S. HRG. 115–251

# THE SEMIANNUAL TESTIMONY ON THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF THE FINANCIAL SYSTEM

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE EFFORTS, ACTIVITIES, OBJECTIVES, AND PLANS OF THE FEDERAL RESERVE BOARD WITH RESPECT TO THE CONDUCT, SUPERVISION, AND REGULATION OF FINANCIAL FIRMS SUPERVISED BY THE FEDERAL RESERVE BOARD

APRIL 19, 2018

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# C O N T E N T S

## THURSDAY, APRIL 19, 2018

# THE SEMIANNUAL TESTIMONY ON THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF THE FINANCIAL SYSTEM

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**THURSDAY, APRIL 19, 2018**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 9:32 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

## OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. The Committee will come to order.

Today we will receive testimony from Federal Reserve Vice Chairman of Supervision Randy Quarles regarding the efforts, activities, objectives, and plans of the Federal Reserve Board with respect to the conduct, supervision, and regulation of financial firms supervised by the Federal Reserve Board. Welcome, Chairman Quarles.

Vice Chairman Quarles has done an excellent job so far, and I urge Congress to confirm him for his full term on the Board as soon as possible.

Promoting economic growth remains a top priority for this Congress, and reducing the rate and cost of excessive and unnecessary regulation leads to more jobs and enables a better functioning economy and more consumer choices.

As Vice Chairman for Supervision, Mr. Quarles plays a key role in developing regulatory and supervisory policy for the Federal Reserve System.

I have been encouraged by the statements by both Federal Reserve Chairman Powell and Vice Chairman for Supervision Quarles which they have made about the need to revisit some of the Federal Reserve's existing regulations.

I was particularly encouraged by Vice Chairman for Supervision Quarles' statements in January that the overarching objectives of his agenda are efficiency, transparency, and simplicity of regulation.

I agree with those objectives.

He highlighted the following initiatives as consistent with these objectives: revising capital rules applicable to community banks; extending the resolution planning cycle for certain banks; enhancing the transparency of stress testing; recalibrating the leverage capital ratio requirements; streamlining the Volcker rule; tailoring liquidity requirements to differentiate between large non- G–SIBs and G–SIBs; revisiting the "Advanced Approaches" thresholds; and reexamining the "complex and occasionally opaque" framework for making determinations of "control" under the Bank Holding Company Act.

Some of these initiatives are already underway, and I hope the others will be commenced and completed in the near future.

I also hope that the Economic Growth, Regulatory Relief, and Consumer Protection Act makes it to the President's desk soon.

The primary purpose of that bill is to make targeted changes to simplify and improve the regulatory regime for community banks, credit unions, midsized banks and regional banks to promote economic growth.

It affords the banking regulators, including the Federal Reserve, more flexibility to tailor regulations, and it will fall on your agency and others to interpret this bill.

I look forward to working with the regulators to ensure their interpretations are consistent with Congress' intent.

I also welcome any additional color Vice Chairman Quarles can provide on areas where the Fed and Congress may act to further reduce regulatory burdens.

Senator Brown.

**OPENING STATEMENT OF SENATOR SHERROD BROWN**

Senator BROWN. Thank you, Mr. Chairman. And, Vice Chairman Quarles, nice to see you again. Thank you for joining us. Thank you for the access and discussions we are able to have.

On this very day 10 years ago—April 19th, 2008—the *Columbus Dispatch*, the newspaper of record in the largest city in my State, reported that 28,000 Ohioans had lost their jobs just in the previous month. As the economy collapsed during those last months and months of the Bush administration, as the economy collapsed because of Wall Street's recklessness, a vice president at the Columbus Chamber of Commerce described Ohio's economy as "the worst of all possible worlds."

For those 28,000 Ohioans, and the millions more around the country that ultimately lost their jobs, 10 years ago probably does not feel so far away. The heartbreak, the fear, and the stress of losing a home to foreclosure, being forced to switch schools, needing to postpone buying expensive prescription drugs, all that casts a long, long shadow.

The Fed missed the crisis the last time. It had the power to rein in predatory mortgage lending; it did not. It had the power to stop banks from operating with too much borrowed money; it did not. It had the power to hold bank executives accountable; it did not. It failed, even as advocates in communities—and I heard from them often in the part of Cleveland I now live in—even as advocates in communities spotted problems and pleaded for the Fed to act.

Because the Fed neglected its mission and the Bush administration, of which you were a part, did not do its job, Congress the next year had to pass Wall Street reform over the opposition of so many on this Committee and so many members of the Senate.

Now with legislation coming from this Congress and the backsliding of this Administration, we are on the verge of unraveling many of these reforms. In the words of one banking analyst, "when we fast forward 5 years, 10 years from now, the dismantling of the financial infrastructure is going to be greater than anyone could foresee at the time."

When Washington dismantles protections, Wall Street always cheers. Ultimately, Main Street pays the price. It did 10 years ago. It will in the future.

The decisions being made now may lead us to the next crash. When times are good, policymakers, lawmakers, and regulators—if they are not vigilant—can get lulled into a sense that "this time it is different."

The horizon certainly looks clear right now—just as it did during the Bush years right before the crisis, when Mr. Quarles was in charge of overseeing bank policy at Treasury.

Just like back then, big banks are raking in record profits. Just like back then, they are lining their pockets with stock buybacks. Just like back then, the White House looks like an executive retreat for Goldman Sachs and other Wall Street executives.

The Fed slapped Wells Fargo with a penalty right as Chair Yellen's term ended. Now that bank is about to get a big boost from a Fed proposal released last week. Under the new plan, Wells Fargo will be allowed to pay out $20 billion in capital to executives and shareholders rather than use that money to make loans or prevent bailouts. And, almost inconceivably, the CEO of Wells Fargo got a 36-percent raise in 2017, even as he presided over one consumer abuse after another. I cannot imagine anybody in either party on this Committee that has sat here and listened to the litany of abuses from Wells Fargo would think that is justified to give a CEO of a bank like that a 36-percent raise.

Collectively, the country's biggest banks stand to get a $121 billion windfall from a plan that would let them operate on more borrowed money, with less skin in the game. Really.

While Mr. Quarles talks about this proposal, and the Fed's many other plans, as a simple "recalibration" or "tailoring" or "re-evaluation"—his words—of the rules, we know what it really means. We know from last week when we heard from CFPB Acting Director Mulvaney what he is doing to consumer protections. The end result? Fewer rules guarding hardworking Americans from taxpayer bailouts and financial scammers; more incentives for Wall Street greed.

Somehow "tailoring" only seems to go in one direction these days. It happens to be the direction that Wall Street wants.

History tells us what will happen next. The IMF, an international financial agency, studied financial markets since the 18th century. Periods of deregulation usually provoke a crisis. Policymakers "learn their lessons" and re-regulate. Eventually, the collective amnesia sets in—we know a lot about collective amnesia in this Committee. The collective amnesia sets in; they deregulate yet again. We know that cycle. Unfortunately, the middle class pays for that cycle.

When big banks are flush with profits, as they are now, policymakers should be preparing them for rough times ahead. Instead, Washington is repeating a failed pattern of boom and bust. When things go bad once again, executives will get golden parachutes. Workers, retirees, and consumers will be left holding the bag. Shameful. Just shameful. Makes me wonder why we are here.

Chairman CRAPO. Thank you.

Now, Chairman Quarles, we will turn to your testimony. As you are aware, we ask that you try to keep your remarks to 5 minutes, but we want to hear everything you have to say, and then we will open it to questions. You may proceed.

**STATEMENT OF RANDAL K. QUARLES, VICE CHAIRMAN FOR SUPERVISION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. QUARLES. Thank you. Thank you, Chairman Crapo, Ranking Member Brown, Members of the Committee. I very much appreciate the opportunity to testify today 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 systemic 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, our 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.

So in my testimony today, I will review our regulatory and supervisory agenda to improve the effectiveness of the postcrisis framework through these principles of increased 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.

Beginning with efficiency measures, 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 the G–SIBs. The proposal would calibrate the eSLR so that it is less likely to act as a primary constraint—because when it is a primary constraint it 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 exercise for midsized firms—those 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. I think that approach should also be considered for a broader range of firms. Last week, we called for comment on that potential expansion.

On the subject of tailoring, I support congressional efforts regarding tailoring, as offered here in the Senate and in the House. 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 that we can improve the efficiency of our requirements with regard to living wills.

The U.S. banking agencies have also taken a number of steps to advance more efficient and effective supervisory programs. For example, we recently increased the threshold for requiring an appraisal on commercial real estate loans from $250,000 to $500,000. That does not pose a threat to safety and soundness. And the Fed has instituted various measures to clarify and streamline its overall approach to the supervision of community and regional banks, in particular. All of that is detailed in my written testimony.

Transparency is central to the Fed'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 the bank's 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 stress 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 of control 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, we issued a proposal that would effectively integrate the results of the supervisory stress test into the Board's nonstress capital requirements. For the largest bank holding companies, the number of loss absorbency ratios would be reduced from 24 to 12, but the proposed changes would generally maintain or 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 capital levels are well above the minimums—and 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 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.

In conclusion, the reforms we have adopted since the financial crisis do 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. We will do everything we can to fulfill the responsibility that has been entrusted to us by the Congress and the American people, and I thank you again for the opportunity to testify before you this morning. I am looking forward to answering your questions.

Chairman CRAPO. Thank you very much, Chairman Quarles. I will start out.

First, last month, as you know, the Senate passed the Economic Growth, Regulatory Relief, and Consumer Protection Act. During the debate there was an intense attack on that bill with a number of allegations. The one I want to refer to and discuss with you is the one that by lifting the threshold, the $250 billion threshold, we were going to leave a number of major banks completely unregulated and susceptible to high risk.

Do you believe that if enacted into law that bill will provide significant regulatory relief to community banks and midsized banks as well as some of our regional banks, while still giving the Federal Reserve the authority it needs to fully supervise and regulate those institutions?

Mr. QUARLES. Yes, Mr. Chairman, both I and the Federal Reserve as an institution are very supportive of efforts to tailor regulation, particularly for community banks, as exemplified in S. 2155. And I do think that the measures that are in that bill would still leave the Federal Reserve with full ability to protect the safety and soundness of the system.

Chairman CRAPO. All right. Thank you. I want to switch now to a question on firearms, which has become much, much more topical these days. According to press reports, the New York State Department of Financial Services is planning to send letters that warn banks and insurers of the reputational risk they incur by doing business with the National Rifle Association and the gun industry. As a prudential regulator, your job is to ensure the safety and soundness of banks. A bank's reputation might be relevant to the bank's safety and soundness, but reputational risk should not be used as an excuse for a regulator to scrutinize any behavior it does not like.

Do you believe that doing business with the NRA or with firearms manufacturers or others in the firearms industry threatens the safety and soundness of banks under the Fed's supervision?

Mr. QUARLES. Well, let me begin, Chairman, by acknowledging the importance and significance of the tragedy in Florida and other tragedies that have resulted in some of these concerns.

That said, I do not believe that lending to the NRA or to a law-abiding gun firm in the gun industry raises safety and soundness questions. I do not believe that the decision not to lend raises safety and soundness questions, and as a consequence, those issues are really outside of our remit as regulators of the system at the Federal Reserve.

Chairman CRAPO. All right. Thank you.

Mr. QUARLES. If I could perhaps amplify.

Chairman CRAPO. Yes.

Mr. QUARLES. One of the principles that I have tried to stress as a supervisor is that we should not substitute our personal judgments as supervisors for the business judgments of bank management and directors, and that is a principle that applies across a broad range of issues, again, that I am trying to stress throughout the supervisory system. And so I think that would apply here as well.

Chairman CRAPO. Well, thank you, and I appreciate the approach you have taken in your career to regulation. You said in your introductory statement something similar to the fact that if we can eliminate complexity, if we can eliminate opaqueness and get more transparency, there are benefits that flow from that.

Could you just discuss what benefits flow from having a regulatory system that is less complex, more transparent, and, frankly, less excessive when we see excessive burdens being applied to any industry, but in this case the financial industry?

Mr. QUARLES. Well, I think the benefits of transparency and simplicity in regulation, actually they flow both ways, right? So there is a significant benefit in reducing burden, not just in the cost of complying with regulation, but there is an improvement in compliance and achieving the objectives of regulation, as well when the measures that are proposed are understandable by the industry, they are then capable of complying with them, that the public can see the consequences better of regulation, understand more what the particular provisions are.

So, I think that you have a significant reduction in cost and an increase in the efficiency of the system at the same time as you have, a greater ability to achieve the objectives of regulation through transparent processes and simple measures.

Chairman CRAPO. And doesn't that all ultimately result in more capital being available to individuals and small businesses?

Mr. QUARLES. It results in an increased ability of the financial sector to support the real economy, the source of job creation, real economic growth, growing living standards; and it also supports the ability of the public to engage with regulation if it is more understandable.

Chairman CRAPO. Thank you.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

The FDIC joined the Fed and the OCC in 2014 to establish the enhanced supplemental leverage ratio, as you know, in part to ensure that not just the parent company has capital but that families' savings in depository institutions are also protected. But last week, FDIC dissented from the Fed's proposed changes to the leverage ratio which would allow the eight largest banks to drain away $120 billion in capital to fund more stock buybacks and dividends and executive bonuses. The leverage ratio proposal also received a no vote from one of the three members of the Fed's Board.

To put that in perspective, Chair Yellen went her entire 4-year term developing consensus without a single dissent from any member of the Fed Board.

Are you concerned the agency tasked with protecting families' deposits opposes your plan and that the Fed is moving away from the consensus-based approach that characterized all the Dodd–Frank rulemakings? Or are you just waiting until the whole entire Trump deregulatory deregulation regulators get put in place?

Mr. QUARLES. We have had a full discussion on the eSLR regulatory proposal, both among the members of the Board and with the other regulatory agencies. I think the issue there is that when the eSLR or any leverage-based capital measure becomes the binding capital constraint on a firm's decision, then that means that it is making its decisions not on a risk-based basis. It has an incentive to take more risk than it otherwise would if it is going to incur the same capital cost.

The FDIC put out a statement expressing its concern that at this point in the cycle this was a modest release of capital. It is quite a small amount given the overall level of capital that would actually be released. It is about $400 million actual change given the role of the eSLR and the overall capital framework. And in the judgment of the majority of the regulators, removing that perverse incentive was something that was important to do quickly.

Senator BROWN. Thank you. I would point out that Chair Yellen had some very conservative regulators, regulators that came out of your administration, with regulators that came later, and she found a way to get consensus. I think your proposals are radical enough that you have not.

A couple other questions. The Fed released a second plan last week proposing changes to CCAR. The Fed's press release said capital requirements would be maintained or would somewhat increase for the eight largest U.S. banks. Analysts at Goldman Sachs estimate that the biggest banks, however, would see a windfall of $54 billion in dividends, buybacks, and bonuses.

Is Goldman's analysis wrong? Did the Fed conduct a comprehensive analysis like Goldman did?

Mr. QUARLES. We have done an analysis on the basis of our 2017 information as to what the capital consequences of the measures that we proposed last week would be, and, as I have indicated, while it varies modestly from firm to firm, for the G–SIBs, capital is basically modestly increased, for the non-G–SIBs modestly decreased. The overall level of capital in the system remains effectively flat.

Senator BROWN. I guess Goldman's analysis would not use, as you did a couple of times, the word "modestly" there. My concern about the Chairman's bank deregulation bill and all of these Fed proposals, it is like a game of Jenga. You are pulling out piece after piece, and soon enough the entire foundation is going to collapse, and you probably will have moved on from your job. Maybe the Chairman and I will have moved on. But it is a concern that I hope this Fed addresses more acutely than you have.

Last question. Last month, Chairman Powell provided a carefully worded answer that obscured the fact that large foreign banks may very well face weaker rules in the U.S. under the Chairman's bank deregulation bill, even if not outright exemption from Section 165. Since that testimony, your former colleagues at your firm, Davis Polk, whose clients have included Deutsche Bank and Barclays, seem to disagree. Davis Polk lawyers about a month ago said they "saw no reason to expect that the Federal Reserve would deviate from their approach in implementing Dodd–Frank when implementing the new $250 billion threshold. It likely means that the toughest Dodd–Frank rules and the requirement to establish an intermediate holding company would not apply unless the foreign bank had $250 billion in assets in the U.S. We attempted to amend. We were unsuccessful."

My question is: Will you commit, absolutely commit, contrary to Secretary Mnuchin, that the Fed will not raise the $50 billion intermediate holding company threshold above which the toughest Dodd–Frank rules apply?

Mr. QUARLES. Well, there is certainly nothing in S. 2155 that would require us to change our approach with respect to the foreign banks, either on the level of establishment of an IHC or on the application of enhanced standards to them. The issue is that the threshold being raised from $50 to $250 billion that is contained in the Senate bill, does not have a practical effect for any foreign bank operating in the United States because you look at their global assets and the global assets of all of them, there is not a bank that is sort of in that range that would be affected by a move from 50 to 250.

So there is nothing in the bill that requires us to change our approach. The overall IHC framework I think has been working fairly well.

Senator BROWN. So I guess—and I'm closing, Mr. Chairman. I guess I can only see that you are leaving your options open to deregulate these foreign banks that have assets above 50 and under 250 assets in the U.S.

Mr. QUARLES. That was not the purpose of my response.

Senator BROWN. But is that the outcome? I mean, are you leaving that option open to deregulate?

Mr. QUARLES. No. As one member of a Board that I hope is soon not just three people, but as one member of a Board of Governors, I obviously cannot commit on what the final outcome will be. But I can assure you we do not have a sort of secret plan in my satchel here as to what we are going to do as soon as the bill passes.

Chairman CRAPO. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. I appreciate you calling this hearing. Vice Chair, thank you for being here and being accessible, as the Ranking Member mentioned. I will say chairing another committee and thinking about the bland opening comments I make, Senator Brown, I admired the cadence and rhetorical flair of your opening comment. I noticed the repetition. It was really something. I am actually going to go chastise my staff for me——

Senator BROWN. I can help you come to some of your new political positions, too, if you would like.

[Laughter.]

Senator CORKER. All right. Thank you so much.

Mr. Vice Chair, you are not confirmed for the longer term, and that has not happened just because it takes so much floor time to make that happen. I have had some conversations with you, and I can tell that there is a little tentativeness as you talk with people like me and others because you have got to depend on Republican votes to be confirmed.

I would say to the my Democratic counterparts that I think the Vice Chair would actually push back more against Republicans if he was actually confirmed. It is just something to think about. I know I called him about something the other day, and he knew Chairman Crapo was in a different place, and he was tentative about talking to me about it. I would just say that to have a guy who is sort of on the bubble really means that even when he disagrees with Crapo or myself or someone else, he is going to be tentative about that until he is confirmed. It is just something to think about. So that is my belief. It really is. And I think it is affecting his ability to push back on some of the large institutions and others and work with them and them rely on guidance. So that is just my observation. He is shaking his head up and down, actually, agreeing with me.

Mr. QUARLES. You might say that, Senator. I could not possibly comment.

[Laughter.]

Senator CORKER. It is something for, I think, people on both sides of the aisle to think about.

During this last bill passage, there was a Section 402—it is actually the issue I was talking about. You know, Senators here try to take care of their constituents back home sometimes, and so we have these custodial banks that are located in only a few States, and so we had some Senators write a bill that did away with certain types of investments on the denominator side of the equation, right? And so everybody around here is enterprising, and so other Senators figured out, hey, you know, there is a way for me to get some other institutions in under the hood if I can just change the language here just a little bit. And so that occurred during the process.

Would we not be better off on technical decisions like that relative to what should and should not be counted, wouldn't we be much better off if people like you were making those decisions? And doesn't the 402 section that we actually have in the bill, doesn't it complicate your life as far as setting ratios in an appropriate way? I would like for you to be really honest with me.

Mr. QUARLES. I appreciate the question and——

Senator CORKER. And I probably will vote for your confirmation regardless, OK?

Mr. QUARLES. And I think I can be pretty candid. You know, I do think that the issue of the fact that the current calibration of the eSLR is a binding constraint, and particularly for the custody banks, but it is not just an issue for the custody banks. You know, it creates those perverse incentives that I——

Senator CORKER. You are saying what is in the bill.

Mr. QUARLES. And so I think that a solution to it is important. The solution that is in the bill, you know, is one solution.

Senator CORKER. Not the preferred solution.

Mr. QUARLES. Well, it is a solution for a limited number of institutions. The concern that I would have as a regulator in pursuing that solution—and, you know, there are regulatory arguments for that solution, but the concern I would have as a regulator is that

I do not know where one would turn off the dial, where one would stop on this slippery slope. So if one excludes a certain class of assets—in this case central bank reserves—should one also include Treasury securities, et cetera? As a regulator, the strong arguments that would be made against me would sort of push me down that slope.

I do think that a legislature is in a better position to resist the slipper slope for that solution. But I also think that there is a broader response——

Senator CORKER. You are saying the regulators are not good at resisting pushback from——

Mr. QUARLES. Well, I think it depends on the specific issue, and on this specific issue you have got sort of a series of arguments, you know, that at least from my perspective I was worried would lead to a slippery slope. I do not think that that applies, however, to the provision in S. 2155. I do think that there is a broader solution that is required. That is why last week we proposed to recalibrate the eSLR to address this same issue. I think that that has broad applicability across a range of firms.

If the provision in S. 2155 does become law, then we will need to think as regulators about how we adjust the calibration to ensure that we are not sort of double counting in some places.

Senator CORKER. So I know my time is up. I would just say to the Chairman, I think 402 is a damaging section to this bill. In some ways it helps lend credence to some of the arguments that Ranking Member Brown was laying out on the front end—just a little bit, not much. Just a little credence, not much. And I would think that we would be better off in your negotiations with Hensarling, we would be better off dropping 402 and letting the regulators do their job. And I think left to their own accord, most of my Democratic colleagues would agree with that. Many Republicans colleagues I know already agree with that, and so I hope we will strike that entire section with that.

Thank you for the time.

Chairman CRAPO. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Vice Chair Quarles, do you agree with the conclusion of the Financial Crisis Inquiry Commission that in the years leading up to the crisis compensation and bonus practices at big banks too often rewarded short-term gains, big bets, and encouraged senior executives to green-light irresponsible risk taking?

Mr. QUARLES. Yes. I do not have sort of in my immediate short-term memory all of the reasoning behind that, but I agree with that statement. I do.

Senator MENENDEZ. OK. In a speech last month, New York Fed President Dudley said, " . . . an effective regulatory regime and comprehensive supervision are not sufficient. We also need to focus on the incentives facing banks and their employees. After all, misaligned incentives contributed greatly to the financial crisis and continue to affect bank conduct and behavior."

Most recently we saw this very problem exposed at Wells Fargo. The former CEO and the head of the Community Bank Division were raking in bonuses while their employees were churning out millions of unauthorized accounts.

Section 956 of Dodd–Frank requires bank regulators to prohibit incentive-based compensation practices that reward senior executives for irresponsible risk taking. Regulators issued a proposal in May of 2016, but nearly 2 years later, nothing has been finalized. In the meantime, Wall Street bonuses jumped 17 percent in 2017 to an estimated $184,220,000, the most since 2006.

When you were asked about this rulemaking in January, you said, "I do not have any updates on that for you. It is not something that I have talked to the other regulators about yet."

So today I am asking you: How is it that you have had time to revisit capital rules, revisit leverage rules, revisit the Volcker rule, all of which were finalized after years of deliberation, public comments, and input from other regulators, and you have not had time to finish the incentive-based compensation rulemaking for the first time?

Mr. QUARLES. That is something that is on the agenda, but it is not something that I have a timeframe for you on today.

Senator MENENDEZ. Well, you revisited a whole host of already existing rules, but a rule that is actually part of a requirement of the law has not even been visited. And it is on the agenda, you tell me, but you cannot give me a timeframe. Well, I think that is pretty outrageous. Can you give me some sense of a timeframe?

Mr. QUARLES. Not a specific timeframe, but I can tell you that I do think that that is an important issue, and it is something that we will be discussing.

Senator MENENDEZ. President Dudley thought a key way of addressing a big bank culture of recidivism was through changing compensation arrangements. In contrast, when you were asked about bank culture, you said it is "perhaps not impossible but very difficult for a financial supervisor to come up with useful, predictable interventions."

Isn't changing compensation precisely how you can address bank culture?

Mr. QUARLES. Addressing the culture of an organization is one of the most important things for an organization, but an extremely complex matter that involves a variety of different incentives. It is something that is most appropriate and ought to be a very high priority for the management of an institution. It is something that is a very high priority for me at the Federal Reserve with our own culture.

Senator MENENDEZ. It is a very high priority for the Congress. They put it into law. And I do not see how you all are seeking to follow the law.

Mr. QUARLES. Well, we are working on implementing that. It has not fallen behind the refrigerator and been forgotten about.

Senator MENENDEZ. Well, I can assure you it will not be going behind the refrigerator because I am going to remind you of it, and others about it as we go ahead.

Finally, I know there is significant interest by this Administration in offering a proposal to make changes to the Community Reinvestment Act. I am not opposed to modernization. When 97 percent of banks receive satisfactory or outstanding ratings, but yet African American and Latino families continue to be disproportionately denied mortgage loans, even when controlling for income loan amount and location, we have got a real problem on our hands.

Now, I have, however, real concerns that new proposals will lead to weakened enforcement by regulators and discounted importance on physical bank branches. Do you expect the Federal Reserve will join the OCC's forthcoming proposed rulemaking?

Mr. QUARLES. We are working on that as a joint matter, so I expect that that will be issued as a joint proposal.

Senator MENENDEZ. If I may, Mr. Chairman, the Treasury report issued earlier this month recommends that the Federal Reserve adopt the OCC's new policy allowing banks with failing CRA ratings to merge or expand so long as they can demonstrate a potential benefit. Do you anticipate the Federal Reserve will adopt this policy?

Mr. QUARLES. We have not considered that policy as a Board, so I do not want to prejudge the judgment of my fellow Governors. But I think that it is important to note that what the Treasury is saying there is that if a benefit in that particular area, in the service of middle-income and lower-income communities can be demonstrated from a particular application, that the whole picture should be taken into account, and that seems reasonable to me.

Senator MENENDEZ. I have other questions, but I will submit them for the record.

Thank you, Mr. Chairman.

Chairman CRAPO. Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman. Good morning, Mr. Chairman.

First, I want to join Senator Corker in his observation that our Ranking Member has a silver tongue, and I mean that as a compliment. A silver-tongued devil.

Number two, this is an observation. I am not looking for a comment. We have not had a recession since 2008, so from one point of view, our too-big-to-fail banks have not really been tested. And I would strongly encourage, for what my opinion is worth, that we tread very carefully before we lower capital and liquidity ratios and start fooling with the leverage ratio until we see how our banks do in a real full-blown recession. But that is not what I really wanted to ask you questions about.

Would Citigroup have survived the meltdown in 2008 had the U.S. Congress not provided it capital?

Mr. QUARLES. I do not know the answer to that question, Senator, but, obviously, it was under extreme financial stress.

Senator KENNEDY. How about the Bank of America?

Mr. QUARLES. I would have to take the same position.

Senator KENNEDY. OK. Did any person in senior management at Citigroup go to jail as a result of the meltdown in 2008?

Mr. QUARLES. I am not aware of anyone.

Senator KENNEDY. OK. And I believe the American taxpayer provided Citigroup somewhere in the neighborhood of $475 billion in capital and loan guarantees. Does that sound about right?

Mr. QUARLES. That sounds about right.

Senator KENNEDY. Let us suppose that a senior member of management at Citigroup had been investigated in 2008 and an FBI agent showed up at his or her house and said, "Hey, I want to come in and look around, but I do not have a warrant," and that Citigroup senior manager said, "Well, look, man, you know, I have got a Fourth Amendment right. You cannot come in here without a warrant." Do you think other banks should not do business with that senior manager at Citigroup because he exercised his Fourth Amendment right?

Mr. QUARLES. No, I do not.

Senator KENNEDY. OK. Let us suppose that senior manager had been subpoenaed to testify in court, and the senior manager took the stand, was sworn in, and said, "You know, I have got a right under the Fifth Amendment of the United States Constitution not to answer questions, and I do not mean to upset anybody, but I think I am going to use that right." Would that have been legal?

Mr. QUARLES. No.

Senator KENNEDY. For him to take the Fifth Amendment?

Mr. QUARLES. I am not speaking as a lawyer here, but I cannot imagine that it would have been illegal.

Senator KENNEDY. Well, trust me. It would have been. OK? Do you think that other banks ought not to do business with that senior manager at Citigroup because he exercised his right under the Fifth Amendment to the United States Constitution?

Mr. QUARLES. That would not be my personal decision, no.

Senator KENNEDY. OK. Let us suppose that a customer wants to exercise his First Amendment right to speak out against abortion. Do you think banks ought not to do business with him?

Mr. QUARLES. On that basis alone, that would not be my personal view. As a supervisor, I am not sure it would be my role to direct the bank on that question.

Senator KENNEDY. OK.

Mr. QUARLES. But that would not be my personal view.

Senator KENNEDY. Let us suppose that a customer wants to speak out in favor of a woman's right to choose. Do you think a bank ought not to do business with him?

Mr. QUARLES. I would have the same view. I would not think that the bank should refuse to do business. As a supervisor, given my stress that we should not be second judging managements and directors on what business lines they choose to go into, I am not sure it would be my role to second guess it, but I personally would not do it.

Senator KENNEDY. Would your answers be the same if the subject were climate change as opposed to abortion?

Mr. QUARLES. Completely.

Senator KENNEDY. OK. Well, as you know, Citigroup and Bank of America have decided to make gun policy for the American people, supplanting the U.S. Congress. Citigroup in particular says it will not do business with anybody that sells guns to people who have not passed a background check. It will not do business with anybody who sells guns to someone under 21, who sells bump stocks, high-capacity magazines, all of which are permissible under the United States Constitution. Would that position violate State and local age discrimination laws?

Mr. QUARLES. I do not know the answer to that.

Senator KENNEDY. Well, if it did and a federally regulated bank was in violation of State and local law, would you do something about it?

Mr. QUARLES. If a bank is violating local law, we have a responsibility as a supervisor to——

Senator KENNEDY. OK. Citigroup says that it will not do business with anybody that sells guns to someone who does not have a background check. Under the NICS data base system, you can actually buy a gun without a data base if your name—if the FBI does not give you an answer within 3 days, you get to buy the gun, and then they keep checking, and later on if they find out you are not entitled to the gun, they come get it. So if Citigroup's position violates Federal law, would you have something to say about that?

Mr. QUARLES. If there were a violation of Federal law, yes, that is part of our role as supervisors.

Senator KENNEDY. All right. I have only got a couple more, Mr. Chairman.

In Arizona, in Alaska, in Wyoming, you can carry a handgun without a permit, concealed or unconcealed, under the United States Constitution. Do you think Citigroup ought to stop doing business in Arizona, Alaska, and Wyoming?

Mr. QUARLES. Well, that is a pretty fraught question because, as a supervisor, I think that their decision——

Senator KENNEDY. All right. Let me interrupt you because I am going to get cutoff.

Mr. QUARLES. OK.

Senator KENNEDY. But I do not mean to be rude.

Mr. QUARLES. I understand. Of course I understand.

Senator KENNEDY. I think you are doing a swell job. In Kansas—in Vermont, you only need to be 16 years old to purchase certain guns. Do you think all banks ought to pull out of Vermont? What do you think Senator Sanders would say?

Mr. QUARLES. I know what Senator Sanders would say, but those are issues, I think, that, again, as supervisors, I am trying to stress that we should not substitute our judgment as to what geographies and business lines banks go into.

Senator KENNEDY. I understand. Well, what I am trying to stress is we do not need red banks and blue banks. We do not need banks that will only do business with people who voted for President Trump. We do not need banks who will only do business for people who voted for Secretary Clinton. We need banks that are safe and sound and honest and that appreciate it when the American taxpayer puts up billions and billions of dollars of their hard-earned money to keep these banks from going belly up. That is what we need.

Thank you, Mr. Chairman.

Mr. QUARLES. Thank you, Senator.

Chairman CRAPO. Thank you. And I have let one Senator on each side take a couple extra minutes. I would like all the other Senators to know that it is balanced and you are back to 5 minutes. [Laughter.]

Senator KENNEDY. I just did it because Senator Brown did it.

Chairman CRAPO. OK, so it is balanced. But, please, honor the time. Senator Schatz.

Senator SCHATZ. Thank you, Mr. Chairman. Vice Chairman, thank you for your service. thank you for being here.

I want to ask you about the evidence of a regulatory burden. In a recent speech, Chairman Jerome Powell stated, "As you look around the world, U.S. banks are competing very, very successfully. They are very profitable. They are earning good returns on capital. Their stock prices are doing well."

So I am looking for the case for some kind of evidence that—and I am open to this—some kind of evidence that regulation is holding them back, and I am not really seeing that case as made at this point. And the data back up his comment. Bank of America announced a profit of $6.9 billion in the first 3 months of this year, the biggest quarterly profit in history. The facts show that banks are thriving. The FDIC shows that banks had record-breaking profits in 2016, and 2017 would have broken that record again if it were not for one-time charges from the new tax law. JPMorgan Chase and Company analysts predict record increases in bank dividends of 38 percent in 2018 and 26 percent in 2019, and the Bank of America, for example, is expected to increase dividends by 126 percent through 2019. Demand for credit, such as home loans, car loans, credit cards, has surpassed pre-recession highs, and lending is up. These are the most profitable financial institutions in history.

And so the question is quite simple: What problem are we trying to solve with deregulation?

Mr. QUARLES. In the first instance, I would say at least as I look at the regulatory reform effort, it is not an effort to deregulate. It is an effort to ensure that we achieve our regulatory objectives in an efficient way. So of the proposals that we made last week, there is in the capital reduction under the stress capital buffer proposal——

Senator SCHATZ. OK, I understand. I mean, I do not want to quibble about how we characterize this thing. I want you to answer the question. If these banks are experiencing record profits, that is one sort of—I think we can agree upon that. Can we?

Mr. QUARLES. Yes, absolutely.

Senator SCHATZ. OK. And then we can also agree that sort of generally the reason you might want to loosen up restrictions or what you call "tailor" is to allow more capital to be deployed to small businesses and individuals who may want loans so they can grow the economy and pursue the American Dream, not so that all of those additional profits can be plowed back into dividends and stock buybacks.

So I ask you again: What problem is being solved by what I call "deregulation" and what you may name differently, but what problem are you solving?

Mr. QUARLES. Well, if we want to get sort of at the very specific level, there has been sort of a shortage, a restriction of small business credit. We have found that at the Federal Reserve. That is the type of credit that has historically in this country been provided by community and regional banks. There are a variety of reasons for that restriction, but I do think that one of those reasons is regulatory burden, and that we can improve the efficiency of the regulatory system without in any way undermining its safety and soundness and address that problem, among a number of others.

Senator SCHATZ. Is there any evidence that when they become more profitable, either as a result of the tax law or as a result of a loosening of the constraints from Dodd–Frank, that they actually make more capital available to small businesses? Because what I see is record stock buybacks and dividends. And so I get the argument you are making, but you are a data-driven person, I assume, and this is a data-driven industry. So I want to understand. Do you have any research that demonstrates that, to the extent that we give tax relief to the most profitable financial institutions in human history and we give regulatory relief to these same institutions, is there any evidence that this actually helps the people that you are describing?

Mr. QUARLES. I certainly know that on the regulatory front—and I am pretty sure, although I cannot think of specific studies on the tax front, but I am pretty sure that in general they exist—that there are economic studies that show that in both of those areas, the benefits will be spread among a number of constituencies, and that will include both——

Senator SCHATZ. But you are just repeating your claim. I am asking you for evidence, and you just kind of go around and around sort of repeating the rhetoric that supports this claim. But I am asking for evidence, and you are saying there is evidence. I am asking you what it is.

Mr. QUARLES. I will be happy to forward that to you.

Senator SCHATZ. OK. I will be waiting.

Thank you.

Senator BROWN [presiding]. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman. Welcome, Mr. Quarles. Thank you for testifying here. Two things I wanted to touch on.

First, it is my understanding that the Board of Governors of the Fed consists of three members right now. There are only three of the seven members. And I wonder if from your perspective that poses any challenges to the day-to-day operations and functioning of the Fed and how important it is in your mind that we confirm individuals to these vacancies.

Mr. QUARLES. It is very obviously welcome but also important to confirm the people who have been nominated to open seats on the Federal Reserve Board. We can do our work, but it is clearly a strain on the organization. And the organization functions better when we have a broader range of viewpoints, more diverse backgrounds, you know, a full complement of people.

Senator TOOMEY. Thank you, and I am hoping soon we will be able to confirm you to the full term that I would suspect and hope would follow the big overwhelming vote I think you got previously.

Mr. QUARLES. Thank you, Senator.

Senator TOOMEY. Let me move on to another one. As you know, the Senate passed by a substantial bipartisan margin a banking regulatory reform bill with mostly modest regulations, regulatory reforms. One of the most important items in that legislation, in my opinion, was raising the threshold for the automatic SIFI designation from $50 billion to $250 billion, so I think that is very constructive because the banks otherwise captured by this are, in fact, not systemically important to the country and they, therefore, do not deserve to be subject to this added cost and regulatory burden.

However, I still think that even in the case of $250 or $300 or $500 billion banks, this whole category, it would still be more appropriate to have a regulatory framework that is based primarily on the activities of the institution rather than an arbitrary asset designation. As you know, there is nothing meaningfully different from an asset threshold point of view about a bank that is $251 billion versus one that is $249 billion.

So, number one, do you agree with that point, with the idea that this regulatory framework ought to be more based on activities certainly for these banks that are in the lower end of this range? And then I have one other question for you.

Mr. QUARLES. On the question of asset thresholds versus activities if I had my druthers, probably you would set an asset threshold below which there was an exemption, below which you were perfectly confident that firms of that size were going to be of a complexity and nature that they would not pose systemic risk. And then above that, you would take a variety of factors into account in determining the application of enhanced standards. Ultimately, as you all know better than I, it is up to the Congress to decide how that balance will be struck. But once it is struck, I think that we as regulators ought to take into account those full range of factors in determining how to tailor regulation in the realm where regulation remains to be applied.

Senator TOOMEY. So one specific area where it is my understanding that you have the discretion to modify this is the application of the LCR, and especially for large regional banks that are not G–SIBs. Smaller banks, under $250 billion, my understanding is there is—the sort of default setting is a different regime, a modified LCR, and that you have the authority to apply a modified version of the LCR for larger banks if their activities warrant that. Are you making progress on making changes to how the LCR would be applied to banks that might be bigger than $250 billion?

Mr. QUARLES. We are, Senator, and I agree with you that that would be an appropriate differentiation. I have said that publicly, and that is something that we are working on to determine exactly how to appropriately tailor that regulation.

Senator TOOMEY. Do you have a timeframe in mind that you could estimate for us when we would see something?

Mr. QUARLES. Well, without wanting to toss this back, we are waiting to see what the legislative framework settles down to be, and when we see what that is, then we will know how to respond on the tailoring front. I suppose certainly at least right now, if that were to extend for a longer period, we might move forward on a different schedule, but at least right now we are waiting to see sort of what the legislative framework we are given is.

Senator TOOMEY. I am sorry for going—I will wrap up, but I would just urge you to—we do not know the timeframe by which we are going to—I assume you are referring to the disposition of the Senate-passed bill.

Mr. QUARLES. Correct.

Senator TOOMEY. It is an open question as to how that is going to proceed, and when is very much an open question. So I would really urge you to move ahead as quickly as you reasonably can.

Mr. QUARLES. I appreciate that, Senator.

Senator TOOMEY. Thank you.

Senator BROWN. Senator Cortez Masto.

Senator CORTEZ MASTO. Thank you, and thank you, Vice Chair, for being here.

Let me switch topics a little to cost-benefit analysis. I understand that the Federal Reserve has a new Policy Effectiveness and Assessment Unit. Is that correct?

Mr. QUARLES. That is correct.

Senator CORTEZ MASTO. And so how many people are working in the unit and what is the core mission of the unit?

Mr. QUARLES. It is a small group of economists. I will have to get you the exact number so that I do not misstate, but the core mission of the unit is to look at the body of postcrisis regulation and to kind of do a deep dive into an analysis of the effectiveness in areas of capital liquidity and resolvability.

Senator CORTEZ MASTO. And do they engage in a cost-benefit analysis? I have heard this topic quite often.

Mr. QUARLES. In the broadest sense of the term, yes. I mean, they are looking at overall effectiveness, and obviously, costs, broadly considered, are part of that.

Senator CORTEZ MASTO. Do you think cost-benefit analysis is a key function for what you are supposed to be doing?

Mr. QUARLES. I think that it is a very important element of what we are supposed to be doing.

Senator CORTEZ MASTO. And I agree. I think sound data is critically important in informing the policies and decisions that you will be making. But one of the things I do have concerns about—and I have seen this over and over again—that such analysis actually fails to capture the human and economic costs of massive financial system failure. Would you agree?

Mr. QUARLES. I would agree with that, yeah.

Senator CORTEZ MASTO. Thank you. Let me ask you this: Would you agree that the Fed underestimated the human costs of a potential financial crisis prior to 2008?

Mr. QUARLES. Yes, I would, because we underestimated the likelihood of it, yes.

Senator CORTEZ MASTO. All right. And, thus, the concern that we are hearing and that I have about rolling back some of these regulations and giving the Fed the authority over safety and soundness. I will tell you, in Nevada, from 2007 to 2014, there was no Federal oversight predicting what was going to happen and then there helping us address the issue. So that is the concern I have with S. 2155 and the rollback of the regulations over the largest banks. So I appreciate your agreeing with me with those concerns.

Let me jump to another topic on fair lending. The Center for Investigative Reporting recently published several articles on modern-day redlining after its year-long investigation based on 31 million records publicly available under the Home Mortgage Disclosure Act to identify lending disparities. The studies found numerous fair lending violations. African Americans and Latinos are charged higher fees and interest on a mortgage than white borrowers with similar credit histories. African Americans, Asians, Latinos, and Native Americans are denied mortgages at higher rates even with similar credit and income. And single women pay higher interest rates for mortgages even when they have higher credit scores and bigger downpayments than single men.

Now, you have said that you oppose discrimination in lending. The Federal Reserve has examination and supervisory authority of banks with fewer than $10 billion in assets. How does the Federal Reserve discover discrimination in lending? Does it involve using the HMDA data?

Mr. QUARLES. We do use HMDA data, but where there is additional data that we believe is necessary, we have the supervisory ability to get that. So the HMDA data at issue here, it is principally a question of public disclosure. We have the ability to get the data that we need to perform that supervisory assessment irrespective of those particular HMDA provisions, and we do.

Senator CORTEZ MASTO. So let me ask you this: If S. 2155, which excludes 85 percent of banks and credit unions from reporting HMDA, becomes law, can you ensure that banks making fewer than 500 mortgage loans a year are not engaged in redlining or other types of discrimination?

Mr. QUARLES. We would have the information that we need, again, through our ability to require it to be provided to us as a supervisory matter to take those actions, yes.

Senator CORTEZ MASTO. And how can we in the public sphere ensure that you are doing that? Because prior to 2007, we know the Feds were not there, and so how do we, without having that public information transparent, so you have independent watchdogs looking and assessing to make sure that redlining is not occurring, how do we ensure that you are doing your job if we do not have that information?

Mr. QUARLES. Transparency and accountability is important, particularly for an institution such as the Federal Reserve. Ultimately, however, the balance between public disclosure and the cost on institutions is one that the Congress will have to make. I can assure you, though, that however you ultimately choose to strike that balance, we will have the ability as supervisors to get the information that we need.

Senator CORTEZ MASTO. But there is no independent verification that you are actually doing it, correct?

Mr. QUARLES. Well, as I understand the provision in 2155, there is quite a bit still of public disclosure. But, the balance that you strike is up to you to strike.

Senator CORTEZ MASTO. Thank you. I know my time is up. Thank you very much.

Senator BROWN. Senator Cotton.

Senator COTTON. Thank you, Mr. Quarles, for your appearance here today. I want to speak to you about FINRA Rule 4210.

Two years ago, I sent a letter to the SEC expressing concern about this rule, which established margin requirements on to-be-announced securities such as mortgage-backed bonds. The key problem here is that Rule 4210 applies to broker-dealers but not to banks. Thus, broker-dealers can use their banking arm to evade the requirement, which can create an unfair and uneven playing field.

Earlier this week, Federal Reserve staff confirmed with my adviser that this is a potential inequity, and I would say that there are Arkansas firms that will simply exit the market if this uneven playing field comes to pass. Do you share my concern about this matter?

Mr. QUARLES. I would say that certainly as a general principle, a level playing field is important, and that is across a range of issues, whether it is banks and broker-dealers, big banks and small banks, domestic banks and international banks. So it is a pretty high priority for us as regulators to try to ensure that our regulatory system creates a level playing field.

On the specific issue of the FINRA rule you are citing, I am only now becoming familiar with it but am very engaged in understanding how it is affecting that level playing field.

Senator COTTON. OK. Rule 4210 is one of those final rules not yet in effect which both the SEC and the Federal Reserve have the ability to alter. Can I get your commitment to take a review of it and to ensure that it does not create an unequal playing field between smaller broker-dealers and larger bank-affiliated firms?

Mr. QUARLES. We will certainly review it through that lens, yes.

Senator COTTON. Thank you. Let us look now to the international system, specifically the Financial Stability Board, or FSB. In January, I sent a letter, along with several other members of this Committee, to President Trump raising my concerns that went to many other members of the Administration, including yourself. I am sure it is right at the top of your mind.

Mr. QUARLES. Actually, it is.

Senator COTTON. Just in case it is not, I will say that I am worried that the FSB has morphed from an advisory organization into a global regulatory body and using quasi-enforcement tools. A couple months ago, Secretary Mnuchin testified that FSB is, in fact, an advisory organization and that its rules are voluntary, not binding. Do you agree that the FSB rules are voluntary?

Mr. QUARLES. Yes. Yes, I do.

Senator COTTON. In 2015, four Chinese banks sought an exemption from an FSB rule related to how much capital they hold. Can you imagine a scenario in which a United States firm would ever have to seek an exemption from an advisory rule of the FSB?

Mr. QUARLES. No.

Senator COTTON. In 2013, the FSB determined that two large American insurers were globally systemically important insurers. Those two insurers, though, had not yet been designated as systemically important financial institutions in the United States. That creates an unusual circumstance in which the FSB, which operates by consensus to include U.S. Government officials, had determined that U.S. firms were globally systemic, yet those same U.S. officials had not determined that they were systemic in our Nation itself. I suspect the Trump administration would have a slightly different approach to this matter, but what can we do to ensure that future Administrations do not take such strange steps in which they are acting through the FSB to achieve results on regulating U.S. firms that they have not yet taken under U.S. law?

Mr. QUARLES. The FSB designations are purely advisory. It is up to national authorities in any particular country to implement them, and we have our FSOC process through which that would be done, and the FSB advisory stance does not really affect the FSOC process.

I think the larger question, though, that you are raising is an important one, which is I do think that we in our engagement in these international fora, the FSB, the Basel Committee, I think is very important because I think trying to ensure a level playing field for our globally active institutions is in their interest. It is in our national interest. But we need to ensure that we are fully engaged with all of the various stakeholders in our country as we go into those national fora and represent, you know, a broad range of views as opposed to a narrow range of views.

Senator COTTON. Thank you. I agree with that. It is important to stay engaged to ensure that we have fair and equal playing fields overseas. It is also important to ensure that U.S. sovereignty prevails in the regulation of our financial institutions, to include large financial institutions which have——

Mr. QUARLES. I completely agree.

Senator COTTON. ——not just rich bankers at their top but lots of clerks and secretaries and delivery personnel and tellers and everything else spread around the country whose jobs may depend on the United States getting a fair and level playing field overseas as well as not having overseas advisory institutions stretch their regulatory hands inside of our borders.

Thank you, Mr. Quarles.

Mr. QUARLES. Thank you, Senator.

Chairman CRAPO [presiding]. Senator Jones.

Senator JONES. Thank you, Mr. Chairman, and thank you, Vice Chairman Quarles, for your attendance here today. I really appreciate your being here.

I want to go back just a moment to an area that Senator Menendez discussed with you, and that is with the Community Reinvestment Act. Frankly, from my State's perspective, that is one of the most important things that the Fed will do, and I think modernizing the CRA is going to be one of the most important things that you may do in your term.

What gives me a little bit of concern right now is that coming out of the OCC I see comments that as part of the modernization effort, they would like to see a universal measurement system, I think the comment was, for $100 million banks in Iowa the same as JPMorgan. That gives me a little bit of concern because of the obvious disparities in communities around the country, and I would like to kind of get your views on what you think. I am not tying you to specifics. I understand that. But I would like to kind of get your views on whether or not the CRA rules should appropriately reflect the individual needs of specific communities across the country.

Mr. QUARLES. I want to make sure that I do not sort of front-run the joint process that is going on——

Senator JONES. Yes.

Mr. QUARLES. ——in discussing exactly these issues among the regulator, because we do want to come out with a joint proposal, and we are still talking about how some of these issues will be handled.

As a general matter, though, I think that the purpose of CRA modernization, CRA reform, however one wants to describe it, is precisely to—I think there is a lot of consensus and desire on the part of community development organizations and players themselves, not just the banks and the regulators, in order to have that process really be broader, directed toward a broader range of community development activities than has happened in the past. And I think that under the principles of transparency and simplicity, I think that we can improve the regulation in a way that creates incentives to do that and creates incentives for compliance—really more than compliance—engagement by the banks that really does help revitalize the moderate- and lower-income sections of communities. And that is the lens through which the Fed is participating in these discussions.

Senator JONES. All right. Thank you, sir. And going back to Senator Cortez Masto's questions, I was a cosponsor and voted for the bank regulatory bill, S. 2155, but the concerns that she raised are still a concern of mine as well. Again, we have a lot of minority communities, and I want to make sure that those folks are not discriminated against. I want to make sure that they are not redlined. Can you just simply—and I heard your answer, and I appreciate that. But will discrimination in housing and lending still be—will it be a priority with you and the Fed?

Mr. QUARLES. A very high priority for me personally and for the Federal Reserve as an institution.

Senator JONES. All right. Thank you, sir.

You have also talked about—I know one of the other priorities has been cybersecurity, and I think that that is a very—that is something that also gives me a lot of pause in today's world. And, particularly, I know there are a lot of efforts going on right now to beef up cybersecurity within our own system, but we are so globally connected now that I worry about our connectivity with other global markets and other banks.

Can you give me a sense of what you are doing in working with international banking regulators to make sure that those banks are as secure and as up-to-date in working with the cybersecurity? Because if it happens somewhere else, it could very well affect folks in Alabama.

Mr. QUARLES. Yeah, that is obviously one of the most significant, if not the most significant risk that faces the financial sector currently, and you are right to highlight the international aspect of it. In our discussions among central banks and among bank regulatory agencies around the world, I would say that that is probably the highest priority item that we have, discussing ways to ensure that our systems are resilient. Internally, domestically, we look at that, including the international component, in sort of a broad range of interagency activities. There is the FBIIC, which is focused on tech infrastructure, the FSOC, you know, there are processes within the FSOC to look at this issue, very high priority for us.

All of that said, I would say that we still have to do more. It is the issue that I am most concerned about and the one that I think that we are probably—that we have most to do on. I do not think that we have the best handle on it yet. We are working very hard on it.

Senator JONES. All right, great. Thank you, Vice Chairman Quarles.

Thank you, Mr. Chairman.

Mr. QUARLES. Thank you, Senator.

Chairman CRAPO. Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman. Thank you, Vice Chairman, for being here this morning.

As you may know, I spent about 20-plus years in the insurance industry.

Mr. QUARLES. I knew that.

Senator SCOTT. I am glad to hear that. And I am a big fan of the State-based regulation system for insurance. We have an old saying in South Carolina, like many things Georgia thinks it started in Georgia, but it started in South Carolina: "If it ain't broke, don't fix it."

Unfortunately, Congress did some fixing in the Dodd–Frank Act as it relates to insurance. Many insurance savings and loan holding companies are now supervised at the holding company level by both the Federal Reserve and State insurance regulations, creating redundant rules of the road that are not proportional to the risk profile of these firms. That runs counter to your preference for regulatory efficiency, and it adds costs for policyholders. I will ask you just a couple questions.

Do you support a more streamlined regulatory approach that would uphold a State-based system of insurance regulation while right-sizing the Fed's examination authority? And will you ensure that the Federal Reserve does not apply bank-centric supervisory tools or expectations to insurance savings and loan holding companies?

Mr. QUARLES. At that level of answer, the answer is definitely yes. I have been concerned, as I have talked with these insurance savings and loan holding companies, that it does seem as if the burden that our regulation of the holding company because of their owning what are sometimes relatively small and certainly in the context of their organizations relatively small savings and loans is out of whack. We are imposing too much burden on them.

I do think that as long as they have a depository institution subsidiary, I think that there are sort of bank regulatory principles that we need to apply. We have not got the balance right. We have not worked out how to do that in a way that does not impose excessive burden on the institutions, and it is a high priority for me to fix that.

Senator SCOTT. That is one of the reasons why I used the word "right-sizing."

Mr. QUARLES. Yes.

Senator SCOTT. Because the reality of it is that the regulatory burden that is placed upon really the policyholders through additional cost should be appropriate for the risk profile that those firms actually have.

Mr. QUARLES. Agreed.

Senator SCOTT. The Fed also regulates insurance through FSOC. Secretary Mnuchin told me a revamp of the nonbank SIFI designation process is underway. Can you give me an update on that? And is it a rule or guidance that is coming?

Mr. QUARLES. Well, again, not wanting to front-run a process that has a number of agencies involved in it and that we are in the middle of, the general direction of the process is pretty clear, which is that we are looking at how to—and certainly I support the approach of designating on an activities basis as opposed to an entities basis and determining what activities can create systemic risk and then finding a way to apply appropriate regulation to those activities. I think that while the practical issues that that raises are difficult, they are solvable, and I think that intellectually that is a superior way to think about the process.

Senator SCOTT. Another way the Fed regulates insurance is through the IAIS. The ICS that you are working on should accommodate our State-based system of insurance regulation, not the other way around. Will you make that clear to the IAIS? And where are we in the ICS process?

Mr. QUARLES. Yes, that has our support for an internationally agreed capital regime that reflects our U.S.-based approach. It is something that we have been pursuing in the international fora and are continuing to do so. We are pretty strong about that.

Senator SCOTT. So I am going to take that as a yes, you will make clear to the IAIS——

Mr. QUARLES. We will, yes.

Senator SCOTT. Thank you. Before I close, I want to mention the Fed's recent enforcement actions against Wells Fargo. I am all for regulatory relief. I think it is clear that we overcorrected in the past and our economy suffered as a result. What I am not for is fraud. What I am not for is theft. I hope you and your colleagues do not hesitate to pursue similar actions in the future when they are warranted.

Thank you.

Mr. QUARLES. Thank you, Senator.

Senator SCOTT. Thank you, Mr. Chairman.

Chairman CRAPO. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

So before the financial crisis, regulators treated dangerous mortgage-backed securities the same way they treated safe Treasury bonds when establishing capital requirements. The regulators badly misjudged the risk of those mortgage-backed securities. The result was that taxpayers were left holding the bag when the big banks did not have enough capital to withstand losses.

So after Dodd–Frank Act, too-big-to-fail banks were required to have a certain amount of capital for each dollar in assets, regardless of the riskiness of those assets. Last week, the Fed proposed weakening this rule.

So, Governor Quarles, this new rule will allow each and every too-big-to-fail bank to satisfy the non-risk-weighted capital requirement while holding less capital than the previous rule, right?

Mr. QUARLES. That is correct.

Senator WARREN. OK. So the Fed is rolling back capital requirements for the biggest banks, and it is not just a marginal rollback.

The FDIC has estimated for this Committee that under the proposed rule, JPMorgan, Citigroup, and Morgan Stanley will be able to reduce their capital by more than 20 percent at their bank subsidiaries and still meet their leverage capital requirements. Wells Fargo and Bank of America can each reduce their capital by more than 15 percent.

The FDIC, which insures these banks and has to pay out if the banks fail, refused to join in this new proposal. Chairman Gruenberg said the leverage ratio requirements are "among the most important postcrisis reforms" and the existing "simple approach has served well in addressing the excessive leverage that helped depend the financial crisis." And Governor Brainard voted no on the proposal, the first dissent since the Fed started making its votes public.

So, Governor Quarles, why did you think it was all right to roll back capital requirements given this unprecedented level of opposition from both the FDIC and your fellow Governor at the Fed?

Mr. QUARLES. A number of reasons. One, our estimate of the actual capital effect of the rule is much smaller.

Senator WARREN. Do you think the FDIC does not know the numbers?

Mr. QUARLES. Our estimate is much smaller, and the incentive that is created when a leverage ratio is actually the binding ratio—I completely agree with you, Senator, that the crisis has shown us that leverage capital measures are an important element of capital regimes, and I have a much greater appreciation of that than I did before the crisis, because our risk assessments, there will always be idiosyncracies, mistakes in even the most careful and granular risk assessment.

But if we set the leverage ratio so that it becomes the binding ratio, which at the level we had set it, it was for a number of institutions, and basically what we are saying to them is you will bear the same capital cost if you take on a very risky asset or if you take on a less risky asset.

Senator WARREN. You know, but what troubles me about this is—I believe the FDIC on their numbers. I have no reason not to. They have been in this business for a very long time, and they are the ones that pay out. But even more importantly, under Chair Yellen the Fed moved carefully and with consensus to strengthen capital requirements. In your first year, you have already started rolling back these requirements, despite significant opposition, and, you know, this is great for big banks already making record profits. But it is the taxpayers that end up on the hook for the risk.

So I want to ask you a related question to this. The banking bill that just passed the Senate also eases capital requirements for institutions "predominantly engaged in custody, safekeeping, and asset servicing activities." Now, this provision clearly applies to the so-called custody banks like Bank of New York Mellon. The question is whether JPMorgan and Citi can also cut their capital under this provision. The CBO says it is a 50–50 shot whether or not JPMorgan and Citi would qualify. You are the guy who will get to make that decision.

So if the bill that just passed the Senate is written into law, will you interpret the custody bank provisions to include JPMorgan and Citi?

Mr. QUARLES. So although I am a lawyer, I am not appearing here as a lawyer, so I do not want to perform—a surgeon should not perform his own appendectomy, but my reading of that provision would be that the word "predominantly" would not include the activities of a firm such as Citi or JPMorgan.

Senator WARREN. So are you saying for certain that the language of the legislation cannot be interpreted to allow JPMorgan and Citi to reduce their capital by an estimated $30 billion?

Mr. QUARLES. That would not be my view.

Senator WARREN. So it will not happen.

Mr. QUARLES. Well, I am one person on a Board that I hope soon has other members.

Senator WARREN. OK, good. You know, I am worried about this because I am worried about the cumulative effect of these rollbacks. Taken separately, each of the rollbacks, the rollbacks you have already done and the rollbacks under the bill, I believe are dangerous. But when they are taken together, they are downright reckless. The banking bill gives even more discretion to you, Mr. Quarles, so that you can help out giant banks and leave taxpayers holding the bag, and I just think that is the wrong direction for us to go.

Thank you, Mr. Chair.

Chairman CRAPO. Senator Tillis.

Senator TILLIS. Thank you, Mr. Chairman. Mr. Quarles, thank you for being here.

I believe it was Senator Corker that was talking about why our colleagues on the other side of the aisle should be really pounding the table for your confirmation to the 14-year term, and I would really recommend an article that was published back in October of last year titled, "Does the new Fed Governor serve at the pleasure of the President?" It was by Peter Conti-Brown, a Democrat who thinks that in this particular case we should be removing all the hurdles and get you on the agenda as quickly as possible and, like you said, get other members appointed so that you all can be independent and get a lot of work done that we need to get done.

I do not remember the time, but I know you recently—maybe it back in January—spoke to the ABA.

Mr. QUARLES. Yes.

Senator TILLIS. And you talked about revisiting advanced approaches thresholds for identifying internationally active banks.

First off, is it still your position that we should revisit the advanced approaches thresholds? Is it still a priority for you? And could you discuss your broader position on the issue and what lies ahead under your leadership?

Mr. QUARLES. Absolutely. Yes, that is a priority, and it is on the agenda. Because it is significantly related to legislative movement on the thresholds, at least for the moment, we have thought that the better part of valor has been to hold off until we see what direction the Congress goes there. But I think that wherever the legislative process settles, there will be an ability for us to continue to move the thresholds on the advanced approaches.

Senator TILLIS. I think you also recently talked about the Volcker rule and how it has been detrimental to capital markets and it has created a great deal of uncertainty. There was a House bill recently passed to streamline the Volcker rule. I believe it passed by a very big margin, 300–104. We have been working on the bill and trying to increase awareness in the Senate to move it forward at some point. But can you talk to me a little bit about the consequences of having five different regulators enforcing the rule and how the bill would be streamlined or how you could streamline it and maybe make that a little bit less problematic?

Mr. QUARLES. There is obviously a lot of coordination work that is involved to have five regulators to agree, even when we are all pulling in the same direction. I would——

Senator TILLIS. What is the rational basis for five of them being at the table, though? I mean, I want you to finish your thought, but cover that as well.

Mr. QUARLES. Well, each of them has sort of entity supervisory authority over entities that are affected by the Volcker rule. So there is a logic to the provision. There are logistical consequences to the provision. I would say that the cooperation that we have had since the beginning of the year on working on revising the Volcker rule has been very productive. The other regulators have worked together very closely with us in developing proposals to simplify that regulation, and it is actually moving fairly well, but it is moving fairly well for a five-headed process.

Senator TILLIS. I think you mentioned earlier you were—I know you were questioned yesterday over on the House side, and someone else mentioned already the insurance saving and loan holding corporations. I will review that for the record, but my staff told me you have already covered that question. I tend not to revisit questions already asked.

So just on a final note in the minute left, you and I have had several discussions about regulatory right-sizing on a broader basis. Volcker is just one of them. But let us assume we fast forward, you have got your 14-year term. I know that there are certain limits about what you can talk about about precisely what you do on regs or reg repeals. But can you give me in broad strokes what your top two or three areas would be to look for opportunities to right-size regs?

Mr. QUARLES. I think that some of them—I think probably all of these I have talked about—that we have not proposed yet, you will see a proposal for, again, a much more transparent and codified framework for determining control under the Bank Holding Company Act, which really is not just an issue of interest to the lawyers, but really can be important for capital raising for community banks because of control issues that frequently come up in those contexts.

Liquidity regulation for firms below the G–SIB level, kind of continuing to gradate that regulatory regime is something that I think that you will see.

I think that as we finalize some of the transparency proposals that we have made, they will go farther than the initial proposals, and then as well the Volcker rule that we are working on.

Senator TILLIS. Thank you.

Chairman CRAPO. Senator Van Hollen.

Senator VAN HOLLEN. Thank you, Mr. Chairman. Welcome, Mr. Quarles.

Mr. QUARLES. Thank you.

Senator VAN HOLLEN. So I know my colleague Senator Schatz mentioned this issue, but I do want to emphasize that we all woke up to a headline in the *Wall Street Journal* the other day stating, "The biggest U.S. banks made $2.5 billion from the tax law in one quarter." It talked about the four biggest banks. That certainly was not how the tax reform plan was advertised here on Capitol Hill, and I think Americans are waking up to the fact that since January 1st of this year, big corporations have spent $250 billion on stock buybacks. Apparently, they could not think of a good investment for the money within their corporation or did not want to use it to give the promised $4,000 pay increases to their employees, so they passed it on to the shareholders. And it is worth noting that 35 percent of their shareholders are foreigners—35 percent of the stock out there is owned by foreigners. So out of the pockets of many middle-class American families into the bank accounts of foreigners. As someone at the Fed, I hope you will continue to monitor the impact of this tax bill in many different ways.

I want to follow up with some of the questions that my colleague Senator Cortez Masto raised. I know in the House yesterday, or whenever you testified, you were asked about a recent Center for Investigative Reporting findings that redlining, discrimination in mortgage lending continues in a very real way. They looked at 31 million mortgage records and found evidence of discrimination in mortgage lending in 61 metropolitan areas. And this, as you know, is not a new story. It goes back decades.

In the lead-up to the financial crisis, there was a very big scandal in Baltimore City. The city of Baltimore sued Wells Fargo. Wells Fargo settled. Very clear documentation that many African Americans and people of color who had good credit ratings were being charged higher interest rates than their peers. And also predatory lending where people who had no documentation about income were granted loans that people knew that they would fail, they knew they could pass those loans up and not have to be held responsible.

So this is an ongoing pattern, and we have a recent report here, and I was listening to your testimony and your answers with respect to Senator Catherine Cortez Masto, and here is what I would ask: Can you take a look at the report from the Center for Investigative Reporting—I do not know if you had a chance to look at it since your House——

Mr. QUARLES. To look at it, but certainly not to study it, and I can obviously commit to do so.

Senator VAN HOLLEN. Because I would like for you to take a look at it, and your colleagues, because you mentioned in your response that at the Fed you have lots of tools to get information. I mean you mentioned the publicly available HMDA information, but you went on to say you actually get a lot of additional information, correct?

Mr. QUARLES. That is correct.

Senator VAN HOLLEN. So the obvious question here is: Where is the breakdown in the system? If these reports are accurate—and you have not looked at it, but it is a very well documented study. I have taken a look. If these reports are accurate, where is the system failing? Because we all, everyone on this Committee is committed to making sure we do not have discrimination in lending. But it is clearly still going on out there in the real world.

So where is the breakdown? And I am going to ask you today, since you do have a lot of data beyond HMDA, I do not think we should have to wait for studies like that from the Center for Investigative Reporting to catch what is happening. We need you and the Fed and the OCC to be on the front lines.

So can you take a deep dive into this report and get back to me and this Committee and let us know what your assessment is and what is broken in the system?

Mr. QUARLES. Absolutely. Very reasonable request. Of course we can.

Senator VAN HOLLEN. Because, you know, we keep hearing, again, that folks have the tools, but the tools do not seem to be working because we keep getting these reports. And it is very disturbing to see the continuing wealth gap, right? We have big income gaps——

Mr. QUARLES. Yes.

Senator VAN HOLLEN. ——we have big wealth gaps between the African American community and communities of color and others. And as you know, for most Americans that wealth is in their home.

Mr. QUARLES. Right.

Senator VAN HOLLEN. So if you cannot get a loan to get a home and build that wealth, that gap grows. So I just want your commitment to work with us to get to the bottom of this. There are these studies out there. We need your help.

Mr. QUARLES. You have that commitment.

Senator VAN HOLLEN. Thank you.

Chairman CRAPO. Senator Perdue.

Senator PERDUE. Thank you, Vice Chair, for being here today. I just have two quick questions.

In your role as Vice Chair, you have a seat on the Financial Stability Board, I believe, as well as the Basel Committee on Banking Supervision. In those roles, give us your opinion about how well capitalized U.S. banks are in your opinion today.

Mr. QUARLES. Relative to sort of peer banks around the world, U.S. banks are extremely well capitalized.

Senator PERDUE. Given that and given the accelerated activity of our implementation of Basel III, particularly in relative terms to what the rest of the signatories have been doing, what are your thoughts about any further implementation of the Basel III agreement relative to what other people—shouldn't we see further implementation or acceleration of implementation before we entertain further rules?

Mr. QUARLES. Well, I think that, assuring that we have that level playing field internationally is one of the reasons for those——

Senator PERDUE. Do we have that today?

Mr. QUARLES. I would say that we are ahead of many other jurisdictions.

Senator PERDUE. Yes, sir.

Mr. QUARLES. That is definitely something that we take into account, assuring that we maintain a level playing field both in encouraging others to come up to standard and as we think about the role of our own regulations.

Senator PERDUE. Under Senate bill 2155 that we just passed in Committee and passed in the Senate, the banking regulatory relief bill, if it becomes law, the Federal Reserve will have the responsibility to determine which banks between $100 and $250 billion in assets will be given relief for enhanced supervision. Senator McCaskill and I actually have a bill, Senate bill 1983, that would require the Federal Reserve to actually use the Basel five-part test in designating G–SIBs. Can you give us your opinion on that? And how do you feel about the current activity level or the current asset size-based approach versus the activity-based approach in determining risk for banks of this size?

Mr. QUARLES. I think that making those determinations is something that we should take a range of factors into account for. Size is one, but it is only one, and complexity and interconnectedness and, you know, the character of bank portfolios, I think all of that goes into an assessment of systemic significance. And so I definitely think that that is something that we ought to do.

Senator PERDUE. You do support moving more to a multi-based approach, multi-factor approach in terms of evaluating the risk of those banks?

Mr. QUARLES. Yes. I think we do that now. I certainly think we should.

Senator PERDUE. Good.

Mr. QUARLES. Yes.

Senator PERDUE. In your role, you evaluate emerging threats and so forth. Can you give us a brief summary, particularly with the size of the central banks in China, Japan, U.S., and Europe, the largest balance sheets we have ever seen, and we see the growth of debt really in emerging markets again within the $200 trillion universe of global debt. Can you give us just your thoughts today in your role here on emerging threats that may threaten the global financial system? How should we be thinking about that today?

Mr. QUARLES. For the global financial system generally, I would say that we view the risks to financial stability essentially as moderate, which is to say about in the middle of where we would expect them to be over a cycle.

Senator PERDUE. Is that down from 10 years ago?

Mr. QUARLES. Ten years before or after the crisis?

Senator PERDUE. Before.

Mr. QUARLES. That is probably about where it would have been 10 years ago, where we would have thought that it would have been 10 years ago. There are individual countries where we think the risks are elevated. Some of the issues that you have cited are issues that we certainly look at. But, in general, the risks to financial stability, both our domestic financial stability and global financial stability, we are in a reason spot right now. I would not say that they are low, but they are not excessively elevated either.

Senator PERDUE. Thank you.

Thank you, Mr. Chair.

Chairman CRAPO. Senator Heitkamp.

Senator HEITKAMP. Thank you, Mr. Chairman. And thank you for your patience. I think I might be the last one here unless—oh, Jack. We have saved the best for last, and I guess that is not me.

I want to just follow up on Senator Toomey's questions. He talked about a lack of Federal nominees, and I would just like to briefly comment on the lack of Federal Board of Governors' confirmations. Do you know the number of Board nominees that were denied a hearing under President Obama?

Mr. QUARLES. I do not.

Senator HEITKAMP. Yeah, well, that never gets talked about, but the answer is two. So I think we have to be really careful when we are pointing fingers about not having a full contingent, because this is not something new. It is something that needs to be addressed desperately here. But let us not paint like this is a brand-new problem that we have here.

The other thing that I probably want to correct on the record is Senator Toomey said, you know, below 250 there is no SIFI designation under 2155. That is not true. Between 100 and 250, the Fed has complete authority if you see an institution that presents systemic risk for whatever reason, and that is to respond to the concern about Countrywide and the risk that they presented. And this puts a burden on you, and I want to make sure that the Fed understands that this is not—at least this sponsor of 2155 did not in any way want to limit your ability to identify those institutions under 250 who present systemic risk. So I want to follow up on a couple quick questions on 2155.

As Vice Chair of Supervision, you will have a lot of responsibility for implementing the changes in that bill, should it be passed by the House and signed by the President, which we very much hope. Some of the opponents of the bill have claimed that the legislation will take us back to the state of play before the financial crisis. Specifically, they have argued that the bill could somehow open up widespread risk in the mortgage market and result in the kind of foreclosure crisis we saw in 2008.

Do you agree that one of the main drivers of the 2008 crisis was that firms were exporting mortgage credit risk and failing to perform appropriate and basic underwriting duties?

Mr. QUARLES. That was certainly an element, yes.

Senator HEITKAMP. Does this legislation do anything to change the strict mortgage lending requirements known as QM rule for larger institutions?

Mr. QUARLES. From my review of it, it does not.

Senator HEITKAMP. Does it change any of the QM requirements for community banks that do not keep that loan on portfolio?

Mr. QUARLES. I do not see that it does, no.

Senator HEITKAMP. Does the legislation do anything to change the risk retention rules put in place after the crisis?

Mr. QUARLES. I do not believe so.

Senator HEITKAMP. So in your view, would 2155 preserve the critical tools that were put in place after the crisis to prevent another mortgage foreclosure crisis?

Mr. QUARLES. I believe that it would, Senator.

Senator HEITKAMP. OK. During your time at Treasury, you worked quite a bit on housing reform, and obviously that is a topic that we are very interested in here, kind of that next turn the page after some of the credit union and small community bank reform that we did in 2155. So I am going to ask you some quick questions on mortgage reform.

Mr. QUARLES. Sure.

Senator HEITKAMP. With respect to Fannie and Freddie, do you think it is likely that one or both could fail again? That is probably not a quick question.

Mr. QUARLES. Exactly. I guess that would be a very difficult question to answer. I would have to dig deeper to——

Senator HEITKAMP. But is there a possibility that they could fail again?

Mr. QUARLES. I would think that there is a possibility.

Senator HEITKAMP. Do you think it is likely that one or both could take a substantial draw from their line of credit from Treasury in the near future?

Mr. QUARLES. Well, I know that when I was at the Treasury, we proposed strict controls on that, and the Treasury does have the ability to limit that. So a lot of that would depend on the Treasury.

Senator HEITKAMP. But you are saying—you cannot give a sense of likelihood, but there is a possibility, correct?

Mr. QUARLES. I think there is the legal possibility.

Senator HEITKAMP. So if Congress fails to take action, what long-term risk do you see in our financial system if our GSEs remain in conservatorship?

Mr. QUARLES. Well, you know, I think certainty is a benefit to the economy in general, and so for me, the principal benefit is to create certainty around what our system of housing finance is going to be going forward and to have that be sort of as private sector driven as possible.

Senator HEITKAMP. Do you believe that a Government backstop is essential to retaining the 30-year fixed-rate mortgage?

Mr. QUARLES. I would want to analyze that question more deeply before giving you a yes or no answer. My belief today is probably not, but I would really want to get back to you with a more considered——

Senator HEITKAMP. We would have to have a long conversation about that because I think that there are a number of people certainly in smaller and midsized institutions who believe that it would be very difficult to take a 30-year interest rate risk without some kind of assurance that they could offload that risk.

Mr. QUARLES. Fair enough.

Senator HEITKAMP. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman. And welcome, Chairman Quarles.

Last time when Chairman Powell was here, we talked about the impact of technology on employment, which is increasingly both problematic and beneficial, so let us talk about the problems first. There is a real concern, I think, about people—and not just economic analysts, but people who are Main Street—who fear that their job will be automated away. That I think contributes to kind of the real concern that is out there despite fairly good economic news. And that raises the issue of, well, how do we respond to multiple ways? First, you know, technology is coming, we know that. Can education and training and more resources in that regard allow us to make the transition so that people can still work, they will not be sort of left behind?

Mr. QUARLES. I think that those are important factors. We need to put a lot of resources into education and training in a society that is innovating like ours, particularly innovating through technology.

Senator REED. I appreciate that. One of the battles we have perennially is putting resources into education. One could always be more efficient or aspire to be more efficient, but I think given this technological challenge, this automation challenge, the emphasis on training actually beginning in pre-K and STEM, et cetera, requires a huge investment. And this year we have done OK, but in the future we are going to look at some very difficult choices.

The other issue this raises would be in terms of the full employment mandate, Mr. Vice Chairman, of the Fed, which is as technology displaces workers, do you factor that in as sort of the new norm, that, you know, our full employment is not X because those jobs do not exist anymore, and that creates kind of a dynamic where there are literally millions of Americans who have a job and we are at full employment?

Mr. QUARLES. We obviously look closely at the relationship between the unemployment rate and the labor participation rate and how that is passing through to inflation, and there have been changes in that relationship over the course of the last 10, 15, 20 years that we do not understand well, that we are doing a lot of research in. Technology clearly has to be an element. I do not think it is the only element. How big of a driver it is, you know, I could not tell you. We really are still trying to figure out exactly why those relationships are changing relative to what they have been in the past.

Senator REED. And I think you would concur, this is a very important analysis because——

Mr. QUARLES. Incredibly important.

Senator REED. This phenomenon, you know, it is not something that 10 years from now we will deal with it. It seems with every week we are seeing more and more amazing applications of technology that just basically takes jobs away or changes them so dramatically.

Mr. QUARLES. Certainly changes the nature of the economy. Now, you know, our experience up to now in this country, globally, with technological advance, has been that jobs are created as jobs are removed. You know, and so I think the historical evidence would give us reason to think that we will see some of that effect here. But this is a pretty dramatic—some of the advances that we are seeing are pretty dramatic and could have significant effects. We are looking at that.

Senator REED. Just a final point. It is my understanding that in 26 States, the number one occupation is driving a vehicle of some kind, and every day we hear more and more—some good, but some bad, but mostly good—about autonomous vehicles and sophisticated AI systems in which driving will be something like blacksmithing, and that will have a huge impact. And it is years away. It is not decades away.

Just a final topic, and I only have a few remaining seconds, and the Chairman and the Vice Chair have been very kind. There is an Advanced Notice of Proposed Rulemaking from the Fed, OCC, and FDIC on cyber, and this is another issue which cannot wait. So can you give us an update on where we are? I think we have got to get the rule out.

One of the components of the rule is that at least raising the question whether board members of publicly held companies—at least one member has to have some type of cybertraining or some arrangement in the company to include cybersensitivity. Can you comment?

Mr. QUARLES. I completely agree with you. Cyber is not only an important risk, it is probably the most important risk that is faced by the financial sector. I think that as regulators we need to step up the pace with which we are taking measures to help support the resiliency of the system.

The ANPR that we put out is an example. The idea of having a board member with cyberexpertise, when I have been on boards that have had a board member with that kind of expertise, that has been extremely useful. That has not just been a nice thing to have. It has been extremely useful.

But I also think that even beyond some of the issues that are in the ANPR, we really need to step up our work not just as regulatory agencies but across the Government in really thinking how we can support the resiliency of the financial sector to cyberrisk in ways that we are not yet. And I think that that needs to be a priority for us beyond even some of these regulatory measures, and that requires not just the banking agencies, but work, you know, across the various agencies of the Government because it is a serious issue for all of us.

Senator REED. Thank you, Mr. Vice Chairman.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Reed. And thank you, Governor Quarles, for being here today and the service you give us at the Federal Reserve Board.

For Senators who wish to submit questions for the record, those questions are due on Thursday, April 26th, and I encourage you, Vice Chairman Quarles, if you receive questions, to please respond very promptly.

Mr. QUARLES. I will do so.

Chairman CRAPO. And with that, this hearing is adjourned.

Mr. QUARLES. Thank you very much.

Chairman CRAPO. Thank you.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

**PREPARED STATEMENT OF RANDAL K. QUARLES**

VICE CHAIRMAN FOR SUPERVISION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

APRIL 19, 2018

Chairman Crapo, Ranking Member Brown, 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 postcrisis 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 nonrecurring 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 8 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 cyberresiliency of the financial sector.[1] Cyberrisk 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 cybervulnerabilities 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 of the ways we have sought to improve the effectiveness of the postcrisis 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

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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.*

[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.*

assets. The eSLR's current calibration has made it the primary capital 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 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 2 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 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.

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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.*

[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.*

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 noncontrolling investments by banking organizations in nonbanking 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 the goal of a safe financial system. The Federal Reserve has worked to simplify the vast and often complex postcrisis 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 nonstress 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.

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

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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.*

[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.*

postcrisis 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 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 postcrisis 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.

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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.*

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM RANDAL K. QUARLES**

**Q.1.** Would removing the Supplemental Leverage Ratio (SLR) from the Comprehensive Capital Analysis and Review (CCAR), as proposed in the Board of Governors of the Federal Reserve System's (Fed) Stress Capital Buffer (SCB) proposal,[1] shift the binding constraint on capital distributions from leverage capital to risk-based capital for any of the domestic Global Systemically Important Banks (G–SIBs)?

If so, which ones?

**A.1.** 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's (Board) stress capital buffer (SCB) proposal would currently extend the proposed stress buffer concept to the tier I leverage ratio, but not to the supplementary leverage ratio (SLR). The Board is seeking public comment on the advantages and disadvantages of both of these specific aspects of the proposal (i.e., the elimination of the post stress SLR but retention of the tier 1 leverage ratio; see questions 1 and 3 in the preamble of the proposed rulemaking).[2]

The Board included an impact analysis as part of the proposal. Due to the confidential nature of certain data (e.g., firms' future capital distribution plans) that were used to develop the impact analysis, the proposal only describes the aggregate impact. The impact of the proposal on individual firms would vary based on each firm's individual risk profile and planned distributions, as well as across time based on the severely adverse stress scenario used in the supervisory stress test.

**Q.2.** How would common equity tier 1 (CET1) capital and total distributable capital change for each of the domestic G–SIBs under the Fed's proposed SCB rule? Please provide firm by firm numbers.

**A.2.** As noted in the response to Question 1 above, due to the confidential nature of the supervisory data included in the projected impact of the proposal on individual firms, the Board is not in a position to provide firm-specific estimates.

The proposal would generally maintain or in some cases increase common equity tier 1 (CET1) capital requirements for global systemically important banks (G–SIBs). The estimated increase for G–SIBs would occur because the capital conservation buffer requirement under the proposal—which, for a G–SIB, includes both the SCB requirement and the G–SIB surcharge—would be greater than the capital required under the current supervisory poststress capital assessment.

Based on data from Comprehensive Analysis and Reviews (CCAR) in 2015, 2016, and 2017, CET1 capital requirements for G–SIBs are projected to increase by approximately $10 billion to $50 billion in aggregate. Had the proposal been in effect during recent CCAR exercises, analysis of those CCAR results and the current level of capital at the G–SIBs indicates that no such firm would

[1] *https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180410a2.pdf*
[2] See 83 *FR* 18160, 18166-7 (April 25, 2018).

have needed to raise additional capital in order to avoid the proposal's limitations on capital distributions.

**Q.3.** Please review the attached analysis from Goldman Sachs equity research. Does the Fed agree that the SCB proposal would lead to an excess capital increase of $54 billion across the large banks the research report considered?

**A.3.** For firms with over $50 billion in assets that are not G–SIBs, the Board estimates that the proposal would generally result in a reduction in the required level of capital to avoid capital distribution limitations relative to what is required today. This estimated reduction is attributable to the proposal's modified assumptions regarding balance sheet growth and capital distributions. While these assumptions would more appropriately reflect the expected performance of bank portfolios under stress, they would be somewhat less stringent than the assumptions currently used in the supervisory stress test. As noted above, for G–SIBs, the proposal would generally maintain or in some cases increase CET1 capital requirements.

The impact of the proposal would vary through the economic and credit cycle based on the risk profile and planned capital distributions of individual firms, as well as on the specific severely adverse stress scenario used in the supervisory stress test. Based on data from CCAR 2015, 2016, and 2017, the impact of the proposal would range from an aggregate reduction in CET1 capital requirements of about $35 billion (based on 2017 data) to an aggregate increase in CET1 capital requirements of about $40 billion (based on 2015 data). More specifically, G–SIBs would have experienced an increase in CET1 capital requirements ranging from $10 billion to $50 billion, while non- G–SIBs would have experienced a decrease in CET1 capital requirements ranging from $10 billion to $45 billion. Had the proposal been in effect during recent CCAR exercises, analysis of those CCAR results indicates that participating firms would not have needed to raise additional capital in order to avoid limitations on capital distributions.

The analysis from Goldman Sachs seems to make additional assumptions about how banks might respond to the SCB proposal. Our estimates describe the changes in the actual level of capital that would be required under the proposal.

**Q.4.** If the goal of the Fed's SCB proposal is to integrate CCAR with ongoing capital requirements, please provide the Fed's rationale for excluding the SLR as a binding constraint in the SCB proposal.

**A.4.** Leverage capital measures work best when they serve as a backstop to risk-based capital measures in the context of a comprehensive capital regime. When leverage measures are binding constraints, they serve as an incentive for regulated institutions to increase the risk in their portfolios (because the capital cost for each additional asset will be the same whether the asset is risky or safe—institutions will thus have an incentive to add high risk/ high return assets because the capital cost of those assets is the same as that of lower return but safer assets). We should try to ensure that the capital regime does not only result in the retention of a robust amount of capital, but also that the structure of the regime does not create unintended incentives for firms to take on risk.

The SCB proposal currently proposes to introduce a stress leverage buffer requirement on top of the 4 percent minimum tier 1 leverage ratio requirement but not extend the stress buffer requirement to the SLR. As noted in the response to question 1 above, the Board is seeking comment on the advantages and disadvantages of these specific aspects of the proposal.

**Q.5.** Why did the Fed choose not to include the enhanced SLR (eSLR) in the SCB proposal?

**A.5.** The enhanced supplementary leverage ratio (eSLR) standards apply in the Board's regulatory capital rule to G–SIBs and their insured depository institution (IDI) subsidiaries. Under the current CCAR program, the Board evaluates the ability of each of the largest bank holding companies to maintain capital above minimum regulatory capital requirements under expected and stressful conditions, assuming that a firm makes all planned capital actions that are in its capital plan. As it is a buffer concept, the eSLR standards are not, and have never been, included in the Federal Reserve's stress testing framework.

With regard to the Board's SCB proposal not extending the stress buffer concept to the supplementary leverage ratio, please see the response to Question 4 above.

**Q.6.** The Fed's eSLR proposal would reduce the amount of tier 1 capital required across the lead insured depository institution (IDI) subsidiaries of the G–SIBs by approximately $121 billion.[3]

How would that $121 billion be deployed by bank holding companies if this proposal were enacted?

**A.6.** The Board estimates that, taking into account the capital constraints imposed by the supervisory stress tests and the Board's regulatory capital rules, the proposed changes to the eSLR standards would reduce the amount of tier 1 capital required across the U.S. G–SIBs on a consolidated basis by approximately $400 million. Thus, nearly all of the $121 billion would be required to remain within the consolidated banking organization, as the G–SIBs would not be able to distribute the capital released at the IDI level. Each individual G–SIB would be able to determine how to reallocate capital, based on its business model or needs within the organization. For example, each G–SIB could continue to hold the capital at the IDI, deploy that capital to nonbank subsidiaries, or hold that capital at the holding company level to use as needed.

**Q.7.** The proposed rulemaking for the Fed's eSLR proposal asks commenters for their views on excluding central bank deposits from the denominator of the SLR, but unlike section 402 of S. 2155, does not narrow the question strictly to custody banks.

Is the Fed considering excluding central bank deposits from the denominator of the SLR for all banks (custody and noncustody)?

**A.7.** The Board and the Office of the Comptroller of the Currency's (OCC) eSLR proposal is based on the current definitions of tier 1 capital and total leverage exposure, which include central bank de-

[3] *https://www.gpo.gov/fdsys/pkg/FR-2018-04-19/pdf/2018-08066.pdf*

posits in the denominator of the SLR. However, the Board and the OCC thought it appropriate generally to seek commenters' views on alternatives to the proposal, including the exclusion of central bank deposits from the denominator. The Board will consider all comments received in connection with the proposal.

**Q.8.** Please provide firm-by-firm analysis for each domestic G–SIB on the combined impact on total distributable capital related to both the SCB and eSLR proposals.

**A.8.** As noted in the response to question I above, due to the confidential nature of the supervisory data included in the projected impact of the proposals on individual firms, the Board has made only aggregate impact data publicly available. The estimated impacts of the SCB proposal and of the eSLR proposal across G–SIBs are described above in the response to Question 2 and Question 6, respectively.

While the discussion in each of 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 G–SIBs under the eSLR proposal ($400 million, as noted above in response to Question 6) into the estimated impact of the SCB proposal across G–SIBs does not meaningfully affect the estimates.

**Q.9.** During your testimony before the House Financial Services Committee, you indicated a desire to change the G–SIB surcharge methodology, perhaps based on the result of a bank holding company's living will submission.

Can you elaborate on this idea? [4]

**A.9.** The G–SIB surcharge was calibrated so that each G–SIB would hold enough capital to lower its probability of failure so that the expected impact of its failure would be approximately equal to that of a non- G–SIB. The Board monitors the impact of its regulations after implementation to assess whether the regulations continue to function as intended. As I have noted more broadly, such a review should have as a goal not only maintaining safety and soundness and financial stability, but also efficiency, transparency, and simplicity. In the preamble to the G–SIB surcharge final rule, the Board indicated that it would be appropriate to reevaluate periodically the fixed coefficients used in the rule.

**Q.10.** Has the Fed considered the potential interaction between this idea, the proposed rule changing the eSLR, and the Fed's intention to make living will submissions required every other year, rather than annually? [5]

**A.10.** The Board's capital rules have been designed to significantly reduce the likelihood and severity of future financial crises by reducing both the probability of failure of a large banking organization and the consequences of such a failure were it to occur. Capital rules and other prudential requirements for large banking organi-

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[4] Response to a question from Congressman Hollingsworth. House Financial Services Committee Hearing. "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System". April 17, 2017.

[5] *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171219a.htm*

zations 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. In this regard, the Board is considering additional potential modifications to its rules, including both the capital rule and the living will rule, to simplify the rules and reduce unnecessary regulatory burden without compromising safety and soundness.

**Q.11.** Earlier this year in Tokyo, you gave a speech describing the strength of the U.S. economy, noting growing optimism, solid bank earnings, the tax bill, and the strong labor market.[6]

If the economy is strong, isn't now the time to impose a Countercyclical Capital Buffer that banks can draw on when the economy eventually gets tough?

**A.11.** The countercyclical capital buffer (CCyB) is an important element of the system of capital regulation that applies to U.S. bank holding companies with more than $250 billion in total assets or more than $10 billion in foreign assets, as well as intermediate holding companies of foreign banking organizations with more than $50 billion in total assets.

In 2016, the Federal Reserve issued a policy statement on the CCyB, in which we spelled out a comprehensive framework for setting its level. The framework incorporates the Board's judgment of not only asset valuations and risk appetite, but also the level of three other key financial vulnerabilities—financial leverage, nonfinancial leverage, and maturity and liquidity transformation—and how all five of those vulnerabilities interact. In this assessment, the Board considers a wide array of economic and financial indicators, as well as a number of statistical models developed by staff. Several of those models are cited in the policy statement. As indicated in the policy statement, the CCyB is intended to address elevated risks from activity that is not well-supported by underlying economic fundamentals. As such, the Board expects the CCyB to be nonzero if overall vulnerabilities were judged to have risen to a level that was "meaningfully above normal."

Within that framework, the runup in asset prices that we have seen in recent years is certainly a key consideration, but we view that run up in the context of the levels of other vulnerabilities, importantly including leverage and maturity transformation in the financial system. Bank capital ratios and liquidity buffers are now substantially higher than they were a decade ago. The stress tests ensure that the largest banks can continue to support economic activity even in the face of a severe recession—importantly, one characterized by extreme declines in asset prices. Outside the banking system, leverage of other financial firms does not appear to have risen to elevated levels, and the risks associated with maturity transformation by money-market mutual funds is much reduced from the levels seen a decade ago. Thus, we believe that overall vulnerabilities in the financial system remain moderate and near their normal range.

[6] *https://www.federalreserve.gov/newsevents/speech/files/quarles20180222a.pdf*

**Q.12.** Do you agree that procyclical regulation has contributed to past downturns in the economy?

If so, why not make bank regulations more stringent during a time when risk appetites in the banking sector are growing? [7]

**A.12.** Procyclical regulation certainly may have contributed to boom and bust cycles in the past. For instance, as house prices rose from 2000 to 2006, the maximum loan amount of residential mortgages that could be guaranteed by the Government-sponsored mortgage enterprises, Fannie Mae and Freddie Mac, increased from $252,700 to $417,000. In addition, research by Federal Reserve economists has shown that there is a procyclical pattern in the assignment of CAMELS ratings to banks by the Federal banking agencies. Our reforms to bank supervision after the financial crisis, such as the establishment of the Large Institution Supervisory Coordinating Committee and the collection of granular data on loan and securities portfolios, are designed to better identify and push back against such tendencies in the future.

Further, to guard against the tendency for lenders to become less cautious during good economic times, the Federal Reserve and the other Federal banking agencies have implemented robust structural capital and liquidity regulation regimes. In addition to requiring higher ratios of capital to total assets and to risk-weighted assets, U.S. capital rules have narrowed the types of instruments that qualified as tier 1 capital, in order to increase loss absorbency. Likewise, capital rules place caps on volatile assets, like mortgage servicing rights and deferred tax assets, above which their amounts must be deducted from capital. Further, the postcrisis capital rules increased the risk weights on certain assets, such as high-volatility commercial real estate, which can be highly procyclical.

Another feature of the U.S. implementation of the new capital and liquidity regimes is that the changes were phased in gradually over several years starting in 2013 in order to give banks time to adjust to the more-stringent regulations without unduly influencing credit availability while the expansion was still relatively weak. Thus, the minimum requirements have indeed been increasing each year, though most U.S. banks have been compliant with the fully phased-in requirements for some time. Most of the requirements will be fully phased in by January 1, 2019, providing a much stronger structural backstop than previously against any excesses that emerge in this and future financial cycles.

Finally, the annual stress tests (that is, CCAR) are based on macroeconomic scenarios that, in line with the Board's policy statement on scenario design, become more adverse as macroeconomic conditions improve. The increased severity of scenarios in the stress tests during buoyant times is designed to limit the procyclicality of regulation.

**Q.13.** Does the Fed have any plans to change the total consolidated asset threshold above which CCAR applies to bank holding companies?

[7] *https://www.wsj.com/articles/financial-deregulation-throws-fuel-on-already-hot-economy1524654001#comments__sector*

**A.13.** We are considering a number of potential changes to our regulatory framework in light of the passage of S. 2155, including raising the asset threshold for CCAR.

**Q.14.** Will this at all change if S. 2155 is enacted?

**A.14.** As noted, we are considering potential changes to our regulatory framework in light of the passage of S. 2155.

**Q.15.** How often does the Fed plan to require Dodd–Frank Act supervisory stress tests for banks with total consolidated assets between $100 billion and $250 billion if the change from "annual" to "periodic" is enacted pursuant to S. 2155?

**A.15.** Supervisory stress tests are one of our most valuable tools to ensure that large banking firms have sufficient capital to continue to lend and operate, even in a severely adverse macroeconomic scenario. Continuing to conduct the supervisory stress tests for institutions with more than $100 billion in assets will provide the Federal Reserve with valuable insight into the state of the American economy.

The dynamic nature of banks and the risks they face could render the results of stress tests stale within a short timeframe. Accordingly, we believe there are safety and soundness and financial stability benefits in conducting capital stress tests regularly. We plan to consider the appropriate timing of stress tests for banks with total consolidated assets between $100 billion and $250 billion as we consider other potential changes to our regulatory framework for the largest and most complex banks.

**Q.16.** How often does the Fed plan to require company-run stress tests for banks with total consolidated assets of more than $250 billion if the change from "semi-annual" to "periodic' is enacted pursuant to S. 2155?

**A.16.** Company-run stress tests have served as a useful complement to supervisory stress tests. They are another tool to assess whether banks sufficient capital to continue operations throughout times of economic and financial stress. In our experience, there are safety and soundness and financial stability benefits in conducting capital stress tests regularly.

As with supervisory stress tests, the dynamic nature of banks and the risks they face could render the results of stress tests stale within a short timeframe. Accordingly, as we implement S. 2155, we will consider the appropriate timing of company run stress tests for banks with more than $250 billion in consolidated assets. We would take into account the tradeoff between firms having less recent information about their risks and their resilience to economic stress, and the reduced burden of less frequent stress tests.

**Q.17.** In testimony before the House Financial Services Committee, you proposed subjecting CCAR stress scenarios to notice and comment, but noted that a formal process under the Administrative Procedures Act (APA) may be unworkable. How does the Fed contemplate putting CCAR scenarios out for comment without following a formal APA process? [8]

**A.17.** The Board regularly considers feedback on its stress testing process and scenario design, including through the public notice and comment process, and we're currently reviewing comments on proposed amendments to the policy statement on scenario design.

In addition, the Board publishes a summary of its stress testing methodologies each year. The methodology has included information about the supervisory scenarios, analytical framework, and information about the models employed in the stress test. The Board has sought comment on a policy statement on the overall approach to stress testing as well as a description of our model risk management and governance framework. The Federal Reserve is considering how best to publish the CCAR scenarios for public comment in a manner that is consistent with the rulemaking procedures in the Administrative Procedure Act and the timelines set forth in the Federal Reserve's capital plan and stress testing rules.

**Q.18.** What problem would putting CCAR scenarios out for comment solve?

**A.18.** The Federal Reserve remains committed to finding ways to continue to enhance transparency in a manner that appropriately balances the benefits and risks of releasing more information about supervisory models and scenarios used in CCAR.

Putting the CCAR scenarios out for comment would provide an opportunity for the Federal Reserve to learn about unintended consequences of the scenarios and ways of improving the overall stress testing process.

**Q.19.** In a speech, you said that the Fed should "revisit" the so-called advanced approaches threshold, which identifies certain large banks whose failure could inflict especially significant damage on the U.S. economy. [9] In the Senate Banking Committee hearing, you told the Committee that you would hold off on revising the advanced approaches threshold until Congress moves. [10]

How could enactment of S. 2155 affect the Fed's decision to revise the advanced approaches threshold?

Is the Fed considering raising the advanced approaches asset threshold to a level that is higher than $250 billion?

What changes to the foreign exposure threshold is the Fed considering?

**A.19.** The advanced approaches threshold was established on an interagency basis with the Federal Deposit Insurance Corporation (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

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[8] Response to a question from Congressman Barr. House Financial Services Committee Hearing. "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System". April 17, 2017.

[9] *https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm*

[10] Response to a question from Senator Tillis. Senate Banking, Housing, and Urban Affairs Committee Hearing. "Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System". April 19, 2017.

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 burden without compromising safety and soundness. We currently are considering ways to better align the advanced approaches threshold with these objectives, which could include changing both the total asset and foreign exposure thresholds, and would take S. 2155 into account. Any proposed changes to the threshold would be issued for public notice and comment after consultation with the FDIC and OCC.

**Q.20.** Is it your opinion that the domestic asset threshold above which foreign banking organizations (FBOs) must establish an Intermediate Holding Company (IHC) should increase from $50 billion?

If so, what is the appropriate threshold?

**A.20.** The Board monitors the impact of its regulations after implementation to assess whether the regulations continue to function as intended. In implementing enhanced prudential standards for foreign banking organizations (FBOs) with a large U.S. presence, the Board sought to ensure that FBOs hold capital and liquidity in the United States—and have a risk management infrastructure—commensurate with the risks in their U.S. operations. As a result of the intermediate holding company requirement with the current threshold, these firms have become less fragmented, hold capital and liquidity buffers in the United States that align with their U.S. footprint, and operate on more equal regulatory footing with their domestic counterparts and we should ensure that these results continue.

**Q.21.** The Fed in 2016 proposed a rule to limit some of banks' activities in commodities markets, with the rationale being that banks' owning, trading, and moving commodities might post a safety and soundness risk to individual banks or to the banking system.[11]

Does the Fed plan to finalize the 2016 commodities proposal?

If not, why not?

If so, when?

**A.21.** 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, aca-

[11] *https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160923a.htm*

demics, 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).

**Q.22.** S&P Global warned earlier this month that leveraged lending standards were deteriorating, and that underwriting standards in this $1 trillion market continue to get weaker and weaker.[12] Previously, guidance was in place to protect banking organizations from leveraged lending risks, but while at the OCC, Acting Comptroller Noreika rescinded it. You have also said that this guidance, because it was declared a rule by the GAO, is "not something that should be cited in supervisory action or taken into account by examiner."[13]

How do you plan to protect banks from systemic risk stemming from leveraged lending if you're telling supervisors to ignore this guidance?

Does the Fed have plans to replace the leveraged lending guidance with a proposed rule?

**A.22.** The Board has broad authority to supervise and regulate banking organizations to promote their safety and soundness. As part of that authority, Federal Reserve supervisors and examiners assess credit and other risks to the safe and sound operations of firms, including risks that may be posed by leveraged lending, and to direct the films to address such risks as appropriate. As part of assessing credit and other risks, Federal Reserve examiners routinely evaluated the underwriting of leveraged loans prior to the issuance of the most recent leveraged lending guidance, and they continue to do so. The guidance was issued to provide clarity regarding safety and soundness issues that may be present in making such loans. The guidance was not issued as a regulation that would be enforceable, and therefore the guidance itself should not be used as the basis for an enforcement or supervisory action. Rather, banking organizations should use it to better understand and manage the risks they are taking, and supervisors should assess a bank's standing under comprehensive principles of safety and soundness rather than pursuant to informal guidance.

Thus, ensuring the guidance is being used in the manner always intended is not telling examiners to "ignore" the guidance nor is it changing the safety and soundness standard that has always governed the evaluation of a bank's loan portfolio. To the contrary, we continue to expect that examiners will evaluate leveraged loans to determine whether they are posing undesirable amounts of risk in a bank's portfolio.

The Board, FDIC, and OCC are discussing whether it would be appropriate to again solicit public comment on the guidance with a view to improving the clarity and reducing any unnecessary burden.

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[12] *https://www.ft.com/content/680953c0-3e2a-11e8-b9f9-de94fa33a81e*

[13] *https://www.americanbanker.com/news/feds-quarles-to-seek-more-tailoring-of-large-bank-rules*

**Q.23.** Publicly you asserted that you believe the Volcker Rule has damaged financial markets.[14]

What evidence can you point to that indicates the Volcker Rule has had a causal impact on liquidity?

Is there a range of optimal liquidity?

**A.23.** Federal Reserve staff and a variety of other researchers have performed substantial analyses of the recent state of financial markets and liquidity in particular. While overall results of these studies are mixed, there are findings suggesting that the Volcker Rule has had an impact on liquidity. For example, one recent study finds evidence that cost of trading distressed corporate bonds (i.e., bonds recently downgraded to below investment-grade ratings) is higher since implementation of the Volcker Rule.[15] Furthermore, the paper finds that broker dealers subject to the Volcker Rule appear less willing to hold inventories of corporate bonds relative to other broker dealers. Taken together, these results indicate that the Volcker Rule has had an adverse impact on the liquidity of distressed corporate bonds. Other studies indicating a causal relationship between the Volcker Rule and reduced liquidity in some markets or for some instruments include Dick-Nielsen and Rossi (2016); Choi and Huh (2016); Bessembinder, Jacobsen, Maxwell, and Venkataraman (2016); and Adrian, Boyarchenko, and Shachar (2016).[16]

The Federal Reserve and the four other Volcker regulatory agencies (OCC, FDIC, the Securities and Exchange Commission and the Commodity Futures Trading Commission) recently issued a proposal that would simplify and streamline the rule to further tailor and reduce burden for firms. For example, the proposal would simplify compliance for a banking entity engaged in market-making, by establishing a presumption that trading activity within appropriately set risk limits is permissible market making. By reducing the current compliance burden associated with the rule and improving the availability of key exemptions like market-making, the simplified proposal, if finalized, should promote increased market liquidity.

**Q.24.** Without disclosure of any data regarding the metrics or banks' positions in covered funds, the public, Congress, and the markets can do little to confirm that covered banking entities are complying with the Volcker Rule.

Can the Federal Reserve and the other four regulators charged with enforcement of the Volcker Rule provide for greater transparency on the implementation and enforcement of the Volcker Rule's prohibitions on proprietary trading by banking institutions?

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[14] *https://www.marketwatch.com/story/volcker-rule-is-harmful-to-capital-markets-feds-top-regulator-says-2018-04-17*

[15] Bao, Jack, and O'Hara, Maureen, and Zhou, Xing (Alex), "The Volcker Rule and Market-Making in Times of Stress" (December 8, 2016). *Journal of Financial Economics* (JFE), Forthcoming; Fourth Annual Conference on Financial Market Regulation. Available at SSRN: *https://ssrn.corn/abstract=2836714* or *http://dx.doi.org/10.2139/ssrn.2836714.*

[16] Dick-Nielsen, J., and M. Rossi (2016), "The Cost of Immediacy for Corporate Bonds", Copenhagen Business School Working Paper; Choi, J., and Y. Huh (2016), "Customer Liquidity Provision: Implications for Corporate Bond Transaction Costs", Bessembinder, H., S. Jacobsen, W. Maxwell, and K. Venkataraman (2016), "Capital Commitment and Illiquidity in Corporate Bonds", Working Paper, Southern Methodist University; Adrian, T., N. Boyarchenko, and O. Shachar (2016), "Dealer Balance Sheets and Bond Liquidity Provision", Federal Reserve Bank of New York Staff Report, 803.

**A.24.** The Federal Reserve, along with the four other Volcker agencies, released rules implementing the statutory requirements of the Volcker rule in December 2013. These implementing rules included a number of provisions designed to ensure compliance by firms, including specific provisions related to the need for a compliance program, and the requirement that certain firms report metrics information. The agencies recently proposed significant revisions to the regulations implementing the Volcker Rule, including simplifying the compliance program standards applicable to most banking entities, and refining the requirements for firms with large trading operations to report trade-related metrics to the agencies.

The quantitative trading metrics are an important component of the agencies' supervisory work to monitor compliance with the Volcker Rule. The metrics are intended to aid the staffs of the Agencies in designing and conducting their examinations of firms' compliance programs and activities subject to the final rules. The metrics do not, on their own, indicate a violation of the Volcker Rule. The staffs of the agencies use these metrics as a tool to help identify instances that may warrant further investigation to determine whether a violation of the Volcker Rule has occurred or whether the activity is within a permitted exemption, such as market making or hedging.

The final rule does not include a provision for public disclosure of metrics data. Nonetheless, we appreciate the value of transparency and public accountability, while striking an appropriate balance between public disclosure and protecting confidential information. Toward that end, the Federal Reserve and the four other Volcker regulatory agencies proposed a simplified and streamlined version of the rule that would further tailor and reduce burden for firms. The proposal requested comment regarding the required compliance program and metrics, in addition to a general request for comment regarding whether certain types of quantitative metrics information should be made publicly available. We look forward to considering all comments received on the proposal.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM RANDAL K. QUARLES**

**Q.1.** I'd like to discuss how the Federal Reserve can encourage innovation in the financial system. On October 18, 2017, now-Federal Reserve Chairman Powell gave a speech entitled "Financial Innovation: A World in Transition", where he articulated the promise and the peril of new financial technologies:

> [T]he challenge is to embrace technology as a means of improving convenience and speed in the delivery of financial services, while also assuring the security and privacy necessary to sustain the public's trust . . . Rapidly changing technology is providing a historic opportunity to transform our daily lives, including the way we pay. FinTech firms and banks are embracing this change, as they strive to address consumer demands for more timely and convenient payments. A range of innovative products that seamlessly integrate with other services is now available at our fingertips. It is essential, however, that this innovation not

come at the cost of a safe and secure payment system that retains the confidence of its end users.

To this end, what is the Federal Reserve exploring or doing to encourage innovation in the financial system in a responsible but effective manner? This is particularly important given new innovations in from FinTech companies in digital currency, the payments systems, artificial intelligence, and more. For example, could the Federal Reserve increase the use of no action letters or—as the SEC has done—authorize limited pilot tests, to gather data on new technologies or regulatory innovations? Do any of these changes need statutory authorization?

**A.1.** The Federal Reserve's general approach to innovation is that first and foremost, we have a responsibility to ensure that the institutions subject to our supervision operate in a safe and sound manner, and that they comply with applicable statutes and regulations. Within that framework, we have a strong interest in encouraging socially beneficial innovations to flourish, while ensuring the risks that they may present are appropriately managed. We do not want to unnecessarily restrict innovations that can benefit consumers and small businesses through expanded access to financial services or greater efficiency, convenience, and reduced transaction costs.

The Federal Reserve System (System) has generally not relied on authorizing pilot projects for private entities or no-action letters, in part due to the necessarily shared nature of many of our regulatory authorities and mandates, although I think this is something we should give greater consideration to in the future. However, within our legal authorities, the System has sought to encourage responsible innovation in the financial sector on a number of fronts.

For example, with respect to payment innovation, in 2015 we issued a call to action for "Strategies for Improving the U.S. Payment System". In the following 2½ years, hundreds of organizations and individuals came together in the Federal Reserve's Faster and Secure Payments Task Forces, to collaborate on strategies for bringing about a payment system that features fast, secure, and efficient cross-border payments. System staff also focus on specific topic areas in the payment space to help facilitate innovation, such as mobile payments or distributed ledger technology. In so doing, System groups routinely engage innovators from the private sector and, in limited cases, have joined public–private consortia to deepen the potential for learning.

From an international perspective, the System engages international organizations that have collaborated on FinTech issues, such as: the Financial Stability Board (and its Financial Innovation Network); the Bank for International Settlements (and related work through its Committee on Payments and Market Infrastructures, Markets Committee, Committee on the Global Financial System, and Basel Committee on Banking Supervision's Task Force on Financial Technology); the International Organization of Securities Commissions; and the Financial Action Task Force.

From a domestic bank supervision perspective, the System has also convened an Interagency FinTech Discussion Forum to facilitate information sharing between Federal banking regulators on

FinTech consumer protection issues and supervisory outcomes. System staff have used the Federal Reserve's publications, such as our "Consumer Compliance Outlook" bulletin, to offer financial institutions and FinTech firms general guideposts for evaluating risks when considering the adoption of new technologies.

Most recently, the System has organized two Systemwide teams of experts tasked with monitoring FinTech and related emerging technology trends as they relate to our supervisory and payment system mandates, respectively. The new teams include representation from all of the Federal Reserve Banks and has leadership from Federal Reserve Board staff. These teams routinely meet with banks, large and small nonbank innovators who may partner with supervised institutions, and domestic and foreign regulators to gather data on new technologies and regulatory innovation.

These two new Systemwide teams share the goal of ensuring that FinTech-related information is disseminated across the System and informs relevant supervisory, policy, and outreach strategies.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR ROUNDS FROM RANDAL K. QUARLES

**Q.1.** In South Dakota, many farmers, ranchers, and manufacturers use the regulated derivatives markets to manage their risk of price variations. It is important that they are able to access these derivative markets in a cost effective manner. Many of the service providers for these farmers, ranchers, and manufacturers are banks.

When an end user accesses the cleared markets through a bank, it must provide margin, in the form of highly liquid assets, such as cash, that is kept in the name of the client for use in the event the client cannot meet its payment obligations.

Margin collected from the end user for the purpose of clearing their derivatives is thus exposure reducing for the banks, yet the leverage ratio still does not recognize it as such.

Do you plan to recognize initial margin as offsetting under the leverage ratio?

**A.1.** We understand that this offset is proposed for European banks.

**Q.2.** Won't a lack of offset potentially put U.S. banks at a disadvantage for the client clearing businesses?

**A.2.** Clearing improves safety for end users and has been recognized by policymakers as such.

**Q.3.** Wouldn't recognizing client margin under the leverage ratio incentive clearing?

**A.3.** Leverage capital requirements, such as the supplementary leverage ratio, require banking organizations to hold a minimum amount of capital against all on-balance sheet assets and certain off-balance sheet exposures. Many banks hold cash customer margin on their own balance sheet. Leverage capital requirements by design cap the debt-to-equity ratio at a bank without regard to the risk of individual exposures, and this practice of banks placing initial margin on their own balance sheets results in a capital charge against those assets.

Nevertheless, the purpose of, and protections around, the funds used as initial margin does indicate that we should look closely at adjusting the treatment of initial margin under the leverage ratio. In my view, this is less because those assets are not risky—the whole point of the leverage ratio is that it applies regardless of risk—but rather because in a number of important ways those assets are not really the bank's assets at all, notwithstanding being placed on the balance sheet. Finally, the Federal Reserve Board (Board) believes that it is important for leverage capital requirements generally to act as a backstop to risk-based capital requirements. To help ensure that this relationship is maintained, the Board recently issued a proposal to recalibrate its enhanced leverage capital requirements for the largest and most complex banking organizations. This should reduce the capital cost of client clearing, and thus the disincentives to these businesses, while we continue to address the issues identified above.

The exact way in which to adjust the leverage ratio to reflect this status is complex, however, and is one of a number of issues that our current capital regime raises for business involving centrally cleared products. To address potential unintended consequences of the leverage ratio on client clearing, in December 2017, the Basel Committee on Banking Supervision, of which the Board is a member, announced that it would monitor the impact of the leverage ratio's treatment of client cleared derivative transactions and review 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.

**Q.4.** As I wrote to you in my letter dated October 25, 2017, it is widely accepted that the Current Exposure Method (CEM) is risk insensitive and does not appropriately measure the economic exposure of a listed option contract.

Not surprisingly, the Treasury Report on Capital Markets recommended both a longer term move to the Standardized Approach for Counterparty Credit Risk (SA–CCR), as well as a "near-term" solution. At a hearing held by the House Financial Services Committee on April 17, 2018, you indicated that the Federal Reserve was working on the longer term solution of a rulemaking to replace CEM with SA–CCR.

Although I believe the Federal Reserve should be working on a near-term solution in addition to a rulemaking, can you provide a date by which the rulemaking will be proposed and when the move to SA–CCR will be effective?

**A.4.** The Board is working expeditiously to implement the standardized approach for measuring counterparty credit risk (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 and the Office of the Comptroller of the Currency as soon as feasible. SA–CCR has many benefits. SA–CCR, as compared to the current exposure method, would allow for increased recognition of netting and margin and results in a more risk-sensitive exposure amount for listed option contracts. We continue to believe that the best way to address these issues is through a proposal to incorporate SA–CCR into the Board's regulatory capital rule. The rulemaking 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.

**Q.5.** During your confirmation hearing last July I asked you whether you would support reexamining bank capital standards, particularly the Supplementary Leverage Ratio or SLR, so that we can simplify and properly calibrate these capital regulations.

Reading the proposals the Federal Reserve made on these issues recently, I want to thank you for taking those concerns to heart.

The changes the Fed made, particularly the clear message it sent that the leverage capital standards should not become a binding capital constraint, will help right-size capital regulations and allow banks to make loans and service their customers. As you continue to examine capital regulations, I want to raise two issues of concern.

First: The proposed capital framework introduces a new "stress leverage buffer" for the tier 1 leverage ratio. Like the SLR, the tier 1 leverage ratio is not tied to the relative risk of a firm's assets. If the stress leverage buffer becomes a binding constraint, then it could create incentives for banks to take on riskier assets and penalize banks with safe balance sheets.

Second: Currently, stress testing is not subject to public notice-and-comment rulemaking and changes year-to-year, making capital planning unpredictable for firms and the market.

I think we would agree that predictable capital standards and tailoring capital regulations to risk increases the stability of the financial system.

To that end, will you commit to reviewing the role of leverage in stress testing and to examine how stress testing transparency could make capital regulations more predictable?

**A.5.** The proposed Stress Capital Buffer would not include one poststress leverage measure (the poststress supplemental leverage ratio) but, as you note, would include another (the poststress tier 1 leverage ratio). This feature of the proposal raises a number of questions, and we are eager for public input on them. We are currently seeking comments on the proposal, and will carefully consider any comments we receive, including those on the stress leverage buffer.

With respect to the publication of the supervisory stress test models, stress tests are designed to ensure that banks are holding sufficient capital to not only survive a severe recession but also continue to lend to creditworthy borrowers during the stressful period. There is a degree of uncertainty in forward-looking capital planning. Both the financial system and the public benefit when firms' capital allocation decisions account for the possibility of severe but plausible macroeconomic outcomes.

The Federal Reserve is committed to further increasing the transparency of the stress testing process to improve the public's understanding of the supervisory stress test.

**Q.6.** 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 postcrisis capital reforms agreed to by the Federal Reserve in December 2017.

When does the Federal Reserve plan to adopt these technical changes to the capital rules for securities financing transactions?

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 process?

**A.6.** As you noted, changes to the capital treatment for securities financing transactions are included in the Basel Committee on Banking Supervision's document "Basel III: Finalizing Post-Crisis Reforms" that was issued in December 2017. This document contains a large number of capital changes that the Basel Committee has stated should be implemented by 2022. The Federal Reserve is aware of the importance of the changes for securities financing transactions for custodian banks, as well as for banking organizations that are active in repo and securities lending markets. The revised treatment of securities financing transactions in the December 2017 document is a significant part of the revised framework that would affect many institutions and their customers.

The Federal Reserve is reviewing the changes with the other banking agencies to determine the extent to which implementation in the United States would be appropriate. Any regulatory changes would occur through the notice and comment process under the Administrative Procedure Act. As part of this process, the Federal Reserve will consider how best to implement any revisions to the United States regulatory capital framework, including in the order in which changes are made and whether certain changes are most appropriate as a package with other changes or separately.

**Q.7.** South Dakota has long been a leader in the financial services industry. Given this time of innovation in our banking system, with many new types of lenders and "FinTech" reducing barriers to entry by expanding financial services products, emerging companies may need capital investments from entities that could be impacted by the Volcker rule if those entities were owned by or partnered with a bank.

Based on comments you made during your testimony before the House Financial Services Committee on April 17, I understand that you agree on the need to limit the potential unintended consequences of the Volcker Rule such that it doesn't limit private capital's ability help to expand financial services offerings to consumers.

As you work to refine and update the scope of the Volcker rule through your notice of proposed rulemaking and other regulatory efforts, will please you keep new technologies in mind and keep my colleagues and I on the Senate Banking Committee updated about your efforts?

**A.7.** With FinTech, as with any other emerging financial product or service, the Federal Reserve is closely watching developments and considering its implications for our supervisory approach. The Federal Reserve has established a multidisciplinary working group that is engaged in a 360-degree analysis of FinTech innovation. We are also engaging with various FinTech firms to learn more about the industry, its business models, its technologies, and the opportunities that it presents. Through these efforts, we continuously assess the impact of technological development on the Federal Reserve's responsibilities, including our role as a regulator.

The Federal Reserve and the four other Volcker regulatory agencies recently issued a Notice of Proposed Rulemaking that would simplify and streamline the rule to further tailor and reduce burdens for firms. Throughout that rulemaking process, we will certainly consider developments in FinTech as well as all other financial products and services.

**Q.8.** I appreciate you putting increased attention at the Federal Reserve on the heightened risk we are facing from potential cyberattacks. I am encouraged to hear that you are working with the private-sector to help provide solutions that will protect our financial sector as a whole. We must be diligent in protecting our financial institutions and the customers they serve, and I believe that the best solutions we can arrive at can be achieved through collaboration.

Can you discuss any steps the Fed has taken to strengthen the cyberinfrastructure of the financial sector?

**A.8.** The Federal Reserve is responsible for supervising a subset of the financial firms that operate the critical infrastructure. Our supervisory program is primarily designed to ensure these firms operate in a safe and sound manner. However, as a member of the Financial and Banking Information Infrastructure Committee (FBIIC), the Federal Reserve also evaluates the resiliency of these firms to cyber and other operational risks that could negatively impact the resiliency of the financial services sector. The Federal Reserve engages in interagency activities with other FBIIC members to improve the cyberresiliency of the financial services sector. The FBIIC holds periodic cyberincident response simulations, commonly referred to as exercises, with the FBIIC members, law enforcement, and industry in order to identify areas of concern and develop the appropriate means to address them. The exercises have led to the creation of a number of private-sector run and public-sector supplied initiatives to enhance the sector's cyberresiliency, including the development of incident management and information sharing protocols that encompass a large percentage of private sector entities. Additionally, through participation in these exercises, the Federal Reserve has improved its ability to respond, in coordination with other financial regulators, to potential operational disruption in the financial sector's critical infrastructure.

The Federal Reserve works with other financial regulators, through the Federal Financial Institutions Examination Council (FFIEC) and other interagency bodies, to strengthen the resilience of the financial sector and reduce the potential impact of a significant cyberincident. The Federal banking agencies have issued supervisory guidance to help the institutions under our supervision to become more resilient to cyberthreats. In addition, the member agencies of the FFIEC regularly update the FFIEC Information Technology Examination Handbook, which includes appropriate practices on cyberrisk management and operational resiliency that can be tailored to an individual institution's risk profile.

Due to the high degree of interconnection between the U.S. financial system and global financial system, the Federal Reserve has been an active participant and leader in international forums addressing the cyberresiliency of the global financial sector. Most recently, the Federal Reserve played a leadership role in the Committee on Payments and Market Infrastructures (CPMI) development of a strategy for reducing the risk of wholesale payments fraud related to endpoint security. The CPMI strategy report, "Reducing the Risk of Wholesale Payments Fraud Related to Endpoint Security", outlines seven elements that are designed to work holistically to address all areas relevant to preventing, detecting, responding to, and communicating about, fraud. The Federal Reserve made significant contributions to the "Stocktake of Publicly Released Cybersecurity Regulations, Guidance and Supervisory Practices" published by Financial Stability Board (FSB) and is leading the FSB's efforts to develop a common cyberlexicon. The Federal Reserve also has a leadership role in the efforts underway at the Basel Committee on Banking Supervision to improve the cyberresiliency at internationally active banks.

At the G7, the Federal Reserve engaged in an initiative to identify a core set of cyberresilience measures expected across the global financial sector, which led to the publication of the G7 "Fundamental Elements of Cybersecurity for the Financial Sector". The publication identifies key elements as the building blocks upon which an entity can design and implement its cybersecurity strategy and operating framework. The Federal Reserve also played a leadership role in the development of cyberresilience guidance for financial market infrastructures (FMIs) by CPMI and the International Organization of Securities Commissions (IOSCO). The CPMI–IOSCO "Guidance on Cyber Resilience for FMIs" outlines an expectation that FMIs must be prepared for the eventuality of successful attacks and make preparations to respond and recover critical services safely and promptly.

With regard to the payments infrastructure, the Federal Reserve is continuing its efforts to identify and provide information related to fraud risks and advance the safety, security, and resiliency of the payment system. The Federal Reserve, in partnership with Boston Consulting Group, is conducting a study designed to inform industry security-improvement efforts. The study analyzes payment fraud and payment system security vulnerabilities. In addition, the Reserve Banks, as operators of critical financial services such as Fed wire, continue to advance initiatives aimed at enhancing the resiliency of the payments system. For example, the Reserve Banks have implemented risk-mitigating processes, controls, and technology highly aligned with the aforementioned CPMI strategy to reduce payments fraud emanating from weak security at the endpoint (see *https://www.newyorkfed.org/newsevents/speeches/2018/dzi180418*).

**Q.9.** Are there any areas where Congress can be helpful on this front?

**A.9.** The Federal Reserve appreciates the heightened focus on this issue by Congress and recognizes our strong, mutual interest in the cyberresilience of the financial sector. The sector's resilience and cyberincident preparedness is evolving rapidly as more firms join information sharing organizations and participate in the sector exercise program, allowing them to develop and test incident protocols and improve their processes and practices. Through the continued work programs of interagency groups like the FFIEC and FBIIC, as well as our partnership with the private sector through the Financial Services Sector Coordinating Council and the Financial Sector Information and Analysis Center, the Federal Reserve continues to advocate for and drive initiatives that strengthen the financial sector's critical infrastructure. Since the financial sector has critical dependencies with the energy and telecommunication sectors, it would be helpful for Congress to support legislative and other effort to strengthen the resiliency of these sectors. It would also be helpful for Congress to support collaborative efforts between these critical sectors and the intelligence community that are intended to coordinate our resiliency to cyberthreats posed by foreign and domestic perpetrators. We would be pleased to discuss with you further details of the collaboration that is currently underway and these suggestions.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM RANDAL K. QUARLES

**Q.1.** *Countercyclical Capital Buffer.* The IMF Global Financial Stability Report said that short-term financial stability risks have been increasing, including vulnerabilities within banks, funding risks, concerns about a trade war, and the risks of a too-sharp monetary policy tightening. At the same time, we're seeing robust global growth and strong corporate earnings, and credit continues to be widely available. One of the lessons of the crisis is just how procyclical credit provision can be. As important as stress testing and risk-based capital requirements are, they can underestimate weaknesses in underwriting and other cyclical behaviors that are revealed during bad economic times.

Given where we are in the economic cycle, and the significant run up in asset prices that we've seen in recent years, under what circumstances would you support an increase in the countercyclical capital buffer from zero?

**A.1.** The countercyclical capital buffer (CCyB) is an important element of the system of capital regulation that applies to U.S. bank holding companies with more than $250 billion in total assets or more than $10 billion in foreign assets, as well as intermediate holding companies of foreign banking organizations with more than $50 billion in total assets.

In 2016, the Federal Reserve issued a policy statement on the CCyB, in which we spelled out a comprehensive framework for setting its level. The framework incorporates the Federal Reserve Board's (Board) judgment of not only asset valuations and risk appetite, but also the level of three other key financial vulnerabilities—financial leverage, nonfinancial leverage, and maturity and liquidity transformation—and how all five of those vulnerabilities interact. In this assessment, the Board considers a wide array of economic and financial indicators, as well as a number of statistical models developed by staff. Several of those models are cited in the policy statement. As indicated in the policy statement, the CCyB is intended to address elevated risks from activity that is not well-supported by underlying economic fundamentals. As such, the Board expects the CCyB to be nonzero if overall vulnerabilities were judged to have risen to a level that was "meaningfully above normal."

Within that framework, the runup in asset prices that we have seen in recent years is certainly a key consideration, but we view that runup in the context of the levels of other vulnerabilities, importantly including leverage and maturity transformation in the financial system. Bank capital ratios and liquidity buffers are now substantially higher than they were a decade ago. The stress tests ensure that the largest banks can continue to support economic activity even in the face of a severe recession—importantly, one characterized by extreme declines in asset prices. Outside the banking system, leverage of other financial firms does not appear to have risen to elevated levels, and the risks associated with maturity transformation by money-market mutual funds is much reduced from the levels seen a decade ago. Thus, we believe that overall vulnerabilities in the financial system remain moderate and near their normal range.

**Q.2.** The key criteria for whether to raise the countercyclical capital buffer is an assessment that financial risks are in the upper third of their historical distribution.

What is your assessment of current financial risks versus their historical distribution?

**A.2.** As emphasized in our policy statement, a nonzero countercyclical capital buffer is appropriate when risks are judged to be meaningfully above normal. As you noted in your previous question, asset valuations across a number of important markets are elevated, and if that were the only criterion for activation of the CCyB, it would be appropriate to consider increasing the CCyB now. However, we also believe that the financial system is quite resilient, with the institutions at the core of the system well-capitalized, run risk well below earlier levels, and central clearing of derivatives limiting the amount of contagion from the distress of an institution. Therefore, our comprehensive assessment is that overall vulnerabilities are moderate, or about at the midpoint of their historical range, and therefore do not meet the criteria of being "meaningfully above normal" set in the policy statement. However, we are carefully assessing developments. If asset valuation pressures were to continue to build, especially if they were accompanied by increased leverage or increased maturity and liquidity transformation, activation of the CCyB could promote additional resilience among the largest U.S. banks.

**Q.3.** *Recent eSLR and Capital Rule Proposals.* The Board recently proposed rules on the calibration of the eSLR and the introduction of a stress capital buffer. Each proposal includes an analysis of the expected changes in required tier 1 capital if the proposal were to be adopted as proposed. The eSLR proposal assesses the effect of the proposal if it were adopted, assuming no changes to the CCAR process; and the stress capital buffer proposal assess the effect of the proposal if it were adopted, assuming no changes to the current eSLR. Neither proposed rule, however, analyzes the cumulative effect on required tier 1 capital at the holding company level were both proposals adopted as proposed.

Before proposing the two rules, did the Board analyzed the effect on tier 1 capital if both proposals were adopted as proposed?

What would the cumulative effect on required tier 1 capital at the holding company level be for G–SIBs if both proposals were adopted as proposed?

**A.3.** While the discussion in each of the stress capital buffer proposal and the enhanced supplementary leverage ratio (eSLR) proposal reflects the estimated impact of those individual proposals relative to current requirements, the Board also considered the potential combined impact in developing the proposals. Factoring the relatively immaterial estimated reduction in required tier 1 capital across global systemically important banks (G–SIBs) under the eSLR proposal (approximately $400 million) into the estimated impact of the stress capital buffer proposal across G–SIBs does not meaningfully affect the estimates.

**Q.4.** *Community Reinvestment Act.* You stated before the House Financial Services Committee that the Community Reinvestment Act (CRA) is "a little formulaic and ossified" and you advocated for giving banks greater flexibility in helping their communities. The Treasury Department recently issued a formal memorandum to bank regulators suggesting changes to the CRA and its implementation. I agree that the CRA needs to be modernized—I think there's widespread agreement that that's the case since the regulations have not been meaningfully updated since 1995. But I am concerned that some of the recommendations in the Treasury memo, depending on their implementation, could weaken one of the stronger tools we have to ensure access to credit for the underserved and investment in communities that have been left behind while others prosper.

One change that seems overdue, and is recommended in the Treasury report, is the need to recognize that, in this digital age, physical branches do not accurately reflect a bank's business footprint.

Do you support reflecting this shift to the age of online banking by updating existing assessment areas?

**A.4.** The Federal Reserve is deeply committed to the Community Reinvestment Act's (CRA) goal of encouraging banks to meet their affirmative obligation to serve their entire community, and in particular, the credit needs of low- and moderate-income communities. When banks are inclusive in their lending, it helps low- and moderate-income communities to thrive by providing opportunities for community members to buy and improve their homes and to start and expand small businesses.

I agree that it is time to review changes to the definition of "assessment area," which is the area in which a bank's CRA performance is evaluated. The banking environment has changed since CRA was enacted and the current CRA regulations were 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 through delivery systems other than branches. Additional thought and analysis on this matter will be needed to determine how best to define such assessment areas and how to evaluate performance in those areas.

**Q.5.** One Treasury recommendation that concerns me is deemphasizing a bank's branch network in its CRA assessment. While technology has certainly helped expand access to credit through alternative delivery systems, studies continue to show that physical branches still provide a significant boost to access to credit to their surrounding community.

Will you support keeping a bank's footprint as a critical factor in a bank's service test in its CRA assessment?

**A.5.** Yes, we are confident that there are ways to expand the area where we evaluate a bank's CRA performance without losing the regulation's consideration of the role banks play in meeting local credit needs and providing services through their branch networks. Treasury's recommendation that the Federal banking agencies revisit the regulations to allow CRA consideration for a bank's activities in its assessment area, as currently delineated around branches and deposit-taking automated teller machines, as well as in low- and moderate-income areas outside that branch footprint, is a reasonable place to start our interagency discussions. Further, CRA provides an incentive to bankers and community stakeholders to work together to identify needs, create investment opportunities, and improve local communities, particularly low- and moderate-income or underserved rural areas.

**Q.6.** *Anti–Money Laundering (AML).* One criticism I've heard about anti–money laundering enforcement is that the banking regulators view AML-compliance as a check-the-box exercise that encourages banks to defensively file SARs that may not truly reflect suspicious activity instead of spending resources to catch bad guys.

Do you believe there is a check-the-box mentality among bank examiners regarding AML compliance? If so, do you believe it is a problem, and if so what do you plan to do to address it?

**A.6.** Under current law and regulations implementing the Bank Secrecy Act (BSA), insured depository institutions and other banking organizations must maintain a system for identifying and reporting to the Government transactions involving known or suspected illegal activities that generally exceed certain dollar thresholds (known as a "Suspicious Activity Report" or "SAR"). The Federal Reserve and the other Federal banking agencies review an institution's compliance with this and other anti–money laundering (AML) requirements through the examination process.

The interagency examination manual that was developed jointly among the Federal Reserve and the other members of the Federal Financial Institutions Examination Council (FFIEC) in consultation with Treasury's Financial Crimes Enforcement Network (FinCEN) describes the regulatory expectations for banking industry compliance with the suspicious activity reporting requirements and explains how examinations will be performed. The examination manual recognizes that the decision to file a SAR under the reporting requirement is an inherently subjective judgment. The manual directs examiners to focus on whether the institution has an effective SAR decision-making process, not individual SAR decisions. The Federal Reserve, along with the other Federal banking agencies, provides ongoing training opportunities to its examiners regarding BSA topics and various aspects of the BSA examination process.

The Federal Reserve recognizes that existing regulatory requirements governing the filing of SARs have prompted criticism due to the concern that they encourage institutions to report transactions that are unlikely to identify unlawful conduct, so-called defensive SARs. Recently, the Federal Reserve and the other Federal banking agencies completed a review consistent with the statutory mandate under the Economic Growth and Regulatory Paperwork Reduction Act. As part of this review, several commenters suggested regulatory changes to the SAR and other reporting requirements, which were referred to FinCEN. FinCEN is the delegated administrator of the BSA, and any changes to the SAR or other reporting requirements would require a change in FinCEN's regulations.

**Q.7.** Some have suggested that having FinCEN retake responsibility for some AML compliance reviews is a good way to realign the compliance incentives—the agency trying to catch the bad guys would be the same agency that's inspecting a bank's AML program.

What do you think about that approach?

**A.7.** The Federal Reserve and the other Federal banking agencies are required by statute to review the BSA/AML compliance program of the banks we supervise at each examination.[1] Thus, unless this requirement is changed by Congress, banking agencies must continue to examine for BSA compliance at banking institutions.

There are important benefits that arise from these statutorily mandated reviews by the banking agencies. A review of an institution's compliance with the BSA is integrally related to our assessment of an institution's safety and soundness. The Federal Reserve expects the institutions we supervise to identify, measure, monitor, and control the risks of an institution's activities. The inability to properly manage legal and compliance risk, for example, can compromise a bank's safety-and-soundness by reducing the confidence of its customers and counterparties and result in loss of capital, lower earnings, and weakened financial condition.

Currently, the Federal Reserve and the other Federal banking agencies routinely coordinate with FinCEN on a range of BSA matters. The FFIEC BSA/AML Working Group, which includes representatives of the banking agencies and FinCEN, meets regularly

[1] See Anti-Drug Abuse Act of 1986, H.R. 5484, 99th Cong. §1359 (1986).

to share information among its members about various BSA/AML initiatives. This forum can encourage the sharing of information developed by FinCEN related to specific types of money laundering typologies and other relevant data that would help prioritize the ongoing examination efforts by the banking agencies.

**Q.8.** It seems another way we can build a more effective compliance regime is to facilitate more information sharing among banks and between the Government and banks.

What role do you think the Federal Reserve should have in facilitating this increased information flow?

**A.8.** Effective implementation of the BSA requires coordination among the different Government agencies and regulated institutions. The Federal Reserve takes seriously its obligation to coordinate with FinCEN and the Federal banking agencies to ensure that banking organizations operate in a safe and sound manner and in compliance with the law. In particular, we participate in the Bank Secrecy Act Advisory Group, a public–private partnership established by Congress for the purpose of soliciting advice on the administration of the BSA, which facilitates sharing of information on regulatory policies and initiatives, industry developments, and emerging money-laundering threats.

As you know, the Federal banking agencies do not have the authority to conduct criminal investigations or to prosecute criminal cases. Rather, the Federal banking agencies ensure that suspected criminal activity is referred to the appropriate criminal authorities for prosecution and the BSA rules are intended to achieve this purpose. Accordingly, the Federal Reserve relies on the Department of Justice and other law enforcement agencies to communicate whether the reporting obligations of banks are furthering law enforcement's objectives. Indeed, communication from law enforcement to regulators and the banking industry is vitally important.

Finally, in terms of information sharing between financial institutions, the primary means of communication related to BSA is governed by Section 314(b) of the USA PATRIOT Act, which encourages financial institutions and associations of financial institutions located in the United States to share information in order to identify and report activities that may involve terrorist activity or money laundering. FinCEN is the agency with the responsibility and authority to facilitate information sharing under the regulation. As part of the ongoing initiatives with FinCEN and the other Federal banking agencies described above, the Federal Reserve has encouraged FinCEN to further consider ways to facilitate financial institutions' ability to share information.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM RANDAL K. QUARLES

**Q.1.** During our exchange, you referenced an analysis that the Fed conducted about how much the less capital each G–SIB would be required to hold under the new Enhanced Supplementary Leverage Ratio rule recently proposed by the Fed. You noted that the Fed's calculations differed from the FDIC's analysis, which I cited.

Could you please provide the Fed's analysis that you referenced and an explanation of the divergence between the Fed and the FDIC?

**A.1.** The Federal Reserve Board (Board) estimated that, taking into account the capital constraints imposed by the supervisory stress tests and the Board's regulatory capital rules, the proposed changes to the enhanced supplementary leverage ratio (eSLR) standards would reduce the amount of tier 1 capital required across the U.S. global systemically important bank holding companies (G–SIBs) by approximately $400 million. That figure is approximately 0.04 percent of the amount of tier 1 capital held by the G–SIBs as of the third quarter of 2017. The Federal Deposit Insurance Corporation's analysis of April 11, 2018, cites the Board's and the Office of the Comptroller of the Currency's estimate that the proposal would reduce the amount of tier 1 capital required across the lead bank subsidiaries of the G–SIBs by approximately $121 billion. The $121 billion figure represents the potential reduction in tier 1 capital required across the lead insured depository institution subsidiaries of the G–SIBs; however, these firms are wholly owned by their parent holding companies. On a consolidated basis, G–SIBs 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 investors. Thus, due to these limitations at the holding company level, the G–SIBs would be required to retain nearly all of the $121 billion amount and would not be able to distribute it to third parties.

**Q.2.** During the hearing, you told me that in your view, Section 402 of S. 2155, which recently passed the Senate and allows banks "predominantly engaged in custody, safekeeping, and asset servicing activities" to have less capital, could not be interpreted to include JPMorgan Chase and Citigroup.

Would that analysis hold if those banks created intermediate holding companies to house their custody services?

**A.2.** Because an intermediate holding company would be disregarded in financial consolidation, the creation of an intermediate holding company to house custody services would not affect the analysis of whether the consolidated organization was "predominantly engaged in custody, safekeeping, and asset servicing activities."

**Q.3.** Will the Fed alter the Enhanced Supplementary Leverage Ratio proposal if S. 2155 passes?

In what way?

**A.3.** The proposal is based on the current regulatory definitions of tier 1 capital (the numerator of the ratio) and total leverage exposure (the denominator of the ratio), which include central bank deposits in the denominator. As noted in the preamble to the proposed rule, significant changes to either of the components of the supplementary leverage ratio would likely necessitate reconsideration of the proposal so that the eSLR standards continue to require an appropriate level of capital. We are considering potential ways that the regulation could be adjusted to account for the changes to the eSLR due to the enactment of S. 2155 into law.

**Q.4.** Why is a reduction in capital requirements necessary at this point in the business cycle?

**A.4.** The proposal would not represent a material reduction in the amount of capital held by firms subject to the eSLR. 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 proposal would reduce the amount of tier 1 capital required across the G–SIBs by approximately $400 million. That figure is approximately 0.04 percent of the amount of tier 1 capital held by the G–SIBs as of the third quarter of 2017.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM RANDAL K. QUARLES**

**Q.1.** In response to my question about whether a Government backstop is essential to retaining the 30-year fixed-rate mortgage, you responded, "probably not" but added that you would need more time to analyze the question.

Can you elaborate on your views regarding the connection between a Government guarantee and the availability of the 30-year fixed-rate mortgage in all credit cycles?

Do you believe that Government guarantees promote or detract from housing market stability?

During the 2000s, as private-label securitization grew to dominate the U.S. housing finance system, we saw very clearly the tendency of nonguaranteed mortgage financing to shun the 30-year fixed-rate mortgage. Indeed, during the period from 2001–2008, private-label securitization displayed a remarkable bias toward adjustable-rate products. Do you believe that nonguaranteed financing and its tendency towards adjustable rates would provide affordable access to credit for American families? In a housing downturn, do you believe that nonguaranteed mortgage financing could provide consumers with similar access to affordable, long-term housing credit?

**A.1.** The 30-year fixed-rate mortgage is a very popular product in this country and for decades has been associated with a credit guarantee. Without a guarantee, it is still likely to be available throughout the credit cycle. However, the cost and availability of the product could vary significantly.

The jumbo-conforming spread, which measures the price difference between private mortgage financing and Government-guaranteed mortgage financing, has varied greatly over time and has tended to increase sharply during times of financial stress. For instance, the jumbo-conforming spread averaged about 10 basis points prior to the financial crisis (2005 through mid-2007), 30–40 basis points during the early stages of the crisis (mid-2007 through mid-2008), and over 75 basis points during the depths of the crisis (mid-2008 through mid-2009). The jumbo-conforming spread has since declined to about 10–15 basis points during the 2016–2017 time period.

A 30-year horizon for a financial asset is a long horizon, particularly an asset with credit risk. Households with such mortgages are likely to encounter periods of financial turmoil over this horizon, sometimes with little equity in their home. In addition, the 30-year fixed-rate mortgage is usually prepayable and thus a household can refinance and withdraw any home equity it has accumulated from the house. As a result of these two factors, managing the credit risk for this mortgage product can be difficult for certain mortgage investors.

Secondary market traders of financial assets usually manage interest-rate risk and avoid assets with credit risks. Thus, the 30-year fixed-rate mortgage can be difficult to trade without a substantial financial premium for traders if it has credit risk. A Government guarantee for the credit risk allows the 30-year fixed-rate mortgage to be more easily used in secondary market trading.

Ultimately, the question of the Government's role in housing finance is an issue for Congress. If Congress does choose to provide a guarantee for mortgages, I would urge that the guarantee be explicit and transparent, done in a manner that protects taxpayers, and apply to securities not institutions.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHATZ FROM RANDAL K. QUARLES

**Q.1.** During the March meeting of the Federal Open Market Committee, the Fed discussed the expected impacts of the recent tax cuts: according to the minutes, "participants generally regarded the magnitude and timing of the economic effects of the fiscal policy changes as uncertain, partly because there have been few historical examples of expansionary fiscal policy being implemented when the economy was operating at a high level of resource utilization."

There are few historical examples of expansionary fiscal policy being implemented when the economy is so strong because it is bad economics. Mainstream economists agree that it is harmful for an economy to enact fiscal stimulus when the economy is operating at or near maximum capacity because it creates strong inflationary pressure.

Do you agree?

Is it good economy policy to enact massive fiscal stimulus when the economy is operating at a high level of resource utilization?

**A.1.** As noted in the March Minutes, because there have been few historical examples of expansionary fiscal policy being implemented when the economy was operating at a high level of resource utilization, the magnitude and timing of the economic effects of recent changes in fiscal policy are uncertain. While the Congress and the President are solely responsible for determining the timing and contours of fiscal policy changes, I will note that Federal fiscal policy is not currently on a sustainable trajectory. Over the coming decades, a large and growing Federal Government debt, relative to the size of the economy, would have negative effects on the economy. In particular, a rising Federal debt burden would reduce national saving, all else equal, and put upward pressure on longer-term rates.

**Q.2.** Bank holding companies under the Fed's supervision have been fined more than $174 billion since the financial crisis for deceptive practices, anti–money laundering violations, and glaring consumer abuses. The egregious practices at Wells Fargo led the

Fed to cap the bank's growth and resulted in hundreds of millions in fines, with more to come.

What these fines demonstrate is that our largest financial institutions are either intentionally and repeatedly breaking the law, or they are too large to be properly managed.

Which do you think it is?

**A.2.** Since 2008, the Federal Reserve has assessed civil money penalties totaling approximately $5.7 billion against 35 institutions of varying asset sizes. Most commonly, these fines were focused on an institution's unsafe or unsound practices that resulted from breakdowns in the institution's oversight, controls, and risk management related to particular regulatory frameworks, for example the Bank Secrecy Act, U.S. sanctions requirements, the application of antitrust law to individual financial markets, such as foreign exchange trading, and servicing and foreclosing on residential mortgage loans.

The enforcement actions taken by the Federal Reserve invariably supplemented the monetary penalty by also requiring the institutions to develop and implement acceptable plans, policies, and programs to remedy the managerial, operational, or compliance deficiencies that were the basis for the actions. Before the remedial requirements of such an enforcement action can be terminated, the Federal Reserve must be assured that the institution has implemented a sustainable, long-term solution to the problem that led to the enforcement action. To that end, the relevant Federal Reserve Bank reviews the plans and programs and the progress reports developed in response to the enforcement action, and provides feedback to senior management. The Federal Reserve also conducts a broader annual supervisory assessment of the institution that includes a review of the institution's compliance with any outstanding enforcement action to ensure the institution addresses the underlying issues.

**Q.3.** Why should we think about lightening prudential requirements on institutions that have such serious legal compliance problems?

**A.3.** The institutions subject to enforcement actions described above were required as part of the actions to fully correct these defective programs. The improvements in regulatory effectiveness, efficiency, and transparency currently being considered by the Federal Reserve should not in any way detract from the obligation of all regulated institutions to maintain comprehensive and effective compliance programs.

**Q.4.** Does the fact that banks have paid record fines at a time when they have made record profits mean that banks have just baked the cost of fines into their business plan?

Are these fines accomplishing anything?

**A.4.** It is the experience of the Federal Reserve that, enforcement actions that impose substantial penalties also tend to serve a deterrent purpose. In addition, effective accountability for institutional misconduct can also be achieved by taking appropriate enforcement actions against culpable individuals who are responsible for the misconduct. Pursuing such actions against culpable insiders, where supplied by the record, is an important priority for the Federal Reserve. In addition, in cases of pervasive and persistent institutional misconduct, such as the Board's recent enforcement action against Wells Fargo & Company, the Federal Reserve did not impose a fine but restricted the institution's asset growth until the firm accomplishes effective remediation.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM RANDAL K. QUARLES**

**Q.1.** Following up on my questions to you, I am very concerned that cost-benefit analysis fails to capture the human and economic cost of massive financial system failure. For example, in 2009, when I was Attorney General, Nevada had 165,983 people unemployed. That year, in a State of 3 million people, we had 28,223 personal bankruptcies, 366,606 mortgage delinquencies and 421,445 credit card delinquencies. In addition, 121,000 Nevada children's lives and educations were disrupted by the foreclosure crisis. We had more than 219,000 foreclosures between 2007 and 2016.

Do you believe that cost-benefit analysis disproportionately benefits industry, since the costs of compliance are easier to calculate, while the benefits of a sound financial system are more difficult to measure?

You noted that the Federal Reserve underestimated the human costs of a potential financial crisis prior to 2008? Please describe some of the ways that Fed underestimated the costs of the Crisis and how you would have assessed them knowing what you know now?

How will the Federal Reserve's new "policy effectiveness and assessment" unit consider the benefits of avoiding a future financial crises? How many people work in the unit? Who are they and what is their background and expertise?

If they were employed at the Federal Reserve prior to the Financial Crisis, what was their role?

If they published anything on the stability or risks in the financial sector between 2004–2008, please provide those documents.

**A.1.** Cost-benefit analysis is intended to provide an objective assessment of the net costs and benefits to society from a pending regulation. This takes into account the myriad impacts of a regulation, including those on consumers, businesses and financial intermediaries. The fact that some of these impacts, such as the cost of compliance, are easier to quantify does not imply that the cost-benefit analysis will favor any particular group.

As I noted in my testimony, the Federal Reserve underestimated the likelihood of a crisis prior to the financial crisis. Indeed, it is in response to these shortcomings that the Federal Reserve has worked with other agencies to significantly raise prudential standards, such as capital and liquidity of financial institutions, thus lowering the probability of another crisis.

The Policy Effectiveness and Assessment section will follow established methods and consider the benefit of avoiding a financial crisis by considering the impact of increased safety and soundness on the reduced probability of a crisis, and the economic losses given a crisis.

Currently, the section has a manager in place (an economist by training) and the team consists of a small number of Ph.D. economists and support staff. As with all Federal Reserve economists, their professional profile and publications are available on our public website at *https://www.federalreserve.gov/econres/theeconomists.htm*. In addition, we recently hired additional Ph.D. economists, and these individuals will be joining the team in the coming months.

**Q.2.** Under S. 2155, the Federal Reserve would have the discretion to apply financial stability rules to banks with between $100 billion and $250 billion in assets. Such discretion especially requiring tailored rules to each institutions—opens up banking regulators to lawsuits. For example, SIFMA sued the CFTC over the definition of "as appropriate" when it came to setting position limits.

Are you concerned that giving the Federal Reserve discretionary authority to implement financial stability rules for banks—rather than relying on a bright line threshold from Congress—will open the Fed to lawsuits by banks that are selected for additional oversight?

**A.2.** The Federal Reserve Board (Board) has developed experience in tailoring its prudential regulations and supervisory programs based on factors such as the size, systemic footprint, and the risk profile of individual institutions.

The Board remains committed to transparency in its rulemaking process and believes it is important to provide the public with an adequate justification for its rules. The public would have the opportunity to comment on any proposed rule, which would provide the Federal Reserve with important information, focus, and feedback, including whether the proposal is appropriately tailored to its intended purpose.

**Q.3.** Former Deputy Treasury Secretary—and Fed Governor—Sarah Bloom Raskin called this "reach down" authority afforded to the Fed, "legislative fool's gold." She knows the Fed will wait until it's too late to regulate banks in the $100 to $250 billion band.

What do you think of her comments?

**A.3.** In the absence of Enhanced Prudential Standards for institutions under $250 billion, the Federal Reserve maintains broad supervisory and regulatory tools to ensure firms continue to adhere to prudential safety and soundness standards. These tools include a rigorous supervisory program with standards for internal stress testing of capital and liquidity as well as risk management frameworks. A firm with $100 billion to $250 billion in assets is still expected to ensure that the consolidated organization and its core business lines can survive under a broad range of internal and external stresses and that it maintains sufficient capital and liquidity, as well as operational resilience, through effective corporate governance and risk management. Moreover, under the Economic Growth, Regulatory Relief, and Consumer Protection Act, the Federal Reserve has discretion to determine which enhanced standards to apply to an institution between $100 billion and $250 billion. I expect that the Board will seek public comment on the application of those standards to this group of institutions.

**Q.4.** As of 2016, the financial sector accounted for 20 percent of the GDP and 25 percent of corporate profits. Do you believe that the financial sector's outsized grasp on profits has a chokehold on the overall economy?

**A.4.** Our responsibilities with regard to the financial sector are to ensure that the financial entities we supervise operate in a safe and sound manner, and to promote financial stability. We take these responsibilities very seriously. Currently, we see financial conditions as generally supportive of continued economic expansion, consistent with the attainment of maximum employment and price stability.

**Q.5.** As your team addresses and analyzes the cost-benefit analysis of any proposed rule, how will they calculate the cost of having a financial sector with outsized and increasing power, influence, and wealth?

**A.5.** As part of the rulemaking process, the Board considers the economic impact, including costs and benefits, of its proposed and final rules. As part of this evaluation, staff will take into account the benefits accruing from improvements in the safety and soundness of Board-regulated institutions and U.S. financial stability, the costs imposed on the regulated entities, as well as potential effects on the overall economy. In addition, the Board provides an analysis of the costs to small depository organizations of its rulemaking consistent with the Regulatory Flexibility Act [1] and computes the anticipated cost of paperwork consistent with the Paperwork Reduction Act. [2] In adopting the final rule, the Board seeks to adopt a regulatory option that faithfully reflects the statutory provisions and the intent of Congress, while minimizing regulatory burden.

**Q.6.** I represent Nevada, which is within the San Francisco Federal Reserve District. We are one of the most diverse districts in the Nation—with many Latino and Asian Pacific American families. We value that diversity because it leads to innovation, economic growth, and stronger connections with other nations in our globally connected world.

A recent report by *Fed Up*, "Working People Still Need a Voice at the Fed: 2018 Diversity Analysis of Federal Reserve Bank Directors", found that there is inadequate diversity at the Federal Reserve. It specifically cited the San Francisco Federal Reserve as one of system's least diverse regional banks. The report states, "Despite covering some of the most demographically diverse counties in the United States, 100 percent of the San Francisco Fed's Board of Directors come from the banking and financial sector. The directors are 78 percent white and 78 percent male."

As the Vice Chair of Supervision, what steps have you taken to promote diversity with the Fed's supervisory, regulatory and enforcement staff?

**A.6.** The Board's action to approve the Diversity and Inclusion Strategic Plan 2016–2019 reflects the Board's strategic initiative on diversity, inclusion, and equality. The implementation of the plan

[1] 5 U.S.C. 601.
[2] 12 U.S.C. 3506.

involves the active involvement of 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 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 addressing the division of Supervision and Regulation's and related divisions' challenges and achievement of their goals.

**Q.7.** What steps can the Fed take to promote diversity within the financial system, especially with respect to the firms the Fed regulates?

**A.7.** As directed by section 342 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act), the Board continues to request from the entities we regulate a submission of 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 provides opportunities to discuss leading practices and challenges in addressing diversity in the financial services industry. In an effort to increase the submission of diversity information, the Board is collaborating with the other financial regulatory agencies to develop symposiums, webinars, and other support initiatives to provide a variety of forums to address what is needed to advance diversity in the financial and banking industry.

**Q.8.** How closely do you work with the Fed's Office of Diversity and Inclusion? Please give a couple of examples.

**A.8.** In my role as Governor and Vice Chairman of Supervision, I am available to the Director of the Office of Minority and Women Inclusion (OMWI) to meet and 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 Board's leadership nomination criteria and process are inclusive. Additionally, a meeting schedule has been established for the OMWI Director and Deputy Director of Supervision Policy to discuss a range of issues within the OMWI purview.

**Q.9.** How will you work to end the outsized representation and influence of the banking and business sectors among the Regional Bank Boards of Directors?

Have you identified directors with nonprofit, academic, and labor backgrounds that could also serve?

**A.9.** I, and my colleagues on the Board, are committed to increasing diversity throughout the Federal Reserve System (System). The Board focuses particular attention on increasing gender, racial, and sector diversity among Reserve Bank and Branch directors because we believe that the System's boards function most effectively when they are constituted in a manner that encourages a variety of perspectives and viewpoints. Monetary policymaking also benefits from having directors who effectively represent the communities they serve because we rely on directors to provide meaningful grassroots economic intelligence.

In vetting candidates for Class C and Board-appointed Branch director vacancies, the Board considers factors such as professional experience, leadership skills, and community engagement. The Board also evaluates a candidate's ability to contribute meaningful insights into economic conditions of significance to the District and the Nation as a whole. As part of this process, the Board focuses considerable attention on whether a candidate is likely to provide the perspective of historically under-represented groups, such as consumer, community, and labor organizations, minorities, and women.

Although there is room for improvement, the System has made significant progress in recent years in recruiting highly qualified, diverse candidates for Reserve Bank and Branch director positions. For example, in 2018, approximately 56 percent of all System directors are diverse in terms of gender and/or race, which represents a 16 percentage point increase in the share of directors since 2014.

As previously mentioned, in addition to gender and racial diversity, the Board also seeks candidates from a wide range of sectors and industries to serve as Reserve Bank and Branch directors. We currently have consumer/community and labor leaders serving on boards throughout the System, and we gain invaluable insight from directors who are affiliated with other types of organizations, including major health care providers, universities and colleges, and regional chambers of commerce, among others.

**Q.10.** If the Consumer Financial Protection Bureau continues to drop lawsuits against predatory online loan companies, like Golden Valley Lending or drop investigations against companies like World Acceptance Corporation, one of the biggest payday lenders, does the Federal Reserve have the enforcement authorities and resources that would allow its staff pick up the slack and protect people from unfair, deceptive and abusive lending practices?

**A.10.** As prescribed by the Dodd–Frank Act, the Federal Reserve has supervisory and enforcement authority for compliance with section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices (UDAP), for all State member banks, regardless of asset size. The Federal Reserve is committed to ensuring that the institutions we have authority to supervise comply fully with the prohibition on unfair or deceptive acts or practices as outlined in the FTC Act.

Under the Dodd–Frank Act, Congress granted supervision and enforcement authority to the Consumer Financial Protection Bureau (CFPB) for all other banks, thrifts, and credit unions with assets over $10 billion, and their affiliates, as well as nonbank mortgage originators and servicers, payday lenders, and private student lenders. As such, the Federal Reserve cannot supervise or enforce consumer protection laws and regulations with respect to institutions that are not within our statutory authority.

**Q.11.** Mick Mulvaney, the OMB Director and the CFPB Acting Director appointed—illegally—by President Trump, has received more than $60,000 in campaign contributions from payday lenders. You recused yourself from any case involving Wells Fargo because of your "wife's family's historical connection."

Do you think Acting Director Mulvaney should recuse himself from any decision on litigation or enforcement for any firm that has provided him significant campaign contributions?

**A.11.** It is not our practice to comment on a non-Federal Reserve official's decision to participate in or recuse himself or herself from a particular matter that does not involve the Federal Reserve. I have no comment on recusal decisions made by other Government officials.

**Q.12.** If the Consumer Financial Protection Bureau's political appointees refuses to police the consumer markets, will you let us know if predatory and deceptive practices are going unaddressed and increasing risks in the financial system?

**A.12.** The Federal Reserve takes seriously our responsibility to supervise and enforce laws that guard consumers against UDAP in the banks for which we have statutory authority. As granted by the Dodd–Frank Act, the Federal Reserve supervises for compliance with the section 5 of the FTC Act, which sets forth consumer protections for UDAP, in State member banks, regardless of asset size. For these banks, we conduct UDAP reviews regularly within the supervisory cycle. Further, examiners may conduct a UDAP review outside of the usual supervisory cycle, if warranted by findings of a risk assessment. When Federal Reserve examiners find evidence of potential discrimination or potential UDAP violations, they work closely with the Board's Division of Consumer and Community Affairs (DCCA) for additional legal and statistical expertise and ensure that fair lending and UDAP laws are enforced consistently and rigorously throughout the System.

When violations are identified, the Federal Reserve frequently uses informal supervisory tools (such as memoranda of understanding between banks' boards of directors and the Federal Reserve Banks, or board resolutions) to ensure that violations are corrected. In these instances, the supervisory information is confidential and cannot be shared with parties outside of the institution and supervisory agencies.

Just as the Federal Reserve cannot share confidential supervisory information with respect to the banks that we supervise, neither can we share confidential supervisory findings of other supervisory agencies.

However, the Federal Reserve has 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. In 2014 and 2015, we brought two enforcement actions requiring restitution for students who were not given full information about the potential fees and limitations associated with opening deposit accounts for their financial aid refunds.

In 2017, the Board brought two public enforcement actions for UDAP violations. In October, the Board issued a consent order against a bank for deceptive practices related to balance transfer credit cards issued to consumers through third parties. The order required the bank to pay approximately $5 million in restitution to nearly 21,000 consumers and to take other corrective actions. In November, the Board issued another consent order against a bank for deceptive residential mortgage origination practices when it had given borrowers the option to pay an additional amount to purchase discount points to lower their mortgage interest rate, but that did not actually provide the reduced rate to many of those borrowers. The enforcement action required the bank to pay approximately $2.8 million into an account to provide restitution to these borrowers. These are a few examples. The Board reports its general overview of UDAP and enforcement actions in our Annual Report to Congress.

**Q.13.** Has the Federal Reserve leadership—either directly or through the Financial Stability Oversight Council—weighed in on the impact from the Trump appointed leadership at the CFPB's decision to weaken fair lending enforcement, suspend the civil penalties fund and stop investigating into firms such as the hack of 147 million people's information held by Equifax?

**A.13.** As you know, Title X of the Dodd–Frank Act transferred rulemaking authority for a number of consumer financial protection laws from seven Federal agencies to the CFPB. With regard to rules for which the CFPB is responsible for promulgating, such as those implementing the Fair Credit Reporting Act, the Board's role in the process is on a consultative basis. We do coordinate in institution examinations as appropriate. The Federal Reserve does not have any oversight of the CFPB's enforcement priorities, nor decisions regarding its organizational or structural design. These matters are solely the purview of CFPB's leadership.

**Q.14.** The Treasury Department, as you know, has released several extensive reports that include dozens and dozens of recommendations to revise the rules governing banks.

Do you think there should be penalties for banks that fail to comply with the Community Reinvestment Act?

What should they be?

**A.14.** The Community Reinvestment Act (CRA) requires the regulators to encourage banks to help meet the credit need of their local communities. We do so by conducting CRA examinations, publishing CRA ratings and performance evaluations on our public website, and considering a bank's CRA performance when evaluating applications for mergers, acquisitions, and opening branches.

The applications process serves as a means of enforcing CRA. CRA requires that the appropriate Federal supervisory agency consider a depository institution's record of helping to meet the credit needs of its local communities and to take that record and public comments into account in evaluating applications for deposit-taking facilities, such as for mergers, acquisitions, and branches. An institution's most recent CRA record is a particularly important consideration in the applications process because it represents a detailed on-site evaluation of the institution's performance under the CRA. The public nature of the ratings and the agencies' consideration of CRA performance in the application process creates an incentive for financial institutions to work with its community to help meet its needs.

**Q.15.** Which, if any, recommendations from the Treasury Department related to CRA do you disagree with?

**A.15.** The Board's staff is continuing to analyze the recommendations made by the Department of Treasury. I share Treasury'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 raised 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 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.

For example, I agree that it is time to review changes to the definition of "assessment area," which is the area in which a bank's 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 communities that banks serve, while retaining the core focus on place.

**Q.16.** Fed Chair Powell recently said that the Fed's requirements for the largest banks are "very high and they're going to remain very high."[3] 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."[4]

Why did the Fed issue a proposal last week that would revise the enhanced Supplementary Leverage Ratio (eSLR), which according to the FDIC, would reduce bank capital by more than $120 billion at the Nation's largest banks?

With banks making big profits, why would the Fed propose to reduce capital in a significant way that diminishes protections for taxpayers and the economy?

If we are seeing regulations being weakened while the banking sector is very strong economically, what do you expect to see regarding banking regulations during an actual downturn or recession?

**A.16.** The proposed recalibration of the enhanced supplementary leverage ratio (eSLR) standards is an example of the Board's efforts to ensure that the postcrisis financial regulations are working as intended. Core aspects of postcrisis financial regulation have resulted in critical gains to the financial system, including higher and better quality capital, a robust 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 the regulations not only to be

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[3] *https://www.federalreserve.gov/newsevents/speech/powell20180406a.htm*
[4] *Politico Pro*, "Powell Doesn't See Need To Loosen Rules on Biggest Banks", April 6, 2018.

effective for maintaining safety and soundness and financial stability, but also to be efficient, transparent, and simple.

The purpose of the eSLR proposal is to recalibrate our 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 SLR has become a generally binding constraint rather than a backstop to the risk-based requirements. If a leverage ratio is calibrated at a level that makes it generally binding, it can create incentives for banking organizations to reduce their participation in business activities with lower risks and returns, such as repo financing, central clearing services for market participants, and taking custody deposits, even when there is client demand for those generally low-risk services and to actually increase the risk in its portfolio since it bears the same capital cost for a risky asset as for a safe and sound one.

I do not believe that the proposal would materially change the amount of capital held by U.S. global systemically important bank holding companies (G–SIBs). The $121 billion figure noted in the proposal represents the potential reduction in tier 1 capital required across the lead insured depository institution subsidiaries of the G–SIBs; however, these firms all are wholly owned by their parent holding companies. On a consolidated basis, G–SIBs 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 investors. Due to these limitations at the holding company level, the G–SIBs would be required to retain the vast majority of the $121 billion amount and would not be able to distribute it to third parties. The Board estimates that the proposal would reduce the amount of tier 1 capital required across the G–SIBs by approximately $400 million. That figure is approximately 0.04 percent of the amount of tier 1 capital held by the G–SIBs as of the third quarter of 2017.

**Q.17.** 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 postcrisis financial rules to seek improvements.

Will these modifications to postcrisis reforms be one-sided with a focus on deregulating the rules protecting people from dangerous behaviors from the financial sector?

**A.17.** Core elements of the postcrisis financial regulatory reforms have made our financial system stronger and more resilient: higher and better-quality capital, an innovative stress testing regime, new liquidity requirements, and improvements in the resolvability of large firms. The reforms to regulation and supervision that have been put in place since the financial crisis have contributed to a financial system that better supports lending to borrowers and protects consumers.

That said, it is the responsibility of financial regulators to review and revisit postcrisis regulations to ensure not only that they are effective, but also to see if the same outcomes can be achieved, where appropriate, in ways that are more efficient, transparent, and simple. More specifically, regulators should continue to tailor rules to the different risks of different firms and ensure that our supervisory program is as efficient as possible, including work to reduce unnecessary burden on community and regional banks, while simultaneously holding our largest, most complex firms to heightened regulatory standards. As we consider possible changes to the postcrisis structure of regulation and supervision, we will remain focused on promoting the strength and resilience of the financial system.

**Q.18.** Chair Powell has said not a single big bank rule requires strengthening.

Do you agree?

**A.18.** At this point, regulators have completed the bulk of the work of implementing postcrisis regulatory reforms, with an important exception being the U.S. implementation of the recently concluded international agreement on bank capital standards. Due in significant part to gains from core postcrisis reforms around capital, stress testing, liquidity, and resolution, we undoubtedly have a stronger and more resilient financial system.

I believe that now is the time to step back and assess whether postcrisis regulations are working as intended and determine ways to improve them, not only to ensure that we are satisfied with their effectiveness, but also to explore opportunities as appropriate to improve the efficiency, transparency, and simplicity of these regulations, while maintaining the resiliency of the current system.

**Q.19.** 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?

**A.19.** 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, deficiencies in Government regulation of financial institutions and markets. In response, 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. As you know, prior to the passage of the Dodd–Frank Act in 2010, the Board had responsibility for writing regulations to implement many consumer protection laws. The Dodd–Frank Act transferred most of these responsibilities to the CFPB, and considerably expanded its consumer protection statutory authorities for supervision and enforcement, and granted the CFPB broad authorities to promulgate consumer protections regulations covering banks and nonbanking entities.

Although the Board no longer has rulewriting authority for most consumer protection regulation, we remain committed to strong consumer protection to promote a fair and transparent financial marketplace, as we have for more than 40 years, 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. Through this division, we oversee the Federal Reserve System's supervision and examination policies and programs for the banks under our supervisory authority to ensure consumer financial protection and promote community reinvestment.

The Dodd–Frank Act established the CFPB as a dedicated agency not only to consumer financial rulemaking, but also supervision for banks, thrifts, and credit unions with assets over $10 billion, as well as their affiliates, and for nonbank mortgage originators and servicers, payday lenders, and private student lenders of all sizes.

Despite responsibilities for supervision that were transferred to the CFPB, the Federal Reserve continues to be dedicated to consumer protection and community reinvestment in carrying out our supervisory and enforcement responsibilities for the financial institutions and for the laws and regulations under our authority. We supervise 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.

The Federal Reserve is committed to ensuring that the financial institutions under our jurisdiction fully comply with all applicable Federal consumer protection laws and regulations. For example, in the last few years, the Federal Reserve has 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. In addition, 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.

At the Board, DCCA staff provide oversight for the Reserve Bank consumer compliance supervision and examination of approximately 800 State member banks and bank holding companies (BHCs) through its policy development, examiner training, and supervision oversight programs, including for banks' performance under the CRA; conducting oversight of and providing guidance to Reserve Bank staff on consumer compliance in BHC matters; assessment of compliance with and enforcement of a wide range of consumer protection laws and regulations including those related to fair lending, UDAP, and flood insurance; analysis of bank and BHC applications in regard to consumer protection, convenience and needs, and the CRA; and processing of consumer complaints. DCCA also monitors trends in consumer products to inform the risk-based supervisory planning process. Quantitative risk metrics and screening systems use data to assess market activity, consumer complaints, and supervisory findings to assist with the determination of risk levels at firms.

**Q.20.** The Administration has proposed in a November report stripping FSOC of its power to designate nonbank SIFIs—like AIG—for heightened supervision by the Fed. The report said this authority was too "blunt" of an instrument.

Has the Fed acted as a blunt instrument in its supervision of nonbank SIFIs?

**A.20.** As consolidated supervisor of nonbank financial companies designated by the Financial Stability Oversight Council (FSOC), the Board's primary objectives encompass ensuring enterprisewide safety and soundness and mitigating threats to financial stability. The Board continues to strive for a tailored approach that reflects, among other things, the size, complexity, and business model of the supervised firm. When supervising firms significantly engaged in insurance activities, the Board conducts its consolidated supervision in coordination with State and foreign insurance regulators, collaborating through mechanisms including discussions of supervisory plans and examination findings, as well as supervisory colleges. We additionally have hosted multiple crisis management groups that included a variety of participants including State insurance departments, the Federal Insurance Office, and the Federal Deposit Insurance Corporation.

**Q.21.** Or has the Financial Stability Oversight Council, or FSOC, helped to eliminate regulatory gaps in our financial regulatory system?

**A.21.** Prior to the creation of the 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 films operating across multiple markets. The FSOC established a venue to facilitate the sharing of regulatory information and coordination to help minimize potential gaps and weaknesses.

Notably, the FSOC must publish a financial stability report each year, 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 Government.

**Q.22.** S&P Global warned earlier this month that leveraged lending standards were deteriorating, and that underwriting standards in this $1 trillion market continue to get weaker and weaker. One PIMCO analyst said, "I'm not sure the market can tolerate much worse."[5] There used to be guidance in place to protect against these risks, but while at the OCC, Acting Comptroller Noreika withdrew its guidance on leveraged lending. And you have said that this guidance, because it was declared a rule by the GAO, is

[5] *https://www.ft.com/content/680953c0-3e2a-11e8-b9f9-de94fa33a81e*

"not something that should be cited in supervisory action or taken into account by examiner."[6]

So judging by your comment, the Republicans' assault on banking guidance has already had a chilling effect on the Fed's ability to constrain emerging risks, is that right?

How do you plan to protect the market from systemic risk if you're telling supervisors to ignore this guidance? What does the Fed plan to replace this guidance with?

**A.22.** The Board has broad authority to supervise and regulate banking organizations to promote their safety and soundness. As part of that authority, Federal Reserve supervisors and examiners assess credit and other risks to the safe and sound operations of firms, including risks that may be posed by leveraged lending, and to direct the firms to address such risks as appropriate. As part of assessing credit and other risks, Federal Reserve examiners routinely evaluated the underwriting of leveraged loans prior to the issuance of the most recent leveraged lending guidance. The guidance was issued to provide clarity regarding safety and soundness issues that may be present in making such loans. The guidance was not issued as a regulation that would be enforceable. Rather, banking organizations should use it to better understand and manage the risks they are taking.

The Board, Federal Deposit Insurance Corporation (FDIC), and OCC are discussing whether it would be appropriate to again solicit public comment on the guidance with a view to improving the clarity and reducing any unnecessary burden.

**Q.23.** The Fed in 2016 proposed a rule to limit some of banks' activities in commodities markets, with the rationale being that banks' owning, trading, and moving commodities might post a safety and soundness risk to the banking system or allow banks to wield outsized power in certain markets.

How does the Fed have time to revisit so many rules that aren't even fully phased in yet—the Volcker Rule, the leverage ratio, risk-based capital rules—when you haven't even completed work from the recent past that was based on years and years of study?

Since the election we have heard nothing about this rule being finalized or about any progress on the rule. Has this rule been abandoned, and if so, why?

**A.23.** 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, aca-

[6] *https://www.americanbanker.com/news/feds-quarles-to-seek-more-tailoring-of-large-bank-rules*

demics, 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.

**Q.24.** A recent NY State Comptroller report reported that Wall Street bonuses showed a dramatic 17 percent increase from last year. Bonuses have increased by 34 percent over the last 2 years, and the average bonus for Wall Street traders is now at the second highest level ever recorded—behind only 2006, the year before the financial crisis began.

We also know, from the Financial Crisis Inquiry Commission and other sources, that out-of-control bonus practices were a major driver of the 2008 financial crisis. Top executives at Bear Stearns and Lehman took out almost $2.5 billion in bonuses in the years before those two companies failed, and never had to repay a dime. After the crisis, multiple surveys showed that more than 80 percent of financial market participants agreed that irresponsible bonus practices were a major contributor to the short-term risk taking that brought down the financial system.

Section 956 of the Dodd–Frank Act instructed bank regulators to reform bonuses at financial institutions, by eliminating "take the money and run" bonus practices that encouraged irresponsible risk-taking. Prior to your confirmation, regulators were close to completing rules that would have placed new limits on big bank bonuses. Yet to all appearances the Federal Reserve and other regulators appear to have abandoned that effort completely, even as bonuses skyrocket back to precrisis levels.

When will the Federal Reserve implement Section 956 of Dodd–Frank and reform bonuses? Why has this rule been delayed so long?

**A.24.** In June 2016, the Board, OCC, FDIC, the SEC, National Credit Union Administration, and Federal Housing Finance Agency (the Agencies), jointly published and requested comment on a proposed rule under section 956 of the Dodd–Frank Act. This joint effort proposed several requirements to address incentive compensation arrangements. The Agencies received over 100 comments on the 2016 proposed rule and are considering the comments. I do not have a projected date for completion of this rulemaking.

The Federal Reserve, along with the other Federal banking agencies, issued Guidance on Sound Incentive Compensation Policies in June 2010 to address incentive compensation programs at financial institutions. This guidance is intended to assist regulated firms in developing appropriate incentive compensation programs that do not encourage inappropriate or excessive risk taking.

The Federal Reserve continues to evaluate incentive compensation practices as a part of ongoing supervision. This supervision has focused on: the design of incentive compensation arrangements; deferral and risk adjustment practices (including forfeiture and clawback mechanisms); governance; and the involvement of the firm's controls and control function groups in various aspects of incentive compensation arrangements.

Supervision focuses on ensuring robust risk management and governance around incentive compensation practices rather than prescribing amounts and types of pay and compensation.