities under Section 342 are carried out, as well as an OMWI Steering Committee which will promote coordination and awareness of OMWI responsibilities across the FDIC and ensure that they are managed in the most effective manner.

### Regulatory Effectiveness

The FDIC recognizes that while the changes required by the Dodd-Frank Act are necessary to establish clear rules that will ensure a stable financial system, these changes must be implemented in a targeted manner to avoid unnecessary regulatory burden. We are working on a number of fronts to achieve that necessary balance. An example is the recent rule to change the deposit insurance assessment system, which relied as much as possible on the current regulatory reporting structure. Although some additional reporting will be required for some institutions, most institutions should see their reporting burden unchanged or slightly reduced as some items that were previously required will no longer be reported.

At the January 20 meeting of the FDIC's Advisory Committee on Community Banking, we engaged the members – mostly bankers themselves – in a full and frank discussion of other ways to ease the regulatory burden on small institutions. Among the ideas discussed at that meeting were:

- Conduct a community bank impact analysis with respect to implementation of regulations under the Dodd-Frank Act,
- Identify which questionnaires and reports can be streamlined through automation,
- Review ways to reduce the total amount of reporting required of banks,
- Impose a moratorium on changes to reporting obligations until some level of regulatory burden reduction has been achieved,
- Develop an approach to bank reporting requirements that is meaningful and focuses on where the risks are increasing, and
- Ensure that community banks are aware that senior FDIC officials are available and interested in receiving their feedback regarding our regulatory and supervisory process.

The FDIC is particularly interested in finding ways to eliminate unnecessary regulatory burden on community banks, whose balance sheets are much less complicated than those of the larger banks. Our goal is to facilitate more effective and targeted regulatory compliance. To this end, we have established as a corporate performance goal for the first quarter of 2011 to modify the content of our Financial Institution Letters (FILs) -- the vehicle used to alert banks to any regulatory changes or guidance -- so that every FIL issued will include a section making clear the applicability to smaller institutions (under \$1 billion). In addition, by June 30 we plan to complete a review of all of our recurring questionnaires and information requests to the industry and to develop recommendations to improve the efficiency and ease of use and a plan to implement these changes.

The FDIC has challenged its staff to find additional ways of translating some of these ideas into action. This includes launching an intensive review of existing reporting requirements to identify areas for streamlining. We have also initiated a process whereby, as part of every risk management examination, we will solicit the views of the institution on aspects of the regulatory and supervisory process that may be adversely affecting credit availability.

Above all, it is important to emphasize to small and mid-sized financial institutions that the Dodd-Frank reforms are not intended to impede their ability to compete in the marketplace. On the contrary, we expect that these reforms will do much to restore competitive balance to the marketplace by restoring market discipline and appropriate regulatory oversight to systemically important financial companies, many of which received direct government assistance in the recent crisis.

## **Conclusion**

In implementing the Dodd-Frank Act, it is important that we continue to move forward with dispatch to remove unnecessary regulatory uncertainties faced by the market and the industry. In passing the Act, the Congress clearly recognized the need for a sounder regulatory framework within which banks and other financial companies could operate under rules that would constrain the excessive risk taking that caused such catastrophic losses to our financial system and our economy during the financial crisis.

In the wake of the passage of the Act, it is essential that this implementation process move forward both promptly and deliberately, in a manner that resolves uncertainty as to what the new framework will be and that promotes long-term confidence in the transparency and stability of our financial system. Throughout this process, regulators must maintain a clear view of the costs of regulation – particularly to the vital community banking sector – while also never forgetting the enormous economic costs of the inadequate regulatory framework that allowed the crisis to occur in the first place. We have a clear obligation to members of the public who have suffered the greatest losses as a result of the crisis to prevent such an episode from ever recurring again.

Thank you for the opportunity to testify.

<sup>1</sup> Transcript of interview with Neil Barofsky, National Public Radio, January 27, 2011. <http://www.npr.org/2011/01/27/133264711/Troubled-Asset-Relief-Program-Update>

<sup>2</sup> For example, see: Ashcraft, Adam B. and Schuermann, Til, "Understanding the Securitization of Subprime Mortgage Credit," Staff Report No. 318, Federal Reserve Bank of New York, March 2008, p. 8. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1071189](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1071189) and "Global Rating Criteria for Structured Finance Servicers," Fitch Ratings / Structured Finance, August 16, 2010, p. 7.