STATEMENT OF

MARTIN J. GRUENBERG
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

WALL STREET REFORM:
OVERSIGHT OF FINANCIAL STABILITY AND CONSUMER AND INVESTOR PROTECTIONS

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
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Chairman Johnson, Ranking Member Crapo and members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's (FDIC) efforts to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The economic dislocations experienced in recent years, which far exceeded any since the 1930s, were the direct result of the financial crisis of 2007-08. The reforms enacted by Congress in the Dodd-Frank Act were aimed at addressing the causes of the crisis. The reforms included changes to the FDIC's deposit insurance program, a series of measures to curb excessive risk-taking at large, complex banks and non-bank financial companies and a mechanism for orderly resolution of large, nonbank financial companies.

The regulatory changes mandated by the Dodd-Frank Act require careful implementation to ensure they address the risks posed by the largest, most complex institutions while being sensitive to the impact on community banks that did not contribute significantly to the crisis. As implementation moves forward, the FDIC has been engaged as well in an extensive effort to better understand the forces driving long-term change among U.S. community banks and to solicit input from community bankers on these trends and on the regulatory process.

My testimony will address the impact of the Dodd-Frank Act on the restoration of the Deposit Insurance Fund (DIF), our efforts to carry out the requirement of the Act to develop the ability to resolve large, systemic financial institutions, and our progress on some of the key rulemakings. In addition, I will briefly discuss the results of our recent community banking initiative.

Condition of the FDIC Deposit Insurance Fund (DIF)

Restoring the DIF

The Dodd-Frank Act raised the minimum reserve ratio for the DIF from 1.15 percent of estimated insured deposits 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 September 30, 2012, the DIF reserve ratio stood at 0.35 percent of estimated insured deposits, up from 0.12 percent a year earlier. The fund balance has grown for eleven consecutive quarters, increasing to $25.2 billion at the end of the third quarter of 2012. Assessment revenue, fewer anticipated bank failures, and the transfer of fees previously set aside for the Temporary Liquidity Guarantee Program (TLGP) have helped to increase the fund balance.

Expiration of the Transaction Account Guarantee (TAG) Program

The Dodd-Frank Act provided temporary unlimited deposit insurance coverage for noninterest-bearing transaction accounts from December 31, 2010, through December

31, 2012. This unlimited coverage was available to all depositors, including consumers, businesses, and government entities, as long as the accounts were truly non-interest bearing. As the TAG came to a conclusion, the FDIC worked closely with banks to ensure that they would continue to be able to meet their funding and liquidity needs after expiration of the program. Thus far, the transition away from this emergency program has proceeded smoothly.

Expiration of the Debt Guarantee Program

Although not established by the Dodd-Frank Act, another program created in response to the crisis, the Debt Guarantee Program (DGP), was established under emergency authority to provide an FDIC guarantee of certain newly issued senior unsecured debt. The program enabled financial institutions to meet their financing needs during a period of record high credit spreads and aided the successful return of the credit markets to near normalcy, despite the recession and slow economic recovery. By providing the ability to issue debt guaranteed by the FDIC, the DGP allowed institutions to extend maturities and obtain more stable unsecured funding.

As with the Dodd-Frank TAG program, the DGP came to a close at the end of 2012. One hundred twenty-two banks and other financial companies participated in the DGP, and the volume of guaranteed debt peaked in early 2009 at $345.8 billion. The FDIC collected $10.4 billion in fees and surcharges under the program. Ultimately, over $9.3 billion in fees collected under the DGP have been transferred to assist in the restoration of the DIF to its statutorily mandated reserve ratio of 1.35 percent of insured deposits.

Implementation of Title I "Living Wills"

In 2011, the FDIC and the Federal Reserve Board (FRB) jointly issued the basic rulemaking regarding resolution plans that systemically important financial institutions (SIFIs) are required to prepare-- the so-called "living wills." The rule requires bank holding companies with total consolidated assets of $50 billion or more, and certain nonbank financial companies that the Financial Stability Oversight Council (FSOC) designates as systemic, to develop, maintain and periodically submit to the FDIC and the FRB resolution plans that are credible and that would enable these entities to be resolved under the Bankruptcy Code. Complementing this joint rulemaking, the FDIC also issued a rule requiring any FDIC-insured depository institution with assets over $50 billion to develop, maintain and periodically submit plans outlining how the FDIC could resolve the institution using the traditional resolution powers under the Federal Deposit Insurance Act.

The two resolution plan rulemakings are designed to work in tandem by covering the full range of business lines, legal entities and capital-structure combinations within a large financial firm. The rulemakings establish a schedule for staggered annual filings. On July 1, 2012, the first group of living wills, generally involving bank holding companies and foreign banking organizations with $250 billion or more in non-bank assets, was received. Banking organizations with less than $250 billion, but $100 billion or more, in assets will file by July 1 of this year, and all other banking organizations with assets over $50 billion will file by December 31.

The Dodd-Frank Act requires that at the end of this process these plans be credible and facilitate an orderly resolution of these firms under the Bankruptcy Code. In 2013, the eleven firms that submitted initial plans in 2012 will be expected to refine and clarify their submissions. The agencies expect the refined plans to focus on key issues and obstacles to an orderly resolution in bankruptcy including global cooperation and the risk of ring-fencing or other precipitous actions. To assess this potential risk, the firms will need to provide detailed, jurisdiction-by-jurisdiction analyses of the actions each would need to take in a resolution, as well as the discretionary actions or forbearances required to be taken by host authorities. Other key issues include the continuity of critical operations, particularly maintaining access to shared services and payment and clearing systems, the potential systemic consequences of counterparty actions, and global liquidity and funding with an emphasis on providing a detailed understanding of the firm's funding operations and flows.

<u>Implementation of Title II Orderly Liquidation Authority</u>

Coordination with Foreign Resolution Authorities

The FDIC has largely completed the rulemaking necessary to carry out its systemic resolution responsibilities under Title II of the Dodd-Frank Act. In July 2011, the FDIC Board approved a final rule implementing the Title II Orderly Liquidation

Authority. This rulemaking addressed, among other things, the priority of claims and the treatment of similarly situated creditors.

The experience of the financial crisis highlighted the importance of coordinating resolution strategies across national jurisdictions. Section 210 of the Dodd-Frank Act expressly requires the FDIC to "coordinate, to the maximum extent possible" with appropriate foreign regulatory authorities in the event of the resolution of a covered financial company with cross-border operations. As we plan internally for such a resolution, the FDIC has continued to work on both multilateral and bilateral bases with our foreign counterparts in supervision and resolution. The aim is to promote cross-border cooperation and coordination associated with planning for an orderly resolution of a globally active, systemically important financial institution (G-SIFIs).

As part of our bilateral efforts, the FDIC and the Bank of England, in conjunction with the prudential regulators in our jurisdictions, have been working to develop contingency plans for the failure of G-SIFIs that have operations in both the U.S. and the U.K. Of the 28 G-SIFIs designated by the Financial Stability Board of the G-20 countries, 4 are headquartered in the U.K, and another 8 are headquartered in the U.S. Moreover, around two-thirds of the reported foreign activities of the 8 U.S. SIFIs emanates from the U.K.[1] The magnitude of these financial relationships makes the U.S. – U.K. bilateral relationship by far the most important with regard to global financial stability. As a result, our two countries have a strong mutual interest in ensuring that, if

[1] Reported foreign activities encompass sum of assets, the notional value of off-balance-sheet derivatives, and other off-balance-sheet items of foreign subsidiaries and branches.

such an institution should fail, it can be resolved at no cost to taxpayers and without placing the financial system at risk. An indication of the close working relationship between the FDIC and U.K authorities is the joint paper on resolution strategies that we released in December. [2]

In addition to the close working relationship with the U.K., the FDIC and the European Commission (E.C.) have agreed to establish a joint Working Group comprised of senior staff to discuss resolution and deposit guarantee issues common to our respective jurisdictions. The Working Group will convene twice a year, once in Washington, once in Brussels, with less formal communications continuing in between. The first of these meetings will take place later this month. We expect that these meetings will enhance close coordination on resolution related matters between the FDIC and the E.C., as well as European Union Member States.

While there is clearly much more work to be done in coordinating SIFI resolution strategies across major jurisdictions, these developments mark significant progress in fulfilling the mandate of section 210 of the Dodd-Frank Act and achieving the type of international coordination that would be needed to effectively resolve a G-SIFI in some future crisis situation.

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[2] "Resolving Globally Active, Systemically Important, Financial Institutions," http://www.fdic.gov/about/srac/2012/gsifi.pdf.

Stress Testing Final Rule

Section 165(i) of the Dodd Frank Act requires the FRB to conduct annual stress tests of Bank Holding Companies with assets of $50 billion or more and nonbank SIFIs designated by FSOC for FRB supervision. This section of the Act also requires financial institutions with assets greater than $10 billion, including insured depository institutions, to conduct company run stress tests in accordance with regulations developed by their primary federal regulator. The FDIC views the stress tests as an important source of forward-looking analysis of institutions' risk exposures that will enhance the supervisory process for these institutions. We also have clarified that these requirements apply only to institutions with assets greater than $10 billion, and not to smaller institutions.

The FDIC issued a proposed rule to implement the requirements of section 165(i) in January 2012, and a final rule in October 2012. The rule, which is substantially similar to rules issued by the Office of the Comptroller of the Currency (OCC) and the FRB, tailors the timelines and requirements of the stress testing process to the size of the institutions, as requested by commenters on the proposed rule.

The agencies are closely coordinating their efforts in the promulgation of scenarios and the review of stress testing results. The first round of stress tests, for certain insured institutions and Bank Holding Companies with assets of $50 billion or more, is underway. Institutions were asked to develop financial projections under defined stress scenarios provided by the agencies in November 2012, based on their September 30, 2012 financial data. Institutions with assets greater than $10 billion, but less than $50 billion, and larger institutions that have not had previous experience with stress testing, will conduct their first round of stress tests this fall.

Other Dodd-Frank Act Rulemakings

The Volcker Rule

The Dodd-Frank Act requires the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), and the federal banking agencies to adopt regulations generally prohibiting proprietary trading and certain acquisitions of interest in hedge funds or private equity funds. The FDIC, jointly with the FRB, OCC, and SEC, published a notice of proposed rulemaking (NPR) requesting public comment on a proposed regulation implementing the prohibition against proprietary trading. The CFTC separately approved the issuance of its NPR to implement the Volcker Rule, with a substantially identical proposed rule text.

The proposed rule also requires banking entities with significant covered trading activities to furnish periodic reports with quantitative measurements designed to help differentiate permitted market-making-related activities from prohibited proprietary trading. Under the proposed rule, these requirements contain important exclusions for banking organizations with trading assets and liabilities less than $1 billion, and reduced reporting requirements for organizations with trading assets and liabilities of less than $5 billion. These thresholds are designed to reduce the burden on smaller, less complex banking entities, which generally engage in limited market-making and other trading activities.

The agencies are evaluating a large body of comments on whether the proposed rule represents a balanced and effective approach or whether alternative approaches exist that would provide greater benefits or implement the statutory requirements with fewer costs. The FDIC is committed to developing a final rule that meets the objectives of the statute while preserving the ability of banking entities to perform important underwriting and market-making functions, including the ability to effectively carry out these functions in less-liquid markets. Most community banks do not engage in trading activities that would be subject to the proposed rule.

Appraisal-Related Provisions

The final rule regarding appraisals for higher-risk mortgages, which implements section 1471 of the Dodd-Frank Act, was adopted by the FDIC and five other agencies earlier this year.[3] The final rule, which will become effective on January 18, 2014, requires creditors making higher-risk mortgages to use a licensed or certified appraiser who prepares a written appraisal report based on a physical visit of the interior of the property. The rule also requires creditors to disclose to applicants information about the purpose of the appraisal and provide consumers with a free copy of any appraisal report. Finally, if the seller acquired the property for a lower price during the prior six months and the price difference exceeds certain thresholds, creditors will have to obtain a second appraisal at no cost to the consumer. This requirement is intended to address fraudulent property flipping by seeking to ensure that the value of the property legitimately

[3] The other agencies are: the FRB, the Consumer Financial Protection Bureau, the Federal Housing Finance Agency, the National Credit Union Administration, and the OCC.

increased. Certain types of loans are exempted from the rule, such as qualified mortgages, and there are limited exemptions from the second appraisal requirement. By ensuring that homes secured by higher-risk mortgages are appraised at their true market value by a qualified appraiser, the rule will benefit both lenders and consumers.

The agencies also are developing notices of proposed rulemaking to address other appraisal-related provisions of the Dodd-Frank Act. These provisions include registration and operating requirements for appraisal management companies and quality controls for automated valuation models. We look forward to considering the public comments we receive on these proposals.

Rulemaking on Risk Retention in Mortgage Securitization

Six agencies[4], including the FDIC, previously issued a joint notice of proposed rulemaking seeking comment on a proposal to implement section 941 of the Dodd-Frank Act. The proposed rule would require sponsors of asset-backed securities to retain at least five percent of the credit risk of the assets underlying the securities and not permit sponsors to transfer or hedge that credit risk. The proposed rule would provide sponsors with various options for meeting the risk-retention requirements. It also provides, as required by section 941, proposed standards for a Qualified Residential Mortgage (QRM) which, if met, would result in exemption from the risk retention requirement.

[4] The rule was proposed by the FRB, the OCC, the FDIC, the SEC, the Federal Housing Finance Agency, and the Department of Housing and Urban Development.

The interagency staff group addressing the credit risk retention rule under section 941 of DFA has been working to address the numerous issues raised by the many comments received on the proposed rule. After initial discussions about QRM, in view of the fact that the statute provides that the definition of QRM can be no broader than the definition of QM, staff turned its attention to the non-QRM issues pending issuance by the Consumer Financial Protection Bureau (CFPB) of its QM rule. With the recent issuance of the QM rule by the CFPB, the interagency group plans to turn its attention back to issues regarding QRM.

Community Banking Initiatives

In light of concerns raised about the future of community banking in the aftermath of the financial crisis, as well as the potential impact of the various rulemakings under the Dodd-Frank Act, the FDIC engaged in a series of initiatives during 2012 focusing on the challenges and opportunities facing community banks in the United States.

FDIC Community Banking Study

In December 2012, the FDIC released the *FDIC Community Banking Study*, a comprehensive review of the U.S. community banking sector covering 27 years of data. The study set out to explore some of the important trends that have shaped the operating environment for community banks over this period, including: long-term industry consolidation; the geographic footprint of community banks; their comparative financial performance overall and by lending specialty group; efficiency and economies of scale; and access to capital. This research was based on a new definition of community bank that goes beyond size, and also accounts for the types of lending and deposit gathering activities and limited geographic scope that are characteristic of community banks.

Our research confirms the crucial role that community banks play in the American financial system. As defined by the Study, community banks represented 95 percent of all U.S. banking organizations in 2011. These institutions account for just 14 percent of the U.S. banking assets in our nation, but hold 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. While their share of total deposits has declined over time, community banks still hold the majority of bank deposits in rural and micropolitan counties.[5] The Study showed that in 629 U.S. counties (or almost one-fifth of all U.S. counties), the only banking offices operated by FDIC-insured institutions at year-end 2011 were those operated by community banks. Without community banks, many rural areas, small towns, and even certain urban neighborhoods, would have little or no physical access to mainstream banking services.

Our Study took an in-depth look at the long-term trend of banking industry consolidation that has reduced the number of federally-insured banks and thrifts from 17,901 in 1984 to 7,357 in 2011. All of this net consolidation can be accounted for by an even larger decline in the number of institutions with assets less than $100 million. But a closer look casts significant doubt on the notion that future consolidation will continue at this same pace, or that the community banking model is in any way obsolete.

[5] The 3,238 U.S. counties in 2010 included 694 micropolitan counties centered on an urban core with population between 10,000 and 50,000 people, and 1,376 rural counties with populations less than 10,000 people.

More than 2,500 institutions have failed since 1984, with the vast majority failing in the crisis periods of the 1980s and early 1990s and the period since 2007. To the extent that future crises can be avoided or mitigated, bank failures should contribute much less to future consolidation. In addition, about one third of the consolidation that has taken place since 1984 is the result of charter consolidation within bank holding companies, while just under half is the result of voluntary mergers. But both of these trends were greatly facilitated by the gradual relaxation of restrictions on intrastate branching at the state level in the 1980s and early 1990s, as well as the interstate branching that came about following enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The pace of voluntary consolidation has indeed slowed over the past 15 years as the effects of these one-time changes were realized. Finally, the Study questions whether the rapid pre-crisis growth of some of the nation's largest banks, which came about largely due to mergers and acquisitions and a focus on retail lending, can continue at the same pace going forward. Some of the pre-crisis cost savings realized by large banks have proven to be unsustainable in the post-crisis period, and a return to pre-crisis rates of growth in consumer and mortgage lending appears, for now anyway, to be a questionable assumption.

The Study finds that community banks that grew slowly and maintained diversified portfolios or otherwise stuck to their core lending competencies during the study period exhibited relatively strong and stable performance over time. Other institutions that pursued higher-growth strategies – frequently through commercial real estate or construction and development lending – encountered severe problems during real estate downturns and generally underperformed over the long run. Moreover, the Study finds that economies of scale play a limited role in the viability of community banks. While average costs are found to be higher for very small community banks, economies of scale are largely realized by the time an institution reaches $100 million in size, and there is no indication of any significant cost savings beyond $500 million in size. These results comport well with the experience of banking industry consolidation since 1984, in which the number of bank and thrift charters with assets less than $25 million has declined by 96 percent, while the number of charters with assets between $100 million and $10 billion has grown by 19 percent.

In summary, the FDIC Study finds that despite the challenges of the current operating environment, the community banking sector remains a viable and vital component of the overall U.S. financial system. It identifies a number of issues for future research, including the role of commercial real estate lending at community banks, their use of new technologies, and how additional information might be obtained on regulatory compliance costs.

Examination and Rulemaking Review

The FDIC also reviewed examination, rulemaking, and guidance processes during 2012 with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent – especially with regard to community banks – consistent with safe and sound banking practices. This review was informed by a series of nationwide roundtable discussions with community bankers, and with the FDIC's Advisory Committee on Community Banking.

Based on concerns raised, the FDIC has implemented a number of enhancements to our supervisory and rulemaking processes. First, the FDIC has revamped the pre-exam process to better scope examinations, define expectations and improve efficiency. Second, the FDIC is taking steps to improve communication by using web-based tools to provide critical information regarding new or changing rules and regulations as well as comment deadlines. Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities for attendance at training workshops and symposiums, and current and planned conference calls and training videos on complex subjects of interest. The FDIC considers its review of examination and rulemaking processes ongoing, and additional enhancements and modifications to our processes will likely continue.

Conclusion

Successful implementation of the various provisions of the Dodd-Frank Act will provide a foundation for a financial system that is more stable and less susceptible to crises, and a regulatory system that is better able to respond to future crises. Significant progress has been made in implementing these reforms. The FDIC has completed the core rulemakings for carrying out its lead responsibilities under the Act regarding deposit insurance and systemic resolution. As we move forward in completing this process, we will continue to rely on constructive input from the regulatory comment process and our other outreach initiatives.