SEMI-ANNUAL TESTIMONY ON THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF THE FINANCIAL SYSTEM

HEARING

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Tuesday, April 17, 2018

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Present: Representatives Hensarling, McHenry, Royce, Lucas, Posey, Luetkemeyer, Huizenga, Duffy, Stivers, Hultgren, Ross, Pittenger, Wagner, Barr, Rothfus, Tipton, Williams, Poliquin, Love, Hill, Emmer, Zeldin, Trott, Loudermilk, Mooney, MacArthur, Davidson, Budd, Kustoff, Tenney, Hollingsworth, Waters, Maloney, Velazquez, Sherman, Lynch, Scott, Green, Cleaver, Moore, Ellison, Himes, Foster, Kildee, Delaney, Sinema, Beatty, Heck, Vargas, Crist, and Kihuen.

Chairman HENSARLING. Committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time, and all members will have 5 legislative days in which to submit extraneous materials to the Chair for inclusion in the record.

This hearing is for the purpose of receiving the Semi-annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System. I now yield myself 3 minutes for an opening statement.

Today, we are very, very pleased—I am very pleased to welcome the Honorable Randy Quarles, Vice Chairman for supervision for the Fed. We have been waiting, Mr. Quarles, 8 years for your arrival. We would like to know what took you so long.

I think what we know is, under Dodd-Frank, the statute says the President shall—"shall" appoint a Vice President of Supervision, not "may." And yet President Obama refused to.

We all know that Governor Tarullo de facto filled the position, but he did it without oversight and without checks and balances. Fortunately, President Trump has a very different view of the statute, Constitution, and his respect of Congress.

We all know that, today, Governor Quarles is appearing on Tax Day. We also know that, thanks to the President and Republican Congress, we now have a 3 percent growth tax code.

We know that 90 percent of all Americans are now receiving better take-home pay because of this act. And people are seeing pay increases, 401(k) increases, and job expansion all over the Nation. That is the good news.

We may have a 3 percent tax policy in America, but we do not yet have a 3 percent of capital markets and banking policy in America. And we need one; 3 percent growth makes a huge difference in the lives of our countrymen.

Since the time that I have been on the face of the planet, a little over half of the years have seen 3 percent growth, and a little less than half the years have seen less than 3 percent growth.

Chairman HENSARLING. In those years that have seen 3 percent growth, four-fifths of all the jobs that were created in my lifetime were created in 3 percent growth years. Poverty fell by almost three-quarters and real median household income grew by approximately $20,000.

In the years since I was born where the economy grew less than 3 percent, only one-fifth of the jobs were created, the poverty rate rose by over a third, and household income fell by over $10,000.

For the average family in America, 3 percent growth is the line of demarcation which determines whether all their work and sacrifice for the year will actually translate into getting ahead. So it is important that we get it right.

And we all know that Dodd-Frank, regardless of what it may have done for financial stability, is perhaps the most complex, costly, confusing regulatory onslaught onto our capital markets that we have seen. Many market participants, in fact, believe that it has cut 0.5 percent to 1 percent of GDP.

That is why, Governor Quarles, we very much welcome your call for efficiency, transparency, and simplicity in regulation, because we also know that, in a post-Dodd-Frank world, the Fed is now our uber-financial regulator. And I particularly appreciate your call for efficiency to make sure that "the cost of regulation in reduced economic growth or increased frictions in the financial system is outweighed by the benefits of the regulation," to quote you. I look forward to hearing more in your testimony.

The Chair now yields 4 minutes to the Ranking Member for an opening statement.

Ms. WATERS. Thank you, Mr. Chairman, and welcome, Vice Chairman Quarles. I look forward to hearing Vice Chairman Quarles' testimony today on the Federal Reserve Bank's supervision and enforcement activities.

I want to point out that the position of Vice Chairman for Supervision was created following the financial crisis as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act as one of several steps to address the Fed's insufficient supervision and enforcement leading into the crisis.

Vice Chairman Quarles is, in fact, the first person to officially hold this important role that is critical in keeping our financial system safe and sound.

I was encouraged when the Fed took action under then-Chair Janet Yellen and initiated a strong enforcement action against Wells Fargo for its egregious consumer abuses and capped the bank's growth until it cleans up its act.

Of particular significance is the fact that this enforcement action is not just a fine, but it comes attached with real consequences for

Wells Fargo, which is a repeat offender with a terrible track record of harming consumers, including by opening up millions of fraudulent accounts without their customers' consent.

I hope to see that they continue to strongly use its enforcement tools. We need our independent regulators to be vigilant in carrying out their statutory duties and make robust use of their authorities to crack down on bad actors.

Sadly, that independence is under attack. Just last week, Office of Management and Budget Director Mick Mulvaney, who was unlawfully appointed by President Trump to serve as acting director of the Consumer Financial Protection Bureau, testified before this committee.

Mr. Mulvaney's illegal appointment—there have been zero enforcement actions by the Consumer Bureau since his appointment, and he has taken a series of actions to weaken the agency's ability to carry out this important mission and benefit the predatory actors that the agency is designed to police.

Indeed, the Trump Administration and my colleagues across the aisle are working to move our system of banking regulation in exactly the wrong direction in their efforts to dismantle the crucial reforms that Democrats put in place in Dodd-Frank.

These efforts at deregulation come at a time of record bank profits for banks of all sizes. But, even though the banks are making money hand over fist, this President and Republicans in Congress are pushing hard to help out the Nation's largest banks.

Nearly every week, Republicans push through harmful legislation that undermines Dodd-Frank. I am also very concerned by the recent proposal from the Fed that would lower the capital buffer at the eight largest banks by a combined $112 billion.

Under this proposal, Wells Fargo, for example, would be allowed to hold 20 billion less in capital than the current standard for a well-capitalized bank of its size.

I look forward to discussing these and other important issues with Vice Chairman Quarles here today. And thank you. I yield back the balance of my time.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, the Chairman of the Financial Institutions and Consumer Credit Subcommittee, for 1 minute.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Vice Chairman Quarles, welcome.

As we all know, the Federal Reserve Board was without a designated Vice Chair for Supervision for almost a decade. With your appointment, that position has finally been filled, and we are pleased to have you here today, Mr. Quarles. Welcome.

Since your initial confirmation in October, you have made many statements outlining your agenda and your intentions. I wholeheartedly agree that it is time to step back and do a comprehensive examination of the previous Administration's regulatory regime.

Looking forward, there is an immense amount of work to be done. As we assess the Federal Reserve's role, we must ensure a more practical approach to supervision, one that extends from the top, all the way down to each and every field examiner.

We also need to ensure the Federal Reserve adequately and appropriately tailors its supervisory approach on an institution-by-institution basis and puts more thought into the manner in which it regulates and examines.

I am confident you will make the critical changes needed to benefit our economy and improve the stability and productivity of our financial system. I look forward to your testimony today.

With that, Mr. Chairman, I yield back. Welcome.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Michigan, Mr. Kildee, the Vice Ranking Member, for 1 minute.

Mr. KILDEE. Thank you, Mr. Chairman and Madam Ranking Member. And, Mr. Quarles, welcome. We appreciate your testimony today.

I have been an advocate for pushing our Federal Government, at every level, to focus more attention on the struggles that America's older industrial cities, old cities and towns face, many of them that continue to be left behind even during periods of economic growth.

The regional banks have done some interesting work in this space, particularly the Cleveland and Boston banks recently, but the Philly and Minneapolis banks have also focused some attention on this.

What I am interested in hearing from you are any thoughts you have about how the supervisory authority of the Fed—the levers that come with that authority can be used not just for the purposes of streamlining the regulatory process, but those levers could be used in ways to increase the efficiency, the efficacy of the Community Reinvestment Act, access to credit—essentially trying to use the tools you have to ensure that there is equity in the way the financial system works, particularly in those places with high unemployment, high levels of poverty, like my hometown of Flint, Michigan.

So thank you for your appearance here today and I look forward to your testimony.

Chairman HENSARLING. Time of the gentleman has expired.

The Chair now recognizes yet another gentleman from Michigan, Mr. Huizenga, the Chairman of the Capital Markets Subcommittee, for 1 minute.

Mr. HUIZENGA. Thank you Mr. Chairman, and happy Tax Day, Vice Chair Quarles, I—I would use air quotes, but, for many of us, we believe that this is the beginning of a better situation.

As the former Chair of the Monetary Policy and Trade Subcommittee that had oversight of the Fed, I watched very closely as the enactment of Dodd-Frank supercharged the Federal Reserve, bestowing on it even more power, influence, and control over the financial system, all while remaining shrouded in mystery to the American people. That is something we hear consistently, is that people don't understand what the Fed does.

Specifically, Title 11 of the Dodd-Frank Act created a new position of the Vice Chair of Supervision. And we are very pleased that you have taken that position.

On February 22, in a speech that you gave, you mentioned that the Federal Reserve and other regulatory agencies have completed the bulk of the work of post-crisis regulation.

And I quote, "as such, now, it is eminently natural and expected time to step back and assess those efforts. It is our responsibility to ensure that they are working as intended. And, given the breadth and complexity of this new body regulation, it is inevitable that we will be able to improve them, especially with the benefit of experience and hindsight."

Mr. Quarles, as has been noted, we have been waiting a long time, and I appreciate this thoughtful retrospective view is happening as we drive this economy forward.

I yield back.

Chairman HENSARLING. Time of the gentleman has expired.

Indeed, today, we now welcome the testimony of the Honorable Randal K. Quarles, the first Vice Chairman for Supervision at the Federal Reserve. Pursuant to Section 1108 of the Dodd-Frank Act, President Trump nominated Mr. Quarles to serve as Vice Chairman for Supervision.

He became a member of the Board of Governors of the Federal Reserve on October 13 of last year to fill an unexpired term. He was sworn in as Vice Chairman for Supervision on October 13, 2017, for a term of 4 years, through October 13, 2021.

Prior to his appointment to the board, Mr. Quarles was Founder and Managing Director of the Cynosure Group, a Utah-based investment firm. Before founding that group, Mr. Quarles was a partner at the Carlyle Group, a private equity firm based here in Washington, D.C.

Mr. Quarles has previously served in public service, having served as Undersecretary of the Treasury for domestic finance, Assistant Secretary of the Treasury for international affairs, policy Chair of the Committee on Foreign Investment in the United States, and the U.S. Executive Director of the International Monetary Fund.

Mr. Quarles received an A.B. in philosophy and economics, summa cum laude, from Columbia and earned a law degree from the Yale Law School. Without objection, the witness's written statement will be made part of the record.

The Chair wishes to inform all members that I expect to excuse the witness no later than 2 p.m. this afternoon and no intervening floor votes are expected at this time.

Mr. Quarles, you are now recognized to give an oral presentation of your testimony. Again, welcome. But you do need to press the button for the microphone.

STATEMENT OF THE HON. RANDAL QUARLES

Mr. QUARLES. Thank you very much, Chairman Hensarling, Ranking Member Waters, other members of the committee. It is a pleasure to appear before you today. And I appreciate the opportunity to testify on the Federal Reserve's regulation and supervision of financial institutions.

The Federal Reserve, along with the other U.S. banking agencies, has made substantial progress in building stronger regulatory and supervisory programs since the global financial crisis, especially with respect to the largest and the most systemically important firms.

These improvements have helped to build a more resilient financial system, one that is well-positioned to provide American consumers, businesses, and communities access to the credit they need, even under challenging economic conditions.

At the same time, we are mindful that, just as there is a strong public interest in the safety and soundness of the financial system, there is a strong public interest in the efficiency of the financial system.

Our financial sector is the critical mechanism for directing the flow of savings and investment in our economy in ways that support economic growth. And economic growth, in turn, is the fundamental precondition for the continuing improvement in the living standards of all of our citizens that has been one of the outstanding achievements of our country.

As a result, the regulation of that system should support and promote the system's efficiency just as it promotes its safety. And, moreover, our achievement of these objectives will be improved when we pursue them through processes that are as transparent as possible and through measures that are clear and simple, rather than needlessly complex.

In my testimony today, I will review our regulatory and supervisory agenda to improve the effectiveness of the post-crisis framework through these principles of efficiency, transparency, and simplicity. I have also included an update on the condition of the industry and the Federal Reserve's engagement with foreign regulators in my written testimony.

So, to begin with efficiency measures, last week, the board and the Office of the Comptroller of the Currency (OCC) issued a proposal that would recalibrate the enhanced supplementary leverage ratio, or the ESLR, applicable to our global systemically important banks, or G-SIBs.

The proposal would calibrate the ESLR so that it is less likely to act as a primary constraint, which can actually encourage excessive risk-taking, while still continuing to serve as a meaningful backstop.

Last year, the board also adopted a rule that eliminated the so-called qualitative objection of the Federal Reserve's CCAR (Comprehensive Capital Analysis and Review) exercise for mid-size firms that pose less systemic risk. As a result, deficiencies in the capital planning processes of those firms will be addressed in the normal course of supervision.

And I believe this approach should also be considered for a broader range of firms. And, last week, we called for comment on that potential expansion.

On the subject of tailoring, I support Congressional efforts regarding tailoring as offered in both the House and Senate. In addition to this potential legislation, there are further measures I believe we can take to match the content of our regulation to the character and risk of the institutions being regulated.

For example, I believe it is time to take concrete steps toward calibrating liquidity coverage ratio requirements differently for non-G-SIBs than for G-SIBs. I also think we can improve the efficiency of our requirements regarding living wills.

U.S. banking agencies have also taken a number of steps to advance more efficient and effective supervisory programs. For example, the agencies recently increased the threshold for acquiring an appraisal on commercial real estate loans from $250,000, to $500,000, which doesn't pose a risk to safety and soundness.

The Federal Reserve has also instituted various measures to clarify and streamline its overall approach to the supervision of community and regional banks in particular, which is detailed in my written testimony.

Transparency is essential to the Federal Reserve's mission in supervision, no less than in monetary policy. Late last year, in the first material proposal following my confirmation, the board released for public comment an enhanced stress testing transparency package.

The proposal would provide greater visibility into the supervisory models that often determine their binding capital constraints. And we are continuing to think about how we can make the stress testing process more transparent without undermining the strength and usefulness of the supervisory test.

Looking ahead, we are also in the process of developing a revised framework for determining control under the Bank Holding Company Act. A more transparent framework should, among other things, facilitate the raising of capital by community banks, where control issues are generally more prevalent.

Simplicity of regulation promotes public understanding and compliance by the industry with regulation. Just last week, the Federal Reserve issued a proposal that would effectively integrate the results of the supervisory stress test into our non-stress capital requirements. For the largest bank holding companies, that would reduce the loss absorbency requirements from 24 to 14.

We estimate that the proposed changes would generally maintain—in some cases, modestly increase—the minimum risk-based capital required for the G-SIBs, although no bank would actually be required to raise capital because their existing capitals are well above those minimums, and generally modestly decrease the amount of risk-based capital required for most non-G-SIBs.

Our fellow regulators are also working with us to further tailor implementation of the Volcker Rule and to reduce burden particularly for firms that do not have large trading operations and don't engage in the sorts of activities that may give rise to proprietary trading.

In conclusion, the reforms we have adopted since the financial crisis represent a substantial strengthening of the Federal Reserve's regulatory framework, should help ensure that the U.S. financial system remains able to fulfill its vital role of supporting the economy. We will do everything we can to fulfill the responsibility that has been entrusted to us by the Congress and by the American people.

Thank you again for the opportunity to testify before you this morning. I am looking forward to answering your questions.

[The prepared statement of Mr. Quarles can be found on page 56 of the Appendix.]

Chairman HENSARLING. Thank you, Chairman Quarles. The Chair now yields himself 5 minutes for questions.

As you heard in my opening statement, I am very concerned with the policies and the implementation of the policies that are necessary to sustain long-term, 3 percent plus economic growth.

And I am somewhat fearful, sometimes, that one day, I may wake up and find out that our financial firms have been turned into the equivalent of public utilities, which will not be commensurate with 3 percent economic growth.

So I have raised this issue before, and that is the whole issue of supervision versus corporate governance. A number of institutions have come to this committee to say that representatives of the Fed have insisted on attending meetings of the board of directors or committee meetings of the board of directors.

So my question is, do you believe that the Fed has the legal authority to demand attendance at board meetings? And, if so, why is this a wise policy?

Mr. QUARLES. I actually can get back to you on the answer of what our legal authority is.

I think the more important question is, is it a wise policy? And we ought to be focusing as supervisors on ensuring that boards are structured in order to be able to do their jobs and that our supervisory and regulatory requirements of them support their fulfilling their roles in the corporate organization.

We came out, as you know, with a board effectiveness guidance proposal last August, when now-Chairman Powell was then responsible for the supervisory and regulatory affairs of the board. And the purpose of that guidance was precisely to scale back some of the excessive micromanagement and misdirection of board—

Chairman HENSARLING. So that is its purpose. I must admit, I have heard from several who believe that it may have the opposite impact in bringing the board more into day-to-day management. So I am heartened to hear that you think it will have the opposite effect.

Let me run a couple of other situations by you. This committee has heard that some Fed examiners have made recommendations to management that certain board members, if you will, be fired. Again, does the Fed have the legal authority to make those recommendations? And, if so, is that wise policy?

Mr. QUARLES. So, again, on the legal authority, I will get back to you with a legal analysis of what our legal authority is.

Chairman HENSARLING. I would appreciate that.

Mr. QUARLES. I do think that, at the highest level, it probably shouldn't be something that, at the direct supervisory team level, would be engaged.

At the highest level, if there were serious concerns about the fitness of a director, I think that probably is something that, at the highest level of the Fed, we should weigh in on. But those would be extremely rare cases, I think.

Chairman HENSARLING. Something else we have heard that the Fed has weighed in on—we had representatives from one large diversified financial services company say their examiners question them about their lobbying activities.

Now, the right to petition your Government for the redress of grievances is enshrined in the Constitution. I assume you would agree that the Federal Reserve Act of 1913 does not trump the

Constitution. Why would it be appropriate supervisory questioning to question one's lobbying activities?

Mr. QUARLES. I can't think of any reason.

Chairman HENSARLING. Is that going to continue under your watch?

Mr. QUARLES. Now that I am aware of it, no.

Chairman HENSARLING. OK.

Again, as you know, typically, corporate governance is determined by State laws. There are, frankly, hundreds of years of case law. I am somewhat concerned, is the Fed trying to supplant itself over State corporate governance law? Where is the line to be drawn between supervision and corporate governance? Because it is getting rather murky.

Mr. QUARLES. So it certainly is our intention, actually, to demurkify that whole area. And that was the intention behind the board effectiveness guidance.

We are receiving comments on that. We have received comments on that and are evaluating them. And I will certainly be looking at those comments through the lens of ensuring that we are providing a clear framework for—that allows bank directors and bank holding company directors—

Chairman HENSARLING. Well, to borrow your phrase, there appears to be a lot of de-murkification to go.

My time has expired. The Chair now yields to the Ranking Member.

Ms. WATERS. Thank you very much.

Could you tell me why you have recused yourself on all matters related to Wells Fargo?

Mr. QUARLES. Thank you. Well, as you know, I do not have a legal conflict with respect to Wells Fargo. I completely cleared that legal conflict.

In reflecting on some of the issues that were facing the board, I thought that it was appropriate to go beyond the mere requirements of the law and avoid even any appearance of an issue.

As some of the members of the committee know, my wife's family had a historical connection with a bank that was acquired by Wells Fargo. It was many years ago now.

So even though it was not required by the law and I do not have a conflict, I thought that it was appropriate for me to go above and beyond and avoid even the question.

Ms. WATERS. The Center for Investigative Reporting published several articles after a year-long investigation of 31 million records publicly available under the Home Mortgage Disclosure Act—that is, HMDA—to identify lending disparities.

Using Philadelphia as a case study, the reporters wrote, I quote, Lending patterns in Philadelphia today resemble redlining maps drawn across the country by Government officials in the 1930's, when lending discrimination was legal, quote, unquote.

The report noted that, despite this evidence of discriminatory lending, 99 percent of banks were deemed satisfactory or outstanding based on inspections administered under the Community Reinvestment Act, a 40-year-old law designed to reverse rampant redlining.

Would you agree that the CRA (Community Reinvestment Act) test is not vigorous enough if nearly all banks get good grades on the CRA exams, and yet discriminatory lending practices remain pervasive in 2018?

Put another way, if 10 banks lend to one side of a city and no banks lend to the other side of the city, how can regulators change this dynamic and implement CRA to ensure banks which are backed by all of that city's residents as taxpayers fully serve the convenience and needs of entire city's residents?

Mr. QUARLES. In reflecting on the current state of the Community Reinvestment Act and ways to improve its application, I think that is an important focus for the regulatory agencies currently.

As you know, the Treasury Department recently put out a report for ways to improve and invigorate the application of CRA. I think that that is something that we should be strongly engaged in.

Ms. WATERS. So do you support the Treasury's recommendations?

Mr. QUARLES. As I have reviewed them, yes, I think that it lays out a good framework for consideration. There are a lot of details that will remain to be decided by the regulatory agencies. But I think that it is a good map.

Ms. WATERS. Do you have any concerns at all about the satisfactory reports of these banks—99 percent, I suppose, satisfactory ratings, even though we have redlining? What do you think about that? What would you do about that?

Mr. QUARLES. Well, I think one of the issues that I, at least, have seen with respect to CRA is that, over the years, it has become a little formulaic and ossified.

And the ways in which both banks themselves and community development institutions themselves would like to—the activity that they would like to see happen really isn't the path of least resistance under practices that have developed under the CRA.

I think moving CRA off autopilot, which is one of the principal benefits, I think, of the Treasury review and of the efforts that are being undertaken by the banking regulators currently, is something that we should be doing and that would help address some of the issues that you have raised.

Ms. WATERS. So when you say you would move them off autopilot, have you determined that they simply get these satisfactory ratings without requirements that would make them better and more effective? Or are you saying that they are just ignored—the requirements now? What are you saying?

Mr. QUARLES. No, I am saying that the banks have developed ways of complying with the law out of genuine desire to comply. The examiners have developed expectations about what they know will be viewed by the community as passing.

Community development institutions have developed, again, practices and expectations. And all of that could be, really, broadened to have greater effect, as opposed to moving down the path of least resistance.

It is not as though the law is being ignored. It is just we have gotten comfortable in how it can be applied, and we really ought to think about ways to apply it more effectively.

Ms. WATERS. Thank you. I yield back.

Chairman HENSARLING. Time of the gentlelady has expired. The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, Chairman of our Financial Institutions Subcommittee.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Quarles, over the years, a large amount of agency guidance, handbooks and circulars have been issued. Almost none of it has ever been withdrawn or rescinded.

Almost none of it went through notice and comment rulemaking or was submitted to Congress, pursuant to the Congressional Review Act. Should banks and examiners be treating this guidance as binding rules?

Mr. QUARLES. No. I do think that there is a role for guidance. I think that it is clear that, in some instances, the practices of the banking regulators have blurred the role between guidance and rules.

If something is to be a binding rule, both our obligation of democratic accountability, as well as our desire to see that rule be as effective as possible and therefore receive as much comment as possible, would require us to go through a transparent rulemaking process. That is good for both of those reasons.

Guidance does have a role. The banks, in fact, want to know, once a rule has been made, if there are—where there are questions of interpretation. But we need to make sure that that guidance really is just guidance and doesn't supplant the rulemaking process.

Mr. LUETKEMEYER. Well, I appreciate that.

I think, we hear consistently and frequently from banks that, these rules are sometimes being enforced as something more than just—guidance is being enforced as a rule, versus whatever.

The other day, we had Chairman Powell here. He made a comment that guidance is guidance and rules are rules. So I look forward to some progress on this. So thank you for your comment.

The DOJ (Department of Justice) has issued a memorandum prohibiting the department from issuing guidance documents that effectively bind the public without undergoing the notice and comment process.

It goes on to prohibit DOJ from using guidance to require regulated parties to take any action beyond what is required by the terms of the applicable statute or lawful regulation. Would you support the Fed issuing a guidance policy along the lines of what DOJ just put out?

Mr. QUARLES. We are considering—we have communicated that message that guidance is guidance and rules are rules to our examiners and throughout the supervisory system. We are considering the right way to further formalize that. I think that is a salutary process, yes.

Mr. LUETKEMEYER. One of the—I have got a couple more questions here, but I want to make sure I get to this one with regards to cost-benefit analysis.

Although Executive branch agencies are subject to mandatory cost-benefit analysis requirements, independent agencies, such as the Federal Reserve, are not. There is no statute that generally imposes on the Fed a requirement to perform regulatory impact analysis or cost-benefit analysis.

However, during a January 19th speech at the American Bar Association Banking Law Committee Annual Meeting, which is a mouthful, Vice Chairman, you indicated additional efforts to implement cost-benefit analysis. And I won't go into your comment, but—because it is quite lengthy, but it is—also is very instructive.

Furthermore, it has been reported that the Federal Reserve has created a new department named the Policy Effectiveness and Assessment Committee, charged with conducting cost-benefit analysis on regulations.

No. 1, would you like to elaborate on these comments? And, No. 2, can you explain the creation of this new department, and is it being used?

Mr. QUARLES. As you have indicated, the thrust of my comments—and as I indicated in my opening remarks to the testimony—we have a very strong public interest in ensuring that our financial system and our regulation of the financial system are efficient, as well as that they are promoting safety and soundness.

And that necessarily involves an assessment of the costs versus the benefits of regulation, both the direct costs of compliance that are imposed on institutions, as well as the larger question of the effectiveness of the regulation in achieving an objective, versus the broader costs that are created by that regulation.

We are looking at that at the Fed. We have stood up a group of economists that are examining the body of post-crisis regulation through those lenses to determine exactly how we measure the effectiveness of the key areas of capital and liquidity and resolution effectiveness.

And I will be looking—that—that is a complicated and lengthy process, and I am looking forward to the results of their work.

Mr. LUETKEMEYER. Well, as you know, with Dodd-Frank, we have a lot of community banks and credit unions going out of business because of the cost of compliance. And I would hope—this is a really important question I would just ask you with regards to cost-benefit analysis.

While a rule may be well-intentioned, if it is going to drive businesses out of business so there is a limit—access to credit, or raises cost for that credit or ability to do financial services work, it really harms the consumer, and we have to really think about that.

Thank you very much.

Chairman HENSARLING. Time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney, Ranking Member of the Capital Markets Subcommittee.

Mrs. MALONEY. Thank you, Mr. Chairman.

Governor Quarles, as you know, the Senate's banking bill, sponsored by Senator Crapo, includes a provision that would allow custody banks to exclude reserves that they hold at the central bank from the supplemental leverage ratio, or SLR.

And then, just last week, the Fed and the OCC proposed an amendment to the SLR that is intended to address the same custody bank issue that Section 402 does. So in your view, do the Fed's proposed changes to the SLR make Section 402 of the Crapo bill unnecessary?

Mr. QUARLES. No, I wouldn't say that they make that unnecessary. Both our objective and the objective of that provision, as you know, are to adjust the ESLR so that it is not a primary binding measure, because, when you have a leverage ratio that is creating the incentives for decisions at the margin, because that leverage ratio isn't risk-sensitive, that means that your decisions at the margin will not be risk-sensitive. You will have an incentive to basically take on more risk.

So I think it is important to calibrate that down. There are two ways to do it. The Crapo bill has proposed one way. Our regulatory proposal, it would accomplish it in a different fashion.

Mrs. MALONEY. So you see them coexisting? You see them coexisting?

Mr. QUARLES. Yes. If that provision in the Senate bill were to become law, I think we would then have to consider how to calibrate our proposal to take account of the fact that certain banks would have had the denominator of the ESLR changed for them. That would be appropriate, if that does become law.

Mrs. MALONEY. And, as you know, the Fed proposed a package of changes designed to increase the transparency of the Fed's stress test last December. Personally, I believe that the Fed's proposal is more than adequate to address transparency issues.

You have stated that you believe that these disclosures should, quote, go further, and that the proposed changes don't go far enough to provide visibility into the stress test models. So my question is, what additional disclosures do you think should be made about the stress test models?

Mr. QUARLES. So we have received a lot of comments, as you might expect, on that proposal, and we are in the process of carefully examining those comments. So I don't want to, at this point, say exactly where we would land.

I think it is clear from the thrust and the strength of the arguments in those comments that there are areas where we will be able to provide more transparency without undermining the effectiveness of—

Mrs. MALONEY. But which areas? Do you know which areas?

Mr. QUARLES. I think one example that we do want to consider and where we had called for comment is with respect to the scenario design itself, as opposed to simply the models of that are used in the stress test.

You know, I think that we would actually benefit, and the credibility of the scenarios would benefit, from some period—not an excessively long period—but for some appropriate period of input from the public on those scenarios, each year.

Mrs. MALONEY. Thank you.

I want to ask about the Financial Stability Board, or FSB, which is an international body of all the major financial regulators, including the Fed, to monitor—where they monitor the global financial stability. Do you believe it is in the country's interest to participate in the FSB?

Mr. QUARLES. I actually do, yes. I think it is actually—we have a strong national interest with respect to—

Mrs. MALONEY. What about—my time is almost up—what about the—is it important for the U.S. banking regulators to participate in the Basel Committee on Banking Supervision?

Mr. QUARLES. Yes. To ensure a level playing field for our banks, we need to be able to influence those decisions and not—

Mrs. MALONEY. And so do you believe that it would harm the American banking system if they pulled out of Basel and the FSB?

Mr. QUARLES. I think that the processes of those institutions can be improved. I think that we can improve their transparency. Even they have acknowledged that. But I do think that we should remain engaged in them, yes.

Mrs. MALONEY. Thank you, my time has expired.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, Chairman of our Capital Markets Subcommittee.

Mr. HUIZENGA. Thank you, Mr. Chairman.

And I want to—Mr. Quarles, I want to revisit the issue that you had talked about with the Chairman, in his questioning, and that—you twice said that you would need to, quote, get back to you on the legalities of the Fed involvement at the board level.

And it seems to me that this is a crucial question to—to what the boundaries of intrusion into the day-to-day management of a company that the Fed has as a regulator.

Somewhat to that—to that point, I would like to, Mr. Chairman, submit for the record a joint letter that myself and Chairman Barr and Chairman Duffy have sent you. I haven't expected that—since it was dated Friday, you probably haven't seen it as of yet, unless you were in the office on the weekend, so—

Chairman HENSARLING. Without objection.

Mr. HUIZENGA. The—and what it is, is specifically the supervisory expectations for board directors. It was docket number OP-1570 on guidance. We write you with some concern that potential to further empower the Federal Reserve to manage—to address the regulatory overreach in the boardroom has placed undue burdens on bank boards.

I don't want to read the whole letter here, but, although the proposed guidance purports to distinguish between the role of the board, one of oversight and guidance, and the role of management, day-to-day functions, it continues to inappropriately blur these lines by creating numerous new requirements that a board, quote, "ensure, establish, approve, set, develop or detail"—all of those were in closed quotes—items that simply do not reflect boards' oversight of and guidance to management.

As such, these terms would impose new legal and managerial requirements on a board that would have the board direct a bank holding company's daily business decisions.

I think this really gets to what both the Chairman and a number of us have said is, if you have a financial institution that is not in trouble, that hasn't tripped any of these legal wires. Really, what is the legal standing for the Federal Reserve and its regulators to come in and be involved with board decisions, much less discussions with committees of that?

So, again, as I said, we must establish those legal boundaries of intrusion by the Fed. So I look forward to your response to this letter.

I do want to—

Mr. QUARLES. And I actually have seen the letter, Congressman.

Mr. HUIZENGA. Well, I commend you for that. So glad to hear that.

I do also want to move on, real quickly, to Volcker. And, on page 10 of your testimony, you address it briefly. And I think you acknowledge what many of us are concerned about, is that it is very complex and it has not been working well.

And, as you say, while the fundamental premise of the rule is simple, the implementing regulation is exceedingly complex. And you talk about the fellow regulators working to further tailor implementation of that. Could you tell us exactly who you are working with as those fellow regulators and what they are doing?

Mr. QUARLES. Yes. There is engagement from the top of the five Volcker agencies, down. That is the CFTC (Commodity Futures Trading Commission), the SEC (U.S. Securities and Exchange Commission), the FDIC (Federal Deposit Insurance Corporation), the OCC, and the Fed.

Mr. HUIZENGA. All an alphabet soup of regulators, I might add.

Mr. QUARLES. Yes.

Mr. HUIZENGA. We have five regulators that are in charge of this.

Mr. QUARLES. Yes. It is a five-headed hydra. And there are certain collective action issues with that. But I would say that over the last few months, we have been working together. The other regulators have been working with the Federal Reserve to develop a revised Volcker Rule proposal.

Mr. HUIZENGA. Is the Volcker Rule, as it is written, detrimental to capital markets right now?

Mr. QUARLES. I think that is unarguable. The extent of the effect on liquidity is something that economists do argue about. But that there is a consequence and simply that there is an excessive burden as a result of the Volcker Rule—great deal of uncertainty, a great deal of cost—I think that part is unarguable.

Mr. HUIZENGA. And do the board or any other regulators tasked with implementation—those five others—can you repeal the Volcker Rule, given the Volcker Rule is technically under the Bank Holding Company Act?

Mr. QUARLES. We can't repeal the Volcker Rule, and there are certain limits on our ability to make changes that we might otherwise have thought appropriate because of the terms of the statute itself.

But there is a lot that we can do to increase the certainty of application, to reduce the burden of application. And the other agencies are working with us, really, quite well together in order to effect that.

Mr. HUIZENGA. We will be watching closely. My time has expired. I appreciate it. Thank you.

Chairman HENSARLING. Time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Quarles, news reports indicate that the Fed and the FDIC have been participating in discussions with the OCC over potential changes to the C.R. But it remains unclear whether the Fed and the FDIC will sign on to the OCC's advance notice of proposed rulemaking.

What can you tell us about these discussions? Do you agree with the direction the OCC is taking?

Mr. QUARLES. So those discussions—they have had the full engagement of all three of the banking regulators. And, so far, they have been—and I have no reason to expect that that would change—they have been collaborative among all three of us.

Ms. VELAZQUEZ. Do you anticipate the Fed signing on to the OCC's ANPR (advanced notice of proposed rulemaking)?

Mr. QUARLES. So I think that there will be a joint ANPR that comes out. Right now, I do expect that to be a joint proposal.

Ms. VELAZQUEZ. Well, Mr. Quarles, I just would like to say that the C.R. is extremely important for LMI communities. While I agree that there is a need to look at the CRA, I would be very concerned with any proposal that drives investment away from these communities.

Mr. Quarles, I have a question about Wells Fargo—submitted plans. But I hear you. You said that you have recused yourself from any matters as it relates to Wells Fargo.

But my message to you and to Wells Fargo is that we are watching Wells Fargo. And we want to make sure that the concerns—or the consumer abuses that Wells Fargo engage in are put to an end.

Mr. QUARLES. Thank you, ma'am.

Ms. VELAZQUEZ. Regarding the asset cap, I echo the statement of the Ranking Member with regard to Wells Fargo as a cap. And I will be concerned if it is removed too soon.

Chairman Quarles, last week, the Fed proposed loosening the supplementary leverage ratio for the eight largest U.S. banks. While the OCC joined the Fed in the proposal, the FDIC did not. And FDIC Chairman Martin Gruenberg specifically cited the reductions in the capital requirements as the reason the FDIC did not join the Fed and the OCC.

And he went on to say that strengthening the leverage capital requirements for the largest, most systematically important banks was among the most important post-crisis reforms. What do you think of the FDIC's decision not to join the proposal? And how would you respond to Chairman Gruenberg's statement?

Mr. QUARLES. I agree that the emphasis on leverage capital ratios after the crisis has been important. And, frankly, that was something that I learned from the crisis. I have a higher estimation of the role of leverage capital ratios in the overall capital regime, given the consequence of the crisis, than I did before.

I do think, however, that their role is as a backstop and that the most effective and efficient capital ratios are those that are risk-sensitive.

If we allow the—any of the various leverage ratios that we have—but if we allow a leverage capital measure to be the marginally effective capital measure for an institution that drives decisions at the margin, then we are creating a regulatory incentive for that institution to add risk, rather than to reduce risk, and we probably shouldn't do that.

And so, in evaluating the changes that we proposed to the SLR last week I looked at what was a relatively modest capital reduction under that leverage ratio—it was a few hundred million dollars out of the many, many, many billions of dollars of capital in the system, against the benefit of changing that incentive, and I thought that this was the right time to do it.

Ms. VELAZQUEZ. Wouldn't that be a slippery slope? You are going to start with a low reduction, and then go on to reduce it more?

Let me just say this: We took substantial steps to raise capital to ensure that the largest banks do not threaten the financial system. And I will tend to agree with Chairman Gruenberg that any proposal to lower the capital requirements is a bad idea.

I yield back.

Chairman HENSARLING. The gentlelady's time has expired. With that the Chair recognizes the gentleman from Wisconsin, Mr. Duffy, the Chairman of the Housing and Insurance Subcommittee.

Mr. DUFFY. Thank you Mr. Chairman. And, Mr. Quarles, welcome. It is, as my colleagues have mentioned, nice to have you here and testifying before the committee. As we have complained, it has been long overdue. So, welcome.

I first want to thank you for your ongoing work to evaluate the systemic risk, or lack thereof, of our U.S. insurance industry; thank you for that. Now, we all know that you have direct oversight over our savings and loan holding companies and those that have been designated as SIFIs (systemically important financial institutions) by FSOC (Financial Stability Oversight Council).

But you have a more indirect role through international insurance standards setting with the Fed's seat on the FSB and the IAIS (International Association of Insurance Supervisors). The IAIS is developing international capital standards similar to our European solvency standards. First for you, do you believe that our State-based insurance regulatory model has been effective in the U.S.?

Mr. QUARLES. Yes. I think that, over the long life of insurance regulation that has been—

Mr. DUFFY. A hundred-plus years, it has been pretty effective, right?

Mr. QUARLES. Yes.

Mr. DUFFY. OK. And so will you commit that the Federal Reserve and your work with Treasury will make clear that we will not cede our regulatory system and move forward with the development of a European-centric international capital standard unless IAIS leadership acknowledges the U.S. insurance regulatory system has—as satisfying any IAIS credit standards—making sure that we are preserving our U.S. model, not ceding our U.S. model to a now European-centric model?

Mr. QUARLES. In those discussions, the Federal Reserve has been a voice for the so-called building-block approach to capital regulation that is, that has been supported through the U.S. processes. And we will certainly continue to do that.

Mr. DUFFY. So—but in regard to trying to preserve our State-based model here, what is your view as you negotiate with the IAIS?

Mr. QUARLES. Well, we certainly—we both wouldn't and couldn't, just given the nature of those bodies, do anything that would affect the Federal distribution of—well, by—Federal with a small f—distribution of insurance regulation in this country.

Mr. DUFFY. Some of us might disagree with what you actually can do through international negotiations and agreements. But let's leave that aside, and hopefully we can work together further on this issue.

I want to move—and you have had this issue brought up a couple of times by the Chairman and by Mr. Huizenga, in regard to board management and the Federal Reserve pressuring boards to fire certain members—are you aware of that actually happening? Because we have had a number of people come in and—given us feedback that that has taken place.

Mr. QUARLES. No, I am not aware of that happening. But I am not challenging that it has happened, either. I think that that is disturbing.

Mr. DUFFY. OK. And, if you are hearing this, does—as you sit here today, maybe for the first time, are you concerned that that would take place?

Mr. QUARLES. Yes. I would think that that is the—I would think that that is the sort of supervisory engagement—as I indicated with the Chairman, I don't know that it is—I don't think that it is always inappropriate that the Fed might have a view on that.

Mr. DUFFY. Let's hold on for a second—who elects the board? Give me 101 here.

Mr. QUARLES. The shareholders, obviously.

Mr. DUFFY. The shareholders do. So does the Fed have a role in electing a board?

Mr. QUARLES. If there were a profoundly unsatisfactory director—

Mr. DUFFY. So, the answer is yes, that the Fed does have a role in electing board members?

Mr. QUARLES. Well, not in electing the board members, but—

Mr. DUFFY. But firing board members that the shareholders actually elected, is that your position?

Mr. QUARLES. In very rare circumstances, I think that could be appropriate, if there is a completely unsatisfactory board member. But it should not—

Mr. DUFFY. As determined by the Fed, not by the shareholders?

Mr. QUARLES. If determined by the Fed, yes, I do think that that could be appropriate in some circumstances.

Mr. DUFFY. So, in essence, we can say the Fed, really, can step in at any point and say, We don't like—we don't like board members, we can supersede shareholders and we can put pressure to have them fired, is what you are saying today?

Mr. QUARLES. Well, the law, for example, would not allow the shareholders to elect people who have committed certain crimes from being board directors. And, if they did, it would be appropriate for the Federal Reserve to say that that is not an appropriate director. I think I am really on your side on this. I think that should be something that is extremely rare.

Mr. DUFFY. I think this is a space that you—I think you need to take a look at. It is concerning, the Fed's role here. And I think, if you take some time, we are going to be on the same page on this issue.

Mr. QUARLES. Exactly.

Mr. DUFFY. I want to look to examiners, in their exams, asking questions of financial institutions about their lobbying efforts. Would that concern you? Is that a proper role of the Fed, to ask questions about how a financial institution is lobbying the Congress?

Mr. QUARLES. I can't imagine how it would be.

Mr. DUFFY. OK. And are you going to implement policies or procedures to root this problem out?

Mr. QUARLES. Absolutely.

Mr. DUFFY. And does that come by memo, directive, e-mail? And I think you have to think about, How do I actually stop this practice—get it down to the boots on the ground and make sure this practice actually stops? And my—tapped—

Mr. HUIZENGA [presiding]. Gentleman's time has expired.

Mr. DUFFY. —tapping and I yield back.

Mr. HUIZENGA. Gentleman's time has expired.

With that, the Chair recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. How are you, Vice Chairman Quarles? Good to have you in the committee.

Mr. Quarles, in your testimony, you said this—you said that you personally believe that our stress-testing disclosures can go further, and you said that we should consider additional measures, such as publishing our stress testing scenarios out for public comment.

Well, with all due respect, I couldn't disagree with you more. Let me explain why.

I was the Democratic lead and negotiator on the stress-testing bill that we marked up in committee last week, as you know. We passed that out.

And, when I negotiated with my Republican partner, Mr. Zeldin, I negotiated out that language that would have required the Fed to publish their stress-test scenario. And let me tell you why.

I think the Fed must be very, very careful not to expose how they are going to conduct these stress tests. Because, as you all know, stress tests are meant to evaluate what happens and what may happen to a bank's assets under stress.

But if a bank knows and is aware in advance of how you are going to do the stress testing, then that bank will be able to optimize its balance sheet for that particular day on which you are doing the stress test.

So I hope you will consider that. We passed a bill. It is in there. With all due respect to you, I think your point is well taken, but I hope you understand that you can't let the cat out of the bag before it is time to get the fair adjustment.

Now, on another point on fintech, there are many people who think that fintech businesses are just in California and New York.

But, in Georgia and in Atlanta, especially, we are becoming the burgeoning capital of this new and exciting industry.

And so you also mention in your testimony, when we talked about that, that the innovations in this industry can expand access to credit, you said, including to underserved communities and small businesses, which can really benefit the economy.

I agree with you 100 percent. But I also believe that fintechs can be the answer to so many other serious problems. But here is where we are: The GAO did a report, as you know, and we talked about that. And there is a problem.

There is a lack of coordination, a lack of harmonization. Now, I am working on legislation that would give the fintechs a voice, because they need to have a point of entry into this new regulatory stream.

Second, they need to have harmonization. It is not just you in the Fed that is seeking to regulate these fintechs. You have got the OCC. You have got the CFPB (Consumer Financial Protection Bureau). You have got the CFTC. You have got all of them clamoring here.

So I wanted you to know about our legislation. I would like to work with you on that, because, of all of the regulators, it is the Fed that is the anchor of our financial system. You are the point person for that in this very good and new position that we created as the supervisor for regulation for the Fed.

And, finally, I want to just ask you if you could help us with something. My good friend, Mr. Luetkemeyer, got a bill, the SIFI bill. It passed, too. Much of what means something is coordinated into Senate bill 2155. But it is sitting in the House. People say it is going to die.

Can you help us? Can you get on the phone over there and help us move this bill and get it going?

Mr. QUARLES. Well, I am very supportive of the efforts in both the House and the Congress to further increase the legislative framework for tailoring the application of our regulation and supervisory principles to institutions, and particularly to relieve the burden on smaller institutions. I am very supportive of that.

Chairman HENSARLING [presiding]. Time of the gentleman has expired.

The Chair now recognizes the gentlelady from Missouri, Mrs. Wagner, Chairman of the Oversight and Investigations Subcommittee.

Mrs. WAGNER. I thank you, Chairman Hensarling. Vice Chairman Quarles, welcome at long last. Since I have a couple of topics that I wanted to touch on today, I will get right to the point.

In your testimony this morning, you noted that the Federal Reserve is very focused on the increased risk to all financial institutions and are working to strengthen the cyber resiliency of the financial sector.

Further, you have stated previously that cyber attacks are often connected to poor basic information technology hygiene and firms must continue to devote resources to these basics. We also know that attackers always work to be one step ahead, and we need to prepare for cyber events. Those are your words.

Recognizing that cyber attacks have increased dramatically over the last decade, do you think it is more important that cybersecurity staff at financial institutions are better using their time to protect their—their company and other critical infrastructure, or to help answer regulatory exam questions from a multitude of different regulators?

Mr. QUARLES. I think you put your finger on something that is very important. I do think—and, across the Government, there is an effort to approach this in a systematic and effective way.

You know, I do think that our supervisory engagement on the cyber issue can be improved to be better directed at actually supporting the ability of these firms to be resilient to a cyber attack.

There is a fair bit of pure compliance, as opposed to real focus on the cyber risk in our current engagement. And we need to work to improve that, and we are.

Mrs. WAGNER. I think so. We need to make sure that the companies are actually protecting themselves, thus the consumer, as opposed to dealing with a constant flow of regulatory exams and things of this nature, doing the real work that keeps us safe, keeps our information, our data, our privacy safe when it comes to cyber attacks.

Mr. QUARLES. Completely agree.

Mrs. WAGNER. Thank you.

You talked also about continuing to collaborate with our Federal agencies on this topic. Are there any specific examples of collaboration where the Federal Reserve is aligning its supervisory activity with other financial services regulatory agencies as it relates to cybersecurity?

Mr. QUARLES. So there are existing interagency processes of the Government that we participate in, and there are also—and, through the FSOC, these consider—these issues are also being considered.

So there is a fair bit of interagency engagement in trying to determine exactly what the right way to improve our focus on actual resilience, as opposed to pure compliance, if you will, can be done. We are still in the process of doing that. It is a difficult question, but an extremely important one.

Mrs. WAGNER. You say, then, you are collaborating with the FSOC?

Mr. QUARLES. Yes, with the FSOC and the FBIIC—the FBIIC, I think, is the acronym.

Mrs. WAGNER. OK. Great. Thank you.

Switching topics somewhat, I want to go back to something you said in your testimony about innovation. You talked about making sure that regulations don't stifle innovation.

But, as regulators, it is your job to make sure it is done in a responsible way. What are you doing to ensure banks understand and manage these risks?

Mr. QUARLES. So that is part of our regular supervisory engagement with the firm. You know, as part of that, we also look at the connections of a banking institutions to both their technology exposure, as well as their technology engagement. And a lot of that is individual to each type of institution, and the direct supervisory teams have individual assessments of each firm.

Mrs. WAGNER. Concerned that, by putting a large focus on systemic risk, are we discouraging innovation? Are we putting competition for consumers at risk?

Mr. QUARLES. Well, it is our job to ensure that we don't. I think that is something that we need to keep in mind.

And one of the themes that I have tried to stress in general about our regulation and supervision currently is that, I think, in the decade following the crisis, the focus was entirely on systemic risk and safety and soundness. And all—those are important, but we also need to focus equally on efficiency and innovation and supporting that.

Mrs. WAGNER. Completely agree. My time has lapsed. I thank the Chairman for his indulgence, and I thank and welcome you.

Chairman HENSARLING. Time of the gentlelady has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Cleaver, Ranking Member of our Housing and Insurance Subcommittee.

Mr. CLEAVER. Thank you, Mr. Chairman. Thank you very much for being here today.

Fintech is rapidly becoming a financial behemoth, and I would like to get your reaction to, first, this phenomenal and continuing growth, and then, secondarily, what, if any involvement in or monitoring of fintech will the Fed look at?

Mr. QUARLES. There clearly is a lot of innovation that is going on in the fintech space currently—has been for some years. And the opportunities that that creates for improvement of consumer service, I think that they are real. And we are seeing that happen.

Most of what people think of as fintech—the startup firms in various parts of the country that are creating different types of user interface to the financial system—do plug into the traditional financial sector at one point or another. They have behind them a traditional bank that is proving the funding or providing the actual payments—payment system services that the fintech firms are the interface for.

And, in the supervision of the traditional banks, we both have insight into what is happening in the fintech sector, we can look into their activities through our ability to examine them under the Bank Service Act—for example, if they are, when the connection is such that it allows that kind of examination.

And so we—I think that we do have tools, currently, that allow us to look at that sector and understand what is happening there.

Mr. CLEAVER. But nothing alarms you?

Mr. QUARLES. I wouldn't say there is anything alarming, currently. I think that there are issues that are raised, and we think about them and are addressing them.

Mr. CLEAVER. Do you believe that there is some way that fintech can help resolve the payday loan issue that impacts millions of low-income Americans?

Mr. QUARLES. Well, one of the hallmarks of fintech generally is reducing cost, and particularly for retail transactions. It is not really my role as a supervisor to make suggestions as to how that issue ought to be addressed through a particular commercial means, but—

Mr. CLEAVER. We don't care. I mean, we are not—we don't—you can do it. Go ahead.

Mr. QUARLES. But I can certainly imagine that happening. I would certainly be something that would be beneficial.

Mr. CLEAVER. Well, I am just curious, because they really are not being regulated right now. And so it would seem to me they have enormous flexibility that could be used for something that most people believe to be important.

I don't have much time left, so I apologize, but—I wanted to get into that even more with you. But let me move to the—one of the other issues that I am concerned about. And it is unemployment among African-Americans and Latinos in this country.

Through the Obama Administration, and then the Trump Administration continuing, the unemployment in the country has, blessedly, dropped significantly. All of us should be happy about it. However, the minority communities are still not dropping at the same rate as non-minorities.

Is there anything that can be done, in your portfolio, there is this issue of employment that—do you have anything in the toolbox that you think would be of help in trying to reduce minority unemployment?

Mr. QUARLES. In the Fed's toolbox, our mandate, which we pursue assiduously, is maximum employment, maximum aggregate employment. And, obviously, that has an effect, because, as maximum aggregate employment has been increasing, unemployment decreasing. Unemployment for all segments of the population, including minority segments, has been going down.

That differential remains. We don't really have the tools to address it. But we do try to provide information and analysis of it to help others who do have the tools.

Chairman HENSARLING. Time of the gentleman has expired. The Chair now recognizes the gentleman from Kentucky, Mr. Barr, Chairman of our Monetary Policy and Trade Subcommittee.

Mr. BARR. Congratulations, Mr. Vice Chairman, on your confirmation. And thank you for your testimony today recognizing that regulation should support and promote financial system efficiency just as much as regulation should support safety and soundness, because, I think as you would agree, overregulation and cost-burdening our banking system can just as much weaken our financial system and contribute to illiquidity as inadequate supervision could.

As you know, the Federal Reserve's performance as a bank regulator in the lead-up to the financial crisis has been subject to scrutiny and criticism on both sides of the aisle and across the political spectrum.

Despite having teams of resident examiners embedded in the largest financial institutions in the run-up to the financial crisis, the Fed failed to identify material weaknesses in these firms' operations and failed to identify risks that were lurking in those portfolios until it was too late.

Yet, instead of scaling back the Federal Reserve's authority, the drafters of the Dodd-Frank Act chose to double down, and they conferred broad new power on the Fed to regulate virtually every corner of the financial sector. And it can be argued that the Dodd-

Frank Act made the Federal Reserve our Nation's most powerful bureaucracy.

So, given the Fed's enormous new supervisory and regulatory powers now, an argument can be made that the Fed should be made more, not less accountable to Congress.

My question to you is, in reference to my colleague, Congressman Davidson's proposal, the Federal Reserve Regulatory Oversight Act, which would bring the non-monetary-policy-related functions of the Board of Governors into the appropriations process, what is your take on that proposal?

Mr. QUARLES. I have thought a lot about these issues and wrestled with them, because the importance of the democratic accountability of the Federal Reserve is something you know that I share. And it is important to our ability to do our jobs.

Similarly—and I know it is something that everyone in this committee shares, as well—I think that a democracy can appropriately determine, and wisely determine, to create a buffer of independence around certain functions of the country, some of the law enforcement functions, some of the monetary policy functions.

So the question is, does a proposal to bring the non-monetary-policy functions of the Federal Reserve—how does it balance those two objectives—democratic accountability and independence around the monetary policy function?

I am concerned that it would, because of the fungibility of money, create the possibility for some future Congress to put pressure on the monetary policy side.

Mr. BARR. Well, I would like to work with you on that. My time is running out, so I want to move on, but I want to work with you on that—

Mr. QUARLES. And I very much so—

Mr. BARR. I think there are—I respect the Fed's independence, as Chairman of the subcommittee oversight over monetary policy, I respect Fed independence with respect to monetary policy.

But, with respect to your jurisdiction and supervision and regulation, the Fed arguably is the most significant, powerful regulator in America with respect to financial services.

And I think it is altogether appropriate, no matter what your perspective—whether there is too little or too great regulation—there should be accountability. And I want to work with you on that, and Mr. Davidson, to make the Fed more accountable with respect to regulation.

And, to that end, the Fed's decision to reduce the burden of stress tests on non-complex firms by focusing the qualitative review and CCAR to the largest, most complex financial institutions, I believe, is a good first step. And I compliment the Fed on that.

However, with regard to the Fed's newly proposed stress capital buffer, do you agree also with your predecessor, who was not known as a deregulator—Mr. Tarullo, Governor Tarullo—that the qualitative assessment in CCAR be phased out for all banking organizations, especially in light of the recent stress capital buffer rule?

Mr. QUARLES. Yes, I think that is something that we should consider and have called for a comment on, definitely.

Mr. BARR. Well, I appreciate you considering that. And, with respect to that proposal to create a stress capital buffer, as you know, the main driver of these stress tests is the severely adverse scenario. And it has been published by the Fed without the benefit of any public comment or external review. And the model that will be employed to calculate the bank's stress losses using that severely adverse scenario is the Fed's proprietary model.

But is there no transparency regarding the elements used in determining a significantly and potentially highly variable component of the minimum capital requirement? And is the Fed open—publishing these scenarios and models for notice in comment?

Mr. QUARLES. I think that we need to get more public input on them. A full APA (Administrative Procedure Act) notice and comment process, which could take years—I think that might be logistically difficult. But I think that there are ways that we can get genuine, serious input and still be consistent with the purposes of the test. I agree with you.

Mr. BARR. Thank you. Thank you. My time is expired.

Chairman HENSARLING. Time of the gentleman has expired.

The Chair now recognizes the gentlelady from Wisconsin, Ms. Moore, Ranking Member of the Monetary Policy and Trade Subcommittee.

Ms. MOORE. Thank you so much, Mr. Chairman, and welcome to you, here today, Mr. Vice Chairman Randy Quarles. I welcome you to your new position and I hope that you are prosperous.

I would just like to hear, since you are new, what lessons that you learned from the financial crisis that you can share with us.

Mr. QUARLES. I would say that there are some specific ones; there are some general ones. Probably the most general one is a sense of humility about the omniscience of the regulators.

You know, as has been mentioned and is certainly widely known, the regulators were closely involved with the financial system at a very granular level. And, for a period there, at least on a policy level, when I was at the Treasury Department, I certainly was involved with policy regarding the financial sector.

And while we considered issues about potential financial stress, none of us believed—none of us knew that the financial—that this sort of financial stress was coming. And, indeed, most people didn't.

I approach my current responsibilities with a great sense of humility about the ability of even very well-meaning, smart, engaged, informed people to know the future. And I think that has to inform how we think about what we think are good ideas currently.

There are some specific examples, as well. I mentioned one of them—the leverage ratio. I did not have a sufficient regard for the role of leverage capital requirements in the overall capital system—

Ms. MOORE. I mean, before the crisis, or since Dodd-Frank?

Mr. QUARLES. Before the crisis.

Ms. MOORE. OK.

Mr. QUARLES. And since then—

Ms. MOORE. So Dodd-Frank has helped in that regard?

Mr. QUARLES. Well, I would say that the regulatory response, in general, has been appropriate, following the crisis.

Ms. MOORE. OK. All right. So banks are doing really well right now. Their profits are up. Their shares are up. And so—but we see a constant drumbeat of complaints, I think, from some of the larger banks and maybe even some of the regional banks regarding so many regulations.

So, very specifically, I would like to know: Do you support the Volcker Rule? Do you support what Dodd-Frank has done with the new derivative framework provided to FSOC? As examples of two things, do you support those things?

Mr. QUARLES. So the Volcker Rule, as it has been implemented, I do think isn't working well. I think that it is excessively burdensome. I think it creates uncertainty. And so I think it is not really an effective implementation of the statutory requirements.

Ms. MOORE. So you are not—you are not afraid of proprietary trading at all and ratcheting things up to where we were?

Mr. QUARLES. Well, there as a regulator, we can't change the Volker Rule, so that will remain the law of the land. I think that we can implement the statutory intent in a way that is actually more effective by clarifying, simplifying the rule, and reducing the burden of complying with it.

Ms. MOORE. OK, just let me just briefly share with you. The Fed Chair Powell has recently been with us and he has talked about the profitability of the banks and their return and their returns on capital and buying back stock and so on. And so I am wondering if—if you are concerned about the—any negative or adverse impacts that you see with the banks enriching themselves and buying back stock, harm to our economy overall? Is there any concern on your part?

Mr. QUARLES. I think that a healthy financial sector is in our interest. It is one of the—having a robust financial sector ensures that we have got robust support for the real economy and for economic growth in the real economy. And as long as that sector is healthy and is safe and sound, our job as regulators is to ensure that they are operating the safe and sound manner. And then the distribution of their profits is up to the shareholders and management and some of that will go to customers and some will go to employees and some will go to shareholders.

Chairman HENSARLING. Time of the gentlelady has expired. The Chair now recognizes the gentleman from California, Mr. Royce, Chairman of the House Foreign Affairs Committee.

Mr. ROYCE. Thank you very much, Mr. Chairman. And Vice Chairman Quarles, thank you. I think in your analysis the response that you gave in terms of the regulatory community and what you did not see coming is partially true but there was one thing the regulatory community did see coming and tried to do something about, it was the overleveraged—the GSEs (government-sponsored enterprises), Fannie Mae and Freddie Mac, which reached 100 to 1.

In 2003 and 2004, I had legislation that tried to control for systemic risk. Tried to transfer the authority to the regulatory community to take down the overleveraged in terms of those portfolios, and the regulatory community, the Fed in particular was very supportive of that. We could not get that legislation through.

I would say that they saw that coming. What perhaps they didn't see coming was also the investment banks—the four big investment banks in doing their own modeling had leveraged up the ratio from what should have been 10 to 1, probably 30 to 1. And so the combination, first housing collapsing with the GSEs, and then on top of it, the big investment banks, I think that was a major blow here.

I think what we are rediscovering in this generation is that this cyclical nature of the economy because we fail to adjust or regulate for these kinds of problems are with us and I think unfortunately Washington tends to exacerbate in some ways, may be exacerbating, rather than mitigating the booms and the busts, and I just wanted to ask you about that because Washington is willing to come in and scale back capital requirements when times are good. When times are bad, as we saw during the last crisis, Washington overshoots and limits the ability of banks to aid in the economic recovery.

We all saw countless examples of that with community banks. What is your view on regulation in terms of the economic cycle? Where do you think we are in the cycle, and how does that impact your assessment of regulatory changes, especially now as it relates to capital?

Mr. QUARLES. So those are extremely good questions. In general, the banks should, and I think that they are, build their capital during good times so that they can survive stress when it comes. And we know that there will be periods of stress in the future. I think that it is an open question. There are regulatory tools that are designed to provide those countercyclical incentives.

The stress test is one of them, it becomes known as asset values increase, as times become good, the stress necessarily if you assume that asset values are going to fall to a certain level, that stress is going to be greater and that provides a certain countercyclical incentive.

There are other tools that we could use. At the same time, the efficiency of the system does—is supported by predictability—the ability of the—of the CFOs and the banks to predict how their bank ought to respond to the overall regulatory system, and balancing that is the difficulty that we wrestle with.

Mr. ROYCE. Let me ask you another question. Is it possible for businesses around the world to take advantage, you said of the fact that we are in a world of opportunity, but it is an opportunity that is unbalanced, that the developed world will face strong significant headwinds, for quite an amount of time, the emerging world has both robust growth and growth that is being driven by consumer consumption?

So that was your—that was your point. Shouldn't we be looking outward to the emerging world for growth? We have got 5 percent of the population, 25 percent of the GDP. Shouldn't we support a renewed interest in the Trans-Pacific Partnership as a net positive for the U.S. economy in terms of that engagement? Just your view on that.

Mr. QUARLES. Well the Fed's responsibility is not trade partnerships, but in general, certainly, the United States has benefited from an open trading system and from open trade and that has been in our interest over a long period of time.

Mr. ROYCE. Thank you, Vice Chairman Quarles, very much. And, Mr. Chairman, I thank you as well for this hearing.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Minnesota, Mr. Ellison.

Mr. ELLISON. Good morning, Mr. Quarles, how are you?

Mr. QUARLES. Thank you.

Mr. ELLISON. So the Center for Investigative Reporting looked at 31 million mortgages using HMDA data and they found evidence that redlining is still alive in about 61 major American cities. Did you see that report?

Mr. QUARLES. I have not had a chance to study it, no.

Mr. ELLISON. We will send it to you. I think this is absolutely unacceptable; 50 years since the passage of the Fair Housing Act, which banned discrimination in lending, 41 years since the passage of the Community Reinvestment Act, which requires banks to lend and to invest in communities which they operate, including low- and moderate-income communities.

In a recent speech you said that you want to improve and I will quote you, "the current supervisory and regulatory framework for the CRA to further the statutes objective of promoting access to credit and financial inclusion."

What did you mean by that?

Mr. QUARLES. Well, I think that the objective of the CRA is a broad one, which is to—

Mr. ELLISON. I will reclaim my time. I was hoping you had some things in mind. Do you have specific things you want to do with the CRA that you could identify today?

Mr. QUARLES. Well, we are working with the other regulators on specific proposals. And since those aren't out yet, I don't want to prejudge that process.

Mr. ELLISON. You don't want to mention them just yet? Well, yes. So where—it is in the process. So, look, can you assure the members of this committee today that you will not support any changes to the CRA that will result or cut lending in low- and moderate-income communities?

Mr. QUARLES. The objective of the changes we are considering is to improve support to communities, not to—

Mr. ELLISON. Right, right.

Mr. QUARLES. —cut it.

Mr. ELLISON. So that is the objective. But the outcome is what I am asking you about. Can you assure us today that you will not support changes to the CRA that will cut lending in low- and moderate-income communities?

Mr. QUARLES. That certainly wouldn't be my intention.

Mr. ELLISON. OK. So what assurance can you give us, that your intentions will be fulfilled regarding the CRA?

Mr. QUARLES. Well, I will—I will be here again shortly, and you can hold me accountable for the outcome of our proposals. We will seek comments, and—on the proposals that we make, and take seriously people's comments as to whether we are achieving our objectives.

Mr. ELLISON. OK. Well, earlier this month, the Treasury released a series of recommendations for revising the CRA, which you have alluded to already.

One of those recommendations related to penalties lenders face for failing CRA exams. Only about, I don't know, 1 percent or 1.5 percent fail, right?

Mr. QUARLES. It is rare to fail.

Mr. ELLISON. Yes. It is rare to fail. But the report says, a bank with a less-than-satisfactory CRA reading—about 1 percent of the people—banks—should continue to receive enhanced scrutiny. But more consideration should be given to the bank's remediation efforts to date, and whether improving the application would benefit the communities served by the bank.

Do you believe Treasury's plan to relax penalties for banks who fail the CRA exam will achieve the CRA's intention—and your intention—of increasing lending and investment in low-income communities?

Mr. QUARLES. Well I don't think that Treasury's intention there, in that reference, is to relax penalties, but rather to consider the overall consequences of a particular transaction that may be proposed.

There are certainly circumstances where the low- and moderate-income portions of a community can be, actually, helped by a particular transaction that, under current practices, might not be allowed for—

Mr. ELLISON. You mean like payday lending and rent-to-own? Is that what you have in mind?

Mr. QUARLES. No. Simply the increasing the ability of a particular institution to service a low-and moderate-income community might be helped. I think they are saying we ought to look at the facts and circumstances of the case, and that I would support. And try to decide whether we are actually achieving our objective.

Mr. ELLISON. Well, when you think about 61 major American cities having evidence of redlining based on home mortgage disclosure data, and still 98 percent pass, I think that the exams should be tougher, not easier.

And I hope that you will carry that forward. Because for the people who are denied mortgages after they have qualified based on, sometimes, the color of their skin, I hope you share my concern with that and will use your authority to uphold people's rights.

Mr. QUARLES. I definitely share the concern that there should not be discrimination in lending.

Mr. ELLISON. Thank you.

Chairman HENSARLING. Time of the gentleman has expired, the Chair now recognizes the gentleman from Florida, Mr. Ross.

Mr. ROSS. Thank you Chairman, and Chairman, thank you for being here as well. I am one of those people who firmly believe that access to capital and liquidity are probably the lifeblood of a stable and vibrant flow of commerce.

I have seen the accumulation of capital, but yet I have not seen until recently the investment of capital.

And what concerns me about that is that while—those that form capital for investment purposes to strengthen an economy do so and choose to do so in environments that are more conducive to investment and consumer satisfaction, just has not been what Dodd-Frank resulted in for us as a Nation.

And now that we see some tax reform, we see the opening up of capital, we see the availability of more liquid markets, some people have said that regulation has impaired market liquidity. What is your position on that?

I mean, is it making it—had it made it more harder and costlier to transact business?

Mr. QUARLES. So I think that there are instances where it has. I think that the Volcker Rule is an example of that. Again as I mentioned, economists will argue over measures of liquidity and how great the extent is of its effect on liquidity.

Certainly practitioners believe it has been great and it is inarguable that it is existent. And I think that it is unnecessary. I think that we can have an implementation of the Volcker Rule that doesn't have those costs, or at least reduces those costs.

Liquidity regulation itself has also had an effect. As I indicated in my testimony, I think that we can and will and should give consideration to how to further tailor liquidity regulation along the scale of firms. Because that also can have an effect that you are describing.

Mr. ROSS. And as we talk about, and I think my colleague Ms. Moore talked about, access to capital for small business. That to me is so fundamental to regrowth of a vibrant economy. Thirty years ago when I started my law practice, I had very limited access to capital.

And I had to actually go and borrow some from friends to get started. And granted, after the track record and solvency and the growth of my business came, well the access to capital was there. Today, I am not so sure we have that access to capital.

Apparently some former members of the Federal Reserve have dismissed concerns about access to capital, and I have expressed the current state of small business lending. For example, a September 2017 Federal Reserve report entitled, "Availability Of Small Credit To Businesses" cited a survey from the NFIB.

Which found that polls suggest credit availability is a relatively minor concern for small businesses. I don't agree with that. I think access to capital is one of the huge, most important concerns of a small business.

During a March 26 speech, you discussed the findings of a survey published by the 12 reserve banks. Can you tell us what that survey revealed in terms of access to capital to small businesses?

Mr. QUARLES. Well without getting into the terms of any particular survey, I think that lending to small businesses is an issue. And one of the things that I did earlier in my career was—

Mr. ROSS. Is an issue as that there are—there is a regulatory impediment to the access to capital?

Mr. QUARLES. I think that there is. Certainly at the community—I think that the cost of regulation on community banks has been an impediment. Community banks are an important source for credit for small businesses.

Earlier in my career when I was an investor in smaller banks, I was very aware—

Mr. ROSS. And so the lifting of that regulatory burden would allow community banks the ability to lend more, and in turn growing those communities and in turn building a more vibrant and productive economy?

Mr. QUARLES. Yes, I believe that.

Mr. ROSS. And we should be doing what is necessary to see that that is done?

Mr. QUARLES. Yes, we should. And some tailoring has happened. I think that there is more that we can do in order to reduce the burden on smaller institutions.

Mr. ROSS. Thank you, and I have just got just a couple seconds left, and I just want to reiterate what the Chairman of the Housing Insurance Committee had talked about with regard to the sanctity of State-regulated insurance.

I think that we, and I hope that you would continue to advocate on behalf of our system of the State-based regulatory scheme, not only in terms of capital standards, not only in terms of solvency, but also in terms of consumer protection. So thank you for being here. I yield back.

Mr. QUARLES. Thank you.

Chairman HENSARLING. Time of the gentleman has expired. The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman. Welcome, Vice Chairman Quarles. I would like to follow up on Ms. Moore's earlier question regarding the Volcker Rule. On January 19th of this year, you gave a speech to the American Bar Association Banking Law Committee.

And you outlined plans to review and modify numerous bank regulations. During your remarks, you said, and this is a quote, "The relevant agencies have begun work on a proposal to streamline the Volcker Rule. It will naturally take a bit of work, but Volcker Rule reform remains a priority."

I am not sure that was the same response that Ms. Moore got. I just want to ask you about that. So the Volcker Rule—at least the core of the Volcker Rule says no more proprietary trading. We had a disaster back during the housing crisis.

A lot of these banks were engaging in speculative activity, very, very highly speculative and risky activity in terms of credit default swaps and all that. A lot of these banks got in trouble, we had to bail them out.

So we said no—the Volcker Rule basically said no more proprietary trading, OK? So my question is how do you streamline no more proprietary trading? How does that actually work?

Mr. QUARLES. Well again, I don't want to directly front run proposals that we are working on with four other regulators and that aren't yet—

Mr. LYNCH. Just conceptually, then. Don't go into their stuff, but just—if it is a stop sign, don't proprietary trade, don't put the American taxpayer at risk. How do you streamline that? I am just wondering.

Mr. QUARLES. The key issues will be around the definition of proprietary trading and providing enough certainty that institutions in fact know what it is that we will consider to be proprietary trading.

Mr. LYNCH. So you are going to change the definition of proprietary trading?

Mr. QUARLES. Well I think that there is a scope to provide additional certainty around that in order to better affect the intention of the statute.

Mr. LYNCH. So what Congress was trying to prohibit was what I just described. So those bets, the speculatory trading, defaults—credit default swaps—all of that. We were unwilling—as taxpayers we were unwilling partners on that activity and we ended up when they lost money the American taxpayer was a loser as well, even though we didn't authorize that—we didn't support it. Are we going back to that?

Mr. QUARLES. No. I mean, absent statutory change the statutory injunction is clear.

Mr. LYNCH. Right, but you were telling me 2 minutes ago that you were going to redefine what proprietary trading is and that makes me nervous because Congress spoke in terms of what we wanted to prohibit, and no is no. There is no streamlining no.

Mr. QUARLES. Right, and we are not proposing to say yes. The question is, if it is impossible to understand and to implement the definition of proprietary trading that the regulators have come up with, not the Congress. I mean, we took the statutory language and have turned it into a virtually—certainly a very difficult, some would say impossible standard.

Mr. LYNCH. We wanted it to be difficult. We did. We saw what happened. So, I just hope you are not trying to disrupt the intent of Congress. We wanted it to stop, and it has stopped.

Mr. QUARLES. I am not even sure that you could say that.

Mr. LYNCH. If you want to have that debate, we think we are the ones that should have that debate about whether it should be relaxed or refined but that is a decision for Congress. We certainly sent a clear message in Dodd-Frank and in the Volcker Rule that we wanted proprietary trading stopped, we wanted the American people to be out of that casino.

We didn't want them being partners of that. We didn't want to have another bailout. Everybody on both sides said no more bailouts—that is enough. So, we looked at the risky activity and we said we don't want any more of this.

So, I just want you to take that back if you would and incorporate that as one ingredient in your discussions.

Mr. QUARLES. No, I deeply appreciate that. We are not seeking to undermine the intent of Congress at all.

Mr. LYNCH. Thank you so much. Mr. Chairman, I yield back.

Chairman HENSARLING. The gentleman yields back. The Chair now recognizes the gentleman from Illinois, Mr. Hultgren.

Mr. HULTGREN. Thank you Mr. Chairman. Thank you, Vice Chairman for being here today and for your work. I want to jump right into questions if I might. I am very concerned with the use of the current exposure method and requirements for banks who cleared the trades of liquidity providers.

As Chairman Powell noted last year, CEM—and I quote—he said, "ignores whether a derivative is margined and undervalued, netting benefits," end quote. The current exposure method is sensitive to risks, so its mandatory use artificially caps market liquidity, particularly in large-cap index options which are crucial hedging vehicles by making it more expensive to hedge artificially constrained liquidity in S&P 500 index options has knock-on effects that increase overall market volatility, as we have seen in recent months.

Rulemaking is the long-term answer but that is a slow process, taking years. Liquidity providers are dealing with this issue now. There is no reason to believe volatility is going to decrease anytime soon. What short-term steps can you take to fix current exposure methods damaging effect on market liquidity? Short of rulemaking, what can be done?

Mr. QUARLES. Well, I think that the most effective method is for us simply to proceed in making that rule effective. Where I completely agree with your assessment of the difficulties that that has caused, and I think that we should proceed at pace and simply have the final rule that will address that effective.

Mr. HULTGREN. Again, my concern is just that we get answers for people soon. The Treasury Department's October 2018 report on capital markets calls for a near-term solution of risk-adjusted approach for valuing options for purposes of a capital rules to better reflect the exposure such as potentially weighting objects by their delta.

Moving on, the Federal Reserve's current large financial institutions risk-management proposal contains expectations for business-line management that would apply to both business lines and critical operations.

I believe this is duplicative. It is regulatory inefficiency that could be addressed. Why is the holding company regulator, the Fed, reviewing the same activities as the bank regulator—banking regulator? If the Fed reviews a bank's credit card business, for example, it is reviewing the same thing the FDIC has already reviewed. What is the justification for the Fed to conduct core business line reviews of activities contained within a holding company's bank's subsidiary when those activities are already subject to examination by the bank's primary regulator?

Mr. QUARLES. Well, I think that to the extent that we do that and frequently we ought to be able to rely on the bank's primary regulator. If there are cases where, for a particular supervisory reason, we think that we should also be involved, we should do that in a way that doesn't duplicate the burden on the institution.

Mr. HULTGREN. With respect to Volcker Rule reform, you have said publicly that it is important to, among other things, redefine the market-making exemption which is admittedly an important issue both for the banks that are market makers as well as for the broader economy.

However, what can be done specifically for smaller banks, say those in the $10 billion to $50 billion range to reduce the burden of Volcker Rule compliance? There are a number of regional banks in Illinois that fall into this category.

Mr. QUARLES. Well, that is one of the things that we are discussing among the four regulators. I think an approach might be—either to be more clear about what it is that would be proprietary trading and therefore that they can be clear that it is not something that they are engaged in and supervisors can be clear it is not something that they need to look at because we have a very clear definition.

There may be a way to look at the risks of particular institutions and determine that simply as an allocation of supervisory resources matter the burden of proof in an examination changes, for example. But that you will be presumed not to be in compliance with the Volcker Rule unless there is a reason to think otherwise, there are a variety of approaches one could use.

Mr. HULTGREN. My last minute here. I want to get into some fintech issues. Technology has significantly changed the way we do most everything including access to financial products and services. Banks must comply with extensive regulations especially in the post Dodd-Frank regulatory environment which other financial services companies may not be subject to.

Are you concerned about nonbanks often times with the competitive advantage of lower regulatory cost, offering nearly identical financial products and services without being subject to the same regulation? And if so, how would you address this in your role as Vice Chair of Supervision?

Mr. QUARLES. So, I think that our regulatory system should not create unlevel playing fields. That is across a whole range of issues, whether it is banks or nonbanks or different banks and different types of regulated entities—small banks and big banks. I mean, we should not be creating an unlevel playing field.

And so, on the specifics of how to address that with banks and nonbanks, that then gets very complex given the limitations of our statutory framework that we have to operate under but something that is a high priority for me.

Mr. HULTGREN. Thanks, Vice Chairman. I yield back.

Mr. MILLER. The time of the gentleman has expired. The Chair now recognizes the gentleman from California, Mr. Sherman.

Mr. SHERMAN. I believe Mr. Huizenga pointed out that the people don't know what the Fed does. That is not by chance, that is by design. The bank is an example of the fact that the elites of this country believe in democracy for every country in the world except ours.

And it is undemocratic in at least three ways. First, both parties seem to have agreed that monetary policy is too important for politicians to talk about or for citizens to try to influence.

Second, the Fed has a structure where the Class A voters are banks; not one person, one vote, one bank, one vote, or 1 billion, one vote. And then the Class B directors are selected by the Class A directors. So it is undemocratic in that it is partially bank-controlled.

And then finally, geographically, 1/5 of all Americans live in the western area, and yet that bank is not entitled to a permanent seat on the FMOC. Eight percent of Americans live in the New York Bank area. That bank is guaranteed.

So if you ever want an example in the United States, not of democracy, but of the Chinese system of government, the Confucian system of government where learned, according to Confucius, men self-select a renewable group of people who have the mandate of heaven, though not the mandate of voters, there is no better example of the Chinese system in the United States.

Mr. Vice Chair, believe it or not I have a question. Are there any financial institutions in this country that are too big to fail?

Mr. QUARLES. I think that we have made really tremendous progress since the financial crisis—

Mr. SHERMAN. That was the exact answer your chairman gave until Senator Kennedy pushed him further and asked—and pressed, is any single bank right now too big to fail? Do you agree with your chairman when he said no?

Mr. QUARLES. Well, I don't want to be in the position of disagreeing with my chairman.

Mr. SHERMAN. You are supposed to. That is why we pay the salaries for more than one person at the Fed. If they are all going to agree, then any one of them would be superfluous.

Mr. QUARLES. But I do think that all of the large banks are much more resolvable than they have been before—

Mr. SHERMAN. Resolvable—are they too big to fail? Could the—could a—could a disaster at one bank bring down our whole economy the way we saw in 2008?

Mr. QUARLES. Currently, I think that the system is much more resilient—

Mr. SHERMAN. I didn't ask you that. Not going to let you slip away. Senator Kennedy was good enough to get your chairman to be specific in an answer. Is there any bank whose failure could bring down our entire economy? Yes or no?

Mr. QUARLES. We think that we have made sufficient progress—

Mr. SHERMAN. That is not an answer. I know you have made progress. Is there any bank the failure of which could bring down our entire economy?

Mr. QUARLES. At the moment I don't see how that could happen.

Mr. SHERMAN. OK, then would you support getting rid of the limited bailout provisions that were in Dodd-Frank since, if any one of those banks were to go under, we should, as good capitalists, simply wave and say that is business? Toys R Us are going out of business and America will survive and you have described a situation where any one bank would pretty much have the same effect.

Mr. QUARLES. Well, in response to a previous question, someone asked what I had learned from the financial crisis, and the principal lesson I learned was the humility that we all ought to have around—

Mr. SHERMAN. We should all—the—

Mr. QUARLES. —our judgments of the future at any particular time.

Mr. SHERMAN. I am going to sneak in one more question. Back in the old days there used to be banks that would make, to a small portion of their—of their loans would be prime-plus-four, prime-plus-five loans, made to local businesses that you and I would agree aren't creditworthy enough so that a bank could make a profit made with a loan of prime-plus-one or prime-plus-two.

Do your regulators allow banks to use 10 or 20 percent of their portfolio to make prime-plus-four loans to businesses like the pizzerias in my district where that would be the appropriate rate? Or are those folks closed out of the banking system and having to call late night television commercial lenders?

Mr. QUARLES. I hope that we don't have supervisors that are preventing that type of credit extension.

Mr. SHERMAN. I will talk to you privately. You do.

Chairman HENSARLING. Time of the gentleman has expired. The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger.

Mr. PITTENGER. Thank you, Mr. Chairman. Thank you, Chairman Quarles, for being with us, for your leadership. And congratulations. In your March 26th speech at the Hope Global Forums Annual Meeting, you stated, quote, "Loans entail high fixed costs that are roughly the same regardless of whether a loan is for $100,000 or $1 million, reducing the profitability of smaller dollar loans," end of quote.

Has the composition of credit that is being offered changed?

Mr. QUARLES. That is an interesting question. I think that inevitably that evolves over time. I don't think that it has changed in a dramatically disadvantageous way.

Mr. PITTENGER. Well, then are larger financial institutions playing a larger role in financing small businesses because of their ability to better eat the cost of high—of higher underwriting standards?

Mr. QUARLES. That I definitely think is true. Yes, I do think that larger institutions are providing a larger share of the credit to small business than happened in the past.

Mr. PITTENGER. Surely. Well, the Dodd-Frank's numerous regulatory rules have constrained the flow of bank credit, holding back small businesses that depend on bank lending while large corporate—corporates benefit from the nonbank sources of finance.

In your March 26th speech, you recognized that, quote, "The economy, small businesses need adequate and affordable credit in order to form, grow and succeed. Otherwise, they may underperform, slowing growth and employment." What are the side effects of reduced access to adequate and affordable credit for small businesses?

Mr. QUARLES. Well, I think the—small businesses as we all know are a principal engine of generating employment. They are an important engine of the economy, and credit to small businesses is an important element of allowing them to grow.

Traditionally, that has come—and a large portion of the credit extended to small businesses has come from community banks. Community banks are closer to the communities in which these small businesses reside, are able to make credit decisions that larger banks sometimes might not be able to make with respect to a particular borrower in a community.

So all of those are issues that are having an effect, clearly.

Mr. PITTENGER. Yes, sir. Thank you. On another matter, as you are fully aware that the Fed Bank of New York, on April the 3rd, began publishing its new reference rate, SOFR, the Secured Overnight Financing Rate, which is intended to be an alternative to LIBOR (London Inter-bank Offered Rate). Mr. Vice Chairman, has there been a robust cost-benefit analysis conducted by the Fed regarding the potential economic impact to consumers and commercial borrowers from shifting from LIBOR to SOFR?

Mr. QUARLES. So the shift to the extent happens would be entirely voluntary. So this isn't something that the Fed is going to require. So while that is a question that we have looked at, we also think that in determining whether any particular institution would make the shift, that cost is something that they would evaluate as well.

So since we are not mandating it, that is a different kind of analysis. Now obviously, we have been told that LIBOR as a potential standard will be disappearing. So I think that our providing this alternative is an important option. I think it will be very useful, but it is voluntary.

Mr. PITTENGER. Have you looked at the impact that this change would have on the borrowing costs for businesses?

Mr. QUARLES. In the context of LIBOR disappearing, I think that that will be—I think inevitably the alternative of not having it available would be a problem.

Mr. PITTENGER. Yes, sir. Well since repo rates move in the opposite direction of LIBOR during the market stress would any new systemic risk arise of the banking sector by shifting to SOFR?

Mr. QUARLES. That is a question that we have looked at. I don't think that we are increasing systemic risk. And again, when one considers the alternative of the current widespread standard disappearing, the provision of an alternative is important I think.

Mr. PITTENGER. Have you all sought the input from community or regional banks concerning the potential costs associated in shifting away from LIBOR?

Mr. QUARLES. Yes, we have.

Mr. PITTENGER. Did you find favorable input?

Mr. QUARLES. Yes, and you know, and as that process continues to move forward, we are continuing to evaluate input.

Mr. PITTENGER. Could you give us a reaction that you have had from the smaller banks?

Mr. QUARLES. You know, again our assessment in general has been that since the shift is going to be voluntary, each institution will decide of itself whether the costs outweigh the benefits.

Mr. PITTENGER. Thank you. My time has expired.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus.

Mr. ROTHFUS. Thank you, Mr. Chairman. Vice Chair Quarles, I want to start by commending you for the posture you assumed earlier in your tenure by setting efficiency, transparency, and simplicity as guiding principles for your regulatory improvement agenda. The mistakes of the last 8 years demonstrated just how important it is that we have regulations that are straightforward and appropriately tailored.

As you know, the implementation of the Dodd-Frank Act—through the implementation of the Dodd-Frank Act, insurance companies have—that have depository institution subsidiaries were brought under Fed supervision. This created a situation in which many of these insurance companies are supervised at the holding company level by both the Federal and State insurance regulators.

This leads to duplicative supervision that is disproportionate to the risks that these insurance companies pose. And I would argue that this violates the principles of efficiency and simplicity. Would you support a more streamlined regulatory approach for these insurance companies that would uphold the State insurance supervisory and regulatory regime while rightsizing the Federal Reserve's examination authority?

Mr. QUARLES. Yes, the devil is in the details of that. But I have spoken to a number of these insurance companies, and I think it is clear that the burden of our regulation is, has been excessive relative to the scope of the issue.

So I think that that is something that we need to work on. Now as long as the insurance companies have depository institution subsidiaries, I think that that is something that we need to have an appropriate regulatory relation to. But we need to do a better job of ensuring that that regulatory engagement is felt by the firms as proportional to the scope of the issue.

Mr. ROTHFUS. I look forward to following up with you on that.

Mr. QUARLES. Yes, very much so.

Mr. ROTHFUS. As you know, the FSOC has begun work on reviewing the objective criteria used for designating non-bank SIFIs. I support that effort. And I look forward to seeing the formal rulemaking. Can you give us an update on the status of that project?

Mr. QUARLES. Not a satisfactory one. Beyond that it is underway, but I support as well the effort to look at an activities based approach for designation, which is where the—where the rest of the thinking is going.

Mr. ROTHFUS. You mentioned the bank exams tailored to risk or BETR (Bank Exams Tailored to Risk) program for regional and community banks in your testimony. BETR uses financial metrics to differentiate the level of risk between banks before exams and ensures that examiners tailor their procedures to minimize regulatory burden for firms engaged in low-risk activities.

I can see how this approach could make sense for all banks, not just community and regional banks. For instance, an institution that is not engaged in consumer activities should not have to go through the same examination process or modeling review of consumer losses as a bank that has a large credit card or mortgage business. Will the Fed expand this risk-based tailoring to supervisory programs for all banks?

Mr. QUARLES. So we haven't given consideration yet as to that particular program. However, the tailoring of supervision to the character and risk of particular institutions is something that I completely agree extends along the spectrum of institutions from the smallest to the largest. And it doesn't stop at any particular level. And we need to be giving thought as to how we do that.

Mr. ROTHFUS. Before my time expires, I want to commend you for recognizing the negative impacts of the supplementary leverage ratio. I know that Congresswoman Maloney had touched on this, especially the effect on custody banks.

As you know, the Fed is currently undertaking a rulemaking to alter the application of the enhanced supplementary leverage ratio, the rulemaking proposal says the following. Over the past few years, concerns have arisen that in certain cases, the standards in the ESLR rule have become a generally binding constraint rather than a backstop to the risk-based standards.

Thus, although the ESLR standards provide incentives to maintain a strong capital base, the current calibration also has created incentives for banking organizations to reduce their participation in lower risk, low-return business activity, such as taking custody deposits, notwithstanding client demand for those services. This is an issue that we have discussed extensively in this committee.

As you know, we unanimously passed a proposal to address this problem earlier this Congress. This solution has also passed the Senate. While I applaud the Fed for beginning to address this issue, I also want to reiterate my support for a legislative solution.

With that, I would yield back to the Chairman.

Chairman HENSARLING. The gentleman yields back. The Chair now recognizes the gentleman from Colorado, Mr. Tipton.

Mr. TIPTON. Thank you, Mr. Chairman. And thank you, Vice Chair Quarles, for being here today. First of all, I do want to commend you in terms of comments that you made to my colleague Mr. Ross in regards to the banks and wanting to be able to see that more tailored to be able to create those access areas.

But wanted to go on a little bit of a different track in regards to some of the proposed rulemaking that is being put forward by the Fed regarding the 2-hour recovery time objective (RTO) from cybersecurity attacks. In February of this year, you stated that you had worked with other financial regulatory agencies on harmonizing cyber risk management standards and regulatory expectations across financial services sector.

The Fed's proposal for the 2-hour RTO, obviously, differs significantly from the standards and principles that are established by other domestic and foreign regulators.

As head of the Committee on Supervision and Regulation, have you studied the risks and benefits of the 2-hour RTO proposal, its lack of harmonization with other regulators, and where it is being exercised elsewhere?

Mr. QUARLES. So those are all important issues. And as part of receiving comments on a proposal, we will certainly take all of that into account.

Given the importance of resiliency, the Fed at the time believed that that was an important issue to get comment on, but we will take into account the comments that we are receiving.

Mr. TIPTON. Great, yes. I think some of the concern was simply the timeframe, 2 hours. And to be able to have the recovery end of it, given all of the different challenges that were there, so we will look forward to hearing back on that.

Also in December, you stated that cyber threat to the financial system is a matter of national security. I assume that is still your position. Do you plan to review the Fed's proposals for cyber-security?

Mr. QUARLES. Yes, yes. As I stated a little earlier, I think that we really do need to focus our engagement in that area on cybersecurity, to seeing how we, in the bank regulatory community and across the Government as a whole, can really support the efforts of these firms to be resilient against cyber-attack.

And because it is such a difficult issue, I do think that a lot of our engagement currently is more focused on compliance than real resiliency, and I don't want to denigrate the importance of compliance, but I think we can do more and better. It is a high priority for me.

Mr. TIPTON. Great. And thank you. Governor Quarles, the Federal Reserve Board is making progress in simplifying the capital rules and stress-testing requirements, particularly for smaller institutions.

I have heard positive feedback from the industry on these goals, but I have also heard some concerns that the evaluation of risk management can be subjective. And that compliance requirements change depending on which supervisor is in charge.

Are efforts being made to be able to evaluate and potentially modify current risk management expectations and supervisory practices, to allow for improved effectiveness and greater reliance on the rule of law?

Mr. QUARLES. Yes. I think that ensuring the uniform application of principles across a diverse body of supervisors is a difficult management task.

But it is one that, again, is a high priority for me and that we are working, and that we definitely are working on, both within the Federal Reserve and across the other bank regulators, to try to ensure that we have more predictability and consistency.

Mr. TIPTON. Can you give us a couple of ideas on what you are— when you say you are looking at it, how trying to be able to pursue that?

Mr. QUARLES. Well, some things that we have actually done about trying to ensure consistency. We do have a structure in place for the largest institutions, that is designed to try to ensure consistency of supervision.

On the—with respect to smaller institutions, that is principally a matter of training. And so we regularly have, when there is a new regulation that comes out or new guidance that comes out, we have various training seminars for the supervisors.

I meet regularly with the leadership in the supervisory function at the Fed, to ensure that those messages are going down to individual supervisors. It is a blocking and tackling management function as opposed to a silver bullet. It is something we have to work at every day.

Mr. TIPTON. Well, I appreciate that and that is, probably, one of the bigger issues that we are hearing out of our smaller institutions, is the trickle-down effect.

Mr. QUARLES. Yes.

Mr. TIPTON. So, obviously, the training will put in a plug for some of the legislation that we have passed through the House with a lot of bipartisan support to try and make sure that we are getting real continuity for the smaller institutions and the opportunity to be able to make those loans for small businesses. I come from a rural community and that is a real challenge, thank you for being here today.

Mr. QUARLES. Thank you.

Chairman HENSARLING. The gentleman yields back. The gentleman from Texas, Mr. Williams, is recognized for 5 minutes.

Mr. WILLIAMS. Thank you, Mr. Chairman and Vice Chairman, good to have you with us today. I am glad to see—finally see a Presidentially appointed, Senate confirmed Vice Chairman for the long unoccupied post.

It has been 8 years since Dodd-Frank was enacted and only now is the economy showing signs of recovery, in spite of the overall burdensome regulatory environment that we have, not because of it.

The role you play as Vice Chairman for Supervision is crucial in tackling some of the regulatory issues that have been plaguing this economy for so long. I hope that you will be a catalyst for change, inside an agency that has, far too long, become immune to change and reform.

Our economy is as strong as it has ever been thanks to this Congress and this Administration's folks on deregulation and a modernized tax code that is propelling Main Street toward landmark gains.

My first question, Mr. Vice Chairman, is we must protect small businesses and consider their credit needs. The 12 Federal Reserve banks recently completed a small business credit survey, which concluded that credit needs continue to go unmet.

As a small business owner, myself, for 47 years, I know, all too well, the difficulty some of these companies face. So, now that Congress has passed tax reform to help spread the development of Main Street. What actions will you take to ensure that small businesses can have their credit needs met?

Mr. QUARLES. Well, I think the principle action that we can take and we have begun this, there is more that we can do, is to reduce the burden on smaller banks, the banks that tend to provide this credit and that are best positioned to provide this credit to smaller businesses.

Through the EGRPRA process, for example, we have reduced some regulatory burden on the community banks, but that is something that we are always continuing to look at. Are ways to reduce the cost of compliance and ensure that the regulations that we are applying to particular banks are appropriate to the activities they are engaged in and the risks that they pose, which, for community banks, is relatively minor.

Mr. WILLIAMS. Great. In your testimony you state that the financial conditions of the community banks also had strengthened significantly since the financial crisis. So, I want to unpack that a bit because I know, first hand, that main—the challenges Main Street has continued to face in the last 10 years.

One credit union or community bank is going out of business each working day. Now, this must be addressed and these critical institutions have forwarded the relief necessary, which you talked about. So, as you examine ways to improve the effectiveness and efficiency of supervisory programs, how do you plan to ease the regulatory burden on the community financial institutions?

Mr. QUARLES. Well, I think, it is through a continuing examination of where it is that we are imposing costs that aren't necessary in order to achieve our objectives. I think that we can. I think that over the course of the last couple of years, I think that we have reduced those costs.

As I had mentioned in response to an earlier question. When I was an investor in smaller banks, the level of that compliance cost was much greater than it had been in the past and was a significant factor in decisions. I think that is a little less over the last couple of years. And, going forward, I think we can make it even less.

Mr. WILLIAMS. Well, that is important because it just hits their bottom line and—

Mr. QUARLES. Precisely.

Mr. WILLIAMS. —keeps it from getting out in the system.

Mr. QUARLES. Yes.

Mr. WILLIAMS. So, as you reflect back on the regulatory actions of the Federal Reserve over the past 8 years, you have recently discussed the need to review the costs and benefits of past initiatives. While I understand that the Federal Reserve is not like most other agencies who are required to adhere to cost-benefit analysis in their rulemakings, I would like to see more consideration given to the consequences of the board's regulatory actions.

So, as you undergo the review of the effectiveness of past initiatives, what factors are you look for and will you make the conclusions of these and reviews available to Congress to examine?

Mr. QUARLES. We are looking, in general, across a broad range of measures of effectiveness of the core elements of regulation. And, clearly a significant portion of that is the cost that they impose upon institutions particularly, both, direct cost and then a broader concept of cost that are imposed on the system and on society.

We are still determining, as this process go underway, exactly how we will deal with the results and how we will make the results public, but certainly, that we will inform our interaction with Congress and our public statements, as to the—as we think about improving the efficiency of regulation.

Mr. WILLIAMS. OK. Mr. Chairman, I yield my time back to the Chair, thank you.

Mr. QUARLES. Thank you.

Mr. ROTHFUS. [Presiding.] The gentleman yields back. The gentlewoman from Utah, Mrs. Love, is recognized for 5 minutes.

Mrs. LOVE. Thank you for testifying today, Mr. Quarles. Last week, the House passed the Volcker Rule Regulatory Harmonization Act, which would conclude community—which would exclude community banks from compliance with the Volcker Rule by exempting banks under $10 billion with limited trading activity. Does the Federal Reserve support exempting community banks from the Volcker Rule?

Mr. QUARLES. Yes, I think that that is a decision that Congress makes. I think that would be, entirely, appropriate.

Mrs. LOVE. OK. So, you would—you would support the—OK. Does the Federal Reserve believe the Volcker Rule is an appropriate or necessary response to the financial crisis or do you think we need to tailor it back a little bit?

Mr. QUARLES. I do think that certainly, the way that we have implemented the Volcker Rule—and that is less Congress's fault than the regulator's fault—it has been excessively burdensome.

Probably the scope of the Volcker Rule limits our ability to really focus on what the Volcker Rule is trying to get at. I just—I think that it does limit our ability to respond.

Mrs. LOVE. Would the Federal Reserve support other changes to the Volcker Rule such as, what we talked about, maybe even expanding the range of banks that are exempt from the rule or even repealing it altogether?

Mr. QUARLES. Yes, in terms of supporting them, I think that those are decisions for Congress to make. And if Congress makes them, we would have no difficulty implementing them. Obviously everything depends on the scope of the particular proposals, but I don't that doing that would create any risk to the safety and soundness of the financial system, at all.

Mrs. LOVE. OK, so, you don't—it almost sounds like you don't really have an opinion about it. You are just saying we are going to take direction from Congress whether it is repealed or not. I just want to get some expertise and experience. Would you support expanding the range of banks that are exempt or just—

Mr. QUARLES. Yes, I don't think that doing that would create any financial stability risk, at all.

Mrs. LOVE. OK. We are also learning more and more about the other unintended consequences with the rule. One that has come up has to do with non-financial companies that own depositories, such as ILCs (industrial loan companies) or unitary thrifts. As the Volcker provision is drafted, if a non-financial company owns a depository, the Volcker requirements apply to all their operations, even those not engaged in any financial services.

This means that non-financial company's ability to carry out some basic risk management could be seriously impacted. Do you believe that the intent of the Volcker provision was to apply it to the non-financial affiliates of an industrial company that owns a depository?

Mr. QUARLES. I am not sure whether that was the intent of the provision, but it may be what the statute says. That is among the issues that we have to deal with in the current statutory construct—statutory language of the Volcker Rule.

Mrs. LOVE. OK, the health and the viability of industrial banking sector is something that is really important to me. As a representative from Utah, I can attest to the importance of our ILCs, the vitality of our State's economy, the size and strength and diversity of our State's banking sector, even to the health of our non-profits, which benefit not just from the financial contributions, but also the intellectual capital that they are able to draw from their colleagues in the banking sector.

It was a big loss to our State when GE decided to give up their banking charter due to the current regulatory environment including the Volcker Rule. I would just be really interested in your thoughts regarding industrial bank sectors. Have you had a chance to review the safety and soundness records of the ILCs at all?

Mr. QUARLES. As a citizen of Utah, I am very familiar with them, and it hasn't been a—and I am familiar with all of the facts that you cite and they are all true and meaningful. It hasn't been a project of the Federal Reserve up to now to consider our regulatory system and how that applies to the ILCs but I am very aware of the importance of the issues that you are stating and the importance of ILCs.

Mrs. LOVE. So you are—you would agree that ILCs have been a stable source of capital in our communities, even during the financial crisis?

Mr. QUARLES. That certainly was my experience, yes.

Mrs. LOVE. OK, thank you, Mr. Chairman, I yield back the rest of my time.

Mr. ROTHFUS. The gentlewoman yields back. The Chair recognizes the gentleman from Arkansas, Mr. Hill, for 5 minutes.

Mr. HILL. Thank the Chairman, thanks Mr. Quarles for being here. I want to echo Chairman Hensarling and Chairman Luetkemeyer's comments about cost-benefit analysis. I noted that back during disco days in 1979, that the Fed agreed to be—abide by OMB's cost-benefit analysis rules, but really hasn't as a general matter over that 35 years.

So I was really heartened by your speech in January where you thought cost-benefit analysis was important, and you have set up a group to look at policy assessment. Does that imply that you are supportive of a regular look at all Fed rules on a cost-benefit basis?

Mr. QUARLES. Yes, I think that we need to do a better job of that. We haven't decided as a board, exactly how we will implement that. But I think that we can do a better job, I think that is evident.

Mr. HILL. And I think, just from my past experience of being in the regulated industries for those same 3 decades, this issue that economists frequently look at marginal cost of a rule, but not at average costs, not at the cumulative cost.

And so this idea of looking at compliance cost by bank size on a percentage of average assets or a percentage of pretax earnings I think should be part of that cost-benefit analysis, and not just look at the particulars of the rule that a group of analysts are considering.

It is the idea that it is—you have heard the old expression of the final straw that breaks the camel's back, let's measure that whole pile of straw and how the marginal rule impacts it. So thank you for that.

Recently I was looking at FINRA (Financial Industry Regulatory Authority), a rule that is gone—going final within Rule 4210, which has to do with mortgage-backed security agency securities and putting up margin on those securities.

This is something the commission has asked FINRA to do and the SEC has approved this rule, and it is going to final, but from reading it, it appeared to me to be two issues. First of all, this says that if we are doing a when-issued mortgage-backed securities pool, that during that 30-day inter-when-issued basis, we would be putting up margin on those securities based on a mark-to-market, which I understand.

And this is integral to every consumer in our country, because that would get a 60-day lock for individual home mortgage, which is very important to consumers. But in looking at this rule, it appears to me two problems with it I would like you to look into it.

One, it appears anti-competitive to me for a bank-owned dealer has an advantage over a non-bank-affiliated broker dealer. Why? Because if FINRA just applies to the broker dealer, a broker dealer that has a bank affiliate, could simply move this one issued business over to the bank, therefore being anti-competitive with non-bank-owned dealers. And I have a problem with that. I think that is unfair in public policy.

And second, you may want to have a little jurisdictional concern because I am not sure that the SEC has the authority to regulate margin and agency securities. I think last time I checked, that was a Federal Reserve prerogative. So would you commit to me that you will look into this rule and see how we can assure a level playing field in the agency market?

Mr. QUARLES. Yes, absolutely. I think that needs to be a very high principle in regulation generally, is that regulation should not be tilting a playing field one way or the other across a whole range of issues.

Mr. HILL. Appreciate that, and in the time I have remaining, another issue I think that is—I think the Fed should weigh in on is—is this issue where under Dodd-Frank, the TLAC (total loss-absorbing capacity) process, putting up abundant capital to resolve potential bank crisis.

I think now appears to me to be in conflict with our new and—tax reform and tax cut package that we are very proud of in the Congress. We believe this is why CBO says we are growing at 3.3 percent now, a big increase from the past decade. And that is great for all Americans.

But part of that was, as you know, on the international tax regime, this base erosion anti-abuse tax feature of the tax reform bill, now appears to me to be in conflict with financial services policies on TLAC. Are you familiar with this and have you talked to the Treasury about this potential conflict?

Mr. QUARLES. Yes, I am familiar with the issue, I have talked with the affected banks, with the Treasury, and what we are trying to do or asking the banks to do is to first quantify the issue because quantifying it is very complex, as you know, because it depends on their whole tax position.

And that has taken them some time, we are beginning to come back with some estimates now from at least some banks at what they think the quantifications are, and then the question is—is the best way to do that through a Treasury rulemaking, through thinking about Federal Reserve regulatory policy, and we are just beginning to start working with the Treasury on that.

Mr. HILL. Good, well best wishes and please keep up apprised on your thoughts there. Thank you very much, I yield back, Chairman.

Mr. QUARLES. Thank you.

Chairman HENSARLING [presiding]. Time of the gentleman has expired. The Chair now recognizes the gentleman from Georgia, Mr. Loudermilk.

Mr. LOUDERMILK. Thank you very much, Mr. Chairman, and thank you for being here with us. A couple areas I just—I want to talk about with you is—is first a 1977 bill, the Community Reinvestment Act, to start with, then I want to talk a little bit about cybersecurity, if we have time for it.

But, as you know, this bill was implemented in 1977, and I, as many others believe, it is time to revisit and revise this bill. And last month I wrote a letter with Mr. Tipton and Mr. Luetkemeyer to the three banking agencies and the Treasury Department about modernizing the implementation of the CRA.

And we received back from the Treasury Department, which recently released its recommendations for CRA reform, and the OCC will be doing the same, and the FDIC Chairman, Mr. Gruenberg, wrote us back and said he agrees that we need to revisit this.

And the three areas that I—I think—that we have been focusing on and I think we need to pay attention to, is, first, the taking in account of the recent developments in fintech; two, is being transparent with banks about which loans receive CRA credit; and the third is giving banks timely CRA exam results.

And so, my first question is simple. Do you agree that there is a need to revisit the implementation, particularly in these areas?

Mr. QUARLES. Very much so. As you have noted, it is a law from 1977, and the world is very different today than it was in 1977, and achieving the same objectives will probably require different measures now than it did then.

Mr. LOUDERMILK. And it—I am often reminded, when I go back and I watch movies from 1977, how much has changed. And it is not just the hair styles, but the economy and technology has changed, and we have been extremely slow in keeping up with technology and the regulations for that. And so I appreciate your answer.

Follow up on that, do you think the CRA can be modernized without detracting from its core purpose?

Mr. QUARLES. Not only without detracting from its core purpose, I think that for it to achieve its core purpose in the modern world, I think it can better achieve it if we take a fresh look at it.

Mr. LOUDERMILK. Well, I appreciate it, and I agree with you on that. So I look forward to working with you as—as we do this. Shift over a little bit on cybersecurity, I spent 20 years in the IT business, this is an area that is very important to me.

And I know during your speech at the Financial Services Roundtable in February, you stated that you support the private sector's efforts to harmonize cybersecurity efforts across the financial services industry, and I agree with that.

But I also think there is a need for Federal regulators to harmonize the many overlapping and sometimes conflicting cybersecurity standards that are applied to private sector companies.

Especially a lot of banks will have multiple cybersecurity requirements—or financial institutions, I should say—that are differing from the different regulating agencies. In fact, I had one tell me one time, Well, if I am in compliance with Regulator A, I am out of compliance with Regulator B in certain instances.

What is the Federal Reserve doing to coordinate these cybersecurity supervisory activities with the other regulatory agencies?

Mr. QUARLES. There are some standing processes—interagency processes that are intended to help coordinate that are focused on the IT infrastructure exams, and the infrastructure of the financial system, generally.

But, as I have indicated, I do think that we need to, in those processes, and within the Federal Reserve, we really need to rejuvenate the way we are thinking about it, and focus on real resiliency, and what we can do to support that, as opposed to pure compliance.

Mr. LOUDERMILK. So do you think there is more that we can do to coordinate between the—

Mr. QUARLES. Very much so.

Mr. LOUDERMILK. —various agencies? You say, when you have conflicting requirements, it actually harms cybersecurity than actually strengthens it, so I think—

Mr. QUARLES. Absolutely.

Mr. LOUDERMILK. —the same thing that you were saying about the CRA, I think we can apply to cybersecurity. Last question: In your testimony, you said that you are focusing on mitigating cybersecurity risk to financial institutions. Can you just hit on a few of the things that you are doing in that arena?

Mr. QUARLES. Right now the principal effort is in these interagency discussions, to think about where are the real risks in the system. So it is behind the scenes, as to figure out exactly what we ought to be doing, and then we work on how to affect what we ought to be doing.

And they are difficult questions, and we are still working on them, but at very high priority.

Mr. LOUDERMILK. Well, thank you. I see my time is expired, and I yield back.

Chairman HENSARLING. Gentleman yields back. Chair now recognizes gentleman from Ohio, Mr. Davidson.

Mr. DAVIDSON. Thank you, Chairman, and thank you Vice Chairman Quarles. I really appreciate your testimony today, both written and in the Q&A session, so thanks for helping with the transparency that is part of the role.

But I will confess that the average constituent, the average person who is maybe looking at the clock, saying, Hey, I am coming up on my second-shift job, catching lunch or something—they may know that the Federal Reserve's out there. They may know that the Federal Reserve Chairman deals with setting interest rates. They might not differentiate that as monetary policy.

Could you succinctly describe, in a basic way, where the distinction between monetary policy and regulatory supervision is drawn?

Mr. QUARLES. I will try to do that succinctly, but because the two are related in important ways, and that gets very complicated to try to describe.

But our regulation of the financial sector and of the banking system is the development of rules to ensure the safe, sound, and efficient operation of the system.

And then we have a supervisory function, where we examine all of the banks that are subject to our jurisdiction to ensure that they are complying with the rules and operating in a safe, sound, and efficient manner.

Mr. DAVIDSON. Thank you. And having been the first person to fill this role, I appreciated your testimony earlier with Mr. Luetkemeyer, when he was differentiating guidance from rulemaking.

And, of course, rulemaking is generally subject to more oversight from Congress, and we struggle with the guidance. And, frankly, there is very little accountability for what guidance is given, except reactionary after the fact, and then it is hard to substantiate, and it is finger pointing—no, he didn't, yes he did—kind of events.

But it has a profound impact on the economy. In your role, how do you see you personally and your team being able to contribute to clarity around that?

Mr. QUARLES. I think that transparency in all of our processes ought to be something that is a high priority for us. And it has been a priority, but I think it is becoming a higher priority.

And that means that when we—when we are taking an action that we think is going to have the effect of a rule that we intend to apply as a rule, then we should take that through a fully APA-compliant process, and seek notice and comment, and put that forward as a rule.

And then, perhaps in the past at the margin that sometimes hasn't happened. I mean, that distinction has been blurred. I do think there is a role for guidance. I don't think that, it is never the case that we would—that we would put out guidance. The banks ask us for guidance, right? Once we have gone through the complex—

Mr. DAVIDSON. We appreciate that distinction from the Fed's activity and the CFPBs, for example, where they don't want to be accountable for even giving guidance.

Mr. QUARLES. Precisely.

Mr. DAVIDSON. Yes.

Mr. QUARLES. And with respect to our guidance, I think that we can be, as opposed to that, which sometimes in the past—that is less than the case of the recent past, but sometimes in the past has—has just gone out to the examiners and the banks.

I think we can go out for comment on guidance, even when something is not a rule. I think that we—I think we benefit from that process. It is not just—again it is not just a question of being fair to the regulated industry, it is not just a question of being accountable to the public. It is also a question of improving the content of what it is that we do by getting as much comment on it as possible.

Mr. DAVIDSON. Well, thank you and thank you for that role in the ability to protect the average American in their safety and soundness of the financial markets in that way.

And Chairman Barr alluded to a bill that I have introduced that would provide a way to do more of that accountability through putting the regulatory side, the supervision side of the Fed on appropriations. And so I look forward to working with you and Chairman Barr on that as you committed to do, so thank you.

Another important role is the engagement with international agreements, and I will confess I have been very concerned about the previous path and personally affected by some of those decisions. How do you plan on having the Fed represented at these international accords in the future given your leadership role?

Mr. QUARLES. So, as I have indicated, I do think that it is in our interest. I know that there has been frustration with these bodies in the past. I think that our engagement with them is in our interest, in part precisely because of that reason. We have particularly for our institutions that do operate globally; we don't want the decisions made in those bodies made without our strong and effective engagement.

I think that we need to argue for them to continue their evolution toward more transparency. I think they have been. I think that as we implement the rules we need to be transparent about how to do that.

Mr. DAVIDSON. Thank you, my time is expired and I yield.

Chairman HENSARLING. Time of the gentleman has expired. The Chair now recognizes the gentleman form North Carolina, Mr. Budd.

Mr. BUDD. Thank you, Mr. Chairman, and also thank you, Vice Chairman Quarles, for coming today and again for your service. You are a breath of fresh air.

My questions are about a smaller part of your portfolio but no less important. It is about insurance oversight.

Mr. QUARLES. Yes.

Mr. BUDD. So specifically I want to talk about the ongoing work on international capital standards that are being developed by the International Association of Insurance Supervisors. So in November of last year at a meeting in Kuala Lumpur, IAIS announced that it was moving forward with an ICS (Insurance Capital Standard) version 2.0. It will be very similar to European Solvency Regulation and will use European accounting rules and European capital resource determinations.

So in my view, this European-centric approach is unworkable for the U.S. Insurance Regulatory system. So with that being said, my first question is do you believe existing State-based capital requirements promote the solvency of the U.S. insurance companies?

Mr. QUARLES. I think they do, yes.

Mr. BUDD. OK, very good. Last week I received a response from Chairman Powell to a letter I sent him on this same topic. Specifically, Chairman Powell cites two rationales for the creation of ICS. One was to provide a level playing field. The second was to prevent regulatory arbitrage. So while I know the response I received was not from you, you and Chairman Powell work very closely together on these, and so I have two brief questions on Chairman Powell's response.

First, why is capital the only component when EU regulators and EU insurers talk about a level playing field? And I will go on. So does Europe have the robust insured—consumer protection insurer resolution mechanisms that we have here in the U.S., and where is the level playing field on these very important topics?

Mr. QUARLES. I agree with you that we need to be thinking about a level playing field across the whole regulatory regime—

Mr. BUDD. And not just with capital standards?

Mr. QUARLES. And not just with capital, certainly yes. That is—that is—that ought to be an important part of our general engagement.

Mr. BUDD. Could you elaborate other areas where we would want to have a level playing field?

Mr. QUARLES. As you have indicated, I think that all the elements of a regulatory regime affect the burden and competitiveness of an institution and it is in our interest to look across all of the elements. And different fora—there may be different fora that are the right places to try to push those arguments, depending on different types of regulation, but it is in our interest to ensure that the whole playing field is level.

Mr. BUDD. So beyond the capital standards insurance and consumer protections and insure resolution mechanisms, level the playing field there, as well, is fair to say? Next question, should the Federal Reserve as a prudential or safety and soundness regulator be concerned about an international level playing field. Isn't that more of a focus of trade policy and not just monetary policy?

Mr. QUARLES. Well, as a financial regulator though, I do think that it gets a little weedy. You know our trade policy generally stands back. Our trade representative and trade negotiations stand back from financial regulation and those are separately negotiated—positions are simply negotiated because we do have an interest in ensuring that our internationally active firms are treated equally and—and—and not subject to differing rules in different jurisdictions in ways that might be deleterious to them.

I do think that we have an interest in engaging in those fora to try to ensure level rules in those areas, and I think that it is appropriate for that to be done in the financial regulatory sphere, both with the Federal Reserve and with other participants.

Mr. BUDD. I appreciate the clarification. Mr. Chairman, I yield back. Thank you.

Chairman HENSARLING. Would you yield to the Chairman?

Mr. BUDD. I yield to the Chairman.

Chairman HENSARLING. Mr. Chairman, under the living will requirements, and I think we may have touched upon this once, you are really given—the Fed is given unreviewable discretion to really fundamentally restructure a number of private businesses that seemingly lack objective standards. And so the entirety of the annual living will process is all predicated on a quote, unquote, credible plan, whatever that is.

So you have talked about transparency. What is it you can do to increase transparency to the living will process? And with respect to having to do this on an annual basis, do you have it within your power to do it on a less frequent basis?

Mr. QUARLES. With respect to transparency, I do think that as with many of our regulatory and supervisory issues we have with firms, I think that we can just be more interactive and open about what our expectations are, get more comment from them about—about our expectations, ask more questions, all of that is something I think that we can do better.

On the frequency, yes, we do have it in our power to have these assessments done less frequently and I think we are probably at a time where it is appropriate to do that. Whatever the merits of the prior process of restructuring, it is largely complete.

Chairman HENSARLING. Time of the gentleman from North Carolina has expired, and the Chair now recognizes the gentleman from Tennessee, Mr. Kustoff.

Mr. KUSTOFF. Thank you, Mr. Chairman, and thank you, Vice Chairman Quarles, for being here with us today this afternoon. I am going to go a little bit more broad than some of the other questions.

Obviously the Federal Reserve—community bank background and, I saw that firsthand with good community banks, especially in my area of West Tennessee.

You gave a speech a few weeks ago to the HOPE Global Forums annual meeting and in that speech, the way I read it, you acknowledge that the small business credit needs are in many instances not being met. Do you believe that there is a need to reduce the regulatory burden on our small community institutions so that they can continue to meet the needs of our small local businesses?

Mr. QUARLES. Yes, I think that there is a need to do that and that it is important for us to address it.

Mr. KUSTOFF. And you talked in your speech about the easing, and in particular, are there particular types of companies that you have identified or that you would identify as having the most difficulty finding adequate access to credit?

Mr. QUARLES. So I am sure that that study has been done. I do not know the facts, but I can certainly get them for you as to our assessment of whether there are particular companies that have the most difficulty getting access credit.

Mr. KUSTOFF. Thank you very much. As it relates to—as it related to fintech, can you explain, if you would how the Fed carries out a supervisory role in new and expanding markets to protect consumers from fraud and cyber attacks?

Mr. QUARLES. With respect to fintech, our supervisory relationship with fintech principally comes from where the fintech firms connect with the directly regulated financial system of the banking system, which most of them do. They receive their funding or access to the payment system through a regulated bank usually in one place or another.

And when they do that, then we both supervise the bank as it engages with the fintech company and in certain cases, we have the ability to look at the fintech company and its connection to the bank, and then we look and determine the compliance of that activity, both with safety and soundness regulation, as well as with consumer compliance regulation.

Mr. KUSTOFF. Thank you very much, and I yield back the balance of my time. Thank you, sir.

Chairman HENSARLING. Would you yield to the Chairman?

Mr. KUSTOFF. I yield to Chairman to the gentleman.

Chairman HENSARLING. I thank the gentleman for yielding. Chairman Quarles, back to the living wills. As I understand it Section 165 of the Dodd-Frank Act would allow you to publicly disclose the assessment framework. Is that your understanding, as well?

Mr. QUARLES. Yes, I think that we could disclose it.

Chairman HENSARLING. OK. Are you familiar with H.R. 4292 of Congressman Zeldin's Financial Institutions Living Will Improvement Act?

Mr. QUARLES. I am.

Chairman HENSARLING. Well, it would—it would do just that. And are you familiar that this bill passed the House 414–0?

Mr. QUARLES. I knew that there was a bill that had and now I know it is that one.

Chairman HENSARLING. You might want to just take my word for it. Anyway, please take this as a very strong suggestion of the

House of Representatives. So, you do have the authority to publicly disclose this assessment framework. The House unanimously is suggesting that you do that. I hope that you will give it careful, careful consideration.

In addition, I believe one—Section 165 of Dodd-Frank would also allow the Federal Reserve to provide feedback on Section 165D, living wills. Is that your understanding, as well?

Mr. QUARLES. Yes.

Chairman HENSARLING. And I suppose you could do this in a timeframe of, say, 6 months?

Mr. QUARLES. That would be possible.

Chairman HENSARLING. OK. Just for your edification, you will also find this in H.R. 4292—and I would suggest that the Fed take a very serious look at doing just that.

Time of the gentleman has expired. The Chair now recognizes the gentleman from Indiana, Mr. Hollingsworth.

Mr. HOLLINGSWORTH. Well, good afternoon. Thank you so much for being here. You have reached the end of the line here. Like Chamberlain at Little Round Top. Well, I wanted to reiterate a few things. I know you have talked a lot about cost-benefit analysis, comprehensive analysis, the importance of that overall, and obviously I am working on a bill specifically that we have dropped that really helps and drives the Federal Reserve to do cost-benefit analysis where their regulations are in excess of the international standard.

And just the statement that says, look, if it needs to be in excess than it should be delivered through a cost-benefit analysis. People deserve to know the reasons why we have done this right and if the analysis itself does not bear out that it should be in excess of international standards then we want to know that as well.

And so it does nothing to force it to match international standards, does nothing to change existing standards, but just as you have said in your testimony as you said in the Q&A period here how important transparency is really helps with that process. So I would love it if you take a look at that as well.

Mr. QUARLES. Absolutely.

Mr. HOLLINGSWORTH. On a very, very different topic I also want to talk about G-SIB surcharge, and how important that is and I am actually reading a book right now that talks a lot about Wheeler and Feynman's collaboration on quantum mechanics. And one of the things that really stuck with me was they said the hardest part about quantum mechanics is the constant change as well as the variables.

And that brings me back to some of the coefficients in the method, too. They have been in place and they have been set since 2015 but the economy, the world, the environment, the risk profile have all changed since then. And so, I wondered if you might comment a little bit about the potential to update some of those coefficients to reflect the new reality and specifically with regard to economic growth. We don't want our firms to be penalized because the economy is growing, because the world has gotten bigger. I wonder if you might comment on that a little bit.

Mr. QUARLES. I think that those are very good points. I think those are things that we have to look at with respect to the calculation of the G-SIB surcharge in general. The original calculation of that was made a number of years ago and in part in relation to the living will process that we have just been talking about—were just talking about.

If we leave, which I do believe I think we—I think it is generally accepted that that has resulted in improvement in resolvability of the firms and that means that the consequence of their default is less. And the reason for the G-SIB surcharge is precisely our assessment of the heightened consequence of their default.

If we have reduced that consequence, we ought to be able to think about—now I don't know exactly what the size of that effect is, what the outcome of that would be, but then a process of thinking about is appropriate now.

Mr. HOLLINGSWORTH. Yes. And, we should reflect that with the reality that we see on the ground, like you said, not only with their lowered risk profile, but the enhanced economic environment, as well.

Ultimately, we haven't slaughtered the business cycle. But we want to make sure that at every step of the way, that the coefficients themselves reflect reality, because if they don't, they start to drive reality and cause firms to make decisions that might not be in the best interest of a stable, safe, secure, but also efficient financial system like you pointed out.

Specifically, one of the things that I wanted to talk about within the method to and within the coefficients is how the short-term wholesale funding is measured and how certain—are treated. And I just wanted to draw your attention to those, as well.

Obviously, like you talked about, I think in your written testimony, you even refer to the great changes that have been made over time, specifically with the G-SIBs in reducing their reliance, but making sure that ultimately we have that reflected in the equations themselves. And I appreciate your work.

And then, as David mentioned, how important it is to overall step back, and how much we appreciate the work that you are beginning, and really looking at, and as you say in your testimony, the fact that it is not incompatible to say we want a safe and secure system, but we also need an efficient, effective system, as well, and making sure that those two go in hand. And I really appreciate the fact that you have been willing to look at so many things, recalibrate so many things.

Because I think this is very much an iterative process and making sure that the things that we have done in the past, whether that is Congress or regulators, haven't had a deleterious effect on the economy, either credit availability, but also on U.S. firms' ability to compete around the world.

Because ultimately financial services is something we do exceptionally well in this country. I will make sure that that continues to be the case and that public policy doesn't stand in a way of that. So thank you for being here today. With that I go back, Mr. Chairman.

Chairman HENSARLING. Would you yield to the Chairman?

Mr. HOLLINGSWORTH. I would, indeed.

Chairman HENSARLING. Mr. Chairman, going back to the CCAR process, recently, the Fed announced that it would no longer object to a company's capital plan based upon the qualitative deficiencies for banks under $250 billion, is that correct?

Mr. QUARLES. Yes.

Chairman HENSARLING. So, under Section 165 of the Dodd-Frank, you also have the power to do that for all banks, is that correct?

Mr. QUARLES. That is also correct.

Chairman HENSARLING. Are you considering doing that for all banks?

Mr. QUARLES. We are.

Chairman HENSARLING. Excellent.

The time of the gentleman has expired. There being no further members in the queue. The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

[Whereupon, at 12:58 p.m., the committee was adjourned.]

A P P E N D I X

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Statement by

Randal K. Quarles

Vice Chairman for Supervision

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

April 17, 2018

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

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

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

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

Current Condition of Regulated Firms

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

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

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

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

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

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

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

Regulatory and Supervisory Agenda

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

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

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

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

Efficiency

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Transparency

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

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

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

Simplicity

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

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

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

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

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

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

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

International Engagement

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

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

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

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

Conclusion

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

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

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

Congress of the United States
Washington, DC 20515

April 13, 2018

The Honorable Jerome Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitutions Ave., NW
Washington, D.C. 20551

The Honorable Randal Quarles
Vice Chairman for Supervision
Board of Governors of the Federal Reserve System
20th Street and Constitutions Ave., NW
Washington, D.C. 20551

Dear Chairman Powell and Vice Chairman Quarles:

The Federal Reserve's input to bank holding companies on effective senior management, the management of business lines, and independent risk management and controls for large financial institutions is valuable but the Federal Reserve should exercise extreme caution and rarely substitute its will over the will of shareholders and boards of directors.

The Federal Reserve's proposed guidance on Supervisory Expectations for the Board of Directors (Docket No. OP-1570)("Guidance") has the potential to further empower the Federal Reserve to manage to address the regulatory overreach into the boardroom that has placed undue burdens on bank boards.

Boards of directors continue to spend far too much time on matters that do not relate to their core functions to oversee management on behalf of shareholders. Although the proposed guidance purports to distinguish between the role of the board (one of oversight and guidance) and the role of management (day-to-day functions), it continues to inappropriately blur these lines by creating numerous new requirements that a board "ensure," "establish," "approve," "set," "develop," or "detail" items that simply do not reflect a board's oversight of and guidance to management. As such, these terms would impose new legal and managerial requirements on a board that would have the board direct a bank holding company's daily business decisions.

Additionally, the proposed guidance is overly prescriptive and does not seek to tailor the guidance to bank holding companies based on activities or size. Instead, it takes a granular "check the box" or "one-size-fits-all" approach in order for the Federal Reserve to consider a board to be "effective." This is particularly problematic as the Federal Reserve attempts to regulate through the use of "examples" set forth in the proposed guidance. Realigning supervisory expectations for boards of directors is critical, nonetheless, just because a topic may relate to a core board function, for example the oversight of strategy, it does not necessitate that the Federal Reserve regulate these areas. The Federal Reserve cannot assume the legal duties of care and loyalty from an elected board of directors.

This proposed guidance must not become another supervisory tool for examiners, who generally lack expertise in corporate governance, to demand additional obligations for boards. Shareholders elect a board to then appoint and oversee management to operate the business.

The Federal Reserve must revise the proposed guidance to specifically acknowledge that there is no "one-size-fits-all" or "gold standard" approach to corporate governance and expressly allow boards of directors and management of bank holding companies the necessary discretion to operate in a manner they deem most appropriate given their business, structure and practices.

We appreciate your willingness to consider our comments. We expect that the Federal Reserve will improve the the proposed guidance so that upon its adoption those institutions that are subject to the Federal Reserve's oversight will have the legal clarity and certainty that smart regulation demands. Clear and specific guidance would reduce examiner discretion and prevent the micromanagement of private companies by the federal government.

Sincerely,

Andy Barr
Chairman
Subcommittee on Monetary Policy and Trade

Bill Huizenga
Chairman
Subcommittee on Capital Markets, Securities, and Investment

Sean Duffy
Chairman
Subcommittee on Housing and Insurance

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Representative Beatty:

1. Governor Quarles, you dedicated a large part of your written testimony discussing efficiency and the efficiency of financial regulation at the Federal Reserve, including focusing on the most stringent of supervisory standards and practices on the riskiest firms. I represent the Third Congressional District of Ohio where we have two insurance companies that are supervised by the Federal Reserve, because they are insurance savings and loan holding companies. These two companies are some of only a handful of insurance companies who are regulated by the Federal Reserve due to the fact one of their subsidiaries is a depository institution.

Recently, I joined with my colleague from Pennsylvania, Mr. Rothfus, to introduce legislation to provide some regulatory relief to these insurance companies from duplicative federal group-wide supervision by the Federal Reserve that our state insurance departments already regulate. This duplicative, bank-centric supervision and examination of these insurance companies does not appear to be efficient or reflect the actual risk these companies pose to the financial system.

Have you and your team looked into this duplicative supervision framework at the Fed, and what are you doing to ensure that the Federal Reserve's rules and regulations are appropriate and proportional to risks these companies pose to the financial system?

The Federal Reserve relies on state insurance regulators to supervise the business of insurance and does not conduct its own independent supervisory work on insurance activities. To avoid duplication and promote efficiency, Federal Reserve supervisors also meet regularly with each insurance savings and loan holding company's (ISLHC) state insurance regulator(s) to discuss any risks associated with insurance activities and whether they could affect the bank or the consolidated condition of the ISLHC. State insurance regulator documents, such as the Own Risk Solvency Assessment (and any accompanying state regulator analysis) and Insurer and Group Profile Summaries are used in the Federal Reserve's supervision. This allows the Federal Reserve to draw conclusions about the condition and performance of a company's insurance activities based on state reports and analysis rather than conducting its own analysis of these activities. In addition, the Federal Reserve tailors its consolidated supervisory approach to focus on areas outside of the business of insurance, including assessing an ISLHC's consolidated risk management framework, material non-insurance subsidiaries, and the potential impact the firm's nonbanking activities may have on its subsidiary insured depository institution.

2. Throughout today's hearing, you have discussed the Federal Reserve's ongoing effort to streamline the Volcker rule. While I would certainly urge caution in your approach, I believe that one area ripe for review is the inequity in the market of requiring a small subset of insurance companies to comply with the rule, while most do not. As you know, the text of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires that implementation of the Volcker rule appropriately accommodate the business of insurance. While many insurance companies are not subject to the Volcker rule, several smaller, less risky, less complex insurance companies are subject to it due to Federal Reserve group-wide supervision. I would urge the Federal Reserve to include examination

of the Volcker rule as it pertains to insurance companies regulated by the Federal Reserve and adjust application of the rule to these companies to eliminate these inequities in the market. What are your views on this topic?

Section 13 of the Bank Holding Company Act (commonly referred to as the "Volcker Rule") applies by its terms to banking entities, the definition of which includes insured depository institutions and their affiliates. Accordingly, any insurance company that is affiliated with an insured depository institution would be deemed to be a banking entity under the Volcker Rule. However, the statute and the implementing regulations provide specific exemptions for the activities of regulated insurance companies. Under these exemptions, regulated insurance companies are generally exempt from the proprietary trading and covered fund restrictions of the Volcker Rule to the extent that these activities are conducted in compliance with the insurance laws and regulations of the state in which the insurance company is domiciled. Under the current statutory framework, the Board and other implementing agencies are unable to completely exclude from the application of Volcker Rule insurance companies that are affiliated with banking entities.

3. For being the global leader the in financial services industry, the United States has lagged behind many other countries when it comes to our payments systems, specifically with regards to the speed of those payments. Last year, the Federal Reserve's Faster Payments Task Force released recommendations for accelerating real time payments in the United States with the goal of reaching real time payments by 2020. Since taking office, what, if any, steps are being taken by the Federal Reserve to modernize our payments system to get to faster, real time payments?

The Federal Reserve plays many roles in the payment system, including payment system operator, supervisor of financial institutions and systemically important financial market utilities, regulator, researcher, and catalyst for improvement. Acting primarily in its catalyst role, the Federal Reserve encouraged payments stakeholders to join together to improve the payment system in the United States in its "Strategies for Improving the U.S. Payment System" paper (Strategies Paper), issued in January 2015.[1] The strategies outlined in the paper included the creation of task forces focused on faster payments and payment security, both of which have provided a forum for a diverse group of industry participants to collaborate on an ongoing basis since they were established in mid-2015.

The Faster Payments Task Force (FPTF) had the mission to identify and assess alternative approaches for implementing safe, ubiquitous, faster payments capabilities in the United States. In support of this mission, the FPTF created the Faster Payments Effectiveness Criteria to assess faster payments solutions and as a guide for innovation in the payments industry.[2] The FPTF also designed a process for which faster payment solution proposals could be submitted for assessment against these Effectiveness Criteria.

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[1] Federal Reserve System, "Strategies for Improving the U.S. Payment System," January 26, 2015. Available at https://fedpaymentsimprovement.org/wp-content/uploads/strategies-improving-us-payment-system.pdf.

[2] Faster Payments Task Force, "Faster Payments Effectiveness Criteria," January 2016. Available at https://fasterpaymentstaskforce.org/effectiveness-criteria-and-solution-proposals/.

The FPTF released the first part of its final report in January 2017. The second part of the final report, released in July 2017, reflected the FPTF's perspectives on challenges and opportunities with implementing faster payments in the United States, outlined its recommendations for next steps, and included the proposals and assessments for the 16 participants that opted to be included in the final report.[3] The FPTF recommendations identified the need for ongoing industry collaboration to address infrastructure gaps; to develop models for governance, rules and standards; and to consider actions and investments that will contribute to a healthy and sustainable payments ecosystem. A number of recommendations called for Federal Reserve support to facilitate this ongoing collaboration.

The mission of the Secure Payments Task Force (SPTF) was to provide a forum for stakeholders to advise the Federal Reserve on payment security matters, and identify and promote actions that could be taken by payment system participants collectively or by the Federal Reserve System. The SPTF worked to advance understanding of the industry's most pressing payment system security issues: identity management, data protection, and fraud and risk information sharing. The SPTF concluded its efforts in March 2018, following publication of its final deliverables.[4]

Following up on the work of the task forces and other efforts to advance both the desired outcomes (focused on speed, security, efficiency, international payments, and collaboration) outlined in the Strategies Paper, the Federal Reserve published, in September 2017, a paper presenting refreshed strategies and tactics that the Federal Reserve is employing in collaboration with payment system stakeholders.[5]

The Federal Reserve kicked off these refreshed strategies and tactics in the summer of 2017 by facilitating the industry's work to address the FPTF recommendations related to governance, directories, rules, standards, and regulations. In addition, consistent with the FPTF recommendations, the Federal Reserve has been assessing the needs and gaps to enabling 24x7x365 settlement in support of a future ubiquitous real-time retail payments environment. Further, the Federal Reserve has started to explore and assess the need, if any, for any other operational roles to support ubiquitous real-time retail payments. These efforts are being pursued in alignment with Federal Reserve policy on the provision of payment services. With respect to payment security, the Federal Reserve is conducting a secondary research review that is intended to understand more fully what data is available regarding payments fraud.

4. Since assuming your role as Vice Chairman of Supervision, you have sought several changes to supervision and policy regulations within the Federal Reserve. In your testimony before this Committee you have made it clear that the Federal Reserve, in collaboration with the OCC and FDIC, will seek public comment on changes to the Community Reinvestment Act.

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[3] Faster Payments Task Force, "Final Report Part One: The Faster Payments Task Force Approach," January 2017, and "Final Report Part Two: A Call to Action," July 2017. Available at https://fasterpaymentstaskforce.org/.

[4] See, https://securepaymentstaskforce.org.

[5] Federal Reserve System, "Strategies for Improving the U.S. Payment System: Federal Reserve Next Steps in the Payments Improvement Journey," September 6, 2017. Available at https://fedpaymentsimprovement.org/wp-content/uploads/next-step-payments-journey.pdf.

Section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, specifically section 342(b)(3), requires each Director of the Office of Minority and Women Inclusion (OMWI) to advise the agency administrator on the impact of the policies and regulations of the agency on minority-owned and women-owned businesses.

a. Pursuant to this section, have you met with the Federal Reserve's OMWI Director?

b. Have you met with, or received input from, the Federal Reserve's OMWI Director in preparation of publicizing your joint proposal to modernize the Community Reinvestment Act?

If so, what was the nature of those conversations?

If not, do you plan to meet with your Director before you release your joint proposal?

c. Have you met with, or received input from, the Federal Reserve's OMWI Director regarding any changes in policy you have made since assuming your role as Vice Chairman of Supervision?

If so, please list those topics of discussion and a short explanation of those explanations?

If not, please provide a legal justification for non-compliance with this legally-mandated requirement?

In addition to the Director of the Office of Minority and Women Inclusion (OMWI) reporting to our Chairman, I too am available to meet and discuss cultivating diversity and inclusion in all aspects of employment and to be informed and apprised on the impact of the supervision policies and regulations on the communities we serve.

The OMWI Director and the Deputy Director for Policy in the Supervision and Regulation Division also have established a process and schedule to meet and discuss regulations to ascertain potential impact on women, minorities and underserved communities. The OMWI Director also participates with Division Directors, senior staff, and Board Members in an internal work stream at the Board established to coordinate economic inclusion and diversity efforts. The group focuses on initiatives not just at the Board, but also more broadly throughout the Federal Reserve System. Board Members meet regularly with the staff to discuss initiatives and progress.

With regard to the Community Reinvestment Act (CRA), Board staff is continuing to analyze the recommendations made by the Department of the Treasury. I share the Treasury Department's goal of improving the current supervisory and regulatory framework for the CRA based on feedback from industry and community stakeholders. The Board is open to considering ways to make the CRA more effective and believes there are ways to expand the area where we evaluate a bank's CRA performance without losing the regulation's focus on the unique role banks play in meeting local credit needs.

<u>Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Representative Budd</u>:

1. Thank you again for your recent testimony, Governor Quarles. Your insights, thoughtful comments, and responsiveness were much appreciated.

I wanted to follow up and ask some additional questions along the same line of discussion we had during your testimony.

As I mentioned at the hearing, Chairman Powell and I recently corresponded about the recent developments at the International Association of Insurance Supervisors (IAIS) and the International Capital Standard (ICS) that is currently under development. In this correspondence, I asked:

"...why is it necessary to develop a new international capital standard for a small group of internationally active insurance groups?"

Chairman Powell responded:

"...the ICS, if done in an appropriate way that is implementable in the U.S., can limit regulatory arbitrage and help provide a level playing field for U.S. firms that are IAIG and operate globally."

While I appreciate the Chairman's response and attempt to provide a rationale for the ongoing work on an ICS by the IAIS, I am deeply concerned that the stated goals of limiting "regulatory arbitrage" and providing "a level playing field" are just examples of vague regulatory jargon, used by the IAIS, without any real evidence that these dangers exist today in the global insurance markets. I realize you did not send me Chairman Powell's response, but I assume you and the Chairman work closely together on important matters such as this. Also, you sited a number of times that ensuring a level playing field internationally was a goal of yours for international standard setting. I would like to develop a better understanding of these two rationales and why a new global capital rule for the insurance industry will address these issues in a satisfactory way.

<u>Provide a Level Playing Field</u>

Every U.S.-based insurer that I have spoken to about the ICS has informed me that the "level playing field" rationale is actually what the European-based insurers and regulators use to justify the ICS because they don't like their costly and burdensome new solvency rules (Solvency II) and leveling the playing field means, to them, imposing Solvency II or its look alike – the ICS—on US insurers and the rest of the world. As Dr. Adam Posen of the Peterson Institute testified at a Senate Banking Committee hearing in July of 2015:

"Right now, the biggest mistake the FSB is making in this regard is in the attempt to extend Solvency II, the European Commission's regulation for insurance firms, to global application...Insurers certainly need regulation and supervision, including clear capitalization to meet their policyholders' expected payouts. But almost every jurisdiction,

and certainly the US states, already provides such pure protective supervision...The insurers in Europe for the most part rightly hate it, but since it seems inevitable to be imposed on them, they have given up fighting Solvency II, and instead back using the FSB to impose it on the US, Japanese, and other competing insurers. They figure if they will be limited, they want to be sure their global competitors are as well. The US needs to stand up against this in the FSB."

Why would we want to complete a European-centric ICS like the one currently envisioned under the Kula Lumpur Agreement that will make U.S. insurers less competitive with their European competitors?

Are Federal Reserve participants at the IAIS agreeing to construct a new capital requirement for U.S. insurers in order to impose new burdens on US insurers to "level the playing field"? What evidence is there that this is necessary from a solvency regulation standpoint? Further, why would we be doing that without ensuring the Europeans create a new insurance consumer protection regime and policyholder guarantee system to mirror the robust U.S. state-based approach to consumer protection and resolution/recovery?

As a member of the International Association of Insurance Supervisors (IAIS), the Federal Reserve, in partnership with the National Association of Insurance Commissioners and the Federal Insurance Office, remains committed to pursuing an engaged dialogue to achieve outcomes on international standards that are appropriate for U.S. firms, U.S. consumers, and the U.S. market.

In the absence of appropriate international standards, non-U.S. firms may derive competitive advantages relative to U.S. firms based on local standards or may take advantage of such standards in accepting risk from U.S. counterparties. With regard to the Insurance Capital Standard (ICS) being developed through the IAIS, I completely agree with you that -- in order for it to be implementable -- it cannot be unsuited or inappropriate for the U.S., the world's largest insurance market.

Among other things, this motivates our advocacy of an aggregation alternative and the use of Generally Accepted Accounting Principles-plus in the ICS being developed through the IAIS. Through field testing and monitoring, we may be able to further advocate that an aggregation method, applied in accordance with U.S. law, provides comparable outcomes to the ICS that is emerging from the IAIS.

The Federal Reserve continues to consider the inclusion of an aggregation alternative to be important to an ICS that is acceptable and implementable in the U.S. It is also important to recall that the IAIS does not have the ability to impose requirements on any national jurisdiction, and any standards developed through these fora are not self-executing or binding on the U.S., unless adopted by the appropriate U.S. lawmakers or regulators in accordance with applicable domestic laws and rulemaking procedures.

2. <u>Limit Regulatory Arbitrage:</u>

Similarly, I am concerned about the assertion that the ICS is needed to combat regulatory arbitrage. I would greatly appreciate it if you could provide me with examples during (or since) the recent financial crisis where a large global insurance company chose to locate itself in a country based on the capital requirements of that country and then collapsed and spread financial contagion into the U.S. financial system based on this risk?

When you examine the largest insurance markets in the world --where the IAIGs are located-- and their insurance regulatory systems – specifically the U.S., EU, Japan, Switzerland, and Bermuda – do you see a major danger of regulatory arbitrage? If there is a problem with one of those jurisdictions, this seems to be an issue to be addressed in supervisory colleges, via the FSAP reviews of regulatory jurisdictions or other regulatory tools, not by a one-size-fits-all group capital standard.

During your testimony, you stated to me that you believed the U.S. state-based system of insurance regulation provided a solvent U.S. insurance system. Given that, could you please provide me a specific, hypothetical example of how an insurance entity could conduct "regulatory arbitrage" without an International Capital Standard and put U.S. taxpayers and consumers at risk?

If we do not need to "level the playing field" for U.S. insurers with an ICS for the reasons listed above AND if the argument to "limit regulatory arbitrage" is the red herring it appears to be AND if the current state-based solvency regime has ensured sound and solvent U.S. insurance companies; then please explain to me why we are working on an ICS in the first place? What specific problem are we trying to solve for? What specific benefits will U.S. insurers receive? Doesn't this whole process likely entail more harm than good for U.S. insurance policyholders and U.S. insurance industry?

As noted in the answer to question 1 above, we are not participating in the IAIS to level the playing field by imposing a European-style capital standard on U.S. firms, but rather to level the playing field by seeking to ensure that a U.S.-appropriate alternative is included in the capital recommendations being discussed there. If we ignore these discussions, they will proceed without us, and could result in global agreements being reached that disadvantage our companies (one possibility if we withdrew, for example, would be other jurisdictions requiring that US firms operating in those jurisdictions comply with capital standards that those U.S. firms would have had no say in developing, and with which they could not comply, potentially making it more costly for U.S. firms to compete abroad). The better alternative is to engage in these discussions to vigorously defend U.S. interests by seeking an alternative capital standard based on the aggregation method that would be suitable for U.S. firms. As also noted above, these discussions are not treaty negotiations and do not lead to any enforceable obligations on any country, including the United States.

3. Kuala Lumpur

One of the reasons there is so much concern regarding where the ICS is headed is because of the IAIS Kuala Lumpur Agreement in November of last year. In that agreement, "Team USA" agreed that the ICS (known as "the reference ICS") would (1) be a

prescribed capital requirement (PCR) and (2) use the European-centric accounting methodology of market-adjusted valuation (MAV).

US State Insurance Commissioners are now developing a group capital assessment tool (the Group Capital Calculation – GCC) that is directly at odds with the two key attributes agreed to in Kuala Lumpur. First, the GCC will be an assessment tool – that is, part of the toolkit a US regulator uses to evaluate groups. The GCC will not be a capital target or requirement. Second, the GCC will be based off US accounting principles – and not MAV.

The KL Agreement pays lip service to the possibility that the US GCC could be deemed "an outcome-equivalent approach for implementation of ICS as a PCR" – but given the very different approaches – that does not seem even theoretically possible.
Moreover, your predecessor, Governor Daniel Tarullo, stated in a speech at the National Association of Insurance Commissioner's International Insurance Forum on May 20, 2016: "There are, as all of you know, a lot of ideas out there as to how we should construct the capital requirements we will apply to insurance companies. Some, such as variations on the Solvency II approach used in the European Union, strike us as unpromising. The valuation frameworks for insurance liabilities adopted in Solvency II differ starkly from U.S. GAAP and may introduce excessive volatility. Such an approach would also be inconsistent with our strong preference for building a predominantly standardized risk-based capital rule that enables comparisons across firms without excessive reliance on internal models. Finally, it appears that Solvency II could be quite pro-cyclical."

Do you share this assessment of your predecessor? If so, why did the Federal Reserve staff participating in the Kuala Lumpur negotiations agree to accede to the Europeans at the IAIS to mandate that the financial reporting for the reference ICS be done using a Solvency II MAV-type approach and not something more suitable for the U.S. insurance industry like GAAP or Statutory accounting? If you do agree with Governor Tarullo that a Solvency II accounting approach introduces excessive volatility into U.S. insurance markets, how do you plan on remedying this at the next IAIS negotiations on ICS?

Please explain how you will ensure the US approach (GCC) is deemed as satisfying the eventual ICS given that the only conceivable outcome that could work for the U.S. insurance industry is to have our system recognized as satisfying the eventual finished ICS.

As I continue to see the work product from the IAIS and the increasingly potential negative outcome it can have for the U.S. insurance industry, I am reminded of the quote, "Don't cling to a mistake just because you spent a lot of time making it." Seems like this advice might also be apt for the IAIS in regard to the ICS.

<u>Additional Questions:</u>

The cornerstone of the November Kuala Lumpur agreement by the IAIS, seeking an international capital standard, is the Market-Adjusted Valuation (MAV). The MAV is wholly inconsistent with GAAP and Statutory Accounting Principles (SAP) used by all 50 states in regulating the business of insurance. Given the likely de-designation of Prudential as the only remaining SIFI, how do you reconcile the inconsistencies of MAV with the Building Block Approach as applied to I-SLHCs—many of which only utilize SAP?

The Insurance Capital Standards Clarification Act of 2014 prohibits the Federal Reserve from requiring certain SAP-only I-SLHCS companies to use GAAP. How do you reconcile this statutory prohibition with the IAIS's demand for MAV? Do you believe the Fed can mandate I-SLHCs to use MAV, notwithstanding the GAAP prohibition?

The IAIS does not have any authority to impose enforceable obligations on U.S. insurance firms, and therefore no outcome of these discussions could result in an application of any capital standard to U.S. insurance firms that is inconsistent with U.S. statutory prohibitions.

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Representative Delaney:

1. In a recent speech you noted that, "The fundamental premise of the Volcker rule is simple: banks with access to the federal safety net--Federal Deposit Insurance Corporation insurance and the Federal Reserve discount window--should not engage in risky, speculative trading for their own account." Or to put it another way, the Volcker Rule is intended to limit banks from using subsidized funds from getting so big that their speculative trading creates the hazard of systemic risk to our banking system - a point I wholeheartedly agree with.

You have also been very public in your belief that the Federal Reserve and the other regulators tasked with implementing the Volcker Rule need to revisit the rule to reduce its complexity. With that in mind, I wanted to raise one point as it relates to the free flow of capital.

In today's modern banking system, we are seeing a growing number of firms looking at different avenues to serve their customers with traditional banking products, including through bank-fintech partnerships or an industrial loan company charter, both of which have an element of deposit insurance and thus have restrictions related to the Volcker Rule. At the end of the day, I believe you and I share the goal of ensuring depository institutions are run in a responsible manner that does not put the Deposit Insurance Fund at risk, and I am confident that the FDIC will take whatever steps necessary to ensure that remains the case. However, I have been made aware of circumstances where the Volcker Rule could restrict the availability of equity capital and certain investment activities unrelated to the insured depository institution.

- **Is this something you are also aware of, and do you anticipate addressing this type of issue in your future rulemaking related to the Volcker Rule?**

Section 13 of the Bank Holding Company Act (commonly referred to as the "Volcker Rule") applies by its terms to banking entities, the definition of which includes insured depository institutions and their affiliates. Accordingly, the Volcker Rule's restrictions cover certain entities, such as non-bank subsidiaries of bank holding companies, which are not insured by the Federal Deposit Insurance Corporation, but which are affiliated with insured depository institutions. The Federal Reserve Board (Board) and other implementing agencies recently issued a notice of proposed rulemaking that would make changes intended to streamline and simplify the requirements of the implementing regulation. Some of these proposed changes are expected to improve the ability of banking entities to provide market liquidity and facilitate capital formation consistent with the requirements of the statute.

- **Given the complexity of the Volcker Rule, are you committed to having Federal Reserve staff, as appropriate, engage directly with companies that may have unique circumstances related to Volcker Rule in order to assist those companies with understanding their obligations under the rule?**

Board staff regularly engage with firms with respect to unique circumstances that come up related to the application of the Volcker Rule to various aspects of their businesses. I am committed to ensuring that this process continues, and to ensuring that Board staff provides as much clarity and transparency as possible so that firms can operate with certainty that their activities are consistent with their obligations under the rule.

- **In the Fed's planned future rulemaking on Volcker, do you intend to have an open and transparent rulemaking process and duly consider all submitted comments?**

Yes. The agencies recently issued a joint notice of proposed rulemaking that would revise the Volcker Rule implementing regulation. The Board and the other agencies are requesting public comment on the proposed rule and will carefully consider all comments.

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Representative Hultgren:

1. During your testimony before the Committee, I asked you about making changes to the Current Exposure Method (CEM) to acknowledge the concept of delta-weighting for certain derivatives. As Chairman Powell noted last year, the CEM "ignores whether a derivative is margined and undervalues netting benefits." The CEM is insensitive to risk so its mandatory use artificially caps market liquidity, particularly in large-cap index options, which are crucial hedging vehicles. You responded that rulemaking, presumably to implement the Standardized Approach for Counterparty Credit Risk (SACCR), would be the appropriate course to address the issue that you acknowledged is damaging liquidity in our derivatives markets. As I mentioned during your testimony, the Treasury Department's October 2018 Report on Capital Markets calls for a "near-term" solution.

1. **Does the Federal Reserve Board have authority to address this issue through Exemptive Relief, Interpretive Relief, or an Interim Final Rule?**
2. **If so, why hasn't the Federal Reserve Board taken action to address this pressing issue? The implementation timeframe for SACCR is unclear; some observers estimate that it could be three of four years until it is finalized in the United States given the myriad of topics it proposes to address.**
3. **Can we expect the Federal Reserve Board to pursue Exemptive Relief, Interpretive Relief, or an Interim Final Rule to address the issue? If so, please provide a reasonable deadline for advising the public of your intention to take such action.**

The Federal Reserve Board (Board) has reviewed the capital rule in order to determine whether there are opportunities for interpretive relief or other near-term solutions to address the concerns raised in your question and by market participants. The primary means of near-term relief identified by the Board would be to exercise its reservation of authority under the rule to provide an alternative risk-weighted asset amount for particular types of exposures, such as listed options. However, the Board can exercise the reservation of authority only on a case-by-case basis for an individual banking organization that requests such a treatment. Addressing the treatment of only a subset of derivative products such as large-cap index options through the reservation of authority would result in disparate treatment under the rule among derivative products that present similar risks and, potentially, among banking organizations.

Due to these concerns, the Board's preferred approach to address the concerns raised regarding the current exposure method (CEM) is to revise the capital rule to incorporate Standardized Approach for Counterparty Credit Risk (SA-CCR). SA-CCR, as compared to CEM, would allow for increased recognition of netting and margin and results in a more risk-sensitive exposure amount for listed option contracts. The rule making process would allow a wide variety of market participants to consider the potential impact of SA-CCR and would open the way for its potential benefits to apply to a wide range of derivative products. Accordingly, the Board is working expeditiously to implement SA-CCR in the United States. Our aim is to issue a SA-CCR proposal for public comment, jointly with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), as soon as feasible.

2. Custodial banks, which provide safekeeping and related services to pension funds, mutual funds, endowments, and other institutional investors, have engaged in substantial dialogue with the Federal Reserve in recent years to develop a new standardized capital methodology for agency securities lending services provided to clients. These discussions have led to the inclusion of technical changes to these capital rules in the finalization of the Basel Committee's post-crisis capital reforms agreed to by the Federal Reserve in December, 2017.

1. **When does the Federal Reserve plan to adopt these technical changes to the capital rules for securities financing transactions?**
2. **Is there an opportunity for the Federal Reserve to propose rules to implement these technical changes, and perhaps others, separately and ahead of its longer range plan to solicit public input on the broader and more substantive capital changes later this year through the Advanced Notice of Proposed Rulemaking (ANPR) process?**

As noted, Board staff, in coordination with the other federal banking agencies, is evaluating this new standard as well as other standards adopted by the Basel Committee. The revised treatment of securities financing transactions adopted by the Basel Committee in December 2017 is meaningfully different from the current treatment in the Board's capital rules. Accordingly, it is unlikely that these changes could be addressed through a technical rulemaking.

3. As you know, one of the perennial problems in bank supervision is how policymakers in Washington, like yourself, ensure that their decisions are faithfully executed in the field – in this case, by your examiners. As you know, a lot can be "lost in translation" as we've learned over the years. It seems to me that this is a key management challenge for you in your current position.

1. **Is there any evidence to suggest that examiners are not faithfully executing the policies established by the Federal Reserve?**

It is very important that we communicate consistent messages to our examiners and to the banks we supervise. Our examiners, who are on the front lines of delivering supervisory messages to the firms we supervise, are committed to public service, and are faced with making tough calls every day. We at the Board have a responsibility to ensure that we provide them enough guidance that they can make those calls without micromanaging a bank's business decisions.

When we implement new regulations, guidance or supervisory practices, we conduct training though webinars or teleconferences to explain the new policies and practices to examiners. Board staff, who have drafted the regulation, guidance, or practices, will typically lead the training to ensure consistent messaging. We also incorporate these new policies and practices into our examiner commissioning training programs for bank examiners. As examiners implement new policies through the examination process, exam findings are carefully vetted to make sure they are consistent with the new policies. We also communicate regularly with senior leaders at the Reserve Banks to provide clear messages from the Board and to understand challenges they may be facing on the ground as they implement the policies and practices that are set here in Washington.

I do not currently have evidence that would suggest examiners are not diligent in executing Federal Reserve policies, but I fully agree with you that preventing gaps from developing between the policy of the Board, on the one hand, and supervisory practice in the field, on the other, will be a continuing challenge and one on which I am very focused. As mentioned above, the Board uses various communication mechanisms, including written guidance, System calls, and portfolio management group meetings, to clarify expectations for policy implementation and execution. The Board also has a formal process for overseeing the supervision activities of the twelve Federal Reserve Banks (Reserve Bank). Through ongoing monitoring and Reserve Bank- or topic-specific reviews, the Board is able to identify situations where a Reserve Bank may not be effectively executing policies established by the Board and would recommend corrective action.

2. **If so, what steps do you plan to make to oversee examiners to ensure they are following the policies established by the Federal Reserve?**

By statute, the Board is responsible for overseeing the supervision activities of the twelve Reserve Banks, including assessing how well Reserve Banks execute the supervisory authority delegated to them by the Board under 12 U.S.C. §248.

The Board has several oversight mechanisms designed to ensure that examiners are effectively applying supervisory policies, rules and guidance.

At least annually, in accordance with the Federal Reserve Act and U.S. Banking Code, the Board provides an assessment of each Reserve Bank's performance. The assessment incorporates results from ongoing monitoring of the Reserve Banks, horizontal reviews, and triennial operations reviews. The Reserve Banks are evaluated on the effectiveness and efficiency of their supervisory programs, their applications processes (e.g. mergers and acquisitions), as well as their support programs (e.g. information technology, training).

Apart from the Reserve Bank oversight process, Board staff also ensure adherence to our guidance, rules and regulations, through regular and ongoing consultation with Reserve Bank staff. Board staff regularly review Reserve Bank work products and provide program direction with the objective of promoting consistency in our supervisory approach around the Federal Reserve System.

To further promote consistency, the Board provides examiner training and commissioning programs along with continuing professional development opportunities on a variety of topics including emerging issues.

4. You have noted that the metrics to identify internationally active banks – such as $250 billion in total assets or $10 billion in on-balance sheet foreign exposures – were formulated well over a decade ago and have not been refined since then. Yet the $10 billion on balance sheet foreign exposure threshold triggers the application of the "advanced approaches" methodology for calculating a Bank Holding Company's capital requirement in addition to the standardized approach, more stringent single party credit limit requirements, and higher Liquidity Coverage Ratio (LCR) requirements.

1. **When will the Fed revisit the Basel Committee's "advanced approaches" thresholds that identify internationally active banks?**
2. **Will the Fed bring these criteria into better alignment with your objectives to tailor supervision and regulation to the size, systemic footprint, risk profile, and business model of banking firms?**

The advanced approaches threshold was established on an interagency basis with the FDIC and OCC, and is relevant for multiple elements of the Board's regulatory framework, including capital requirements, the liquidity coverage ratio rule, and related reporting requirements. The Board believes that capital and other prudential requirements for large banking organizations should be set at a level that protects financial stability and maximizes long-term, through-the-cycle credit availability and economic growth. At the same time, the Board recognizes that prudential requirements should be tailored to the size, risk, and complexity of the firms subject to those requirements and is considering ways to adjust its regulations that will simplify rules and reduce unnecessary regulatory burdens without compromising safety and soundness. We are currently considering ways to better align the advanced approaches threshold with this objective, which could include changing both the total asset and foreign exposure thresholds, and would take into account the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act as part of this evaluation. Any proposed changes to the thresholds would be issued for public notice and comment after consultation in coordination with the FDIC and OCC.

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Representative Luetkemeyer:

1. The National Institute of Standards and Technology (NIST) recently released its Cybersecurity Framework Version 1.1, after consulting numerous experts in private industry and government. Financial services firms have told us that this work is the state of the art, and are concerned that they will now have to spend vast amounts of time mapping how compliance with NIST 1.1 satisfies the reams of guidance, handbooks and informal mandates that the banking agencies have issued over the years. Is this an appropriate time for the Federal Reserve and the other agencies to do a zero-based review, and seek public comment on whether any agency standards in addition to NIST 1.1 are necessary?

The Federal Reserve Board (Board) is committed to aligning our guidance to the National Institute of Standards and Technology Cybersecurity Framework Version 1.1 (NIST 1.1) as part of our efforts to reduce potential regulatory burden. NIST 1.1 was published on April 16, 2018, and the Federal Reserve is considering changes to our guidance as appropriate. In addition, the Federal Reserve is working with other regulatory agencies to streamline and harmonize existing cybersecurity guidance across the financial sector in a manner that aligns with the NIST Cybersecurity Framework.

For example, through the Financial and Banking Information Infrastructure Committee, the Federal Reserve, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission are engaged in a cybersecurity regulatory harmonization effort designed to identify opportunities to further coordinate cyber risk supervisory activities for firms subject to the authority of multiple regulators.

The Federal Reserve also works through the Federal Financial Institutions Examination Council (FFIEC), which includes the FDIC, OCC, the National Credit Union Administration and the Consumer Financial Protection Bureau, to promote uniformity in the supervision of financial institutions, including supervisory assessments related to cybersecurity, and to execute examinations in a manner that is consistent across entities supervised by FFIEC member agencies.

2. During the course of the hearing, Chairman Hensarling asked whether Federal Reserve staff had the legal authority to participate in bank board meetings. Please provide an answer to whether or not any Federal Reserve staff have such authority and, if appropriate, the mechanism by which that authority is derived. Have Federal Reserve staff in the past or do any Federal Reserve staff currently participate in bank board meetings?

The Federal Reserve Board (Board) is responsible for examining state member banks and bank holding companies to ensure that they are operated in a safe and sound manner. The Board's supervisory examinations evaluate a broad set of quantitative and qualitative factors to identify material risks to the safety and soundness of the examined institution and the financial stability of the United States.[1]

When an examination is complete, Board examiners may attend certain board meetings, or portions of meetings, to present the supervisors' examination findings and to allow for the exchange of information. A dialogue between examiners and boards of directors is part of the normal interactive supervisory process, and often serves as an opportunity to ensure that the entire board of a banking organization is aware of any supervisory concerns. When I have served on boards in the past, I have generally wanted the opportunity to hear directly from the bank's supervisors concerning their sentiment of an institution's condition. The Board views boards of directors as critical players in supporting the safety and soundness of their institutions and promoting compliance with laws and regulations. The Board's bank holding company rating system (also called the "RFI rating system") provides the framework[2] for communicating supervisory findings to the institution.

The RFI rating system also provides the framework for assessing a bank holding company's overall managerial condition, which is captured under the rating system's risk management component. To conduct the risk management component of the RFI rating system, Board examiners may from time to time attend portions of boards of directors meetings. Risk management examinations generally assess the ability of the bank holding company's board of directors to identify, measure, monitor, and control risk, and evaluates the adequacy and effectiveness of the board's understanding and management of risk inherent in the bank holding company's activities, as well as the general capabilities of management.

In exercising its general examination authority for state member banks[3], the Board uses the Uniform Financial Institutions Rating System (UFIRS). Under UFIRS, which is also used by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, a supervisory assessment of management is made, which generally considers the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of a bank's activities and to ensure a bank's safe, sound, and efficient operation in compliance with applicable laws and regulations.

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1 Section 5(c)(2)(A) of the Bank Holding Company Act (12 U.S.C. 1844(c)(2)(A)) and section 10(b)(4)(A) of the Home Owners' Loan Act (12 U.S.C. 1467a(b)(4)(A)) authorize the Federal Reserve to write rules to conduct examinations of bank holding companies (BHCs) and savings and loan holding companies (SLHCs), respectively, to assess the financial, operational and other risks that may pose a threat to the safety and soundness of the company, its subsidiaries, or to U.S. financial stability.

2 SR Letter 04-18, *Bank Holding Company Rating System*, at https://www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm.

3 Section 9(7) of the Federal Reserve Act (12 U.S.C. 325.) requires, as a condition of membership in the Federal Reserve System, that state member banks to be subject to examinations by the Federal Reserve.

Consistent with the above, it would not generally be appropriate for examiners or other supervisory personnel to insist on being present during an entire board meeting or at every board meeting or to routinely participate in the deliberations of a board of directors.

3. The availability of cleared markets for end-users like farmers and manufacturers is being discouraged by the lack of an off-set for client margin in the supplemental leverage ratio. How do you propose to deal with this issue specifically?

The Board is carefully evaluating its regulatory capital framework to ensure that its post-crisis regulations do not create unintended consequences and do not create undue regulatory burden, including for the provision of central clearing services. In 2017, the Board and the federal banking agencies issued supervisory guidance on the treatment of certain centrally-cleared trades that are conducted under a new settle-to-market model, which has provided regulatory capital relief for certain trades. The Board also is actively engaged with the domestic and international standard-setters in discussing the impact of the regulatory capital rules, including the supplementary leverage ratio, on the provision of the central clearing services. In April of 2018, the Board and OCC issued a proposal that would recalibrate the enhanced supplementary leverage ratio (eSLR) standards to further tailor leverage ratio requirements to the business activities and risk profiles of the largest domestic firms. The proposed recalibration may provide firms with additional flexibility to reallocate some of their regulatory capital to central clearing and other business lines if they choose to do so. In addition, the Board is participating in a review of the impact of the leverage ratio on clearing services being conducted at the Basel Committee on Banking Supervision (BCBS).

4. The Federal Reserve proposal to reduce the enhanced supplementary leverage ratio impacts only the nation's 8 largest banks. What additional steps will you take to encourage other banks to return to providing clearing services and thus improve competition in the cleared markets?

As noted in the response to question 3, the Board is participating in the BCBS leverage ratio monitoring exercise to address potential unintended consequences of the leverage ratio on client clearing. The exercise is focused on monitoring the impact of the leverage ratio's treatment of client cleared derivative transactions and reviewing the impact of the leverage ratio on banks' provision of clearing services and its effect on central counterparty clearing. The review involves surveying client clearing market participants to understand the impact of the leverage ratio on incentives to centrally clear over-the-counter derivatives.

5. Since 2008, policymakers and regulators have determined that cleared markets improve the safety of the financial system as a whole as well as safety for customers. How does your proposal to reduce the enhanced supplementary leverage ratio improve incentives to clear when the exposure reducing nature of initial client margin is still not recognized?

The purpose of the eSLR proposal is to recalibrate the Board's capital standards for banking organizations such that the ratio generally serves as a backstop to risk-based capital requirements and not as a binding constraint. Over the past few years, concerns have arisen that, in certain cases, the supplementary leverage ratio has become a generally binding constraint rather than a backstop to the risk-based requirements. Thus, under the eSLR proposal, a clearing-focused firm may have additional capacity to engage in centrally cleared transactions. We recognize that the treatment of initial client margin is an additional question to address and we are doing so through the mechanisms described in questions 3 and 4 above.

6. If the enhanced supplementary leverage ratio proposal is finalized, the U.S. will be more in line with the global standard on its calibration. However, the European Union is in the process of recognizing client initial margin by providing an offset under the leverage ratio. Until the time the U.S. provides such an offset, European banks continue to have a competitive advantage over U.S. banks. Do you plan to take steps to look at providing U.S. banks such an offset for client initial margin?

As noted in the response to questions 3 and 4, the Board is participating in the BCBS leverage ratio monitoring exercise. The results of that exercise would in part inform any additional adjustments to the leverage ratio that we would consider.

<u>**Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Representative Rothfus:**</u>

1. Mr. Quarles, thank you for your thoughtful response to my questions regarding the supervision of insurance savings and loan holding companies ("ISLHCs"). I appreciate your commitment to resolving this issue your sense of urgency around it. As you know, currently the Federal Reserve Board treats ISLHCs over $50 billion as "large banking organizations" under SR 12-17. This has led to an inappropriate, bank-like supervisory regime that is disproportionate to the risk to the taxpayers posed by these institutions. Will you immediately suspend SR 12-17 while you are undertaking your important review of the supervisory regime for ISLHCs?

Our principal supervisory objectives for insurance savings and loan holding companies (ISLHCs), reflecting a baseline of consolidated supervision that accompanies insured bank ownership, include protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions, which serves to safeguard the taxpayer-backed federal safety net. In applying our consolidated supervision, we should work to ensure that rules, supervisory guidance, and expectations are appropriately tailored to account for the unique complexities and characteristics of ISLHCs. We remain committed to tailoring our supervision of ISLHCs to the firms and their insurance operations, as well as conducting our consolidated supervision of these firms in coordination with state insurance regulators.

The framework set forth in Supervision and Regulation Letter 12-17 (SR 12-17) is designed to be general and flexible enough to be applied to large financial institutions supervised by the Federal Reserve Board, as well as support a tailored supervisory approach that accounts for the unique risk characteristics of each firm. I believe we can make better use of the flexibility permitted in SR 12-17 to tailor our supervisory program for ISLHCs to each firm's size, structure, risk profile, and business model as well as the size and scale of banking and other non-insurance activities. The Federal Reserve also seeks to protect the subsidiary insured depository institution (IDI) from risks related to nonbanking activities, including insurance, as well as intercompany transactions between the parent and IDI to ensure that the IDI is not adversely affected. To avoid duplication, we also rely on the state insurance departments to the greatest extent possible, including their supervision of the business of insurance.

In applying SR 12-17 while we further tailor our supervisory framework (including, as relevant, SR 12-17), we will review and adjust our supervisory expectations to ensure that they are appropriate for the ISLHCs' business models and structures. We remain committed to tailoring our approach to supervising ISLHCs and welcome feedback on ways we can improve our supervision.

2. Recently, there has been interest both domestically and internationally in developing an "activities-based approach" (ABA) to regulating systemic risk in the insurance industry. Such an approach, if not properly tailored, could result in significant, unwarranted regulation that will make it harder for Americans to obtain affordable financial security products. To ensure that such an approach does not result in overregulation, do you believe that an ABA should look broader than an insurer's activities in isolation and consider

whether an insurer's activities are also sufficiently connected to the larger financial markets so that they could actually increase systemic risk?

It is important for an activities-based approach to look broader than a firm's activities in isolation and take into account the firm's activities in relation to the wider economy. The Federal Reserve aims to promote financial stability through, among other things, working with domestic agencies directly and through the Financial Stability Oversight Council (FSOC), and engaging with the global community in relation to monitoring, supervision, and regulation. A central tenet of the Federal Reserve's efforts in promoting financial stability is an approach that accounts for the stability of the financial system as a whole, in addition to a micro-prudential approach that focuses on the safety and soundness of individual institutions. In the development of the activities-based approach in the International Association of Insurance Supervisors, the Federal Reserve continues to advocate the broader use of cross-sectoral comparison of insurers against banks and other financial intermediaries, reflecting an approach grounded in risk exposures together with their associated transmission channels. The analysis of the FSOC also reflects activities of a firm that could pose threats to U.S. financial stability, including through a firm's connections to financial markets as a channel for systemic risk.

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Representative Tipton:

1. Market Structure

Background: On October 15, 2014, the market for U.S. Treasury Securities, one of the deepest, most liquid, and critical markets in the world, experienced price volatility of historical magnitude with no obvious explanation. The 2015 Joint Staff Report developed and issued by staff from Treasury, the Fed, the SEC, and the CFTC could point to no clear culprit for the extreme volatility that day. They did identify several potential issues with the market structure, however, including wash trading (i.e., self-trading) and a lack of clearing by principal trading firms through a centralized counterparty. Since the release of Joint Staff Report in 2015, FINRA has mandated that its member firms report secondary-market transactions in Treasury securities to the Treasury and their supervisors. The reporting is not available to the public.

Question: There have been recent media reports suggesting that the Treasury Department is considering ways to bring even more transparency to the marketplace for Treasuries, as recommended in the department's Capital Markets Report from last year. Do you support this recommendation, and do you agree that bringing principal trading firms into clearing would also increase the safety, soundness, and stability to the U.S. Treasury securities market?

Regarding the first part of your question on bringing further transparency to the marketplace for Treasury securities, as was discussed in the 2015 Joint Staff Report (JSR) following the high level of volatility in the Treasury market on October 15, 2014, the structure of the Treasury market has evolved considerably over time. As highlighted in the JSR, the Treasury market has changed in ways not easily understood by either the official sector or the public due to a lack of readily available data on Treasury secondary market transactions. Through the JSR, we learned a great deal about how the Treasury market has evolved and the analysis conducted in the report made clear that gaining further insights into the Treasury market would be appropriate.

In July 2017, the Financial Industry Regulatory Authority (FINRA) began collecting from its members, Treasury secondary market transaction data through its Trade Reporting and Compliance Engine (TRACE). The collection of this data has been a useful contribution to the official sector's ability to monitor and understand the structure of, and activity in, the deepest and most liquid government securities market in the world. The recommendations in the Treasury Department's Capital Markets Report to require trading platforms operated by FINRA members to identify customers in their reports of Treasury security transactions to TRACE, as well as inter-agency efforts to collect Treasury transactions data from depository institutions, would likely further this understanding.

The Treasury TRACE data collection effort is still in its early stages, and a number of issues regarding the data collection are currently being worked out among FINRA and the members of the Inter-Agency Working Group on Treasury Market Surveillance (IAWG). Therefore, before taking a position on what data should be made available to the public, if any, further assessment is needed of the available data and of the potential impact on market functioning or other.

potential costs of public dissemination of the Treasury TRACE data. Note that the issue of public dissemination was raised in the Treasury Department's Request for Information in January 2016 and this received mixed feedback from market participants. As a general matter, my view is that increased transparency in the Treasury market would be desirable and can further bolster investor confidence in this market. However, any policy regarding public dissemination of Treasury market data would need to be consistent with the principle of not harming market functioning or adversely affecting liquidity.

Regarding your question on bringing principal trading firms (PTFs) into clearing, the implementation of more comprehensive clearing arrangements for Treasury securities, including appropriate risk management, would likely increase the stability of the Treasury market. However, what the potential solutions are for achieving this objective remains an open question, and significant study would be required. For example, the Treasury Department's Capital Markets Report notes that the fees and other standards imposed by the Fixed Income Clearing Corporation (FICC) on its members are not widely understood, and that these arrangements could pose an economic barrier for entry to PTFs. While FICC has recently altered its fee structure, the effect of this change is still unclear. Implementing more comprehensive clearing arrangements should take into consideration the potential risks and costs of any significant disruption to the structure and functioning of the Treasury market.

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Representative Velázquez:

1. Chairman Quarles, I appreciated your commitment during our recent hearing that you will ensure the continuation of robust capital requirements for large, systemically-important banks. I believe these capital reforms were some of the most important components of the Dodd-Frank Act and the actions of the Obama Administration. Ensuring that larger banks hold significant capital buffers is critical to protecting consumers and ensuring financial stability. Similarly, I was heartened to hear you explain your views on the need for a rigorous stress testing program, predicated on risk- based measures, to guarantee that global banks have capital sufficient to withstand shocks. To that end, I am closely reviewing the capital reform and stress testing proposal the Fed recently published.

You correctly pointed out in your testimony that leverage capital standards should be a strong backstop, but not the binding, capital constraint. As you know, this is because binding leverage standards penalize low-risk banking activities such as accepting deposits and processing transactions, and create incentives to pursue higher-risk activities. I am concerned that having firms primarily engaged in custody and asset servicing operations bound by leverage-based standards could have the perverse effect of increasing, rather decreasing systemic risk.

As you finalize the new stress testing program will you commit that the Fed will not create a new binding leverage standard through the imposition of a stressed leverage buffer?

I believe that, as a general matter, leverage capital requirements should serve as a backstop to risk-based capital requirements in order to reduce incentives for firms to increase their exposure to riskier assets. The Federal Reserve Board (Board) has recently taken two important steps to help ensure that leverage-based capital requirements generally serve as a backstop to risk-based capital requirements. First, the Board, in conjunction with the Office of the Comptroller of the Currency, issued a proposal that would recalibrate the enhanced supplementary leverage ratio standards for certain large domestic firms in a manner that is expected to help ensure that these firms' risk-based capital requirements remain their binding regulatory capital constraint. Second, the Board's stress buffer proposal, which would integrate the quantitative assessment of the Comprehensive Capital Analysis and Review program with the capital rule's requirements, was designed with the goal of simplifying capital requirements while helping to ensure that leverage-based capital requirements generally continue to serve as a backstop to risk-based capital requirements. The Board is currently seeking public comment on these proposals. In addition to these two proposals, the Board, in collaboration with the other federal banking agencies, will revise the capital rule to address the recent legislative exclusion of central bank reserves from the total leverage exposure amount of certain banking organizations.

Questions for The Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System from Ranking Member Waters:

1. Fair Lending

As we discussed during the hearing, the Center for Investigative Reporting published several disturbing articles after a yearlong investigation of 31 million records publicly available under the Home Mortgage Disclosure Act (HMDA) to identify lending disparities.[1]

- **(a) I appreciate your initial reaction, but I would ask you to review the materials, and provide a detailed written assessment of the reporting. What lessons, if any, should the Federal Reserve and Congress bear in mind as we explore ways to address modern-day redlining and end pervasive discriminatory practices in the financial sector?**

As we mark the 50th anniversary of the Fair Housing Act (FHA), at the Federal Reserve, we believe the fair lending laws remain critical to addressing discrimination, including redlining, as well as fostering vibrant communities and a fair and transparent consumer financial services marketplace. We share the vital goal of promoting a fair and transparent marketplace for financial services, which is crucial for advancing economic opportunity and inclusion. Our economy is stronger when everyone has a chance to contribute fully and share in our national prosperity. Our fair lending laws help us realize a founding notion of our country--that this is a place where opportunity, innovation, and productivity are encouraged and rewarded.

The recent study of publicly-available Home Mortgage Disclosure Act (HMDA) data highlights serious concerns about racial disparities in lending. This study of HMDA data conducted by the Center for Investigative Reporting and published by Reveal News concluded that African Americans, Latinos, and other individuals of color were more likely to be denied conventional loans for home purchases and home remodeling than white borrowers.[2] Studies such as these put much-needed focus on racial disparities and Federal Reserve staff is carefully reviewing them.

However, HMDA data have limitations. These data do not include important underwriting criteria, such as credit scores and loan-to-value ratios. If concerns arise regarding a Federal Reserve-regulated institution, we will request additional data beyond the publicly-available HMDA data to fully evaluate whether applicants with similar characteristics received different underwriting outcomes on a prohibited basis (for example, on the basis of race), or whether legitimate underwriting criteria can explain the differences.

[1] The reporting is available online at: https://www.revealnews.org/article/for-people-of-color-banks-are-shutting-the-door-to-homeownership/, https://www.revealnews.org/article/gentrification-became-low-income-lending-laws-unintended-consequence/, https://www.revealnews.org/article/8-lenders-that-arent-serving-people-of-color-for-home-loans/, https://www.revealnews.org/article/how-we-identified-lending-disparities-in-federal-mortgage-data/, and https://s3-us-west-2.amazonaws.com/revealnews.org/uploads/lending_disparities_whitepaper_180214.pdf.

[2] We note that the study excluded FHA/VA and other government program loans. These loans can be an important resource for lower-income borrowers.

- **(b) You discussed the ongoing work that the Federal Reserve is engaged with the Office of the Comptroller of the Currency (OCC) and other regulators with respect to modernizing the Community Reinvestment Act (CRA). To that end, does the Federal Reserve plan to adopt a change the OCC made last October to its CRA examination policies that has weakened CRA enforcement by easing the consequences for banks that violate fair lending laws and harm consumers? Will this kind of CRA reform benefit megabanks, like Wells Fargo, which has repeatedly harmed consumers?**

The Community Reinvestment Act (CRA) establishes an affirmative obligation on banks to help meet the credit needs of their entire community, including low-and moderate-income (LMI) communities. We have not changed our approach to considering violations involving discrimination or other illegal credit practices when assigning CRA ratings. When illegal credit practices are identified, we follow the examination procedures and consider whether such practices should result in a ratings downgrade.

- **(c) As we discussed, the Treasury Department issued a memorandum regarding CRA modernization on April 3, 2018, addressed to the U.S. banking regulators, including the Federal Reserve Board, and made 15 recommendations in the areas of CRA assessment areas, examination clarity and flexibility, examination process, and performance.[3] You generally seemed favorable toward Treasury's CRA recommendations in your testimony and responses to questions. Please note whether you agree or disagree with each recommendation, along with an explanation and assessment of the public policy pros and cons of each recommendation.**

The Federal Reserve Board (Board) staff is continuing to review the U.S. Department of Treasury's recommendations to modernize the CRA. I share the Treasury Department's goal of improving the current supervisory and regulatory framework for CRA based on feedback from industry and community stakeholders. I agree that many of the issues and potential solutions they raise are worthy of consideration.

The Board is open to considering ways to make the CRA more effective and believes there are ways to expand the areas where we can evaluate a bank's CRA performance without losing the regulation's focus on the unique role banks play in meeting local credit needs.

I agree that it is time to review changes to the definition of a bank's "assessment area," which is the area in which its CRA performance is evaluated. The banking environment has changed since CRA was enacted and the current CRA regulation was adopted. Banks may now serve consumers in areas far from their physical branches. Therefore, it is sensible for the agencies to consider expanding the assessment area definition to reflect the local communities that banks serve, while retaining a consideration of place.

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[3] https://home.treasury.gov/sites/default/files/2018-04/4-3-18%20CRA%20memo.pdf.

- **(d) Would you review the National Community Reinvestment Coalition's (NCRC) analysis of Treasury's recommendations,[4] and consider their perspective in responding to the question above?**

Any change we make to the CRA implementing regulation will be proposed through the rulemaking process. The Federal Reserve takes every comment it receives about its regulations into consideration. Board staff will consider the National Community Reinvestment Coalition's (NCRC) analysis you mention and other public comments we expect will be submitted through the rulemaking process.

We agree with the analysis that it is time to consider updating the CRA to reflect changes in the banking industry. Among the many suggestions offered by NCRC, the Federal Reserve is reviewing their suggestions for updates to the assessment area definition to include areas with branches and other areas where banks gather deposits or conduct substantial business, as well as their suggestion to establish more real time communication among banks, regulators, community groups, and advocates to promote more objective measures of performance.

As with other stakeholders, the Federal Reserve seeks input from NCRC on a regular basis. NCRC will be meeting with the Chair and Federal Reserve staff very soon. This meeting will be an opportunity for NCRC to share their analysis in more detail with the Board.

- **(e) Previously, NCRC submitted a letter to Treasury on CRA reform efforts on February 5, 2018.[5] Would you please review NCRC's letter and recommendation, and provide responses if you agree or disagree with their recommendations along with any analysis supporting your views?**

The Board staff has also reviewed the NCRC letter to the Treasury Department and will be taking their perspective into consideration as we receive public comments through the rulemaking process. As stated previously, we agree with the NCRC that it is time to consider updating the CRA to reflect changes in the banking industry.

The NCRC letter refers to a number of topics with regard to CRA reform efforts including: expanding CRA to nonbank subsidiaries; updating assessment areas to capture outside lending; maintaining the threshold for small bank test and fair lending; standardizing CRA exams across the agencies; continuing to focus the definition of community development on LMI; and not shortening merger approval timelines for banks earning a rating of outstanding on a CRA exam. The Federal Reserve will review each of these ideas as we consider each aspect of the CRA regulation under review.

- **(f) Based on the Center for Investigative Reporting on discriminatory lending practices and other evidence, are there ways the Federal Reserve Board can utilize CRA or other tools to incentivize banks to lend on affordable terms and invest in communities that are being ignored and underserved?**

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[4] NCRC's analysis is available at: https://ncrc.org/ncrc-analysis-of-cra-treasury-report/.

[5] The letter is available at: https://ncrc.org/letter-to-treasury/.

The research conducted by the Center for Investigative Reporting and published by Reveal News lamented the lack of progress in the 50 years since Congress enacted the Fair Housing Act. We note the study analyzed 2015 and 2016 publicly-available HMDA data on 31 million mortgage applications in 409 geographies for conventional loans and concluded that African Americans, Latinos, and other individuals of color were more likely to be denied loans for home purchases and home remodeling than white borrowers in 61 of those geographies.

As I noted above, studies based on publicly-available HMDA data have limitations. Irrespective of that, the financial regulators must ensure that we continue to act consistently with the purpose of CRA and provide incentives for banks to remain engaged in local community and economic development initiatives. We will also continue to identify promising practices of banks that offer deposit and credit products to help rent-burdened customers save for homeownership and that support underserved communities. Even with an improved economy, LMI areas have significant hurdles remaining, which is why I believe that the CRA is more important than ever.

- **(g) To the extent the Federal Reserve Board considers expanding options for banks to receive CRA credit, how do you ensure these adjustments are done in an efficient and robust manner so they don't otherwise water down the CRA grading system in light of the fact that 99% of banks get high marks even though discriminatory lending remains pervasive?**

The Federal Reserve takes its CRA obligations very seriously and any update to the regulation will seek to maintain the integrity of examinations. The Federal Reserve's highest interest is to see credit flowing to consumers and businesses in all communities consistent with safe and sound lending. This includes meeting credit needs in LMI areas and furthering economic development and financial inclusion. The Federal Reserve consumer examiners are specially-trained and solely dedicated to conducting CRA reviews and consumer compliance examinations, which include fair lending. As with any regulatory change, we will provide examiners training and tools to ensure that they are able to conduct rigorous reviews of the institutions that we supervise.

- **(h) What is the timetable for any new regulations or guidance that we should expect the Federal Reserve Board to issue on CRA reforms?**

The Federal Reserve has been in discussions with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) on how to approach revisions to the CRA regulations. Unfortunately, I am not in a position to announce a timetable at this point.

- **(i) Will the Federal Reserve Board consider holding public hearings across the country on any new CRA proposal you consider to better ensure you get the maximum amount of feedback, especially from the communities that CRA was intended to help. If so, what would the timetable be of such hearings? What other steps will the Federal Reserve Board take to ensure you receive the maximum amount of input on proposed CRA changes?**

The Federal Reserve participated in interagency public hearings on the Community Reinvestment Act (CRA) in 2010 and in the interagency public outreach meetings related to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 in 2014 and 2015, in which CRA was one of many regulations discussed. The agencies with responsibility for CRA rule writing have not yet determined whether and, if so, when to hold public hearings. In the meantime, the Federal Reserve will continue to collect feedback through roundtables and listening sessions with banks, community groups, and other stakeholders.

- **(j) Do you have any legislative recommendations with respect to strengthening CRA, and how the Federal Reserve Board can better fulfill the intent and purpose of the law?**

The Federal Reserve recognizes the importance of basic banking services to meeting the financial needs of LMI areas and people. We believe that revisions to the regulations should be sufficient to address concerns that the CRA has not kept pace with changes in the banking industry.

- **(k) Beyond CRA, are there other legislative or regulatory reforms that policymakers should consider to end pervasive discriminatory practices in the financial sector?**

Discrimination has no place in the financial marketplace. Beyond the CRA, there are already legislative and regulatory protections in place to address discrimination in the financial sector. For all state member banks, we enforce the federal Fair Housing Act, which prohibits discrimination in mortgages, including redlining, pricing, and underwriting discrimination. For state member banks of $10 billion dollars or less in assets, we also enforce the Equal Credit Opportunity Act, which prohibits discrimination in any credit product. Together, these laws prohibit discrimination on the basis of race, color, national origin, sex, religion, marital status, familial status, age, handicap/disability, receipt of public assistance, and the good faith exercise of rights under the Consumer Credit Protection Act. We believe that enforcing existing legislative and regulatory protections is critical to addressing pervasive discrimination.

With respect to other legislative reforms, we stand ready to consult with Congress as appropriate.

2. Diversity at the Fed and in the Financial Sector

- **(a) Democrats have repeatedly pushed the Federal Reserve and other regulators to do their part to promote diversity in its work. As the Vice Chair of Supervision, what steps have you taken to promote diversity with the Fed's supervisory, regulatory and enforcement staff?**

The Board approved the Diversity and Inclusion Strategic Plan 2016-2019 which reflects the Board's strategic initiative on diversity, inclusion, and equality. The implementation of the plan involves the active involvement of senior leaders throughout the Board. In support of the Board's strategic objectives and commitment to attract, hire, develop, promote and retain a highly diverse workforce, each functional division is required to establish a diversity and inclusion scorecard. The purpose of the scorecard provides a process that helps us organize and develop a systematic effort in support of the diversity and inclusion strategic plan. I am firmly committed to the achievement of these goals.

- **(b) What steps can the Fed take to promote diversity within the financial system, especially with respect to the firms the Fed regulates?**

As directed by section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Board continues to request a submission from the entities we regulate containing information that supports the diversity policies and practices of their institutions. The assessment of submissions provides an opportunity to strengthen and promote transparency of organizational diversity and inclusion within the entities' U.S. operations and provide opportunities to discuss leading practices and challenges in addressing the lack of diversity in the financial services industry. The Board and the financial regulatory agencies are collaborating to develop symposiums, webinars and other support initiatives to address what is needed to advance diversity.

- **(c) How closely do you work with the Fed's Office of Diversity and Inclusion?[6] Please give examples of how your work leverages the office's expertise in carrying out the Federal Reserve Board's regulatory, supervisory and enforcement work.**

In addition to the Director of the Office of Minority and Women Inclusion (OMWI) reporting to our Chairman, I too meet with to the Office of Minority and Women Inclusion (OMWI) director to discuss cultivating diversity and inclusion in all aspects of employment. The OMWI director is involved in the appointment process of official staff to ensure that the Federal Reserve Board's (Board) leadership nomination criteria and process are inclusive. Additionally, a meeting schedule has been established for the OMWI Director and the Deputy Director for Policy of the Supervision and Regulation Division to discuss regulations that may disproportionally affect minority-owned and women-owned businesses. The OMWI Director also participates with Division Directors, senior staff, and Board Members in an internal work stream at the Board established to coordinate economic inclusion and diversity efforts. The group focuses on initiatives not just at the Board, but also more broadly throughout the Federal Reserve System. Board Members meet regularly with the staff to discuss initiatives and progress.

- **(d) What legislative recommendations do you have for how Congress could strengthen efforts to promote diversity and inclusion at the Federal Reserve Board, as well as the firms you regulate?**

The Board continues to be committed to cultivating diversity in all aspects of employment and recognizes the value of building and sustaining an inclusive work environment. This includes a commitment to the letter and spirit of all current law. While we have made progress implementing section 342 of the Dodd-Frank Act, we continue to focus on areas of opportunity where there is more to be done. We continue to encourage firms we regulate, to provide assessments of their diversity and inclusion practices in order to promote transparency and identify opportunities for improvement. Additional outreach initiatives regarding submission of self-assessments as well as meetings to discuss diversity strategies needed to increase diversity are continuing.

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[6] The Office of Diversity and Inclusion fulfills the See https://www.federalreserve.gov/publications/files/omwi-report-20180330.pdf for the Fed's 2018 Report to the Congress on the Office of Minority and Women Inclusion.

3. Fintech, Payments and Digital Currency

- **(a) What is your view of the rapid growth of financial technology, or fintech, in the financial services marketplace? What are your top priorities at the Fed with respect to fintech?**

The Federal Reserve views developments in financial technology through the lens of our long-standing public policy goals of safety and soundness of financial institutions, consumer protection, safety and efficiency for the payment system, financial stability more broadly, and an innovative financial system that provides widely shared benefits to the public over time.

Overall, the Federal Reserve is supportive of private-sector innovation in the financial services industry. At the same time, because of the transformative potential of financial technology in the financial services marketplace, we attach considerable importance to the Federal Reserve actively researching and monitoring these digital innovations. With this objective in mind, we have been evaluating developments in financial technology through a multidisciplinary lens, combining information technology and policy analysis to study the potential implications of digital innovations for payments policy, supervision and regulation, financial stability, monetary policy, and the provision of financial services. In its research, the Federal Reserve is working to identify both the benefits of various digital innovations as well as challenges associated with their implementation.

Almost all fintech innovations rely on connections to banks for: (1) access to consumer deposits or related account data; (2) access to the payment system; or (3) credit origination. Accordingly, when considering the Federal Reserve's role as a bank supervisor, first and foremost, we have a responsibility to ensure that the institutions subject to our supervision are operated safely and soundly and that they comply with applicable statutes and regulations and sound principles of consumer protection as they explore advances in financial technology.

Within that framework, we have an interest in encouraging socially beneficial and financially sound innovations to flourish, while ensuring the risks that they may present are appropriately identified and managed. I believe we should allow responsible innovations to develop, which can benefit consumers and small businesses through expanded access to financial services or greater efficiency, convenience, and reduced transaction costs. If the marketplace and regulators can support responsible connectivity between fintech firms and supervised entities, such integration could benefit banks, particularly community banks, which may be able to more readily outsource the development of more efficient digital consumer interfaces, mobile apps, digital wallets, or lending products.

The Federal Reserve System's (System) approach in the payments, clearing, and settlement space is similar. Board and System staff have been monitoring developments related to cryptocurrencies, central bank-issued digital currencies, wholesale digital tokens, and distributed ledger technology. Staff have found that although cryptocurrencies are innovative and may provide benefits related to automation and validation, they also pose challenges associated with speculative dynamics, investor and consumer protections, money-laundering risks, and governance. In addition, although central bank-issued digital currencies may be able to overcome some of the particular vulnerabilities that cryptocurrencies face, they too have significant challenges related to cybersecurity, money laundering, and the retail financial system. Even so, digital tokens for wholesale payments and some applications of distributed ledgers – the key technology underlying cryptocurrencies – may hold promise for strengthening traditional financial instruments and markets.

- **(b) GAO issued a recent report making a series of recommendations that the Fed and other regulators coordinate better on fintech issues.[7] What steps is the Fed taking to respond to these recommendations, and coordinate better with other regulators?**

The Federal Reserve recognizes the importance of working collaboratively with other regulators when determining how best to encourage socially beneficial innovation in the marketplace, while ensuring a safe and sound financial system and that consumers' interests are protected. Even prior to the U.S. Government Accountability Office (GAO) report, the Federal Reserve and other regulators had already committed to coordinating on these issues in a variety of fora, including the Federal Financial Institutions Examination Council (FFIEC) Task Force on Supervision, the FFIEC Task Force on Consumer Compliance, and the Interagency Fintech Discussion Forum. This calendar year, the Federal Reserve has also organized a number of meetings with industry actors, trade associations, and consumer advocates in a variety of fintech areas, which have included joint participation from a number of relevant regulators, like the OCC, FDIC, Consumer Financial Protection Bureau (CFPB), and several Federal Reserve Banks.

With regard to the GAO report's recommendation that the Board invite the National Credit Union Administration (NCUA) to participate in the Board's Interagency Fintech Discussion Forum, we agree that the NCUA's oversight of credit unions provides it with experiences and perspectives that are relevant to the group's collaborative work on fintech consumer protection issues. Accordingly, Board staff has invited NCUA staff to take part in future meetings of the Interagency Fintech Discussion Forum.

Similarly, staff at the Federal Reserve Banks of Atlanta and Boston have discussed with staff at the Federal Communications Commission (FCC) the benefits of the FCC's participation in the 2018-2019 Federal Reserve's Mobile Payments Industry Working Group (MPIW). FCC representatives advise that they plan to attend the next occurring MPIW meeting.

Among other efforts that focus on financial innovation, the Federal Reserve System has recently organized two System-wide teams of experts tasked with monitoring fintech and related emerging technology trends as they relate to our supervisory and payment system responsibilities, respectively. The new teams include representation from all of the Federal Reserve Banks, with Board staff providing leadership. The teams' critical objectives include ensuring that fintech-related information is shared across the System and informs relevant supervisory, policy, and outreach strategies.

We will continue to facilitate and engage in collaborative discussions with other relevant financial regulators in these and other settings to address in the context of the Federal Reserve's supervisory and regulatory responsibilities the important issues raised by the GAO report.

[7] https://www.gao.gov/products/GAO-18-254.

- **(c) The United States continues to have an outdated payment system, especially compared to other countries that have real-time payment systems. What steps is the Fed taking to modernize our payments system?**

The Federal Reserve plays many roles in the payment system, including payment system operator, supervisor of financial institutions and systemically important financial market utilities, regulator, researcher, and catalyst for improvement. Acting primarily in its catalyst role, the Federal Reserve encouraged payments stakeholders to join together to improve the payment system in the United States in its "Strategies for Improving the U.S. Payment System" paper (Strategies Paper), issued in January 2015.[8] The strategies outlined in the Strategies Paper included the creation of task forces focused on faster payments and payment security, both of which have provided a forum for diverse industry participants to collaborate on an ongoing basis since they were established in mid-2015.

The Faster Payments Task Force (FPTF) had the mission to identify and assess alternative approaches for implementing safe, ubiquitous, faster payments capabilities in the United States. In support of this mission, the FPTF created the Faster Payments Effectiveness Criteria to assess faster payments solutions and as a guide for innovation in the payments industry.[9] The FPTF also designed a process for which faster payment solution proposals could be submitted for assessment against these Effectiveness Criteria.

The FPTF released the first part of its final report in January 2017. The second part of the final report, released in July 2017, reflected the FPTF's perspectives on challenges and opportunities with implementing faster payments in the United States, outlined its recommendations for next steps, and included the proposals and assessments for the 16 proposers that opted to be included in the final report.[10] The FPTF recommendations identified the need for ongoing industry collaboration to address infrastructure gaps; develop models for governance, rules and standards; and consider actions and investments that will contribute to a healthy and sustainable payments ecosystem. A number of recommendations called for Federal Reserve support to facilitate this ongoing collaboration.

The mission of the Secure Payments Task Force (SPTF) was to provide a forum for stakeholders to advise the Federal Reserve on payment security matters, and identify and promote actions that could be taken by payment system participants collectively or by the Federal Reserve System. The SPTF worked to advance understanding of the industry's most pressing payment system security issues: identity management, data protection, and fraud and risk information sharing. The SPTF concluded its efforts in March 2018, following publication of its final deliverables.[11]

Following the work of the task forces and other efforts to advance both the desired outcomes (focused on speed, security, efficiency, international payments, and collaboration) outlined in the

[8] Federal Reserve System, "Strategies for Improving the U.S. Payment System," January 26, 2015. Available at https://fedpaymentsimprovement.org/wp-content/uploads/strategies-improving-us-payment-system.pdf.

[9] Faster Payments Task Force, "Faster Payments Effectiveness Criteria," January 2016. Available at https://fasterpaymentstaskforce.org/effectiveness-criteria-and-solution-proposals/.

[10] Faster Payments Task Force, "Final Report Part One: The Faster Payments Task Force Approach," January 2017, and "Final Report Part Two: A Call to Action," July 2017. Available at https://fasterpaymentstaskforce.org/.

[11] See,https://securepaymentstaskforce.org.

Strategies Paper, the Federal Reserve published, in September 2017, a paper presenting refreshed strategies and tactics that the Federal Reserve is employing in collaboration with payment system stakeholders.[12]

The Federal Reserve kicked off these refreshed strategies and tactics in the summer of 2017 by facilitating the industry's work to address the FPTF recommendations related to governance, directories, rules, standards, and regulations. In addition, consistent with the FPTF recommendations, the Federal Reserve has been assessing the needs and gaps to enabling 24x7x365 settlement in support of a future ubiquitous real-time retail payments environment. Further, the Federal Reserve has started to explore and assess the need, if any, for any other operational roles to support ubiquitous real-time retail payments. These efforts are being pursued in alignment with Federal Reserve policy on the provision of payment services. With respect to payment security, the Federal Reserve is conducting a secondary research review that is intended to understand more fully what data is available regarding payments fraud.

- **(d) What concerns, if any, do you have about Bitcoin and the use of other virtual currency in the U.S. financial system? Should banks promote or discourage their use? What protections are needed to ensure these cryptocurrencies can't be used to evade anti-money laundering laws?**

The Board does not currently have financial stability concerns related to virtual currencies because their current levels of adoption and near-term potential for scalability of virtual currencies are limited. The Board is concerned about some of the consumer protection, Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT), governance and payment risk issues that have emerged and are linked to these virtual currencies and the exchanges where they are traded.

Banks have, to date, taken a very cautious stance with respect to the use and promotion of the use of virtual currencies; many have been reluctant to even provide banking services to virtual currency-related businesses.

With regard to AML/CFT issues, cryptocurrencies and virtual currencies have features that make them a potential vehicle for money laundering and terrorist financing. Many cryptocurrencies store in their ledger little to no information about the identity of owners of the cryptocurrency. Further, cryptocurrencies are easy to transfer across international borders. Indeed, a cryptocurrency that mimics a bearer instrument and provides significant privacy in transactions could raise significant money-laundering and terrorist-financing concerns. For example, large amounts of an electronic instrument could be easily transferred and peer-to-peer transactions outside of the United States could be very challenging to prevent and detect. Where a banking organization supervised by the Federal Reserve provides services to a business or individual that deals in a crypto-asset, the Federal Reserve seeks to ensure that the banking organization fully complies with all applicable AML/CFT requirements, under the Bank Secrecy Act (BSA) and Office of Foreign Assets Control (OFAC) regulations, and is adequately addressing risks posed by this type of activity.

[12] Federal Reserve System, "Strategies for Improving the U.S. Payment System: Federal Reserve Next Steps in the Payments Improvement Journey," September 6, 2017. Available at https://fedpaymentsimprovement.org/wp-content/uploads/next-step-payments-journey.pdf.

Considerable work is being done domestically and internationally to understand and potentially to address some of the concerns mentioned, including evasion of AML laws. However, it is too early to say what steps need to be taken to address all of these concerns, as these currencies and their usage is changing rapidly. Board staff support international cooperation to study and monitor crypto-assets, through venues such as the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructure, the Financial Stability Board (FSB) and others. Because crypto-asset trades do not respect international borders, international cooperation is likely to be crucial to any steps taken to address concerns.

- **(e) What are your views on "open banking"? Other countries seem to be pursuing this approach to ensure consumers have full access and control of their personal information, and can use new mobile applications to do a better job shopping for the best financial products and services. What are the pros and cons of promoting "open banking" in the United States?**

"Open banking" is an approach that allows third parties to access a financial institution's data and systems in order to build applications and services around the financial institution. There are important distinctions between the United States and other countries that are exploring open banking. Open banking regulations in other countries mitigate the attendant data-security and consumer-protection risks with a number of measures that, by and large, are not readily available policy options in the United States, where banking regulators have different and overlapping statutory authorities. For example, under the European Union's Revised Payment Systems Directive (PSD2), third parties with access to bank accounts will be subject to licensing and registration requirements, as well as associated capital and insurance requirements. PSD2 also requires that electronic payments will be authorized by two-factor authentication--for example "something you know" and "something you are." Further, many jurisdictions that are exploring open banking frameworks feature far fewer banks than the United States. The open banking mandates in these other jurisdictions are often forwarded by regulators that have competition mandates, in addition to prudential and conduct authorities. In the United States, by contrast, banking regulators' statutory mandates generally do not extend to competition issues.

Given these distinctions, the United States is likely to address these issues in a different way, at least initially, given that regulatory authorities are more broadly distributed, and the relevant statutory language predates these technological developments. Safety and soundness regulation--and with it, concerns about data security, cyber security, and vendor risk management--is distributed among a number of regulators. Accordingly, we are actively collaborating with other regulators and monitoring the rapidly-changing data aggregation space, recognizing that a variety of actors (e.g., large banks, small banks, core system providers, fintech developers, data aggregators, and regulators) are working through the different ways that banks can facilitate connectivity to outside developers. Regarding interpretation of statutory language, the Consumer Financial Protection Bureau (CFPB), for instance, issued a Request for Information last fall to explore issues surrounding consumers' granting access to account information to third parties under Section 1033 of the Dodd-Frank Act.

Of particular concern is a current open banking practice whereby data aggregators log onto a bank's online consumer website as if they were the actual consumers and extract information.

This practice of "screen scraping" raises concerns about creating large repositories of consumers' on-line banking logins and passwords. This is particularly concerning because most data aggregation companies are generally not subject to bank-like examinations by regulators at a state or federal level for data security or consumer compliance.

But even when screen scraping is not involved, it is not clear the extent to which banks understand (or have input into) the criteria used by data aggregators in choosing which developers the data aggregators will provide data obtained from the banks. Similarly, it is not clear if banks are even aware of which developers receive the data – much less what limitations those developers have on the use, preservation, or dissemination of the data they receive.

From a consumer protection perspective, it is unclear if consumers understand that they are entering into agreements with data aggregators when using third-party applications. Log-in screens used by screen scrapers may feature the logos of banks, making it difficult for consumers to discern whether or not their bank has an underlying agreement with a developer or aggregator. Consumers may not understand the extent to which their liability for erroneous and fraudulent transactions may change when they are using a data aggregator. And many aggregators use contractual provisions that limit their liability to consumers and prevent consumers from seeking relief in court or as a class. Consumers also may not understand that data aggregators may continue to access their bank accounts well after consumers have stopped using or even deleted the fintech "apps" that created the data aggregation relationship in the first place.

4. Lessons from the Financial Crisis and the Benefits of Dodd-Frank

Mr. Quarles, you have repeatedly said that since it has been a decade since the 2008 financial crisis, it is time to review and revisit all of the post-crisis financial rules to seek improvements.

- **(a) Will these modifications to post-crisis reforms be one-sided with a focus on deregulating the financial industry?**

The regulatory reforms that were put in place in the wake of the financial crisis have helped to make the U.S. financial system stronger and more resilient. As I have stated publicly on several occasions, I believe that the core regulatory reforms -- heightened capital and liquidity standards, stress testing, and resolution planning -- should be preserved.

My focus is not deregulation. Rather, my goals are to match the character of our regulation and supervision to the risk characteristics of firms and to find ways to reduce unnecessary burdens while maintaining the safety and soundness of the financial system. I also support exploring whether our supervisory and regulatory objectives can be met in a way that is more transparent, efficient, and simple, while still ensuring that the financial system remains resilient.

- **(b) Do you think lessons from the financial crisis have faded in the minds of some policymakers?**

I certainly hope that policymakers have not forgotten the material adverse impact that the financial crisis had on families, businesses, and the broader economy. The core reforms that were put in place in the wake of the crisis -- notably, higher capital and liquidity requirements, stress testing, and resolution planning -- were aimed at reducing the risk that bank failures or distress will have such a harmful impact on economic growth in the future.

- **(c) What is your diagnosis for the causes of the financial crisis?**

The causes of the financial crisis are complex and will be studied for years, but there are things that we can say, in general terms, about the causes at present. In the years leading up to the crisis, there was a buildup of financial vulnerabilities that left our financial system in a fragile state by late 2007. Financial institutions, households, and many businesses were highly leveraged. At financial institutions this vulnerability was compounded by a mismatch between the maturity of the assets held and the maturity of the borrowing that supported those assets. In many cases the assets were long-term and illiquid, like housing, while the funding was short-term and could be called at a moment's notice. This buildup of vulnerabilities was not limited to the United States, and many foreign financial systems experienced similar conditions.

As a result of these domestic and international vulnerabilities, the financial system -- which lacked sufficient capital and liquidity, particularly at the largest and most complex firms -- was not able to handle the unexpected downturn in U.S. asset values. When that occurred, these vulnerabilities amplified the effect of the initial shock, and the result was the financial crisis.

- **(d) What Dodd-Frank requirements do you think have helped address the numerous problems exposed by the crisis?**

While a number of post-crisis reforms addressed problems that were exposed during the financial crisis, I would point to several that were particularly valuable.

Stronger capital requirements. Maintaining the safety and soundness of the largest U.S. banks is fundamental to maintaining the stability of the U.S. financial system and the broader economy. To be safe and sound financial institutions, these firms must be well-capitalized. The U.S. banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system. In fact, since the crisis, capital has increased by approximately $800 billion.

Stress testing. The capital adequacy of the largest U.S. banking firms has been further bolstered by the annual stress testing and Comprehensive Capital Analysis and Review (CCAR) exercises, which consider the losses these firms would suffer under adverse economic scenarios on a forward-looking basis. In doing so, these programs help determine firms' capital needs in a serious economic downturn.

Enhanced liquidity requirements. The financial crisis demonstrated that large global banks had outsized liquidity risks that were insufficiently constrained by the existing regulatory framework. These liquidity risks often led to the failure of the firm or to substantial dependence by the firm on liquidity support from the federal government. The federal banking agencies have subsequently required large banking firms to substantially reduce their liquidity risk through stronger regulatory and supervisory requirements. Liquidity positions within the U.S. banking system have improved substantially since the financial crisis.

Resolution planning. The focus of resolution planning is for firms to structure their operations in normal times to facilitate orderly resolution in bankruptcy to mitigate the systemic risks of a firm's failure. The resolution planning process has caused the largest U.S. banking firms to substantially improve their internal structures, governance, information collection systems, and allocation of capital and liquidity in ways that promote resolvability.

- **(e) Do you believe the Fed failed, as many of us do, at implementing and enforcing our consumer financial protections laws prior to the creation of the Consumer Financial Protection Bureau?**

Before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010, the Board had responsibility for writing regulations to implement many consumer protection laws. The financial crisis revealed the need to address fundamental problems across the financial system in both the private and public sectors, including failures of risk management in many financial firms, and deficiencies in government regulation of financial institutions and markets. Congress enacted the Dodd-Frank Act to address the weaknesses that had emerged in various areas of the mortgage market, including underwriting standards, capitalization, and securitization, as well as consumer protection. To that end, the Dodd-Frank Act transferred most of the Federal Reserve's rulewriting responsibilities pertaining to consumer protection to the CFPB, as well as considerably expanding its consumer protection statutory authorities for supervision and enforcement, and granting the CFPB broad authorities to promulgate consumer protections regulations covering banks and non-banking entities.

Although the Board no longer has rulewriting authority for most consumer protection regulation, we remain committed as we have for over 40 years to strong consumer protection to promote a fair and transparent financial marketplace. We carry out this commitment through the Board's Division of Consumer and Community Affairs (DCCA), which is solely dedicated to consumer compliance supervision, community development, and consumer-focused research, analysis, and outreach. The DCCA facilitates our oversight of the Federal Reserve System's supervision and examination policies and programs for the approximately 800 banks we supervise to ensure consumer financial protection and promote community reinvestment.

The Federal Reserve supervises all state member banks for compliance with the Fair Housing Act and Equal Credit Opportunity Act, as well as for other consumer protection rules for state member banks of $10 billion or less. Federal Reserve staff coordinate with the prudential regulators and the CFPB as part of the supervisory coordination requirements under the Dodd-Frank Act to ensure that consumer compliance risk is appropriately incorporated into the consolidated risk-management program of the approximately 135 bank and financial holding companies with assets over $10 billion.

Additionally, we have addressed unfair and deceptive practices through public enforcement actions that have collectively benefited hundreds of thousands of consumers and provided millions of dollars in restitution, and our examiners evaluate fair lending risk at every consumer compliance exam. Pursuant to the Equal Credit Opportunity Act, if we determine that a bank has engaged in a pattern or practice of discrimination, we refer the matter to the Department of Justice (DOJ). Federal Reserve referrals have resulted in DOJ public actions in critical areas, such as redlining and mortgage-pricing discrimination.

The Board also provides oversight for the Reserve Bank consumer compliance supervision and examination through our policy development, examiner training, and supervision oversight programs. A number of critical areas are included in these programs, such as banks' performance under the CRA; consumer compliance in bank holding company matters; compliance with and enforcement of a wide range of consumer protection laws and regulations including those related to fair lending, unfair or deceptive acts or practices, and flood insurance; analysis of bank and bank holding company applications related to consumer protection, convenience and needs, and the CRA; and processing of consumer complaints. We also monitor trends in consumer products to inform the risk-based and enterprise-wide supervision.

- **(f) Was it important to impose enhanced prudential standards on the nation's largest banks, including requiring more capital, more liquidity and less leverage?**

Yes. As I noted above, I consider these to be among the most valuable post-crisis reforms. Stronger risk-based capital and liquidity regulations for large banking organizations, together with our stress testing program, have helped to ensure that banking organizations are better positioned to continue lending through periods of economic stress and market turbulence.

- **(g) Has the Financial Stability Oversight Council, or FSOC, helped to eliminate regulatory gaps in our financial regulatory system? Should FSOC maintain broad tools to deal with the next crisis?**

Prior to the creation of the Financial Stability Oversight Council (FSOC), the U.S. financial regulatory framework focused narrowly on individual institutions and markets, and no single regulator had the responsibility for monitoring and assessing overall risks to financial stability, which could involve different types of financial firms operating across multiple markets.

Importantly, the FSOC established a venue to facilitate regulatory information sharing and coordination to help minimize potential regulatory gaps and weaknesses. A key component of this is the FSOC's annual financial stability report, signed by the voting members. Past reports have highlighted vulnerabilities such as prime money market mutual funds that benefit investors who withdraw their funds first – with the potential for destabilizing runs of the kind that stressed the financial system in September 2008. Subsequent reports have noted that the Securities and Exchange Commission's (SEC) regulatory reforms, which took effect in late 2016, were instituted to mitigate the risk of runs on money funds, and led to significant structural changes in the industry, with assets flowing to funds that held only assets guaranteed by the federal government.

The creation of FSOC was valuable and necessary to fill the regulatory gaps that contributed to the financial crisis. Of course, the regulatory community has learned from the experiences of the past several years, and there may be ways to improve the processes currently followed by the FSOC. However, we learned from the experience of the financial crisis that an excessively narrow focus can lead to regulatory gaps, and that it is necessary to deal with vulnerabilities before they grow sufficiently material to leave the financial system too weak to handle bad financial shocks.

- **(h) What has Dodd-Frank's new derivatives oversight framework provided to FSOC? Since the Fed serves on FSOC, does this oversight of the derivatives market help the FSOC to better monitor and mitigate potential threats to financial stability?**

The Financial Stability Oversight Council (FSOC) designates systemically important financial market utilities (FMUs) and, when needed, facilitates coordination among the regulatory agencies involved in overseeing the designated FMUs (DFMUs).[13] To date, the FSOC has designated three derivatives-clearing organizations - the Chicago Mercantile Exchange, ICE Clear Credit, and the Options Clearing Corporation - as systemically important.

Prior to the creation of the FSOC, the U.S. financial supervisory framework focused largely on individual institutions and markets, and no single regulator had the responsibility for monitoring and assessing overall risks to financial stability. The FSOC provides a forum for members to share information and analysis related to a broad range of financial institutions and markets, including over the counter derivatives markets. In our experience, this information-sharing and coordination helps members to identify and address potential gaps and weaknesses.

At various times since the FSOC's inception, FSOC working groups and committees have received presentations on developments in derivatives markets and the use of derivatives by classes of institutions. Typically, these presentations have been developed internally by individual FSOC member agencies or the Office of Financial Research and shared with other FSOC members after supporting confidential data have been appropriately aggregated and anonymized. For example, the FSOC Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee (FMU Committee) supports the FSOC in fulfilling its responsibilities related to FMUs and payment, clearing and settlement (PCS) activities under Title VIII of the Dodd-Frank Act. The FMU Committee has focused primarily on conducting analyses and providing recommendations to the FSOC related to designations of FMUs, consulting with supervisory agencies regarding risk management standards applicable to DFMUs pursuant to Dodd-Frank Act section 805, educating members on FMUs, and discussing products and risks relevant to clearing.

Further, section 809 of the Dodd-Frank Act authorizes broad information-sharing between the FSOC and Title VIII Supervisory Agencies, and, if necessary, authorizes the FSOC and the Board to collect reports or data from a DFMU to assess the safety and soundness of the DFMU and the systemic risk the DFMU's operations pose to the financial system. To date, FSOC has not requested any information using this authority.

- **(i) Do you support the Volcker Rule's prohibition on proprietary trading so that banks that benefit from the federal safety net do not gamble with deposits?**

The objective of the Volcker Rule is simple: banks with access to the federal safety net should not engage in risky, speculative trading for their own account.

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[13] Dodd-Frank Act section 804 requires the FSOC to designate FMUs or PCS activities that the FSOC determines are, or are likely to become, systemically important such that "a disruption to the[ir] functioning…could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system in the United States."

However, we are now at a point where it is both relevant and timely to examine the post-crisis reforms and identify areas where we can achieve our regulatory objectives with improved efficiency, transparency, and simplicity. The recently issued proposal by the Board and the other Volcker Rule agencies, which I support, includes best first efforts to further tailor the regulatory requirements and reduce burdens and costs, all in a manner consistent with the statute. That proposal is an important step in comprehensive Volcker Rule reform, and the Board looks forward to receiving comments from the public.

5. Stronger Regulations and Enforcement

- **(a) As you lead the Fed's efforts to revisit the post-crisis financial rulebook, what regulatory areas do you think need to be strengthened instead of rolled back?**

After spending almost a decade building the post-crisis regulatory regime, the bulk of the work of post-crisis regulation is complete. We and the other banking agencies have recently implemented or are in the process of implementing the final outstanding post-crisis measures to strengthen the regulatory framework.

The Board voted on June 14 to adopt a final rule to establish single-counterparty credit limits. This rule applies to the largest banking organizations, placing limits on a firm's credit exposures to a single counterparty, with exposures between systemically important firms subject to the most stringent limitations. These limits address risks to the economy that are created when large banking organizations have significant exposures to one another. The Board believes that this rule will improve the stability of the financial system by limiting exposures between financial firms.

The banking agencies are also working to finalize the net stable funding ratio (NSFR) rule. As a longer-term, standardized quantitative liquidity metric and requirement, the NSFR rule provides an important complement to the liquidity coverage ratio (LCR) rule and the internal liquidity stress testing and liquidity risk management requirements the Board established starting in 2012 and 2014. By improving banking organizations' ability to prepare for and absorb shocks arising from financial and economic stress, these measures will help to promote a more resilient banking sector and financial system.

- **(b) The Treasury Department, as you know, has released several extensive reports that include dozens and dozens of recommendations to revise financial regulations.[14]**
  - **Do you support the recommendations Treasury made that the Fed take that were included in its first report focused on banks and credit unions? Which, if any, recommendations did you disagree with?**
  - **Are you concerned that few to no recommendations made by Treasury would result in stronger oversight of the largest, most complex financial firms?**

The Treasury Department's regulatory report acknowledged that regulatory policies implemented since the financial crisis have improved the safety and soundness of the financial system and noted that the U.S. banking system is significantly better-capitalized as a result of

[14] https://home.treasury.gov/top-priorities/regulatory-reform.

post-crisis regulatory capital requirements and stress testing. The report also made a series of recommendations for the U.S. regulatory agencies to consider in order to reduce regulatory costs for the banking system.

As I said in my testimony to the Committee, I am committed to maintaining the core elements of the post-crisis framework that have been put in place to protect the financial system's strength and resiliency, while also seeking ways to enhance its effectiveness. We will continue to evaluate the effects of regulation on financial stability and on the broader economy and where appropriate make adjustments. I am also committed to enhancing the simplicity, transparency and efficiency with which the Federal Reserve supervises and regulates firms under our jurisdiction.

- **(c) While there was some discussion of insurance savings and loan holding companies (SLHCs) and the Federal Reserve's approach to regulating them during the hearing, it is worth noting the Office of Thrift Supervision (OTS) was roundly criticized for its weak oversight, including of AIG, leading up to the 2008 financial crisis. Given that the supervision of SLHCs were transferred from the OTS to the Federal Reserve Board, what steps is the Federal Reserve Board taking to improve oversight of all SLHCs and not repeat past mistakes?**

The Office of Thrift Supervision's supervisory activities at insurance savings and loan holding companies (ISLHCs) focused on assessing the condition of the subsidiary thrift(s) with a minimal review of non-banking activities, including insurance. In contrast, the Federal Reserve's ISLHC supervisory program focuses on consolidated risk management and an overall assessment of the safety and soundness of the ISLHC. The Federal Reserve also employs a number of insurance specialists at both the Board and the Reserve Banks who are directly responsible for overseeing the ISLHCs.

The Federal Reserve conducts ISLHC inspections on an annual basis and tailors the supervisory program to each firm's size, structure, risk profile, and business model as well as the size and scale of banking and other non-insurance activities. Supervisory emphasis is placed on assessing an ISLHC's consolidated risk management framework, material non-insurance subsidiaries, and the potential impact the firm's activities may have on its subsidiary insured depository institution (IDI). The Federal Reserve also seeks to protect the IDI from risks related to nonbanking activities, including insurance, as well as intercompany transactions between the parent and IDI to ensure that the IDI is not adversely affected.

In light of the McCarran-Ferguson Act, we rely on the state insurance departments (DOIs) to supervise the business of insurance including the DOIs' assessment of risk and the financial condition of insurance operations. Discussions with the DOIs are held on a regular basis to understand the risks associated insurance activities that could affect the bank or the consolidated condition of the ISLHC, such as those that led to the developments at AIG. The Federal Reserve also meets routinely with the DOIs to share supervisory information and coordinate supervisory approaches.

6. Large Bank Supervision and Enforcement

While you are recused from Wells Fargo matters, you play a critical role at the Federal Reserve Board with respect to large bank supervision and enforcement. Wells Fargo is a repeat offender with a terrible track record of harming consumers, including opening millions of fraudulent accounts without their customers' consent. Wells Fargo deserves the punishment that former Chair Yellen handed down to cap the bank's size until it cleans up its act while several bank directors stepped down. Yellen's action must be vigorously implemented, and more should be done by regulators to use existing tools to crack down on repeated violations of the law by megabanks. Fines won't cut it any more, they are just the cost of doing business. That is why I introduced the Megabank Accountability and Consequences Act last year to require the banking regulators to fully utilize existing authorities—such as the ability to shut down a megabank and ban culpable executives from working again in the industry—to stop megabanks like Wells Fargo that clearly and repeatedly engage in practices that harm consumers.

- **(a) Would you please review a Democratic Committee staff report issued in September 2017,[15] and H.R. 3937, the Megabank Accountability and Consequences Act,[16] I subsequently introduced, and list the full range of enforcement tools the Federal Reserve Board has to ensure the largest banks are following the law and sufficiently deterred from repeatedly breaking the law and harming consumers?**

Congress has conferred on the Federal Reserve and the other bank regulators a broad array of both informal and formal enforcement tools to be exercised at appropriate points throughout the course of the supervisory process. Enforcement measures may escalate depending on the severity or difficulty of the problem. If a problem requires a more detailed resolution than can be addressed through the normal examination process or is more pervasive at an institution, the Federal Reserve may enter into a memorandum of understanding (MOU) with the financial institution in which the board of directors commits to specific actions to correct potentially unsafe and unsound banking practices or possible violations of laws or regulations. These are private supervision matters.

The Federal Reserve also confronts situations where an institution engages in an unsafe or unsound practice or alleged violation of law that is more widespread or more serious so that MOUs or other informal supervisory methods are not appropriate or sufficient. In these cases, the Federal Reserve will begin more formal types of enforcement action against the regulated financial institution and its institution-affiliated parties, such as current or former employees.

As described in the Democratic Committee Report, these more formal remedies include entering into formal written agreements or imposing orders directing the financial institution or its institution-affiliated parties to cease and desist from engaging in the improper or prohibited conduct, directing the firm to take certain actions to return to safe and sound banking practices and, where appropriate, requiring the firm to make restitution or provide reimbursement, indemnification, or guaranty to third parties harmed by the wrongful conduct. The Federal Reserve may also remove an institution-affiliated party from the banking institution and prohibit the party from participating in banking at other financial institutions. Finally, we may

[15] https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=400807.
[16] https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=400815.

determine that the assessment of civil money penalties is appropriate against either the offending institution or an institution-affiliated party.

- **(b) Does the Federal Reserve Board use different enforcement tools depending on the size of the bank holding company?**

The enforcement tools available to the Federal Reserve and other federal banking agencies are applicable to the institutions we supervise regardless of size. In each case where the Federal Reserve assesses whether an enforcement action is warranted, the Federal Reserve considers whether the relevant legal standards for seeking the proposed remedy are supported by the facts and circumstances. These standards generally do not refer to the size of the institution involved. However, when imposing a civil money penalty, the Federal Reserve is required, by law, to consider the size and financial resources of the institution, in addition to whether it acted in good faith, the gravity of the violation, the history of previous violations, and other matters as justice may require.[17] As evidenced by its public enforcement actions, the Federal Reserve has used its enforcement tools against institutions of a wide range of asset sizes.[18]

- **(c) The Federal Reserve Board, under former Chair Yellen, capped Wells Fargo's size until it can demonstrate it cleaned up its act. Has the Federal Reserve Board taken a similar action against other banks in the past? If so, please list each instance the Federal Reserve Board took such an action.**

The Federal Reserve has not previously used its formal enforcement authority to restrict the asset growth of an institution until it sufficiently makes required improvements. Before my becoming a member of the Board, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), under their resolution planning authority, imposed restrictions on the growth of international and non-bank activities (as opposed to asset size) of one domestic banking organization until the firm remedied deficiencies identified in its resolution plan.

- **(d) While some of my colleagues suggested the Federal Reserve Board does not have the authority to oversee board of directors of a bank holding company, do you agree the law is clear that the Federal Reserve Board indeed has such authority, and can remove certain directors if not ban them from working again in the industry? Please list each instance the Federal Reserve Board has taken such a step in the last 20 years, along with the size of the bank holding company when such an action was taken?**

As part of its examination of regulated institutions, the Federal Reserve regularly reviews the performance of the boards of directors and senior managers of these institutions and may take action against an institution-affiliated party under specific circumstances.[19] In determining whether to remove or prohibit an institution-affiliated party, the Federal Reserve must consider whether each of three statutory criteria are met: misconduct (typically, a violation of law, unsafe

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[17] *See* 12 U.S.C. § 1818(i)(2)(G).

[18] Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/apps/enforcementactions/search.aspx (last visited Jun. 21, 2018).

[19] *See* 12 U.S.C. § 1818(e).

and sound practice, or breach of fiduciary duty), culpability (the individual must knowingly or recklessly participate in the conduct or the conduct must evidence personal dishonesty) and effect (the misconduct caused or is likely to cause financial loss or other damage to the institution, prejudiced the interests of depositors, or resulted in financial gain to the individual).[20] An individual is also prohibited by law from participating in the affairs of any banking organization if the individual is convicted of a felony or any criminal offense involving dishonesty, breach of trust or money laundering.

The attachment in Appendix A is a chart that includes the prohibition actions the Federal Reserve has taken in the last 20 years, both contested and consent actions, and the asset size of the bank holding company or foreign bank parent company of the relevant institution at or around the time of the action, where available. The highlighted prohibition actions represent instances where an individual was a member of the board of directors of the relevant institution. Note that, in these instances, an individual may also have had an additional role at the institution, such as a bank officer.

- **(e) Will the Fed consider taking similar action – capping their size – if other megabanks are found to repeatedly break the law?**

The Federal Reserve takes seriously its responsibility to ensure the safety and soundness of the nation's banking and financial system and will continue to use all available tools where warranted.

- **(f) Will the Fed Board hold a vote before it uncaps Wells Fargo's size constraints? Why or why not?**

As noted in one of your previous questions, I am recused from this matter. As Chairman Powell stated in a letter sent in May to Senator Warren, the Board will vote on any decision to terminate the asset growth restriction the Federal Reserve imposed on Wells Fargo in the Consent Order issued earlier this year.

- **(g) The Government Accountability Office (GAO) issued a report last year entitled, "Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence."[21] GAO made six recommendations to the Federal Reserve Board in the report. What are the status of the Federal Reserve Board's efforts to address those recommendations?**

Thank you for the opportunity to provide an update regarding the steps taken by the Board to address the recommendations related to the Board's Large Institution Supervision Coordinating Committee (LISCC) made by the GAO in its report titled: *Large Bank Supervision: Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence* (GAO-18-118). As noted in the Board's prior updates to the GAO regarding these recommendations, we believe that we are effectively managing the risks of regulatory capture in the supervision of large financial institutions. A summary of the status relating to each of the GAO's findings is below.

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[20] *Id.*

[21] https://www.gao.gov/products/GAO-18-118.

Develop ERM Framework to Include a Component to Identify and Assess Risks of Regulatory Capture across the LISCC Program

With respect to the first recommendation, the enterprise risk management (ERM) framework being developed by the Board will not significantly alter the management processes that the Board and System have in place under the LISCC program that continue to work effectively. Since the report's issuance, the Board has continued to develop the ERM framework by establishing a Board Risk Committee comprised of senior leaders, which serves as the central forum for Board-wide risk issues and oversight of the ERM program. Additionally, a number of strategic components of the ERM framework have begun to be implemented throughout the Board.

Finalize and Implement Program-wide Guidance for the LISCC Reserve Banks on Implementing LISCC Policies

Since the Federal Reserve's last update on the recommendations made in the GAO's report, the LISCC supervisory program has continued its efforts to address the GAO's second recommendation that the Federal Reserve "finalize and implement program-wide guidance for the LISCC Reserve Banks on implementing LISCC policies." The Federal Reserve has memorialized all aspects of the LISCC supervisory program within a comprehensive LISCC program manual.[22] The LISCC program manual remains in a near-final form pending completion of a proposal to revise the Federal Reserve's supervisory ratings system, which the Federal Reserve anticipates being finalized by year-end 2018.[23] Despite the manual's near-final status, the LISCC supervisory program has operated under the manual's guidelines since January 1, 2018, thereby satisfying the spirit of the GAO's recommendation to "finalize and implement program-wide guidance."

In addition to the LISCC program manual, the LISCC Office of the Operating Committee has continued its work with the core programs and Reserve Banks' dedicated supervisory teams to refine and develop operating policies, procedures, and guidance for the conduct of supervisory activities. When concluded, each core program and dedicated supervisory team will have established operating standards that will include (1) documentation and deliverable requirements, including for the vetting of supervisory findings, assessments, and ratings; (2) automated storage requirements for horizontal and firm-specific documentation; and (3) supervisory cycle timing, planning, and deliverable requirements.

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[22] The LISCC core programs are (1) capital, (2) liquidity, (3) recovery and resolution, (4) governance and controls, and (5) monitoring and analysis. The LISCC program manual provides detailed guidance on the core programs' (1) governance structure and roles and responsibilities; (2) focus for the year-round horizontal activities and ongoing firm-specific supervisory work; (3) expected role that the dedicated supervisory teams have in relation to the execution of the core program work; (4) documentation and deliverable requirements for activities and supervisory work, including electronic storage requirements; (5) vetting, divergent views, and decision-making process; (6) ratings process; and (7) external communication requirements.

[23] Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. 158, 39049 (proposed Aug. 17, 2017) (to be codified at 12 C.F.R. pts. 211 and 238).

It is the Federal Reserve's expectation that the LISCC program manual, as well as the core program and dedicated supervisory teams' operating manuals, will be completed by fall 2019. This additional time will help to ensure we are able to incorporate lessons learned from the LISCC supervisory program's first year of operations under the LISCC core program model. Once completed, this program-wide guidance will help to ensure the consistent and effective implementation of LISCC program requirements and will aid in mitigating threats to independence by ensuring the Federal Reserve's supervisory conclusions remain transparent and based on sound evidence.

Monitor and Assess Implementation of LISCC Policies and Procedures

The GAO's report acknowledged that internal reviews have been effective in identifying some issues regarding implementation of the LISCC program and recommended that the Federal Reserve finalize and implement a mechanism to monitor and regularly assess Reserve Banks' implementation of LISCC policies and procedures. The Federal Reserve currently assesses the effectiveness of Reserve Bank supervision functions, including their adherence to System guidance, through a continuous oversight program. The Federal Reserve has recognized that the GAO recommendation to formalize the monitoring and assessment of the LISCC program would provide greater assurance regarding the implementation of LISCC guidance. As noted in the GAO's report, the Federal Reserve has implemented changes to augment the oversight program through the development in the first half of 2018 of a LISCC-specific oversight framework that encompasses all Board and Reserve Bank LISCC activities and provides for a comprehensive assessment of program effectiveness. In the second half of 2018, staff have identified further targeted review and oversight activities employing and testing the LISCC-specific oversight framework.

Streamline Conflicts of Interest Reviews

The GAO's report recommended that the Federal Reserve streamline its conflict-of-interest disclosure review process for participants in the LISCC program by, for example, storing disclosure information in compatible electronic systems. The report indicated that different parties involved in the conflicts review process have different means of collecting and storing information, which may hinder how efficiently and effectively this information is used in the review process.

As described in the report, our objective is to effectively identify and manage conflicts of interest when supervisory staff join the Federal Reserve, during their tenure as supervisors, and when they leave the organization. We appreciate the observations provided in the report and are exploring options for streamlining our approach, including, among other things, assessing the feasibility of integrating existing systems. We have drafted guidance that develops a LISCC-specific conflicts-of-interest and examiner credential program that will seek to ensure consistency in the interpretation and application of conflicts-of-interest rules for all staff, both at the Board and the Reserve Banks, that participate in the LISCC supervisory program. We plan to issue this guidance and begin implementation of a more consistent and centralized disclosure review approach in 2018. In addition, we have begun collecting and storing conflicts-of-interest disclosure information for all LISCC participants, including Board LISCC staff, in one electronic system. We have also provided initial training to Board LISCC staff on the disclosure review process and the electronic system to ensure consistent collection of conflicts-of-interest data for all LISCC participants.

Systematically Collect Pre- and Post-Employment Data

The Federal Reserve has implemented policies intended to mitigate the risk that an employee may be influenced by prior employment or the prospect of future employment and place his or her private interests ahead of the organization's supervisory mission. For instance, the Federal Reserve recently broadened the scope of post-employment restrictions applicable to senior examiners. According to the GAO's report, the Federal Reserve could do more to mitigate this risk, specifically by systematically collecting pre-and post-employment information from supervisory employees. We agree that "revolving door" risk can pose a threat to supervisory objectivity and have begun discussions to develop a more systematic approach to collect and monitor pre- and post-employment data through the use of an electronic system. The updated electronic system is scheduled to be released, for both Board and Reserve Banks' use, in 2019. With respect to the collection of post-employment information, it is important to note that departing employees have no obligation to identify their future employer.

Conduct a Periodic Self-assessment of Ethics Programs, Policies, and Procedures That Apply to LISCC Program Participants

Board Ethics Program staff and Supervision and Regulation division staff are jointly assessing the current programs, policies, and procedures applicable to LISCC program participants. Within the next year, we expect to finalize and implement new conflicts-of-interest policies and procedures applicable to LISCC participants.

- **(h) The New York Fed is relocating its bank examination staff so it is not prone to regulatory capture. Do you agree this is the right approach? Do you disagree with Comptroller Otting's decision to leave OCC examiners permanently on-site at national banks? Why or why not?**

The Federal Reserve is constantly looking for ways to improve the effectiveness of our supervision. To that end, we are in the midst of a change that enhances our ability to look at the largest banking organizations from a cross-firm perspective. To further facilitate that, the Federal Reserve Bank of New York (FRBNY) has moved their dedicated teams of examiners back to FRBNY headquarters where they can more readily interact with colleagues from other teams and compare and contrast firm practices, processes, and risks.

Examiners will continue to have regular and consistent interactions with firms, including with their senior management and directors, and access to relevant data facilitated by technology. Additionally, the FRBNY will maintain space at the firms for at least six months as we evaluate what arrangement will be most productive over time for purposes that include accommodating examiners' needs during on-site exams, interacting with the firms, and other supervisory work.

- **(i) What other priorities do you have as the Vice Chair of Supervision to strengthen oversight and enforcement relating to the largest bank holding companies?**

I am very supportive of the steps that the Federal Reserve has taken since the financial crisis to strengthen its supervision, particularly at the largest firms. Notably, our supervision of these firms is aimed at ensuring that they have sufficient capital and liquidity, and we have substantially raised our expectations for how well these firms manage their risks, maintain internal controls, and exercise governance. In addition, to improve our supervision of the largest systemically important firms, we have created the LISCC, which helps us look at firms both individually and collectively.

Going forward, we are looking for ways to potentially make our supervision of firms of all sizes more efficient, transparent, and simple. In doing so, however, I believe that we should not weaken the stringency of our supervisory programs. Moreover, I strongly support continued tailoring of our supervisory programs relative to the size, complexity, and risk profile of the firms we supervise, with the highest expectations for the most systemically important firms.

- **(j) Unlike the Savings and Loan crisis when more than 1,000 bank executives were prosecuted, there was no similar accountability following the worst financial crisis since the Great Depression.**
    - **Do you believe such a result was a just outcome?**
    - **Do you believe any bank holding company is "too big to jail"?**
    - **What steps can the Federal Reserve Board take to ensure full accountability for individuals who work at entities you regulate that break the law?**
    - **Do deferred prosecution agreements (DPA) with bank holding companies weaken individual accountability? Why or why not?**

The decision to file criminal charges in a particular case is solely within the discretion of the Department of Justice (DOJ) and state prosecutors who alone have the authority to press criminal charges. As I have said before, no institution or individual is above the law.

The Federal Reserve has exercised its civil enforcement authority where warranted to address unsafe or unsound conduct or illegal activity that occurred during the recent financial crisis. Since the start of the financial crisis in 2008, the Federal Reserve has assessed civil money penalties and restitution payments against institutions under the Federal Deposit Insurance Act totaling more than $5.7 billion. In addition, our investigations of persons employed by or affiliated with supervised institutions have led the Federal Reserve to seek the permanent ban or suspension of more than 72 individuals from the banking industry, including senior officers and directors who failed to protect consumers and those who engaged in irresponsible banking practices that led to the crisis.[24]

Because the Federal Reserve does not have authority with respect to criminal prosecutions, we are not in a position to comment on whether the tools available to the DOJ to address corporate misconduct, including the use of deferred prosecution agreements, are effective.

7. Capital and Leverage Rules for the Largest Banks

[24] See Appendix A.

Chair Powell recently said that the Fed's requirements for the largest banks are "very high and they're going to remain very high."[25] He continued, "As you look around the world, U.S. banks are competing very, very successfully. They're very profitable. They're earning good returns on capital. Their stock prices are doing well. So I'm looking for the case, for some kind of evidence that — and I'm open to this — some kind of evidence that regulation is holding them back, and I'm not really seeing that case as made at this point."[26] I agree, which is why I'm confused why the Fed, along with the OCC, proposed to slash the leverage ratio and reduce tier 1 capital for our largest banks by more than $120 billion, according to the FDIC. JPMorgan, Citigroup, Bank of America, Goldman Sachs, Morgan Stanley, State Street and Bank of New York Mellon would all benefit, and while it varies, they could see their capital reduced by as much as $34 billion, or a reduction as high as 37.5 percent of their current tier 1 capital. This would likely result in more stock buybacks, not more loans. Wells Fargo, the recidivist megabank whose size has been capped by the Fed, could see their tier 1 capital requirements reduced by more than $20 billion.

Instead of lowering the leverage ratio so it not a binding constraint, the Fed could *raise* risk-based capital levels to achieve this objective. In fact, the Fed's own research notes current capital levels are too low, and should be raised to somewhere between 13 and 26 percent.[27] And the Minnesota Fed has proposed an even more aggressive risk-based capital ratio of 23.5 percent and a leverage ratio of 15 percent as a first step to end too big to fail.[28]

- **(a) Mr. Quarles, do you disagree with Chair Powell that there is no evidence that regulation is holding big banks back? Why or why not?**

Maintaining the safety and soundness of the largest banking firms is fundamental to maintaining the stability of the U.S. financial system and the broader economy. To be safe and sound financial institutions, these firms must be well-capitalized. The Board and the other federal banking agencies have substantially strengthened regulatory capital requirements for large banking firms, improving the quality and increasing the amount of capital in the banking system. Indeed, large banking firms have roughly doubled their capital positions from before the crisis to today, making them significantly more resilient, as well as better able to support lending and financial intermediation in times of financial stress. These improvements have helped to build a more resilient financial system, one that is well-positioned to meet American consumers', businesses' and communities' credit needs, even under challenging economic conditions.

At the same time, I am mindful that, just as there is a strong public interest in the safety and

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[25] https://www.federalreserve.gov/newsevents/speech/powell20180406a.htm.

[26] Politico Pro, "Powell doesn't see need to loosen rules on biggest banks," April 6, 2018, https://www.politicopro.com/financial-services/whiteboard/2018/04/powell-doesnt-see-need-to-loosen-rules-on-biggest-banks-967593.

[27] Simon Firestone, Amy Lorenc and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S. (PDF)," Finance and Economic Discussion Series 2017-034 (Washington: Board of Governors of the Federal Reserve System), available at: https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf.

[28] https://www.minneapolisfed.org/publications/special-studies/endingtbtf/final-proposal.

soundness of the financial system, there is a strong public interest in the efficiency of the financial system. Thus, the Board is assessing the effects on the economy and large banking firms of our recent regulatory efforts, including whether they are having any unintended results and whether they can be revised to accomplish the same goals in a more efficient manner.

- **(b) Why did the Fed issue a proposal last week that would revise the enhanced Supplementary Leverage Ratio (eSLR) and, according to the FDIC, would reduce bank capital by more than $120 billion at the nation's largest banks?**

I do not believe that the enhanced supplementary leverage ratio (eSLR) proposal would materially change the amount of capital held by U.S. global systemically important bank holding companies (GSIBs). The $121 billion figure noted in the eSLR proposal represents the potential reduction in tier 1 capital required across the lead insured depository institution subsidiaries of the GSIBs; however, these entities all are wholly-owned by their parent holding companies. On a consolidated basis, GSIBs would continue to be subject to risk-based capital requirements, supervisory stress testing constraints, and other limitations applicable at the holding company level that would restrict the amount of capital that such firms may distribute to third-party investors. Due to these limitations at the holding company level, the GSIBs would be required to retain nearly all of the $121 billion amount and would not be able to distribute it to third parties. Indeed, the Board estimates that the eSLR proposal would reduce the amount of tier 1 capital required across the GSIBs on a consolidated basis by only approximately $400 million. That amount is approximately 0.04 percent of the amount of tier 1 capital held by the GSIBs as of the first quarter of 2018.

- **(c) With banks doing so well, why would the Fed propose to reduce capital in a significant way that diminishes protections for taxpayers and the economy? What research does the Federal Reserve Board have that any reduction in capital requirements will result in more lending as opposed to more stock buybacks, dividend payments, or bonuses for executives?**

As noted above, I do not believe that the eSLR proposal would materially change the amount of capital required to be held by U.S. GSIBs. As noted, any capital released at the depository institution level would be nearly all unavailable for distribution to third-party investors.

- **(d) Will you provide the Federal Reserve Board's estimate for how your proposed changes to the eSLR and stress capital buffer would impact each U.S. global systemically important banks (G-SIBs), both at the holding company level and at the primary insured depository institution subsidiary?**

As a general matter, the Federal Reserve believes that leverage requirements should serve as a backstop to risk-based capital requirements in order to reduce incentives for firms to increase their exposure to riskier assets. The Board's stress capital buffer (SCB) proposal would extend the proposed stress buffer concept to the leverage ratio, but not to the supplementary leverage ratio. The Board is seeking comment on the advantages and disadvantages of this specific aspect of the SCB proposal (see question 3 in the preamble of the proposed SCB rulemaking).

Due to the sensitive nature of the supervisory data and assumptions included in the impact assessment of the eSLR proposal, the Board has made only aggregate impact data publicly available. The impact of the eSLR proposal would vary across firms based on their individual risk profiles and planned distributions and would vary across time based on the severely adverse stress scenario used in the supervisory stress test. While the discussion in the SCB proposal and the eSLR proposal reflects the estimated impact of those individual proposals relative to current requirements, in developing the proposals, the combined impact was also considered. Factoring the relatively immaterial estimated reduction in required tier 1 capital across GSIBs under the eSLR proposal ($400 million, as noted above in response to question 4b) into the estimated impact of the SCB proposal across GSIBs does not meaningfully affect the estimates provided in the proposals.

- **(e) Do you disavow the Federal Reserve Board's own research on the need to raise capital requirements for the nation's largest banks? Why or why not?**

As noted above, U.S. banking firms have roughly doubled their capital positions from before the crisis to today, making them significantly more resilient, as well as able to support lending and financial intermediation in times of financial stress. A number of studies have examined the relative costs and benefits of bank capital requirements.

- These studies use data and assumptions on the cost and severity of financial crises and the costs of increasing capital requirements to estimate the level of capital requirements that results in the largest net benefit to the economy.
- Such studies have been conducted by economists affiliated with the Basel Committee on Banking Supervision (2010), The Bank of England (2015), the Federal Reserve Bank of Minneapolis (2016), as well as economists at the Federal Reserve Board (2017).
- Some of these studies produce results that are consistent with current levels of capital for the GSIBs, while others call for more capital. This range in capital levels among the different studies reflects varying assumptions and data sources.

A different and perhaps preferable way to assess capital adequacy is through stress testing. All U.S. GSIBs demonstrated their ability to survive a shock more severe than the most recent global financial crisis while still continuing to supply credit and maintaining their recent dividends. Firms whose proposed additional capital payouts were not supported by their current capital bases were required to scale back their requests or take steps to reduce risk; in addition, they are expected to improve their capital positions this year.

- **(f) What is your view of the Federal Reserve Bank of Minneapolis's work on too big to fail, and their set of recommendations included in their plan? Do you agree or disagree with their recommendations? Why or why not?**

As Vice Chairman for Supervision, I believe that it is beneficial to have a robust public debate on how to best ensure and maintain the strength and resiliency of the financial sector. In that regard, I welcome all contributions to this ongoing debate.

With regard to the question of the optimal capital in the banking system, this issue has been addressed in a number of studies, including the paper from the Federal Reserve Bank of

Minneapolis. These studies aim to quantify the costs and benefits of bank capital. The studies generally find that higher bank capital requirements (up to a point) are good for long-term credit availability and economic growth, but that with levels of capital beyond that point, social welfare is reduced. While the optimal level of capital varies between studies, in part because the studies use different underlying assumptions, the basic framework is the same. I believe the overall level of risk-based capital in the banking system is appropriate at the present time.

- **(g) During your testimony, you focused on the fact that the SLR has become the binding constraint for many banks, and how that produces perverse outcomes. Would not raising risk-based capital levels while maintaining the current leverage ratios produce the same outcome, while also being responsive to research from the Federal Reserve Board and other organizations that capital requirements should be increased?**

The purpose of the eSLR proposal is to recalibrate the Board's capital standards for banking organizations such that the ratio generally serves as a backstop to risk-based capital requirements and not as a binding constraint. At this time, I believe that the substantial gains to the overall resilience of the financial system, as well as the minimal capital release that is likely to occur if the eSLR proposal were to be finalized, support the Board and the OCC's narrow approach to recalibrating the eSLR standards.

- **(h) Why should Wells Fargo be rewarded after harming millions of consumers by reducing their capital requirements by 17 percent at a time while at the same time, the Federal Reserve Board capped the bank's size in light of their misdeeds?**

As you know, I am recused from issues related specifically to Wells Fargo. In general, the Federal Reserve Board's (Board) proposal to modify the enhanced supplementary leverage ratio (eSLR) requirement (proposal) would apply to a number of large financial firms, including all U.S. global systemically important banks (GSIBs). The proposal is based on the principle that leverage capital requirements, such as the eSLR, generally should serve as a backstop to risk-based capital requirements, rather than as a binding constraint. As noted, if a leverage ratio becomes a binding constraint, it can create incentives for banking organizations to engage in riskier activities. As indicated in the proposal, Federal Reserve analysis suggests that the proposal would reduce the amount of consolidated capital required across all U.S. GSIBs, including Wells Fargo, by approximately $400 million. That figure is approximately 0.04 percent of the amount of consolidated capital held by all U.S. GSIBs as of the third quarter of 2017.

- **(i) What impact will the Federal Reserve Board's efforts to weaken capital and leverage rules, or other prudential rules, for the nation's largest banks mean for community banks? Won't this accelerate consolidation trends in the industry?**

Community banks benefit from the financial stability that results from increased standards that apply to the U.S. GSIBs. The eSLR proposal would not materially change the amount of capital held by U.S. GSIBs, therefore I do not believe this will have an appreciable effect on financial stability, the overall composition of the banking industry in the United States, or on competition among community banks and GSIBs. Taking into account the capital constraints imposed by the

Board's supervisory stress testing requirements, as well as the Board's regulatory capital rules, we estimate that the eSLR proposal would reduce the amount of tier 1 capital required across the GSIBs by approximately $400 million. That figure is approximately 0.04 percent of the amount of tier 1 capital held by the GSIBs as of third quarter of 2017. The Board's recent eSLR and SCB proposals would only apply to relatively large banking organizations and would not directly impact community banks.

8. Custodial Assets

Congress has proposed exempting custodial assets from the denominator of the leverage ratio rules, in part, to deal with the concern that the leverage rules could inadvertently make it harder for custodial banks, like Bank of New York Mellon, to accept a rapid increase in such deposits when there is a flight to safe assets in a crisis, and make it harder for central banks, like the Federal Reserve, to respond. Notably, the Basel Committee on Banking Supervision (Basel Committee) suggested a more targeted proposal than the one Congress is considering that would provide for a temporary exemption of central bank reserves from a country's leverage ratio to the extent the amount of reserves is disclosed and that the bank would have to make offsetting changes to its balance sheet to remain safe and sound.

- **(a) The Fed serves on the Basel Committee and was a party to the December 2017 Basel III end game agreement[29] that included that recommendation. Do you support the proposed narrower adjustment over a more sweeping exemption that has been proposed by Congress?**

Since this question was posed, Congress passed, and the President signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). The EGRRCPA requires the Board, for purposes of calculating total leverage exposure, to exclude the funds of a custodial bank that are deposited with a central bank.

- **(b) What would the effect of the Federal Reserve's proposed changes to eSLR be if they occurred in addition to Section 402 of S. 2155 to fully exempt central bank deposits from the leverage ratio for custodial banks was signed into law? Does the Federal Reserve Board have the flexibility to implement these proposals in a manner that is more akin to the more targeted proposal put forward by the Basel Committee?**

The proposed recalibration to the eSLR standards assumed that the components of the supplementary leverage ratio use the capital rule's current definitions of tier 1 capital and total leverage exposure. If the changes to total leverage exposure in the EGRRCPA were taken together with the Board's proposal, the removal of central bank reserves from total leverage exposure would generally increase supplementary leverage ratios for firms that are predominantly engaged in custodial services. The Board is considering the proposed recalibration in light of the statutory mandate to exclude central bank deposits from total leverage exposure for certain firms, taking into account safety and soundness of these firms as well as the resilience of the financial system.

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[29] https://www.bis.org/bcbs/publ/d424_hlsummary.pdf.

9. "Too Big to Fail"

Mr. Quarles, last November, Chairman Powell responded to a question from Senator Kennedy about whether any U.S. bank was still "too big to fail."[30] He initially responded by saying, "We've made a great deal of progress on that." When the Senator pressed for an answer, Chairman Powell said, "I would say no to that."

- **(a) Do you agree that no U.S. bank is "too big to fail"? Why or why not?**

U.S. regulators have indeed made a great deal of progress in our work to address the issue of "too big to fail." Notably, the statutory framework established by Congress and the efforts of the U.S. regulators have made the largest banking firms more resilient and have significantly improved their resolvability. In particular, for the largest, most systemically important firms, we have increased the quantity and quality of capital that they maintain, have established capital surcharges that are scaled to each firm's systemic risk footprint, have required our largest banks have more stable liquidity risk profiles, and have required them to carry long-term debt that can be converted to equity as part of a resolution.

In this regard, I believe it is much more likely than before that the failure of one of our most systemically important financial institutions, while undoubtedly posing a severe shock to the economy, could be resolved without critically undermining the financial stability of the United States. Moreover, more of the losses from such a failure would fall on the firm's shareholders and bondholders, not the FDIC or taxpayers. Investors have recognized this progress and the major rating agencies have removed the government support rating benefit that they once ascribed to the largest bank holding companies. Financial institutions and markets are always evolving, however, so it is important to remain vigilant regarding changing systemic risks.

- **(b) Do you support the Treasury Department's report recommending the preservation of Dodd-Frank's Orderly Liquidation Authority?[31] Will "too big to fail" return if Dodd-Frank's tools are rolled back or eliminated, including Dodd-Frank's Orderly Liquidation Authority as the Chairman and other Republicans have advocated?**

The Treasury Report on Orderly Liquidation Authority (OLA) and Bankruptcy Reform is thoughtful about the strengths and weaknesses of the current regimes for handling the resolution of a failing financial firm. While I believe that bankruptcy should be the preferred resolution framework for a failing firm, given the uncertainties around how financial crises unfold, I understand the argument presented in the Treasury Report that it remains prudent to keep OLA as a backstop resolution framework. As the Treasury Report recognizes, OLA provides an alternative to bankruptcy in those circumstances where bankruptcy may not be feasible due to current limitations of the bankruptcy code.

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[30] https://www.bloomberg.com/news/articles/2017-11-29/trump-s-pick-to-run-the-fed-says-no-u-s-banks-are-still-too-big-to-fail.

[31] https://home.treasury.gov/news/press-release/sm0295.

- **(c) The Dodd-Frank Act gives financial regulators, especially the Fed, a number of authorities to address this issue. This includes enhanced capital requirements, and authorities that are activated -- including breaking up the largest banks -- if living wills cannot credibly demonstrate a firm can be safely resolved through the Bankruptcy Code, or if the Fed determines a megabank poses a grave threat to financial stability. Will you commit to fully utilizing these and other Dodd-Frank tools to end too big to fail?**

We have made great strides with the FDIC through the living wills process to make our largest banking firms easier to resolve under the current Bankruptcy Code. In addition, we have increased the quantity and quality of capital maintained by the largest banks and imposed requirements to help ensure that our largest banks have more stable liquidity risk profiles. As stated previously, financial institutions and markets are always evolving, however, so it is important to remain vigilant regarding changing systemic risks. I will continue to consider all of the Board's authorities in response.

10. Restrictions on Bank Activities

- **(a) In the last election, the Republican party platform called to reimpose the Glass-Steagall firewall between commercial and investment banking. Has the Trump Administration given up on pursuing reimposing Glass-Steagall? Do you support reimposing Glass-Steagall? Why or why not?**

The central provisions of the Glass Steagall Act – section 16 which prohibits a bank from engaging in the securities business and section 21 which prohibits securities firms from taking deposits - have never been repealed and remain the law of the land. The Gramm-Leach-Bliley Act of 1999 rescinded two ancillary provisions dealing with the activities of some affiliates and certain restrictions on directors, but in addition to leaving in place the core Glass Steagall provisions also left in place the provisions of the Federal Reserve Act and other fundamental provisions of banking law that limit the ability of such affiliates to interact with insured banks. I am not aware that the Administration has proposed to re-impose these ancillary provisions, and – because of the retention of the core provisions of Glass Steagall and the limitations on interaction between banks and their affiliates – I am not convinced that the repeal of these ancillary provisions contributed materially to the financial crisis of 2008-2009. In the crisis, the most notable failures were of specialized financial firms that did not materially combine investment banking and commercial banking, such as AIG, Washington Mutual, Countrywide, Bear Stearns and Lehman Brothers. I think that the fundamental lesson from the crisis is that the largest, most interconnected financial firms need to hold substantially more capital, take substantially less liquidity risk, and face an effective orderly resolution regime if they fail. Consistent with its statutory authorities, the Board has endeavored to implement a regulatory framework that accomplishes these objectives.

- **(b) Should banks be in the business of owning warehouses full of copper or other commodities? The Federal Reserve has a pending rule that would curb the strange bank business of owning, trading and moving commodities. Do you support that proposal and when should we expect it to be finalized?**

The Board began its review of the physical commodities activities of financial holding companies after a substantial increase in these activities among financial holding companies during the financial crisis. In January 2014, the Board invited public comment on a range of issues related to these activities through an advance notice of proposed rulemaking. In response, the Board received a large number of comments from a variety of perspectives. The Board considered those comments in developing the proposed rulemaking that was issued in September 2016. After providing an extended comment period (150 days) to allow commenters time to understand and address the important and complex issues raised by the proposal, the Board again received a large number of comments from a variety of perspectives, including Members of Congress, academics, users and producers of physical commodities, and banking organizations. The Board continues to consider the proposal in light of the many comments received and to monitor the physical commodities activities of financial holding companies.

- **(c) The Federal Reserve has previously proposed, pursuant to the Dodd-Frank Section 620 report, several legislative changes regarding banks.[32] They proposed that Congress:**
  - **repeal the authority of Financial Holding Companies (FHCs) to engage in merchant banking activities;**
  - **repeal the grandfather authority for certain FHCs to engage in commodities activities under section 4(o) of the BHC Act;**
  - **repeal the exemption that permits corporate owners of industrial loan companies (ILC) to operate outside of the regulatory and supervisory framework applicable to other corporate owners of insured depository institutions; and**
  - **repeal the exemption for grandfathered unitary SLHCs from the activities restrictions applicable to all other SLHCs.**

With respect to the merchant banking and section 4(o) grandfather authorities of the Bank Holding Company Act, the Board has issued an advance notice of proposed rulemaking in 2014 and a notice of proposed rulemaking in 2016 to consider appropriate actions that the Board may take to address these matters. The Board continues to consider the proposals in light of the many comments received and to monitor activities under these authorities.

Unlike merchant banking and section 4(o) grandfather authorities, the exemptions for grandfathered unitary savings and loan holding companies and owners of industrial loan companies (ILCs) place institutions under these exemptions outside of the Board's supervision and regulation. Therefore, the Board may not directly address the concerns with these exemptions that the 620 Report describes (e.g., affiliation of commercial and financial entities, lack of consolidated supervision and regulation, competitive advantage).

- **(d) Do you support any of these recommendations? Why or why not?**

The Board's report to Congress and the FSOC pursuant to section 620 of the Dodd-Frank Act raises a number of complex issues that I believe merit further consideration. I have the report under review and look forward to completing that consideration.

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[32] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160908a.htm.

11. Foreign Banks

There has been much discussion about how foreign banks would be treated under S. 2155, the Senate financial deregulatory bill pending in the House. Under current rules, the enhanced prudential regime applies to foreign banking organizations that have more than $50 billion in *global* assets and operate in the United States. However, the Fed's implementing regulations have imposed significantly lower requirements on foreign banks with less than $50 billion in *U.S.* non-branch assets compared to those with more than $50 billion in U.S. non-branch assets.

- **(a) What assurances can you give this Committee that stringent rules for large foreign banks that operate in the U.S. that are applied in the exact same manner, and at the exact same threshold, as they are today will not be changed, even if S. 2155 becomes law?**

Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directs the Board to establish enhanced prudential standards for large banking organizations. In applying section 165 to foreign banks, the Dodd-Frank Act directs the Board to take into consideration principles of national treatment, equality of competitive opportunity, and the extent to which the foreign bank is subject to prudential regulation by its home country. Accordingly, as you note, the Board has tailored the application of the enhanced prudential standards to foreign banks based, in part, on size and nature of a foreign bank's activities in the United States. The intermediate holding company requirement applies to foreign banks with total global consolidated assets that meet the threshold for application of section 165, and with at least $50 billion in U.S. non-branch assets. The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) raises the threshold for application of section 165, but does not affect the threshold for the application of the intermediate holding company requirement. The existing population of foreign banks that have intermediate holding companies in the United States also have total global consolidated assets in excess of $250 billion.

The amendments made by EGRRCPA provide for additional tailoring of section 165 while maintaining the authority of the federal banking agencies to ensure the safety and soundness of depository institutions and their holding companies and to apply enhanced prudential standards to large banking organizations address financial stability.

12. Executive Compensation

The Wells Fargo fraudulent account scandal, and its incentive-based cross-selling strategy that fueled it, is a stark reminder how important it is for financial regulators to finalize executive compensation rules. As you know, Section 956 of the Dodd-Frank Act directed regulators, including the Fed, to adopt joint rules aimed at prohibiting incentive compensation arrangements that might encourage inappropriate risks at financial institutions. The regulators made an initial proposal in 2011, then reworked the proposal and issued a new plan in 2016. The proposal increases in stringency based on the financial company's asset size with enhanced requirements for senior executive officers and significant risk-takers.

- **(a) Given that this is not a discretionary requirement, what steps are you taking to implement and enforce this provision of the law?**

After the Board, OCC, FDIC, SEC, NCUA, and Federal Housing Finance Agency (the agencies), jointly published and requested comment on the revised proposed rule in June 2016, the agencies received over one hundred comments. These comments raised many important and complicated questions. The agencies are considering the comments. Compensation practices are, and will remain, a core element that we examine as part of our regular supervisory engagement with each firm.

13. International Coordination on Financial Regulations

Mr. Quarles, there have been news reports suggesting that the Treasury Department is pushing for you to be considered as a candidate to lead the Financial Stability Board (FSB).[33]

- **(a) Are you interested in the job leading the FSB? When will such a decision be made?**

The FSB is one of the important international bodies created since the crisis that promotes financial stability. I am a candidate for the FSB chairmanship because I believe that the global reach of the banking industry means that financial stability is necessarily a global undertaking. When rightly structured, our participation in these groups makes our financial system significantly stronger by ensuring that the U.S. perspective is part of the discussions and reflected in agreed-to standards. Further, many financial vulnerabilities arise abroad, so having a global forum where those vulnerabilities can be discussed is critical to ensuring that we are aware of developments abroad that have the potential to adversely affect the stability of our own financial system. U.S. consumers and businesses are more secure and prosperous because the FSB helps make sure that all countries are doing their share in promoting financial stability and not gaining an unfair advantage. While I cannot speak directly to the conclusion of the decision-making process, I would expect a successor would be in place when the current FSB chairman's term expires later this year.

- **(b) How do you assess FSB's record at promoting global financial stability through international coordination?**

The FSB promotes international financial stability by monitoring international developments related to financial stability and providing its members a forum to coordinate their work developing strong regulatory, supervisory, and other financial sector policies.

Since the financial crisis, the members of the FSB have emphasized four priorities for reform: building the resilience of financial institutions, ending "too big to fail," increasing the safety of derivatives markets, and transforming shadow banking to transparent and resilient market-based financing.[34] In addition, they regularly review and update a set of Key Standards for Sound

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[33] https://www.ft.com/content/846d7b00-27b3-11e8-b27e-cc62a39d57a0.

[34] http://www.fsb.org/what-we-do/policy-development/.

Financial Systems.[35] The key standards currently cover three policy areas: macroeconomic policy and data transparency, financial regulation and supervision, and institutional and market infrastructure.

In his most recent letter to the G-20 leaders, FSB Chairman Mark Carney highlighted the following improvements in the financial system:

- Banks are stronger, more liquid, and more focused;
- A number of steps have been taken to eliminate "toxic forms of shadow banking and transforming it into resilient market-based finance;" and
- Changes to derivatives markets resulted in a more transparent system that reduces dangerous exposures.

With the post-crisis reform era coming to an end, FSB members will shift focus towards monitoring the implementation of reforms, beginning with country peer reviews and an annual survey of the status of implementation in each member jurisdiction. Of course, the FSB will continue to be an important forum for monitoring emerging global risks and coordinating discussion on cross-border stability issues.

- **(c) What would your priorities be at the FSB?**

In terms of my priorities, monitoring emerging financial stability risks is at the top of my list. Given the scope of its membership, the FSB is uniquely positioned to identify emerging risks. In addition, now that the body of post-crisis regulation is largely complete, I would also support the FSB examining the effects that reforms and standards are having. Finally, I would support improving the transparency of the FSB's operations.

- **(d) The largest banks have complained about so-called "gold-plating" of prudential rules, like capital or leverage, where U.S. regulators implemented a standard that is more stringent than what an international body, like the Basel Committee, agreed to. But some observers have suggested "gold-plating" has helped the U.S. push other jurisdictions to raise their standards. Do you believe when the U.S. leads by example by raising the bar on financial regulation, it makes it harder for other countries to ignore that record and lower their standards?**

By design, international standards are a minimum, and countries are expected to implement more stringent standards when justified by national circumstances. In some cases, we have implemented standards above these minimums. We are cognizant that once standards are implemented, there may be effects that are greater than or different from those anticipated. For this reason, we believe it is important to monitor the implementation of new standards carefully and initiate adjustments where appropriate. Thus, with the revised regulatory framework and a more resilient system in place, the Board is assessing the effects of those efforts, and examining whether they are having unintended results and whether they can be revised to accomplish the same goals in a more efficient manner.

[35] http://www.fsb.org/what-we-do/about-the-compendium-of-standards/key_standards.

- **(e) Last December, the Fed and other U.S. regulators finalized the so-called Basel III "end game" with your international counterparts. But based on the Fed and the OCC's proposal last week to lower the eSLR, it seems as if you are using the international agreement to roll back important U.S. regulations. By changing course, is the Fed leading other financial regulators around the world in a new race to the bottom, deregulating a global financial industry that caused significant damage not only to the U.S. economy, but the global economy?**

The proposed recalibration of the eSLR standards is an example of the Board's efforts to ensure that the post-crisis financial regulations are working as intended. Core aspects of post-crisis financial regulation have resulted in critical gains to the stability of the financial system, including higher and better quality capital, an innovative stress testing regime, new liquidity regulation, and improvements in the resolvability of large firms. The financial system is stronger and more resilient as a result, helping banks to lend through the business cycle. With the revised regulatory framework in place, the Board is assessing the effect of those efforts. In undertaking this review and assessment, the Board is mindful of the need for regulations not only to be effective for maintaining safety and soundness and financial stability, but also to be efficient, transparent, and simple.

- **(f) What, if any, global financial standards currently do not go far enough and need to be made more stringent?**

The Board, along with the other U.S. banking agencies, has made substantial progress working within the Basel Committee to develop stronger regulatory and supervisory standards since the global financial crisis, especially with respect to the largest and most systemic firms. These improved standards have helped to build a more resilient financial system, one that is well positioned to provide American consumers, businesses and communities access to the credit they need, even under challenging economic conditions. In promulgating regulations, the Board determined that it was appropriate to impose requirements that are more stringent than the standards of the Basel Committee on several occasions when we determined, based on national circumstances, it was warranted to ensure the safety and soundness of U.S. banks and of the broader financial system.

14. Cost-Benefit Analysis

According to the Federal Reserve Board's website and as was discussed at the hearing, there is a new "Policy Effectiveness and Assessment section" which "focuses on understanding the economics of financial regulation. Section staff work on conducting ex ante analysis of the costs and benefits of pending regulations as well as the ex post assessment of existing regulations. Section economists also engage in academic research on topics related to banking and financial regulation."

- **(a) Under what statutory authority did the Federal Reserve Board establish this unit? What is the unit's mandate and priorities?**

The Board is committed to evaluating the economic impact of and costs and benefits associated with its rulemakings. To the extent possible, the Board attempts to minimize regulatory burden in its rulemakings consistent with the effective implementation of the Board's statutory responsibilities. Increasingly, the Board has published discrete quantitative analyses in connection with its rulemakings. Recent examples include the analysis conducted in conjunction with the Board's GSIB surcharge rule, single-counterparty credit limit rule, and long-term debt rule. To further these efforts, the Board established an office and hired economists and additional staff to focus on analyzing the costs and benefits associated with its rulemakings. Section 11 of the Federal Reserve Act authorizes the Board to "employ such attorneys, experts, assistants, clerks, or other employees as may be necessary to conduct the business of the Board." 12 U.S.C. 248(l).

- **(b) As of April 25, 2018, there were three individuals listed as working in the unit. How many staff does the Federal Reserve Board expect to hire for this unit? What is its budget? How will this unit interact with other divisions and units at the Federal Reserve Board?**

Currently, the Policy Effectiveness and Assessment section consists of a manager (an economist by training), a small number of Ph.D. economists and support staff. We recently hired additional Ph.D. economists to fill out staffing and these individuals will be joining in the coming months. The section is funded through the overall budget of the Division of Supervision and Regulation. In carrying out its responsibilities, the section staff will collaborate with economists and staff with specialized skills in other divisions and sections at the Board as appropriate.

- **(c) As you know, predicting the benefits from financial regulations preventing a future financial crisis are extremely difficult. How will this unit and the Federal Reserve Board include those considerations in any cost-benefit analysis of any regulation?**

There exists a significant body of work that examines the benefit of reducing the probability and severity of a financial crisis that has been carried out by academic economists and staff at the Federal Reserve and other financial regulators. Section staff will incorporate this knowledge into the evaluation of the benefits of any regulation.

- **(d) There has been a wide range of studies that have attempted to analyze the cost of the 2008 financial crisis. Given its significance in any cost-benefit analysis the Federal Reserve Board may engage in, I would ask this unit conduct its own analysis of the cost of the financial crisis to the U.S. economy and its citizens, including taxpayers, consumers, investors and homeowners. Will you ask this unit to conduct such an analysis and provide that analysis to the Committee?**

As shown in the existing literature, the causes and consequences of financial crises in history can be varied. A comprehensive reassessment of the underlying causes of the 2008 financial crisis and cost-benefit analysis of the entire package of reforms would not be feasible in the near-term given the priorities of the section and its planned focus in the near-term. However, section staff will take a holistic approach for every topic in the work plan that is informed by past experience including, but not limited to, the recent financial crisis.

15. Racial Disparities in the Labor Market

- **(a) African-Americans in particular continue to suffer from overt employment discrimination. Indeed, the unemployment experience for better-educated African-Americans is on average worse than the unemployment rate for less educated whites.[36] To what extent can and should the Fed take such discrimination into account as it sets monetary policy? What policy recommendations can you offer for overcoming this persistent discrimination?**

Despite continued improvement in the labor market that has seen the unemployment rate for African Americans drop to an historic low of 5.9 percent in May, joblessness for African Americans remains well above that for white Americans. This long-term disparity in economic outcomes for African Americans is concerning. The best way for the Federal Reserve to promote the economic welfare of African Americans is to do our utmost to fulfill our dual mandate of maximum employment and price stability. However, even at maximum employment, structural disparities will likely remain. Addressing these disparities will require policy tools beyond those available to the Federal Reserve.

16. Wages

- **(a) Despite progress in reducing the overall level of unemployment, wage growth has largely remained low and stagnant for the vast majority of American families. What are the key factors in your view that explain why a tighter labor-market has yet to translate into higher pay for most families? Do you believe that the general rule in economics that a tight U.S. labor market will produce higher wages for U.S. workers will hold, or are there other factors at play that will continue to depress the income earned by U.S. workers?**

Most measures of wage growth remain below rates seen in previous strong labor markets. The most important factor contributing to this slower wage growth is the slowdown in productivity growth over the past decade or so. Since 2007, productivity growth has averaged only a little over 1 percent, well below the average of 2¼ percent seen since 1950. When productivity growth is lower, employers are not able to increase wages by as much as otherwise. I believe that tighter labor markets do lead to higher wage growth. Indeed, we have seen most measures of wage growth increase modestly over the past few years, as the labor market has continued to tighten.

17. Normalization of the Fed's Balance Sheet

- **(a) Last October the Federal Reserve began the process gradually reducing its securities holdings in order to normalize the size of its balance sheet. Simultaneously policy makers at the Federal Reserve have outlined their intention to slowly lift the federal funds rate target. Can you discuss how these two normalization strategies are working in tandem? How is the Fed taking into effect the contractionary effects of balance sheet normalization in conjunction with its rate hikes?**

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[36] http://financialservices.house.gov/uploadedfiles/hhrg-114-ba19-wstate-wspriggs-20160907.pdf.

The Federal Open Market Committee's (Committee) monetary policy decisions take into account that its program of gradual reduction in the Federal Reserve's securities holdings is removing policy accommodation. This is because the program's removal of policy accommodation is one of the factors affecting the Committee's assessment of the economic outlook, and the Committee's decisions regarding the federal funds rate are based on that assessment.

Since October 2017, the Committee has been implementing a program of gradual reduction in the Federal Reserve's securities holdings. Against this backdrop, the Committee remains able to respond to economic developments and to adjust monetary policy in light of changes in the economic outlook, as it makes decisions at every FOMC meeting on the setting of its primary monetary policy tool, the federal funds rate. One of the considerations entering these decisions is the Committee's view that changes in its securities holdings affect overall financial conditions and U.S. economic activity. Consequently, its assessment of the economic outlook is informed by its best estimate of the effect of its balance sheet normalization program on financial conditions and the economy. If the economic outlook changes as the balance sheet normalization program proceeds, the Committee will be able to make appropriate adjustments to the stance of monetary policy by changing the current level and future path of the target range for the federal funds rate.

18. Banks Hoarding Interest Income as the Fed Raises Rates

- **(a) Since the Fed began raising interest rates, banks have seen a significant jump in net interest income and charged consumers more for loans, all while keeping the interest rate paid on customer deposits relatively flat. Can you discuss why depositors seem to be getting short changed as the Fed raises the rate it pays banks on their reserves?**

The market for bank deposits remains competitive, and consumers have choices on where to place their savings, including amongst brick-and-mortar bank branches, online banks, credit unions and money market mutual funds. Some banks have been paying higher deposit rates on certain types of accounts to maintain those deposit accounts in light of higher short-term interest rates, and some banks have been offering higher interest rates and other incentives to depositors to open new accounts. Many depositors also receive other services from banks where they maintain deposit accounts. Many customers choose to keep their deposits in low-interest-bearing accounts for convenience factors, such as check-writing ability, access to ATMs and physical branches, as well as access to other financial services. For customers seeking a higher return on their savings relative to that paid on deposit accounts, banks and other financial institutions do offer higher interest rate products, such as certificates of deposit and money market funds.

19. GOP Tax Plan

- **(a) Would you agree that the amount in compensation companies have provided their workers following the enactment of the GOP tax law, is only a small fraction of what corporations will return to shareholders and pay corporate executives in under the new law? Would you agree that the stimulative economic effects of the GOP tax law will be much smaller than had the tax law provided a larger share to lower and middle income families?**

Assessing the net effects of such a large and complicated set of tax policy changes as those in the Tax Cut and Jobs Act (TCJA) is very challenging and subject to considerable uncertainty. Indeed, a number of analysts have produced estimates of the demand-side and supply-side effects of the tax cuts, and there is a wide range of views. While there is a fairly broad view that lower corporate taxes can potentially induce greater economic output, wages, and profits, there is no consensus on the magnitude of those effects nor the distribution of those potential benefits. For example, in the Congressional Budget Office's (CBO) recent April 2018 report, The Budget and Economic Outlook: 2018 to 2028, the effects of the TCJA on the CBO's economic projections and a comparison of those effects to available estimates from other organizations is presented.[37]

Many analysts think that lower-income families are likely to spend more of their tax cut than higher-income families, which suggests that the demand-side effects can vary depending on the distribution of the tax cut. And I suspect that is true, but the degree of the difference is not well understood. Moreover, potential differences between higher- and lower-income households of any supply-side response through changes in labor supply and in investment are quite uncertain and subject to alternative views.

[37] See Appendix B in the report, pp. 105-130, https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf.