Statement of Richard J. Osterman, Jr., Acting General Counsel, Federal Deposit Insurance Corporation on Regulatory Activity of the FDIC Before the Committee on Financial Services, United States House of Representatives; 2128 Rayburn House Office Building

April 8, 2014

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify today on the recent regulatory activity of the Federal Deposit Insurance Corporation (FDIC).

My testimony will address several topics. First, I will discuss the improving state of the industry following the financial crisis. I will then address recent regulatory activity of the FDIC, including actions related to capital and liquidity requirements, and credit risk retention. Finally, I will describe our efforts to tailor regulations and our supervisory approaches for community banks in recognition of the unique role they play in the financial system.

Improving State of the Industry

The banking industry in the United States continues to experience gradual but steady improvement since the financial crisis. Asset quality has improved; there are fewer troubled institutions; and capital and liquidity ratios are stronger.

Annual earnings in the industry have increased for the past four years. FDIC-insured commercial banks and savings institutions reported aggregate net income of $40.3 billion in the fourth quarter of 2013, a $5.8 billion (16.9 percent) increase from a year ago. Over half (53.0 percent) of the 6,812 FDIC-insured institutions in the fourth quarter reported a year-over-year increase in earnings. The proportion of banks that were unprofitable in the fourth quarter fell to 12.2 percent from 15.0 percent a year earlier.

Balance sheets in the industry also have improved. Net charge-offs have posted a year-over-year decline for 14 consecutive quarters, and noncurrent loan balances have declined for 15 consecutive quarters. Importantly, loan balances for the industry as a whole have grown in nine out of the last 11 quarters. These positive trends have been broadly shared across the industry among large institutions, mid-size institutions, and community banks.

Other indicators of industry conditions have been moving in a positive direction. The number of banks on the FDIC "Problem List"—those institutions with the lowest supervisory CAMELS ratings of 4 or 5—peaked in March 2011 at 888 institutions. By December 2013, the number of problem banks had dropped to 467. The number of bank failures also has been declining steadily. Bank failures peaked in 2010 at 157. In 2013, there were 24 bank failures.

Another sign of the improving health of the banking industry is the decline in the number of enforcement actions by the FDIC. The total number of FDIC enforcement actions,

both formal and informal, decreased by 27 percent last year, from 775 in 2012 to 567 in 2013. Last year, for the first time since 2008, the total number of enforcement actions terminated outpaced the number of enforcement actions issued.

Despite these positive trends, the banking industry still faces a number of challenges. For example, although credit quality has improved, delinquent loans and charge-offs remain at elevated levels. In addition, tighter net interest margins and relatively modest loan growth have created incentives for institutions to reach for yield in their loan and investment portfolios, which has heightened their vulnerability to interest rate risk. The federal banking agencies have reiterated their expectation that banks manage risk in a prudent manner. Interest rate risk is an ongoing concern for bank regulators, and it will continue to be a focus of attention in safety and soundness examinations.

The Deposit Insurance Fund

As the industry has recovered over the past few years, the Deposit Insurance Fund (DIF) also has moved into a stronger financial position.

The Dodd-Frank Act raised the minimum reserve ratio for the DIF (the DIF balance as a percent of estimated insured deposits) from 1.15 percent to 1.35 percent, and required that the reserve ratio reach 1.35 percent by September 30, 2020. The FDIC is currently operating under a DIF Restoration Plan that is designed to meet this deadline, and the DIF reserve ratio is recovering at a pace that remains on track under the Plan. As of December 31, 2013, the DIF reserve ratio stood at 0.79 percent of estimated insured deposits, up from 0.68 percent at September 30, 2013, and from 0.44 percent at year-end 2012.

The fund balance has grown every quarter for the past four years and stood at $47.2 billion at December 31, 2013. This is in contrast to the negative $21 billion fund balance at its low point at the end of 2009. Assessment revenue, fewer anticipated bank failures, and lower estimated losses on failed bank assets have been the primary drivers of the growth in the DIF balance.

Regulatory Activity

Capital and Liquidity Requirements

Interagency Rulemakings on Basel III and the Supplementary Leverage Ratio

In July 2013, the FDIC Board acted on two important regulatory capital rulemakings. First, the FDIC joined the Federal Reserve Board and the OCC in issuing rules that significantly revise and strengthen risk-based capital regulations through implementation of the Basel III capital standards adopted by the Basel Committee on Banking Supervision (Basel Committee) and certain requirements of the Dodd-Frank Act (Basel III rulemaking). Second, these agencies also issued a notice of proposed rulemaking (Enhanced Supplemental Leverage Ratio NPR) that would strengthen leverage capital requirements for eight of the largest and most systemically important U.S. bank holding companies (BHCs) and their insured banks.

The Basel III rulemaking substantially strengthens both the quality and the quantity of risk-based capital for all banks in the U.S. by placing greater emphasis on common equity tier 1 capital. Common equity tier 1 capital is widely recognized as the most loss-absorbing form of capital, and the Basel III changes are expected to result in a stronger, more resilient industry better able to withstand periods of economic stress in the future. The Basel III rulemaking also includes a new supplementary leverage ratio requirement, as provided in the Basel III framework. This represents an important enhancement to the international capital framework. Finally, in response to industry comments on the proposal, the Basel III rulemaking includes provisions designed specifically to reduce burden on smaller banking organizations. The Basel III rules are effective on January 1, 2015, for banking organizations that are not subject to the advanced approaches risk-based capital rules. This timeframe provides most banks with an additional year to implement the rules, as compared to the largest organizations that are subject to the advanced approaches. While most banks already meet the Basel III requirements, those that need more time will benefit from the rule's extended phase-in period.

As noted above, the agencies also issued an Enhanced Supplementary Leverage Ratio NPR, which proposes enhanced supplementary leverage standards for eight large and systemically important BHCs and their insured banks. The NPR would require covered IDIs to satisfy a six percent supplementary leverage ratio to be considered well capitalized for prompt corrective action (PCA) purposes. BHCs covered by the Enhanced Supplementary Leverage Ratio NPR would need to maintain a supplementary leverage ratio of at least five percent (a three percent minimum plus a two percent buffer) to avoid restrictions on capital distributions and executive compensation.

Higher leverage capital requirements would help reduce the risk these institutions pose to the financial system and would also put additional private capital at risk before the DIF and the FDIC's resolution mechanisms would be called upon. The issuance of the Enhanced Supplementary Leverage Ratio NPR is one of the most important steps the banking agencies could take to strengthen the safety and soundness of the U.S. banking and financial systems. The comment period for the Enhanced Supplementary Leverage Ratio NPR ended on October 21, 2013. The FDIC Board is considering a final rule on the supplementary leverage ratio later today.

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

A number of large financial institutions experienced significant liquidity problems during the financial crisis that exacerbated stress on the banking system and destabilized the financial system. In response, in October 2013, the FDIC, together with the OCC and the Federal Reserve Board, issued an interagency proposed rule to implement a quantitative liquidity requirement consistent with the Liquidity Coverage Ratio (LCR) developed by the Basel Committee on which the U.S. banking agencies serve as members. The comment period on this proposal closed on January 31, 2014, and the agencies are in the process of reviewing the more than 100 comments received.

Risk Retention

On August 28, 2013, the FDIC Board approved a NPR issued jointly with five other federal agencies to implement the credit risk retention requirement set forth in Section 941 of the Dodd-Frank Act, which seeks to ensure that securitization sponsors have appropriate incentives for prudent underwriting.[1] The proposed rule generally requires that the sponsor of any asset-backed security (ABS) retain an economic interest equal to at least five percent of the aggregate credit risk of the collateral. This is the second proposal under Section 941; the first was issued in April 2011.

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

The FDIC received over 200 comments on the current NPR. A number of comments relate to risk retention issues regarding open market collateralized loan obligations (CLOs).[2] The proposed rule considers an open market CLO manager to be a securitization sponsor and, therefore, the manager would generally be required to retain five percent of the credit risk of CLO issuances. As an alternative, managers or sponsors could satisfy the risk retention requirement if the lead arrangers of the loans (typically the main lender) purchased by the open market CLO retained the required risk. Some commenters have argued that the lead arranger option is unworkable and that the proposal would significantly affect the formation and continued operation of CLOs, and that this could reduce the volume of commercial lending. The agencies are continuing to review comments and meet with interested groups to discuss their concerns and will give full consideration to all issues raised before issuing the final rule.

Review of Resolution Plans

As required by the Dodd-Frank Act, the FDIC is developing a framework for the resolution of a systemically important financial institution (SIFI) in the event of a failure. Under the Act, bankruptcy is the preferred option for dealing with the failure of a SIFI that is not itself an insured depository institution. To make this objective achievable, Title I of the Dodd-Frank Act requires that all bank holding companies with total consolidated assets of $50 billion or more, and nonbank financial companies that the Financial Stability Oversight Council (FSOC) determines could pose a threat to the financial stability of the United States, prepare resolution plans, or "living wills," to

demonstrate how the company could be resolved in a rapid and orderly manner under the U.S. Bankruptcy Code in the event of the company's financial distress or failure.

The 165(d) Rule, jointly issued by the FDIC and the Federal Reserve Board in 2011, implemented the requirements for resolution plans and provided for staggered annual submission deadlines based on the size and complexity of the companies. Eleven of the largest, most complex institutions submitted initial plans in 2012 and revised plans in 2013. In 2013, another 120 institutions submitted initial resolution plans under the 165(d) Rule. In addition, the FSOC designated three non-bank financial institutions for Federal Reserve Board supervision. These firms are expected to submit initial resolution plans in 2014, along with five additional institutions that have qualified as covered companies under the 165(d) Rule in the period following its issuance.

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

Following the review of the initial resolution plans submitted in 2012, the Federal Reserve Board and FDIC issued guidance for the eleven initial firms concerning the information that should be included in their 2013 resolution plan submissions. The guidance identified an initial set of significant obstacles to rapid and orderly resolution that the firms are expected to address in the plans, including the actions or steps a company has taken or proposes to take to remediate or otherwise mitigate each obstacle and a timeline for any proposed actions.

Developing Regulatory Approaches

The FDIC has an ongoing commitment to ensure that its regulations and policies achieve legislative and regulatory goals in the most efficient and effective manner possible. As a key component, the FDIC has long recognized the necessity of carefully considering all available information relating to the benefits and costs of new regulations to ensure that they effectively promote financial stability without placing undue burden on insured depository institutions and the public. Last year, the FDIC Board of Directors reviewed and updated its Policy Statement on the Development and Review of FDIC Regulations and Policies.[3] This Policy Statement sets out a number of principles governing the development and review of all FDIC regulations and policies, including the evaluation of benefits and costs based on available information, and the consideration of reasonable and possible alternatives. Particular attention is focused on the impact that a regulation will have on small institutions and whether there are comprehensive or targeted alternatives to accomplish the FDIC's goal which would minimize any burden on small institutions. Specifically, the FDIC seeks to minimize to

the extent practicable the burdens which a proposed regulation or policy imposes on the banking industry and consumers.

Another critical component of our rulemaking process is to provide the public the opportunity to participate in notice and comment rulemaking under the Administrative Procedure Act. When proposing a new rule, the FDIC provides the public with a notice of proposed rulemaking and the opportunity to submit comments, including comments on the potential effect on consumers. The FDIC carefully considers all comments submitted in response to the proposed rule, and weighs potential costs against the potential benefits based on available information before issuing the final rule. The FDIC also publishes on its website all comments received. Throughout the notice and comment rulemaking process, the FDIC is committed to ensuring that its regulations achieve legislative goals.

To ensure that the FDIC's regulations and written statements of policy are current, effective, and efficient, and continue to meet the principles set forth in this Policy, the FDIC periodically undertakes a review of each regulation and statement of policy. Sometimes, this review is done in conjunction with a change to a regulation or policy statement triggered by a change in the law. In addition, under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 and in conjunction with the other agencies of the Federal Financial Institutions Examination Council, the FDIC conducts a comprehensive review of its regulations, at least once every ten years, to identify any outdated, unnecessary, or unduly burdensome regulatory requirements imposed on financial institutions. The FDIC also may initiate a targeted review in a specific area based on changes in the markets or observations at bank examinations, for example.

The regulatory approach followed by the FDIC is intended to implement the statutes enacted by Congress. Rather than prohibiting financial products or services, the FDIC seeks to ensure that they are offered to consumers fairly, and are consistent with safe and sound banking practices.

Community Bank Issues

As the primary federal regulator for the majority of smaller institutions, the FDIC is keenly aware of the challenges facing community banks. The FDIC has tailored its supervisory approach to consider the size, complexity, and risk profile of the institutions it oversees. For example, large institutions (those with $10 billion or more in total assets) are generally subject to continuous supervision (targeted reviews throughout the year), while smaller banks are examined periodically (every 12 to 18 months) based on their size and condition. Additionally, the frequency of our examinations of compliance with the Community Reinvestment Act can be extended for smaller, well-managed institutions. Moreover, in Financial Institution Letters issued to the industry to explain regulations and guidance, the FDIC includes a Statement of Applicability to institutions with less than $1 billion in total assets.

The FDIC also reviewed its examination, rulemaking, and guidance processes during 2012 as part of our broader review of community banking challenges, with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent, while maintaining safe and sound banking practices. Based on the review, the FDIC has implemented a number of enhancements to our supervisory and rulemaking processes. First, the FDIC has restructured the pre-exam process to better scope examinations, define expectations, and improve efficiency. Second, the FDIC is taking steps to improve communication with banks under our supervision through the use of web-based tools, regional meetings and outreach. Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities to attend training workshops and symposiums, and conference calls and training videos on complex topics of interest to community bankers. The FDIC is continuing its review of examination and rulemaking processes, and continues to explore new initiatives to provide technical assistance to community banks.

In addition, the FDIC and our fellow banking regulators have been receptive to issues identified by community banks during the rulemaking process. For example, the regulators addressed several issues in the capital rulemaking that were raised by community banks during the comment period. Also, the compliance requirements of the Volcker Rule are designed to avoid placing needless requirements on banks that do not engage in the activities covered by the Rule, such as most community banks.

Finally, the FDIC has taken regulatory action that directly benefitted community banks. In accordance with the Dodd-Frank Act, the FDIC redefined the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. As Congress intended, the change in the assessment base shifted some of the overall assessment burden from community banks to the largest institutions. Aggregate premiums paid by institutions with less than $10 billion in assets declined by approximately one-third in the second quarter of 2011, primarily due to the assessment base change. The Dodd-Frank Act also made permanent the increase in the deposit insurance coverage limit to $250,000, a provision generally viewed by community banks as helping them attract deposits.

Conclusion

Thank you for the opportunity to testify on the recent regulatory activity of the FDIC. The condition of the banking industry continues to improve from the recent crisis. The FDIC continues to work to reduce the risk of a future crisis and to improve the regulatory tools available if one should occur. At the same time, the FDIC continues to tailor its supervisory approaches to take into account the size and complexity of the institutions it supervises. I would be glad to respond to your questions.

[1]Credit Risk Retention, 78 Fed. Reg. 57,928 (proposed Sept. 20. 2013), http://www.fdic.gov/regulations/laws/federal/2013/2013-09-20_proposed-rule.pdf

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

[3]https://www.fdic.gov/laws-and-regulations/fdic-and-interagency-statements#fdic5000developmentar