S. HRG. 118–513

OVERSIGHT OF FINANCIAL REGULATORS: PROTECTING MAIN STREET NOT WALL STREET

HEARING

BEFORE THE

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

ONE HUNDRED EIGHTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING HOW TO PROTECT OUR BANKING AND CREDIT UNION SYSTEMS ENSURING THEY SERVE EVERYONE

NOVEMBER 14, 2023

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: https://www.govinfo.gov/

U.S. GOVERNMENT PUBLISHING OFFICE
57–730 PDF WASHINGTON : 2025

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C O N T E N T S

TUESDAY, NOVEMBER 14, 2023

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

OVERSIGHT OF FINANCIAL REGULATORS: PROTECTING MAIN STREET NOT WALL STREET

TUESDAY, NOVEMBER 14, 2023

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

The Committee met at 10 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chair of the Committee, presiding.

OPENING STATEMENT OF CHAIR SHERROD BROWN

Chair BROWN. Banking, Housing, and Urban Affairs Committee has come to order. Thank you all for being here. Senator Rounds will serve as Ranking Member again. His future may be cut short, I am not sure, but that is for him and his friends to work out.

Senator ROUNDS. Looking forward to it.

Chair BROWN. Yes. We will hear testimony from the heads of the four Federal agencies responsible for protecting our banking and credit union system and making sure it serves everyone—The Board of Governors of the Federal Reserve, Federal Deposit Insurance Corporation, National Credit Union Administration, and the Office of Comptroller of the Currency. Thanks for being here, all four of you, today.

Earlier this year, we witnessed three of the largest bank failures in U.S. history. These failures reminded us that bankers' hubris and greed and negligence continue to pose grave threats to our financial system, and perhaps more importantly even, to workers and small businesses. This time our system bent. Fortunately it did not break. To avoid breaking, however, the Treasury Department and your agencies had to intervene and invoke the Systemic Risk Exception and guarantee all deposits at Silicon Valley Bank and Signature Bank. It should not have gotten that far. The bank failures exposed weaknesses in the supervision of the banking system, disrupted the financial system's stability, and reminded many Americans why they do not trust Wall Street.

A disconcerting finding in the aftermath of the failures was that the agencies did in fact identify the risks at these institutions. You called them out, but that failed to result in real action from bank management to actually do anything to mitigate these risks. It is as predictable as it is unacceptable after years of lobbying for weaker rules and lax oversight, including by SVB and Signature

Bank executives showing up in the laws of Congress and in your agencies.

We must turn the lessons of this year into action. It means improving bank supervisions. It means holding bank executives accountable for risky behavior that does in fact sometimes drive their banks into the ground. It means strengthening rules so that banks serve their communities, and have the capital necessary to continue to serve their community during even stressful events. These are things we should agree about. It is why in the wake of this bank crash, we worked together to take the first real action in more than a decade to rein in risky behavior by bank executives. Congress must finish the job and pass our bipartisan RECOUP Act that came out of this Committee 21:–2—everybody on the dais now voted for it—to hold senior bank executives accountable when they gamble with customers' money.

The turmoil in the financial industry earlier this year reminded us about the policies and actions that continue to make the big banks even bigger, and leave the financial system vulnerable to the ever-expanding bank balance sheets of the largest institutions in our country. We have created a financial system where a handful of the largest banks now hold $14.75 trillion in assets—$14.75 thousand-billion dollars in assets, more than half the Nation's GDP.

Fewer, larger and larger banks means consumers have less choice in the marketplace for banking services. Less competition means banks pay depositors less and charge higher fees. Mergers and acquisitions serve as justification for branch closures, particularly in rural areas and working-class communities. We have seen that everywhere. We have seen it far too often in Ohio. We know that drives more consumers out of the banking system toward high-fee, predatory nonbank financial companies like check-cashers and payday lenders and fintech apps.

Banking consolidation also means reduced access to credit for small businesses and increased borrowing costs. Fundamentally, it means that more power in our economy ends up concentrated in the hands of a tinier and tinier number of big bankers on Wall Street. We have seen over and over what a problem that is and the harm that the Wall Street business model does in places like Ohio, encouraging everything from inflation to outsourcing to lax safety. Look at East Palestine and the rail crash there just 10 months ago. We need strong action now from your agencies on this issue, because these trends impose real and direct costs on Americans.

With less competition, with less choice, with less access, it is more important than ever that we ensure banks are meeting the needs of the entire community. That is why I was encouraged to see that the FDIC, the Fed, and the OCC were able to come together last month and finalize the new Community Reinvestment Act. Thank you for that. The CRA was enacted 46 years ago to ensure that banks meet the credit needs of all the communities in which they do business. CRA regulations last received a significant refresh in 1995. Since '95, the internet and mobile technology have fundamentally altered how Americans interact with the banking system. This modernization effort is critical to ensuring that banks are fulfilling the promise of CRA by serving and investing in their communities. I thank your agencies for working through this very complex rulemaking and delivering a final rule that we all believe will encourage banks to meet the credit needs of their entire community.

In addition to CRA, the FDIC, Fed, and OCC also issued what is known as the Basel III Endgame Capital Proposal. For anyone not steeped in financial regulation, that is an actual rule critical to protecting the economy. It is not the latest video game or Marvel movie. These capital rules represent the final and long, long overdue plank in the post-financial crisis overhaul of our regulatory capital framework, about ensuring that the largest banks have enough capital to address the risks that are unique to their institution, and weather crises and emergencies and other sudden events that affect their banks. This proposal also recognizes the systemic importance of banks that are large, just not quite as massive as the Wall Street megabanks, banks like Silicon Valley before it collapsed.

As we saw this spring, mismanagement, risky bets at those banks still threaten the financial system. They also need to have enough capital to prevent this kind of threat to the economy we worried about earlier this year. Of course we know that complaints are coming; in fact, they started before we even saw the proposal. The industry has relentlessly attacked it with the same old, tired arguments—compliance will cost too much. We will not be competitive. We already have enough capital. We will not be able to lend to small business. We have heard it; you have heard it before.

Be clear—the largest banks will need to redirect a tiny fraction of their enormous profits over a period of several years to get to the new capital levels. Every single bank that would be impacted by this proposal has the capacity to comply with the new capital levels and extend credit to small businesses and working-class and middleclass families, all while remaining wildly, in most cases, profitable. I trust your agencies see these arguments for what they really are, the same old Wall Street whining, and that you will deliver a strong capital rule, one that prioritizes the American people and their communities over quarterly profits of the banking industry.

Finally, as we have discussed in this Committee, illicit finance continues to pose a serious threat to the United States and the world. We have seen it most recently with funding Hamas was able to raise for its terrorist attacks on Israel. We see it every day in our communities with what has happened with fentanyl coming into our country. I implore your agencies to be vigilant when it comes to all the risks associated with illicit finance in the banking and credit union systems. You are all public servants. You are all responsible for making sure the financial system operates in a safe and sound manner, and works for American people. Do not let us down. Ranking Member Rounds.

STATEMENT OF SENATOR MIKE ROUNDS

Senator ROUNDS. Thank you, Chairman Brown, and thank you to our witnesses for appearing before us today. While this group comes before the Committee every year, today's hearing feels particularly timely given the number and breadth of regulations being pushed through by our financial regulators. In the last few months alone, your agencies have put forth or finalized regulations and guidance that represent the biggest rewrite of banking regulations since the passage of Dodd-Frank.

We have seen regulations on bank capital, long-term debt resolution planning, the Community Reinvestment Act, debit card interchange fees, and climate risk management, just to name a few. These proposals collectively amount to thousands of pages, with the Community Reinvestment Act alone standing at almost 1,500 pages, nearly double the length of the entire Dodd-Frank act. Moreover, none of these regulations exist in a vacuum. As legislators, my colleagues and I recognize the importance of actively considering all possible effects a law might have, including its impact on individuals and how we can mitigate unintended consequences. Therefore, we find it concerning that you have failed to consider how these rules will impact banks and businesses of all sizes, ultimately harming the American people.

As a direct result of these regulations and proposals, banks will now spend their time complying with more Washington bureaucratic red tape instead of investing that time or resources into their local communities. Beyond overly burdensome compliance costs to financial institutions, we must recognize and emphasize that the cost of this rulemaking onslaught will ultimately be borne by small businesses and wage-earners who are on a fixed income and rely on their local banks for loans and access to credit.

Yesterday, several of the witnesses before us received a letter, led by Ranking Member Scott, on the Basel III Endgame rule, which was signed by myself and 37 other Republican senators. We have heard from countless constituents from all walks of life about the harm they will experience should this rule go into effect. Our letter emphasized the detrimental impacts, such as limiting the availability of credit for housing in low- and moderate-income communities, severely restricting small business lending, and decreasing the retirement savings of hardworking Americans. Vice Chair Barr, you recently stated that, and I quote, "The proposal is projected to raise capital for large banks. This may result in higher funding costs, but this is only half the story." End of quote.

However, I think the other half of the story is the millions of hardworking families who will be unable to achieve the American dream of home ownership, the tens of thousands of small businesses who will be unable to secure a loan, and the workers forced to stay on the job past retirement age because their pensions are providing less returns. What happens to them? We must remember that at the end of each regulation are real people, people who care about the safety and security of their families, including financial safety and security.

Results matter. Since the Biden administration took office, it now costs the average American family of four over $700 more per month to live in this country. It is close to $1,000 in my home State of South Dakota. You are adding to that pain. This rule would put a strain on all institutions seeking to provide services that would help American consumers and businesses prosper, like many of those in my home State of South Dakota. Due to the scale and breadth of each of these proposals, I would support having a hearing dedicated to each and every one to understand the impacts that they will have.

But seeing as my time today is limited, I wanted to call attention to another proposal where the regulators are operating well outside the mandates given to them by Congress. We have heard Federal Reserve officials, including Chair Powell, state as recently as last month that the Fed is not and will not become a climate policymaker. Yet our regulators are mandating that banks must engage in climate scenario analysis.

Earlier this year, when the Fed conducted a climate scenario analysis exercise, officials stated that it would have no supervisory implications. But now, banks are being told that they will be supervised to make sure they have such programs in place. So, which is it? Not a single bank has failed because they have failed to account for climate risk. As Governor Bowman discussed in her dissent of the climate guidance, this action could ultimately lead to negative impacts on low-income communities who will have reduced access to capital.

In your desire to worship at the altar of climate change, you are sacrificing the economic well-being and capabilities of hardworking Americans. Let me repeat—none of these regulations exist in a vacuum, and collectively, these rules paint a devastating picture for consumers, especially low- and moderate-income communities. At a time when all Americans are suffering from persistently high inflation caused by Bidenomics, the last thing they need is a bunch of Washington bureaucrats upending and rewriting a decade's worth of banking rules, which will only serve to restrict capital, harm the economy, and punish American families. I think you need to go back to the drawing board. Thank you, Mr. Chairman.

Chair BROWN. Thank you, Senator Rounds. Thanks for the service, all of you today. Vice Chair Barr, please begin your testimony.

STATEMENT OF MICHAEL BARR, VICE CHAIR FOR SUPERVISION, FEDERAL RESERVE

Mr. BARR. Chairman Brown, Senator Rounds, and other Members of the Committee, thank you for the opportunity to testify on the Federal Reserve's supervisory and regulatory activities. Our banking system is sound and resilient. The acute stress that occurred in March has receded, and banking organizations continue to report capital and liquidity ratios above minimum regulatory levels. However, some banks have recorded sizable declines in the fair value of assets as interest rates have increased, putting pressure on tangible capital. These banks are actively managing the resulting set of risks, but these could take some time to address.

Additionally, some banks that have high reliance on uninsured deposits are using more expensive funding sources to manage their liquidity. Looking forward, preserving a sound and resilient banking system requires continued attention to address identified vulnerabilities, and vigilance to changing conditions.

Starting with supervision, since the bank failures earlier this year, the Federal Reserve has been moving forward with ways to improve the speed, force, and agility of supervision as appropriate. In considering improvements to supervision, we are very mindful of the differences in size, risk, and complexity of supervised institutions, and the importance of maintaining the strength and diversity of banks of all sizes that serve communities across the country.

Furthermore, supervisors have been focused on addressing material risks presented by the current economic environment. This includes conducting targeted reviews at banks exhibiting higher interest rate and liquidity risk profiles, and monitoring for potential credit deterioration, particularly within the consumer and CRE lending segments. A key component of this resilience is capital. Capital allows banks to absorb losses on those assets while continuing to serve households and businesses.

In the Global Financial Crisis, the effects of woefully undercapitalized banks had a devastating impact on our economy, and resulted in the worst recession since the Great Depression. It took 6 years for employment to recover, more than 10 million people fell into poverty, and 6 million families lost their homes to foreclosure. And these costs occurred even with substantial support from the Government.

In the years following the Global Financial Crisis, the Board adopted a set of capital reforms, which greatly strengthened our banking system, and capital ratios of the largest banks have more than doubled since 2009. At the same time, the U.S. banking system has grown from $12 trillion in assets in 2009 to $23 trillion today, while showing strong profitability and overall market valuation.

U.S. banks have enhanced their position as leaders in global capital markets activity. Importantly, these reforms have served the U.S. economy well. Our economy has grown substantially with the continued support of robust lending from a stronger banking system.

The reforms to the capital requirement framework that the banking agencies proposed earlier this year are the last stage of these postcrisis capital reforms. It has long been recognized that work remains to improve how banks measure risk, which is critically important, because the riskier a bank's assets are, the more capital it needs to protect against those risks. The proposed rules would apply to banks with at least $100 billion in assets, fewer than 40 of the over 4,000 banks in our banking system. Community banks would not be affected by this proposal. The effects for each bank would vary based on its activities and risk profile. Notably, the increases would be the most substantial for the largest and most complex banks, the G–SIBs, and the bulk of the estimated rise is attributed to trading and other nonlending activities.

The comment period is an important part of the rulemaking process. We are providing the public nearly 6 months to review the proposal so they can provide meaningful comments. We welcome all comments that provide the agencies with additional data and analysis, to help ensure the rules accurately reflect risk.

I would also like to briefly highlight our long-term debt proposal. In August, the agencies proposed a rule that would expand long-term debt and resolution planning requirements to additional large banks. The proposal's goal is to increase the potential options available for resolving depository institutions, and to enhance overall financial stability. Importantly, the proposed requirements would be calibrated at a lower level relative to the largest and most complex banks.

As with the capital rules, I would like to emphasize that these are proposed rules, and we look forward to hearing the public's comments. Thank you. I am happy to take your questions.

Chair BROWN. Mr. Gruenberg, welcome.

STATEMENT OF MARTIN J. GRUENBERG, CHAIR, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. GRUENBERG. Thank you, Mr. Chairman. Chairman Brown, Senator Rounds, and Members of the Committee, I am pleased to appear at today's hearing on Oversight of Financial Regulators. The U.S. banking industry has proven to be quite resilient, despite the period of stress earlier this year. In the second quarter of this year, key banking industry measures of performance remained favorable, net income remained high by historical measures, asset quality measures were stable, and the industry remained well capitalized. However, banks reported lower net interest margins and higher funding pressures for a second consecutive quarter. Higher market interest rates caused market values for debt to generally fall during the second quarter, resulting in higher unrealized losses on securities, an issue that became apparent earlier this year.

In the second quarter, uninsured deposits declined by 2½ percent. That is a significant slowing from the 8 percent decline that we experienced in the first quarter. By contrast, insured deposits increased by .8 percent during the second quarter of this year. In the second quarter also, depositors sought higher yields, often at nonbank financial institutions, particularly money market mutual funds. Many banks have increased deposit rates to compete, resulting in a higher cost of funds.

The banking industry continues to face significant downside risks from the effects of inflation, rising market interest rates, and geopolitical uncertainty. The economic outlook remains uncertain despite relatively solid growth and low employment so far this year. These risks could cause credit quality and profitability to weaken, loan growth to slow, provision expenses to rise, and liquidity to become more constrained.

Commercial real estate loan portfolios, particularly loans backed by office properties, face challenges when loans mature, as demand for office space remains weak and property values continue to soften. Banks have tightened underwriting standards over the past year across a range of household and business loans, and they may continue to tighten further.

The failure of three large regional banks this spring demonstrated the risk to financial stability that large regional banks can pose. The FDIC, along with the Federal Reserve and the OCC, proposed rulemakings that would enhance the resilience and improve resolvability of large regional banks. These include a long-term debt proposal that would require a layer of loss-absorbing capacity at large banks to take losses before uninsured and insured depositors, thus decreasing the incentive for uninsured depositors to run, and mitigating the need for a systemic risk exception in a future failure.

In July, the banking agencies issued a Notice of Proposed Rulemaking for Basel III. The proposal is a continuation of the Federal banking agencies' efforts to revise the regulatory capital framework for our Nation's largest, most systemic financial institutions following the Global Financial Crisis of 2008. Notably, it does not apply to community banks. The NPR would make important changes to address capital weaknesses identified in the 2008 financial crisis, enhance the resilience and stability of the banking system, and enable the banking system to better serve the U.S. economy.

In addition, the FDIC is undertaking a comprehensive review of its supervision program, with a focus on interest rate risk, unrealized losses on securities and loans, uninsured deposits, rapid growth, and the need when necessary to escalate supervisory matters and take actions to compel compliance. In October, the banking agencies adopted a final rule to strengthen and modernize the Community Reinvestment Act.

In closing, if I may, I would like to address a recent news report regarding incidents of sexual harassment and misbehavior at the FDIC. I am personally disturbed and deeply troubled by this report. The FDIC is conducting a comprehensive review, including engaging an independent third party, to ensure that we understand the nature of these issues and take all appropriate actions to address them. Let me underscore, I have no higher priority than to ensure that all FDIC employees work in a safe environment where they feel valued and respected. That concludes my statement, Mr. Chairman.

Chair BROWN. Mr. Harper, welcome.

STATEMENT OF TODD HARPER, CHAIR, NATIONAL CREDIT UNION ADMINISTRATION

Mr. HARPER. Chairman Brown, Senator Rounds, and Members of the Committee, thank you for the invitation to discuss the work of the National Credit Union Administration. My remarks here will focus on the state of the credit union system, and two legislative requests.

During the last year, the credit union system has largely remained stable in its performance, and resilient against economic disruptions. At the end of the second quarter, the system had $2.2 trillion in assets, and $1.5 trillion in outstanding loans. And the system's aggregate net worth ratio was 10.6 percent, well above the 7 percent well-capitalized leverage ratio required by statute.

The Share Insurance Fund also continues to perform well, with no premiums currently expected. And to better position the fund's liquidity in the current economic environment, the NCUA has increased overnight investments to $4 billion. Nevertheless, we should pay attention to several emerging issues and trends. Net charge-off ratios at credit unions have risen over the last year, and annualized returns on average assets have declined slightly. Increasing liquidity, interest rate, and credit risks have also led to a drop in composite CAMELS Code ratings to 3s, 4s, and 5s.

Assets in CAMELS Code-3 institutions, for example, increased sizably in the second quarter, especially among those complex credit unions with more than $500 million in assets. Ultimately, the data from the first half of the year reveal a tale of two types of credit union members. The first type are those who have shifted their share savings deposits to share certificates to capitalize on better rates. In all, time deposits have increased approximately 70 percent during the last year. Unless carefully managed, this switch from low-paying to higher-yielding accounts can expose credit unions to greater interest rate and liquidity risks.

Delinquency rates on most types of loans are also rising, and that leads to the second type of members, those with growing financial difficulties. Credit card balances are elevated and higher than what we should expect in the typical second quarter. Additionally, balances on home equity lines of credit and other second liens have increased by a third during the last four quarters. In some cases, those increases may indicate household financial stress. Consequently, credit unions must carefully manage their credit risks going forward. Early intervention at the onset of a delinquency can improve the credit union member's financial footing and prevent a charge-off.

The current economic environment also underscores the importance of the NCUA's Central Liquidity Facility, or CLF for short, as a liquidity shock absorber. As of September 30th, the CLF had $19.8 billion in lending capacity. This figure contrasts sharply with 9 months earlier when the CLF had $27.5 billion in lending capacity. This sizable contraction resulted from the expiration of temporary statutory enhancements that facilitated the agent membership of corporate credit unions. To address this expiration and growing liquidity risks within the system, the NCUA Board has unanimously requested that Congress restore the CLF's Corporate Credit Union and Agent Member Provisions, which the Congressional Budget Office has scored at no cost to the taxpayer.

Additionally, it remains the policy of the NCUA Board to restore the NCUA's authority to examine and supervise third-party vendors. The Government Accountability Office, the Financial Stability Oversight Council, and the NCUA's Office of Inspector General have all recommended this reform. Vendor authority would allow the NCUA to gain a better understanding of all the risks present in the credit union system, and close a growing regulatory blind spot. And such legislation would reduce the compliance costs, due diligence burdens, and future Share Insurance Fund premiums for credit unions.

In sum, the NCUA stands ready to address the impact of the evolving risks within the credit union system, including growing liquidity, interest rate, and credit risks. The NCUA will also continue to coordinate with other financial regulators to ensure the overall resiliency and stability of our Nation's financial markets. That concludes my remarks. I look forward to your questions.

Chair BROWN. Thank you, Mr. Harper. Mr. Hsu, welcome.

STATEMENT OF MICHAEL HSU, ACTING COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. HSU. Thank you, Mr. Chairman. Chairman Brown, Senator Rounds, Members of the Committee, I am pleased to testify today to provide an update on the activities of the Office of the Comptroller of the Currency. Despite the significant market stresses earlier this year and the challenging interest rate environment, the overall condition of the Federal banking system is sound. OCC-supervised banks in the aggregate have strong levels of regulatory capital and healthy levels of profitability, while maintaining sufficient liquidity buffers.

The OCC engages directly with the institutions it supervises to ensure that they are being vigilant in managing their risks. Our recently released Bank Supervision Operating Plan for 2024 summarizes the agency's examiNation priorities for next year and highlights asset liability management, credit risk and allowance for credit losses, cybersecurity, operational risk, and consumer compliance risk, among others, as key areas of focus.

My written statement provides an update on the agency's work advancing its key priorities of guarding against complacency, reducing inequality, adapting to digitalization, and managing climate-related financial risks at the largest banks. I will highlight some of these efforts here.

Despite the relative calm in the market today, the OCC has urged the banks it supervises to stay on the balls of their feet with regards to risk management. To assist banks, the OCC has updated guidance for the industry. For example, in response to increasing risk in commercial real estate, the OCC and other regulators published the Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts, which updates existing interagency supervisory guidance on CRE loan workouts, and reminds banks to work prudently and constructively with creditworthy borrowers during times of financial stress.

Ensuring that financial services are offered responsibly and fairly takes continued effort and vigilance by banks, regulators, and other stakeholders. On October 24th, 2023, the Federal banking agencies issued an interagency final rule implementing the Community Reinvestment Act. The CRA was enacted in 1977 to prevent redlining and to encourage banks and savings associations to help meet the credit needs of the communities in which they operate, especially low- and moderate-income neighborhoods and individuals.

The final rule modernizes the CRA by recognizing banking activities that take place beyond physical branches and ATMs, being significantly more data-driven and objective, and providing for greater transparency. It strengthens the CRA by addressing concerns related to grade inflation in CRA ratings, and by better incentivizing CRA lending and investments in LMI communities. The rule tailors evaluations and data collections to bank size so that community banks do not have additional burdens.

Banks' relationships with third parties, including financial technology companies, continue to expand. The use of third parties has significant potential benefits, but poor third-party risk management can hurt consumers, weaken banks, and contribute to an unlevel playing field. Recently, the OCC and other regulators jointly issued Interagency Guidance on Third-Party Relationships: Risk Management, reminding banks of their responsibility to operate in a safe and sound manner, and in compliance with applicable laws and regulations, regardless of whether their activities are performed in-house or outsourced.

The OCC also recognizes the considerable interest by the banking industry in artificial intelligence. To date, banks have generally approached machine learning and AI cautiously, across a range of use cases. The potential benefits of more widespread adoption of AI are significant, but so are the risks, which we expect banks to continue to manage appropriately.

In the digital asset space, attention is shifting from crypto to the tokenization of real-world assets and liabilities. In contrast to crypto, tokenization is driven by solving real-world settlement problems, and can be developed in a safe, sound, and fair manner. Next February, the OCC will host a public symposium on tokenization to take stock of developments, help enable strong foundations, and promote public discussion.

This fall, the OCC, along with the Federal Reserve and the FDIC, approved principles for climate-related financial risk management for large banks. The principles are focused exclusively on risk management and do not tell bankers what customers or businesses they may or may not bank, but clarify how large banks can maintain effective risk management and keep their balance sheets sound so they can continue to be a source of strength to their customers and communities through a range of severe weather scenarios.

In closing, the OCC continues to be engaged in a range of efforts to ensure that OCC-supervised banks operate in a safe, sound, and fair manner, meet the credit needs of their communities, treat all customers fairly, and comply with laws and regulations now and into the future. Thank you. Happy to take your questions.

Chair BROWN. Thank you, Mr. Hsu. Chair Gruenberg, I will start with you. Yesterday—you mentioned this—reported that pervasive sexual harassment, misogyny, lack of accountability have created a toxic environment for female bank examiners. These allegations, to say the least, are troubling. When the FDIC IG highlighted these problems more than 3 years ago, the FDIC agreed to changes but disagreed that its anti-harassment program was inadequate. What are you doing now to address these problems?

Mr. GRUENBERG. Thank you, Mr. Chairman. As I indicated, the report yesterday was deeply disturbing and troubling, and it is quite clear that we have had employees at the FDIC subjected to horrendous experiences that simply are unacceptable and cannot be tolerated. And it is really going to be incumbent on the agency to take all actions necessary to come to grips with this and to address it effectively. We are engaging a third party, an independent third party to do an agency-wide review, both of Washington as well as our regional and field offices, to inform us on the nature of the challenge here and how we may be able to address it effectively.

I think the core issue here, if I may say—you know, we have appropriate policies and procedures in place—the issue is it is really on management to instill the confidence in our employees to utilize those procedures and policies in a way that they can feel safe and secure, and that their information is kept confidential. And that is not an easy thing to do. I mean we can work on the policies and the procedures, but on the part of management, giving employees the sense of confidence that they can actually utilize these mechanisms to protect themselves if they are treated improperly, and also to have processes to hold individuals accountable who engage in misconduct, that is the core challenge that we are going to work on, through all the resources of the agency to try to address. We will be transparent as we proceed with this process. We will report out to you, and glad to keep you informed as we——

Chair BROWN. Thank you.

Mr. GRUENBERG. ——as we work.

Chair BROWN. As you said, perhaps not an easy thing to do, but we expect you to create a safe and welcoming workplace for all employees, examiners and others. It is also why we must confirm the FDIC Inspector General who was marked up in this Committee last week.

Second question, now for Vice Chair Barr. Capital allows banks to lend in good times and bad. It prevents taxpayers from having to bail out Wall Street banks again that take on too much risk. Briefly, why is this capital proposal needed?

Mr. BARR. Thank you, Mr. Chairman. I agree; capital is key to a resilient banking system and to a thriving economy. We need our banking system to serve households and businesses. Strong capital helps them do that, as you said, in good times and in bad. Capital is key to preventing financial crises and reducing their cost. This proposal only applies to the largest banks, fewer than 40 out of the more than 4,000 in this country. The proposal focuses on having stronger capital rules for trading and other nonlending activities where banks have had large losses.

The proposed changes for credit and the operational risk associated with credit are very small compared to the current rules. Overall, the proposal makes our capital system more consistent, more transparent, and more risk-sensitive. That said, we recognize that the rule may not appropriately capture all risks. We welcome all comments on all aspects of the rule. We will take these comments seriously to improve the rule going forward.

Chair BROWN. Thank you, Mr. Vice Chair. This spring, we saw that the weakened rules demanded by the Trump administration resulted in three of the four largest bank failures in our Nation's history. Starting with you, Comptroller Hsu, how has OCC revised—and I will ask each of you, so I will ask them all and then please answer in the last few seconds—how has OCC revised its supervisory approach to address the gaps that the prior administration created and the bank failures earlier this year exposed. Chair Harper, has NCUA implemented any changes in its approach to supervision in response to those bank failures? And then Chair Gruenberg of the FDIC, and Vice Chair Barr at the Federal Reserve. And since I am over my time, be as brief as you can. Thank you.

Mr. HSU. Sure. At the OCC, we have got strong processes in place. None of the bank failures that happened earlier this year were national banks. That being said, we have carefully reviewed all of the post mortems of those and identified areas where we can strengthen the agility and the speed with which we supervise, and the intensity of our supervision.

Mr. HARPER. Briefly, we have increased our assessments of liquidity within individual credit unions. We are also looking at commercial real estate, as we know that that is a rising concern. Fortunately, we had recently implemented our risk-based capital rules, which are increasing the capital to strengthen the system. And last, within the credit union system, 90 percent of deposits are insured, and so we did not see the instability necessarily that was seen in the banks.

Chair BROWN. Mr. Gruenberg.

Mr. GRUENBERG. Thank you, Mr. Chairman. We learned some hard lessons from the experience earlier this year. We have issued guidance for our examiners, focused on some of the key lessons from that experience—managing interest rate risk, concentrations of unrealized losses on loans and securities, uninsured deposit concentrations, rapid growth, and the need when necessary to escalate matters in regard to an institution, and to compel compliance if an institution is not responsive.

Chair BROWN. Mr. Barr.

Mr. BARR. Thank you. We have been focused on improving the speed, force, and agility of supervision as appropriate for the institutions we supervise. We are working on ensuring that we have appropriately intensified our supervision of the highest-risk firms. We are working to make sure that the assessment of risk appropriately influences supervisory activities. We are making sure that issuance of supervisory findings and enforcement actions are timely, and that they provide bank management and board of directors with the necessary information and incentives to remediate deficiencies quickly. And we are working to align the intensity of supervision with the institution's size, complexity, and business model, appropriately addressing rapid growth, for example, and other risk factors. As with other agencies, we are currently focused on issues such as interest rate risk, liquidity risk, risk to the credit profile of institutions, particularly CRE office risk, and also cyber risks.

Chair BROWN. Thank you. The senator from South Dakota, Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman. Mr. Chairman, as you have indicated earlier, yesterday the *Wall Street Journal* did publish a concerning article about the toxic atmosphere at bank regulator FDIC. I would like to enter a copy of this article in the record.

Chair BROWN. Without objection, so ordered.

Senator ROUNDS. Thank you.

Chair Gruenberg, were you aware of these allegations before the publication? A simple yes or a no would do.

Mr. GRUENBERG. As a general matter, no, Senator.

Senator ROUNDS. After the publication of this report yesterday, I understand, as you have stated before the Committee a few minutes ago, that you have informed the FDIC staff that the FDIC would hire an independent firm to conduct an assessment of these concerning allegations. It is also my understanding that there may be additional press reports coming as well. Are you going to be the object of any of these future reporting issues on this matter?

Mr. GRUENBERG. In terms of the agency's work? Not that I am aware of.

Senator ROUNDS. You personally, Mr. Gruenberg, are you going to be the object of any of these reports?

Mr. GRUENBERG. For news reports?

Senator ROUNDS. Yes.

Mr. GRUENBERG. I mean I cannot speak to that. You would really have to speak to the news organization, Senator.

Senator ROUNDS. Thank you, Mr. Gruenberg. Vice Chair Barr, as I detailed in my opening remarks, I do have deep concerns about the impacts that the Basel III Endgame Proposal will have on consumers and small businesses across the country. In fact, Vice Chair Jefferson asked at the time of the proposal, and I will quote, "Can you give me a sense of how and to what degree these higher capital requirements could constrain a bank's ability to lend to businesses and individuals? I am very concerned about these impacts." End of quote.

I echo Vice Chair's concerns and have yet to see any proof that this rule would not be incredibly harmful to businesses and individuals. My question for you is, how many days did you give your colleagues to review your holistic review before providing them the rulemaking?

Mr. BARR. Senator, I do not have the exact number of days in my head; we can get back to you on that. They had quite a long period of time to review the proposal——

Senator ROUNDS. I would appreciate——

Mr. BARR. ——and to provide input on that proposal.

Senator ROUNDS. Yes, I would appreciate it for the record——

Mr. BARR. It was——

Senator ROUNDS. ——as to how much time that you provided them on that.

Mr. BARR. I would be happy to provide that. There was an extensive period of time for review of the proposal before its issuance.

Senator ROUNDS. OK. When will this holistic review be released to the public, or at least to this Committee?

Mr. BARR. Senator, I was referring to the proposal that we put forward. The proposal itself is what goes through the normal notice and comment rulemaking process. The holistic review preceded that. It is what my predecessor did. It is what the person before in that job did. It is a chance to wrap our arms around the whole system before deciding whether to move forward with a proposal. The proposal follows the normal notice and rulemaking comment, the normal engagement with board members, normal engagement from the public.

Senator ROUNDS. So, you are saying——

Mr. BARR. We very much welcome those comments.

Senator ROUNDS. ——that holistic review is out already?

Mr. BARR. The holistic review preceded the work to engage in——

Senator ROUNDS. And is——

Mr. BARR. ——a public proposal.

Senator ROUNDS. ——is it public today?

Mr. BARR. The holistic review is an internal review——

Senator ROUNDS. And is that——

Mr. BARR. ——that I undertook in order to engage in this activity. I published remarks saying that as a result of that review, I thought the overall framework was sound.

Senator ROUNDS. But would that not have been something that would have been shared with other Members——

Mr. BARR. In the——

Senator ROUNDS. ——holistic review?

Mr. BARR. I am sorry; with other members of the Board?

Senator ROUNDS. Would other members of the Board not have had a chance to look at that review?

Mr. BARR. Other members of the Board have a normal chance to engage with the rulemaking process.

Senator ROUNDS. Well, but——

Mr. BARR. I have had many discussions——

Senator ROUNDS. ——but you did not share this holistic review with other members of—other members did not see it?

Senator ROUNDS. I had many discussions with other members of the Board about this capital rule and about my views on the capital process overall. So, I have been engaging with my fellow board members quite extensively.

Senator ROUNDS. So, you did not give your colleagues a copy of, or give them an opportunity to review, your holistic review before providing them the rulemaking.

Mr. BARR. There is not a document that is the holistic review, sir. That is not——

Senator ROUNDS. OK.

Mr. BARR. ——the result of that process. The work that is the result of that process is a decision about whether to move forward with a proposal. That proposal is the Basel III Endgame Proposal that we put forward, and the long-term debt rule that we put forward. Those proposals are fully public, and I have been engaging with——

Senator ROUNDS. Without a written analysis?

Mr. BARR. No, they contain a detailed written analysis in both cases as part of——

Senator ROUNDS. The detailed——

Mr. BARR. ——the proposal.

Senator ROUNDS. The detailed analysis, then—what you are saying is the rulemaking itself contains the detailed analysis?

Mr. BARR. Correct.

Senator ROUNDS. So, the detailed analysis, as a part of the rulemaking, comes out at the same time the rulemaking does, without any preliminary data being laid out before the rest of——

Mr. BARR. Sir, the rulemaking has followed the normal administrative rulemaking process, which is to include in the proposed rule all the analysis that supports the rule. We followed that exact same process here. It is the process we have used for rulemaking during the Fed's history. So, it is no different process; it is the same process that we always follow.

Senator ROUNDS. Thank you. My time has expired. Thank you, Mr. Chairman.

Chair BROWN. Senator Reed of Rhode Island is recognized.

Senator REED. Well, thank you very much, Mr. Chairman, and I would note that the Federal Reserve recently approved synthetic risk transfers in which banks use derivatives to reduce their capital requirements by shifting recent losses onto private equity funds and hedge funds. Having survived with 2008 and Dodd-Frank, when I hear derivative, I get nervous. When I hear it is synthetic, I get very nervous.

Mr. Barr, what are the risks of the financial stability of banks that are permitted to engage in these synthetic risk transfers on a significant scale, and what guardrails are appropriate to protect the financial system and ensure that we do not relive the past?

Mr. BARR. Thank you, Senator. It is an important question. We looked carefully at these sets of transactions. The transactions are different from transactions that we permit by rule under the existing authorities to offset credit risks that banks might face. We wanted to take a careful and cautious approach with respect to these transactions, so we have approved them on a case-by-case basis, subject to limitations. We are going to wait and see how those instruments perform. If they perform as intended, then they might be more generally available. If we see risks arising in those transactions, then we would limit their use for capital mitigation.

Senator REED. How much visibility do you have in the private equity and hedge funds that are involved in these transactions?

Mr. BARR. We have very strong visibility into the bank side of the transaction, that is, how the bank engages with third parties with respect to these risks. We will be monitoring those risks. We have, of course, much less visibility into hedge funds and private equity funds. That is a longstanding issue in supervision.

Senator REED. Well, you know, I think you have to have a really good perception of both sides of the transaction to conduct these, because there is a possibility that a private equity firm could be undercapitalized, mismanaged, and the transactions would fail.

Mr. BARR. In these particular transactions, Senator, the transaction that we approve, the cash is actually provided up front to the bank, and then it diminishes over time as the, as the credit continues to perform. So, in these particular transactions—I agree with you that that is a general concern—but in these particular transactions, the cash is actually provided at the beginning of the transaction rather than at the end of the transaction.

Senator ROUNDS. Thank you. Mr. Gruenberg and Mr. Hsu, do you see any risk to the financial system in these types of synthetic risk transfers?

Mr. GRUENBERG. I think there is considerable uncertainty, and we need to approach it with great caution and attention, Senator.

Senator REED. Thank you. Mr. Hsu.

Mr. HSU. I agree. They do require heightened attention, especially when risk transfer is thought of as risk elimination, which it is not. However, when done appropriately, in a safe and sound manner with controls, it can help to be part of an effective risk management program, but that does require a careful look.

Senator REED. Let me turn to another situation, the rent-a-bank situation in which banks partner with nonbanks to provide deposits and loans, and these arrangements can facilitate evasion of State usury limits and other important consumer protections. In fact, I think that is why they have these rent-a-bank arrangements. Mr. Gruenberg and Mr. Hsu, can you provide an update on what you are doing with respect to these rent-a-bank situations? Mr. Gruenberg.

Mr. GRUENBERG. Yes, thank you, Senator. You raise an important risk management issue for banks. These third-party relationships carry a lot of risk, and when a bank partners with a third party and that third party is carrying out services of the bank, it is as if the bank itself is doing that directly, and the bank is accountable for it. So, the management of those third-party relationships are really quite important and carry a lot of risk with it.

The challenge here in part is the ability of States to export their interest rates to other States and circumvent the usury laws, and that is something we are giving some attention to.

Senator REED. OK. Mr. Hsu, quickly?

Mr. HSU. Yes. So, predatory lending has no place in the national banking system, whether done directly by banks or in partnership with fintechs, and we have made sure of that.

Senator REED. Thank you very much. Thank you, Mr. Chairman.

Chair BROWN. Thank you, Senator Reed. Senator Tillis of North Carolina is recognized.

Senator TILLIS. Thank you, Mr. Chairman. Mr. Gruenberg, in response to Senator Rounds' question about whether or not you had any knowledge prior to the publication of the report, you said, as a general matter, no. Should I read anything into that, or did you not know about any of these activities before the report?

Mr. GRUENBERG. Yes, I did not know about the individual cases. I would not in the normal course of things, Senator.

Senator TILLIS. OK, thank you. Mr. Barr, the thing I have admired about the Fed, I think the thing that the industry has admired about the Fed is it has a long history of consensus-driven decisionmaking. You clearly at this point do not have consensus on some of the notice of public rulemaking, the endgame for Basel III; I know of maybe some questions or concerns that Mr. Jefferson had raised, Mr. Powell, and others. Do you intend to move forward with this if you do not have consensus among the Board?

Mr. BARR. Thank you, Senator Tillis. I will be working to achieve broad consensus of the Board in——

Senator TILLIS. What if you do not?

Mr. BARR. ——the final rule. As with all rules, we try very hard to get as close to full consensus. I would like to get broad consensus. I do not know whether I will be able to get full consensus——

Senator TILLIS. And what would broad consensus look like?

Mr. BARR. Broad consensus would be that most of the Board believes that this is an appropriate step. You know, most of the activities that we have put forward over the last year and a half since I have been on the Board—not quite a year and a half, but 15 months—most of those have been full-consensus items. We have had about 50 substantive supervision and regulation matters come before the Board. Almost all of them every Board member has voted in favor of. I very much appreciate and value the collegial nature of the Board and the consensus——

Senator TILLIS. Well, if time allows, I want to get to some of the areas, particularly the cost and putting us at a competitive disadvantage, but I want to move on to something else. The Chair talked about—and this has been suggested before—that Silicon Valley Bank and Signature Bank failed because of Senate Bill 2155, bipartisan regulatory reform that we implemented in the Trump administration, with the support of the Democrat members in this Committee. Have we passed a law since Silicon Valley Bank failed that has increased your supervisory authority?

Mr. BARR. No, Senator.

Senator TILLIS. No. But you did say you have stepped up and you have intensified supervision. I am assuming you did part of that by using the optionality in Senate Bill 2155 to actually increase your MRAs and MRIAs. Is that accurate?

Mr. BARR. As I have indicated in previous testimony, we have the legal authority we need to——

Senator TILLIS. So, I guess that——

Mr. BARR. ——engage in this——

Senator TILLIS. ——it is just odd to me to think that we had a bill that has been more than once pointed to as a reason for the failure. We have not changed a line of regulatory legislation. You are intensifying your supervisory functions, which you should if they are founded on banking activities that you think represent a risk. So, I just do not get it. You had that optionality. One of the reasons why I think Signature failed is because someone was asleep at the switch in the supervisory function, and a management failure. But I just cannot let that go unchecked, because you are stepping up, and it relates to another question I have.

I sent a letter back in September when there was a news report talking about seven different financial institutions and their dramatically increased—specific institutions—dramatically increased MRAs and MRIAs. I cannot imagine that those seven banks just went to the press and said, hey, we are getting a lot more impact. That sounds like someone from the Fed or a supervisor had to have leaked confidential supervisory information. We copied you on the letter, but can you tell me whether or not there is any investigation underway to figure out how that information got out? I cannot imagine it came from the industry. It just does not make sense for any reporter to have that specific information on seven institutions to serve as a basis for a report.

Mr. BARR. Senator, I also was upset by that article. I did not think that it was appropriate. We do have strict rules on confidential supervisory information. I am not aware of the source of that article, but I do find it upsetting.

Senator TILLIS. Yes, and I think somebody needs to be tracked down and terminated for doing it. Mr. Chair, I would like to seek unanimous consent to introduce this article. It was written by my alma mater, by PricewaterhouseCoopers—"A Financial Services Update, Basel III Endgame, Outsized Operational Risk Impact".

Chair BROWN. Without objection, so ordered.

Senator TILLIS. Thank you. I have only got 20 seconds left, so we are going to have to submit questions for the record. I believe, in its current form—and that is why I hope that you can find consensus—in its current form, I think we are going to disadvantage banking institutions in terms of global competition. I think the operational risk is outsized, and we have got a lot of questions, and I do not have any more time. Thank you.

Senator Tester of Montana is recognized.

Senator TESTER. Yes, thank you, Chairman, Ranking Member, and I want to thank everybody for testifying today. Marty, the article that came out in the paper is damning, very damning. I guess the question is, it says in this article that folks were demoted, but nobody was fired. But the things, if true, the stuff in here, do you see them as a fireable offense?

Mr. GRUENBERG. You really have to look at the individual cases, Senator. We have had cases in the past where individuals are separated from the agency. We have had cases in which other disciplinary actions short of separation have been utilized. It depends on the facts of the case, and the law, and you really have to look at the individual cases.

Senator TESTER. And I understand that, but I will tell you that this is so pervasive that 20 women have quit. I know you have got a big agency so that might not be a lot, but man, I think if you are going to change behavior, the best way to do it would be to deal with these folks very severely. And I know you need probably more regulators than you have now, but the truth is is that what was represented in that *Wall Street Journal* article is absolutely, as you already pointed out, unacceptable.

I want to talk about Basel. It is the same line of questions as has been talked about here from both sides of the aisle. Look, I am concerned about small businesses, because Montana is a small business State. They have to have access to capital. These rules do not affect any banks in Montana, but they do affect the big guys that affect Montana, OK? And if you look at our system, it has worked incredibly well, especially when you compare it to what folks in other countries have access to, but I do have some concerns about the proposed changes and how its impact will be on workers and households and small businesses, and access to credit and overall vibrancy of our capital markets. So, the question is is, how are you guys—and I am talking Barr and Hsu and Gruenberg—how are you evaluating the impact of these proposal changes on the consumers? Go ahead.

Mr. BARR. Thank you very much, Senator Tester. First of all, let me just say we share your same concerns. We want a capital system, a banking system that works for households, it works for businesses, works for small businesses around the country that are really the lifeblood of their communities. The way we have analyzed this rule, we do not believe that this will have significant negative effects on small businesses. The credit provisions in the rule are quite similar to existing, binding provisions, and we welcome comment if we can improve the rule in that regard.

Senator TESTER. We will stick with you, Michael. And so you are in the process of taking in comments that go until the end of January, correct, or end of January, somewhere in that——

Mr. BARR. That is correct, January 16th.

Senator TESTER. And so can you tell me, have you looked at those comments yet, and do any of them talk about the issue that I am talking about, about how this is going to affect consumers?

Mr. BARR. We expect most comments to come in in mid-January, but we already have heard in the public discourse a concern in this regard, and we are paying very, very close attention to that. And as I said, if there are areas that we can improve the rule, we are very open to doing that.

Senator TESTER. And so you are open to improving, a.k.a. rewriting the rule, if the comments reflect that?

Mr. BARR. We very much welcome all of those comments. We have to look at the substance of them, but we want to make sure the rule works right for households and businesses, and if we need to make adjustments to the rule to make sure that that is the case, we will do it.

Senator TESTER. OK. So, not to beat this horse anymore, but I will just tell you that from a small business standpoint, if this rule does not work, it is going to raise hell with the economy of my State, so that is all I need to tell you.

I have also had a conversation about how potentially this could push activities into the nonbank sector that is not regulated. And I will stick with you, Michael, because I do not have enough time to go down the line. How do you consider those larger impacts, based off the rule that is going to be put out? Because as most of us at this side, all of this side, I mean we remember what happened in '08 pretty vividly. Jack referred to it. Could you tell me how you weigh this stuff out? Because if we are pushing stuff to the nonbank—and I am sorry I am over time—but if we are pushing stuff to the nonbank, that is not a good thing. Talk to me.

Mr. BARR. Thank you, Senator Tester. I share your concern. It is an issue that we take very seriously, will continue to take seriously as we get in comment. If it looks like in the mix of things that we are increasing risk, we obviously would not want to do that. We want to make sure that we are reducing risk with the capital proposal. We want to make sure we have good, strong regulation of the nonbank sector, and we want good, strong rules in the banking sector, because we need a vibrant banking sector to support the American economy.

Mr. TESTER. It is absolutely critical. Without access to capital, we are dead in the water. Thank you, Mr. Chairman.

Chair BROWN. Thank you. Senator Britt from Alabama is recognized.

Senator BRITT. Thank you, Mr. Chairman. Thank you all for being here today. Since your last appearance before this Committee in May, banks of all sizes have yet again proven their strength and ability to withstand unexpected volatility. In fact, quickly I would like to just go down the row, and each of you please answer with yes or no. Do you believe that the U.S. banking system at large is strong? Vice Chair Barr, we will start with you.

Mr. BARR. Yes, I do.

Mr. GRUENBERG. Yes, Senator.

Mr. HARPER. Yes.

Mr. HSU. Yes.

Senator BRITT. Great, thank you. So, for the record, all of you believe the U.S. banking sector is strong, yet over the last several months, we have seen a wholesale attempt to fundamentally alter our banking system. Not only do your agencies' recent proposed rules undermine the proven strength of our banking sector, but they risk making it weaker, and it is Main Street America that will ultimately be punished. I have spoken directly with dozens of banks and credit unions of all sizes. It is clear that your proposed rules are so wide-reaching that they leave no financial institution untouched.

Even more concerning, it is apparent that the lack of effort from you as regulators to engage these institutions is startling. Along with the absence of any stated rationale for making these key decisions, I want to start with the Basel Endgame rule. Let me follow up on a question that Senator Rounds asked. Vice Chair Barr, how long did your fellow Board members have to review the proposed rule prior to it being issued?

Mr. BARR. They had an extensive period of time. I will get you the exact number of days, but it was many, many weeks. I believe—well, anyway, I do not want to guess. I will tell you the exact number of days for the record, but it was many weeks to review.

Senator BRITT. Many weeks. So, many weeks would be longer than 2, then.

Mr. BARR. Correct.

Senator BRITT. OK. So, your colleague Governor Cook testified in this Committee on June 21 that she had not yet seen the Basel III proposal, so that just 2 weeks later, the proposal was rolled out. So, does that mean that your colleagues had less than 2 weeks to actually to review the rule, or was she mistaken in that testimony?

Mr. BARR. Each Governor can decide how much they want to engage in the process——

Senator BRITT. But she had been given——

Mr. BARR. ——they are available——

Senator BRITT. ——the opportunity and then chose not to, I guess?

Mr. BARR. I cannot speak specifically to what Governor Cook chose to do, but every Governor was given the opportunity to meet with staff and to be briefed on the proposal in detail.

Senator BRITT. OK. Well, the rule assumes that banks are significantly undercapitalized for operational risk, but yet cites no evidence to support this assumption. Not only are these risks already accounted for in stress testing, but the new standardized approach is not tailored to the varying business models of various banks. Vice Chair Barr, would you say you have done a thorough analysis to understand the impacts of the proposed operational risk requirements, and what they would have on availability of mortgages, on small businesses, small business loans, and retail credit to consumers?

Mr. BARR. Thank you, Senator. The analysis goes into detail in the preamble on these items. As I suggested, with respect to credit risk, whether that is for mortgages or small businesses or consumers, just the combination of the credit risk proposal and operational risk is very, very small in relation to current rules.

Senator BRITT. So, obviously that is a yes. The way that I view this, the Basel Proposal is over 1,000 pages, with fewer than 20 pages dedicated to actual economic analysis. Also absent is a study of the combined impacts of other concurrent proposals, like the long-term debt proposal and debit fee caps, despite the fact that each of these proposals will actually clearly overlap. And it raises the question if you are unable to do a cumulative impact and put that actually in the rule, or are you just unwilling to do that?

Mr. BARR. We continue to study impacts of the rule. We welcome public comment, both on the long-term debt proposal and on the capital proposal. If analysis is coming from the public that is helpful, we are happy to include that——

Senator BRITT. I think it is——

Mr. BARR. ——in improving the rule.

Senator BRITT. ——critically important—and I am almost out of time. We have to look at how these things work together, because it is clear that there is a trickledown effect, and I think we have got to do a better job of stating that.

Mr. Barr or Chair Gruenberg, what is the Cumulative Impact Study, and have you conducted that and actually put that in in writing?

Mr. BARR. The Quantitative Impact Study is a study that we did prior to release of the rule. It was done by the Board in 2021.

Senator BRITT. OK.

Mr. BARR. That was included in the proposal, and now in addition to that, we are updating that Quantitative Impact Study with a new study that will gather information to make sure we have the most up-to-date information as we proceed to finalize the rule.

Senator BRITT. And last before I run out of time, do you plan to grant a comment period extension for the proposal on long-term debt and resolution planning?

Mr. BARR. That is a simpler rule, a pretty straightforward rule compared to the Basel Proposal, but if there are concerns that——

Senator BRITT. I think there are concerns——

Mr. BARR. ——people need more time——

Senator BRITT. Absolutely, and——

Mr. BARR. ——we are happy to consider such matters.

Senator BRITT. Well, thank you so much. I hope that you will do that. Look forward to it. Thank you.

Chair BROWN. Senator Cortez Masto from Nevada.

Senator CORTEZ MASTO. Thank you, thank you. Gentlemen, thank you for being here. Chairman Gruenberg, let me start with you. Thank you for reaching out to talk about the concerns. I think we all are alarmed by what we are reading in the *Wall Street Journal* regarding the sexual harassment at FDIC, so I appreciate you reaching out. I also appreciate the fact that you have talked here today about doing a comprehensive review, an independent third-party, agencywide review. Thank you for that. I guess my question is, one, how long will that review take, and two, in the meantime, what do employees do if they want to come forward and feel confident in coming forward with a complaint?

Mr. GRUENBERG. That work is just beginning, Senator. I think we would hope to get it done as soon as possible, 90 days or less if we can, but we are just starting on that. In the interim, I mean we do have a range of processes that employees can take advantage of if they want to report some experience that is problematic. We obviously want to look at that and see how effective that is, and how we can make the system—give employees as much confidence as possible to be able to utilize it effectively.

Senator CORTEZ MASTO. Thank you, and I look forward to working with you as we follow up on this review to make sure this is addressed.

Mr. GRUENBERG. Thank you, Senator.

Senator CORTEZ MASTO. So, I appreciate the comments today. Let me jump to the Community Reinvestment Act. I want to say congratulations on the new CRA. First question is, how will this new rule improve lending and investments in low- and moderate-income communities? And let me just start with the Comptroller. Thank you.

Mr. HSU. Sure. Thank you so much for that question. So, the CRA, the final rule that was just adopted both modernizes and strengthens the CRA implementing rules, and it modernizes it by basically taking into account a lot of these banking activities that take place outside of traditional branches and the ATMs. That is an important part of the rule. You know, banks do activities outside of those areas, and so now they, under the rule, have to meet the needs of all of those, including LMI communities in those locations. It also strengthens the rule by putting in more objective thresholds and benchmarks for their activities, which should lead to an increase in CRA lending and investment activities across both retail and community development.

Senator CORTEZ MASTO. Thank you. Chairman Gruenberg, anything else to add?

Mr. GRUENBERG. Yes, I would add that there is a lot in this rule, but a third really critical point is that it gives banks the flexibility to engage in community development financing, whether lending or investment in any LMI community across the country and can get CRA credit for it, so it really helps address the issue of banking deserts, communities that lack access to banks in their local area will now be able to seek support from banks anywhere, and those banks will get credit if the lending and investment activity takes place in an LMI community. This will benefit rural areas, Native lands, and other severely underserved communities.

Senator CORTEZ MASTO. And thank you for bringing that up. My next question was our Native lands, our Tribes, because I know they are so challenged, and I am hopeful that we are also focusing on ensuring we are bringing access to the central finance there as well.

Mr. GRUENBERG. That is very much a focus of that, Senator.

Senator CORTEZ MASTO. Thank you. And I do not know; Vice Chair Barr, do you have any additional comments?

Mr. BARR. Thank you. I do think that the rules implementing CRA have been updated in an important way. I think it will provide additional transparency and consistency in evaluation, across the agencies and across the country, that will help both banks and communities. I do think this is a win-win final rule. It will work better for banks in helping them to serve communities. It will work better for communities themselves.

I also wanted to just particularly call out the consideration that is given for investments in loans and support for community development financial institutions and minority depository institutions. I think that is a critical part of the rule, along with the clarity that is provided for a range of community development activities.

Senator CORTEZ MASTO. I do as well. We are challenged in Nevada with a lack of CDFIs and different opportunities to ensure we are bringing access to capital and financial means to individuals in Nevada, in our rural and urban areas. So, this is a big, really a positive change, and I just hope as the implementation and follow-through, we are seeing the intent here at the end of the day, so thank you.

Comptroller Hsu, can you describe how Project REACh is promoting home ownership for Latinos, African Americans, and those on Tribal lands?

Mr. HSU. Sure. So, in Project REACh, the OCC functions as a convener. We bring together leaders of banks, community organizations, civil rights organizations, technology companies. They have identified in the home ownership workstream very some specific issues and problems and challenges with home ownership on Tribal lands, because a lot of the ownership issues are quite different. So, brought that together, really produced a set of materials to enable banks and community groups to engage, and hosted a webinar; I think there were several hundred people that joined that webinar. A lot of it is about education. So, there is no excuse, because before, there was the sense of, oh, this is too hard. We have now made that much easier.

Senator CORTEZ MASTO. Thank you. Thank you, Mr. Chair.

Chair BROWN. Thank you, Senator Cortez Masto. Senator Kennedy from Louisiana is recognized.

Senator KENNEDY. Thank you, Mr. Chairman. Mr. Gruenberg, what the hell is going on at the FDIC?

Mr. GRUENBERG. That is a troubling question, Senator. I read the report as you did. As I indicated earlier, it is deeply disturbing and troubling, and we are going to bring all the resources of the FDIC to bear to understand what is going on, what has occurred, and how we can most effectively address it.

Senator KENNEDY. How long have you been at the FDIC?

Mr. GRUENBERG. I joined the Board as a member in August of 2005.

Senator KENNEDY. OK. Almost 20 years, then, huh?

Mr. GRUENBERG. Yes, sir.

Senator KENNEDY. Have you ever sexually harassed an employee at the FDIC?

Mr. GRUENBERG. No, sir.

Senator KENNEDY. Apparently you are the only one. I mean I just find this incredible. A former female employee recalled her male colleague saying women needed to use sex to get ahead at the FDIC, as they stared at her. Did you read that?

Mr. GRUENBERG. I did, Senator.

Senator KENNEDY. Quote, "According to one young woman, it was just an accepted part of the culture." One of the female examiners received a photo of a colleague's penis. During lunch with an examiner, another young female employee, who had become friendly with this person she was having lunch with, the guy she was having lunch with complained to her about his marriage, telling her he was not having enough sex. And then he said to the young woman, "Obviously, if I walk into this office and you were naked, I'd 'f' you right here." Did you read that?

Mr. GRUENBERG. I did, Senator.

Senator KENNEDY. Did you read the 2020 Inspector General's report when it said that the people at the FDIC were acting like they were in Animal House or Porky's Revenge? Did you read that report?

Mr. GRUENBERG. I read the Inspector General's report, sir.

Senator KENNEDY. And what did you do about it?

Mr. GRUENBERG. Well, I was not chairman at that time. There were 15 recommendations, if I may say, 15 recommendations in that report, and I believe the agency addressed all 15 of those.

Senator KENNEDY. What did you do about it personally? What was your position——

Mr. GRUENBERG. I was a member of the Board at the time, but I was not——

Senator KENNEDY. And what did you do about it personally?

Mr. GRUENBERG. At that time, I did not have the responsibility of——

Senator KENNEDY. You did not do anything, did you?

Mr. GRUENBERG. Not at that time, Senator, no.

Senator KENNEDY. OK. Did any of your fellow Board members do anything?

Mr. GRUENBERG. As a general matter, that falls to the chairman, who is responsible for the day-to-day management——

Senator KENNEDY. It was somebody else's problem, not yours.

Mr. GRUENBERG. No, I was a member of the Board to the extent that we were consulted, but in this matter it is really a management——

Senator KENNEDY. You did not think you had a fiduciary obligation to those young women and to the organization, and to the banks that put up the money?

Mr. GRUENBERG. Well, certainly as a Board we had that obligation, but it really falls to the chairman to take the lead on this.

Senator KENNEDY. Oh. Somebody else's fault.

Mr. GRUENBERG. Well, it was the chairman——

Senator KENNEDY. I mean that is what you are saying, is it not, Mr. Chairman?

Mr. GRUENBERG. No, I think the Board——

Senator KENNEDY. Sounds to me like it.

Mr. GRUENBERG. Senator, if I may say, the Board certainly has oversight responsibility, but in the day-to-day management of the agency, which matters like this would fall to, I think it is reasonable to expect the chairman to take the lead.

Senator KENNEDY. Well, when the banks last spring screwed up out in California, you blamed it on their Board, did you not?

Mr. GRUENBERG. I think the report that was done on the failure found that the root cause of the issue was the management of the institution.

Senator KENNEDY. Right.

Mr. GRUENBERG. It also found accountability for the supervisors——

Senator KENNEDY. The Board was blameless, is that right? Is that what you are saying?

Mr. GRUENBERG. No, I think the agency——

Senator KENNEDY. Kind of like the Board at the FDIC is blameless?

Mr. GRUENBERG. If I may say, Senator, the report found, and I think I would indicate, that we shared responsibility as a supervisor.

Senator KENNEDY. You and your colleagues ought to hide your head in a bag. This is no country for creepy old men, and they have got no place at the FDIC. And this was not a news flash for you. You had a 2020 report, and you sat on the Board, and you did not do anything. And your colleagues did not do anything.

Mr. Barr, let me ask you about Basel III Endgame. I know you know this—about half of our credit now in America comes from nonbanks. Is your increase in capital requirements not just going to make credit more expensive for banks, and push people in the nonregulated, nonbank financial system?

Mr. BARR. Senator, the capital increases mostly affect trading activity of banks and other nonlending activities of banks. With respect to credit, we expect the proposal to have only a very modest effect on the price of credit. For example, if all of the operational credit risk——

Senator KENNEDY. You would stake your reputation on that?

Mr. BARR. I believe that the analysis is correct in the proposal to the rule, but we are——

Senator KENNEDY. OK. If I could ask one more question, Mr. Chairman, if that is OK.

Mr. BARR. ——but we are very open to comment on the proposal. So, if people have other analysis that would help us make a better judgment about that, we are very open to it.

Senator KENNEDY. The banks out West and elsewhere that went broke last spring, would this change have prevented that?

Mr. BARR. The banks that suffered losses, suffered losses primarily because of interest rate risk. In this proposal——

Senator KENNEDY. It would not have prevented it?

Mr. BARR. Sorry——

Senator KENNEDY. I am going to get cutoff.

Chair BROWN. Senator Kennedy, last question. This is it.

Senator KENNEDY. If you could just answer my question. My time——

Mr. BARR. I am trying to, sir. Yes, it would directly address that, because for large banks, their interest rate risk would be brought into the capital rule. Their unrealized losses and gains would be reflected in capital, so it does directly address the kind of risk that we saw.

Chair BROWN. Senator Menendez is recognized.

Senator MENENDEZ. Thank you, Mr. Chairman. The United States is facing a housing crisis, and affordable housing advocates I have heard from are concerned that the new capital requirements proposed by your agencies may make the problem worse. And analysis from the Urban Institute indicates that banks affected by your proposal account for more than half of all mortgage originations. The Urban Institute's analysis further indicates that the proposal will disproportionately increase costs for Black, Hispanic, and low- and moderate-income borrowers, so one effect of this proposed rule seems to be in direct conflict with the goal I and many members of this Committee share, to close the racial home ownership gap and make housing more affordable for first-time homebuyers, particularly buyers of color.

Vice Chair Barr, Chairman Gruenberg, Comptroller Hsu, as you work to finalize this rule, what do you say to Black and Hispanic communities who are concerned that your proposal could make the dream of home ownership even more difficult to achieve?

Mr. BARR. Senator, first let me say we take these concerns very seriously. We are quite open to comment, and we want to improve the rule before we get to a final rule. This is one area where we have heard there may be concerns that the mortgage rules are over-calibrated. Of course, the proposal leaves the same rules governing mortgages that are issued by FHA or that are insured by Fannie and Freddie, or they are guaranteed by Fannie and Freddie, agricultural loan, VA loan, so those rules do not change. Those are most mortgages in the country, but we do care very much about access to credit for low- and moderate-income borrowers. We hear those concerns, and we will very much take those into account as we work to finalize the rule.

Mr. GRUENBERG. If I may say, Senator, we are deeply sensitive to this issue. The preamble to the rule actually asks a couple of questions and outlines alternative approaches for risk weights in regard to mortgages, and I am hopeful that we will be able to address this issue in the final rule in a satisfactory way.

Mr. HSU. I agree with what Vice Chair Barr and Chairman Gruenberg said.

Senator MENENDEZ. Well, I appreciate your desire to maintain safety and soundness in the financial system, but I would encourage you to also ensure that we keep enough capital flowing so hardworking borrowers can become homeowners. And while it is true that some of those other entities, FHA and others, may not be affected by this, not everybody is necessarily going to fall in that category to qualify, so it is really important.

I want to thank you all on the work on the updated CRA rule. I think the changes make a strong step toward more accurately evaluating and encouraging banks' engagement with low- and moderate-income and majority-minority communities that for far too long have faced barriers to financial inclusion. However, even the strongest of rules will not have an impact unless they are accompanied by appropriate supervision and enforcement.

We saw earlier this year with the collapses of SVB and Signature Bank what can happen when regulators fail to properly supervise their charges and enforce our banking laws. So, Vice Chair Barr, Chairman Gruenberg, Comptroller Hsu, as you work to implement the updated rule, what will you do to ensure your supervisory teams are fully trained and properly evaluating banks under the new guidelines?

Mr. BARR. Senator, you raise a very important point. Having an effective rule is only effective if you have effective implementation. We are going to be taking the next 2 years, as the rule comes into place in 2 years from now, to make sure that we have good, strong training for examiners, that we have good guidelines for examiners, that we make sure we are working very closely with banks and communities in partnership on implementation so we have an implementation approach that works for banks, that works for communities, that provides the clarity that both banks and communities want. We are going to be developing online tools to help banks be able to comply with the rule at lower cost, and to provide transparency to consumers and households that want to know how banks are performing under the rule.

Mr. GRUENBERG. Senator, I would underscore that the three banking agencies worked collaboratively to finalize this rule, and we do think the final rule is a strong one. And I think we are all committed to work together in a coordinated way on the effective implementation. As Vice Chair Barr said, the rule is only as meaningful as its implementation will be, and I think we are all entirely focused on that.

Mr. HSU. And I can say that staff are already working on implementation as we speak.

Senator MENENDEZ. All right. Well, I look forward to seeing the actual implementation in the way it is meant. Finally, Vice Chair Barr, you and I have spoken about the broken process for selecting Federal Reserve Bank presidents, which in 109 years has never resulted in a Hispanic or Latino bank president. And during the confirmation process, you made a commitment to develop a transparent process with meaningful public input on the selection of Federal Reserve leadership. I suggested six ideas to you. Since then, we have had a series of openings at Kansas City, Chicago; there is one ongoing in St. Louis. Can you give us an update on your efforts to reform the selection process? What changes have you made, and how have they impacted the recent and ongoing searches?

Mr. BARR. Thank you, Senator. First let me say I share your view that diversity among Reserve Bank presidents and among the staff of the Federal Reserve, and among the Federal Reserve Board and the FOMC is an important part of making sure that the Federal Reserve as an organization hears lots of perspectives and makes good decisions. There have been improvements in the process for selection of Reserve Bank presidents, improved transparency, improved outreach, but I think we have more that we need to do in that regard.

Chair BROWN. Thank you, Senator Menendez. Senator Lummis of Wyoming is recognized.

Senator LUMMIS. Thank you, Mr. Chairman. Chairman Gruenberg, I came down on you when you were here before with regard to the fact that you and CFPB Director Chopra and Acting Comptroller Hsu voted to oust your predecessor. She was a highly qualified woman. So, you ousted her, and now you are the chairman. You have been there for 18 years, at an agency that now has been exposed as having a hostile work environment toward women, that women are denied opportunities for advancement, they are denied opportunities to travel on the road so this disgusting behavior can continue among your colleagues, people who work for you, under your direction.

We know that some of the employees who harassed women at the FDIC found employment at other agencies. Great, send them elsewhere instead of oust them from the system. The careers of women have been stalled out, and the culture is skanky at the FDIC. It is disgusting. So, what reforms to Civil Service do you need to remove bad employees from positions of public trust, instead of shuffling them to the Fed or the OCC? And further, what are you specifically going to do about this?

Mr. GRUENBERG. Senator, thank you for the question. As I indicated earlier, we are undertaking a comprehensive review of the agency, both Washington, the regional offices, and the field offices, to try to get a handle on the nature of this issue. We are utilizing an independent third party to assist us in that, and to try to get at the underlying issues that you raise. And the issues will go to both management providing confidence to employees that they can, in a safe, secure, and confidential way register complaints if——

Senator LUMMIS. Yes, but tell me why you have not done anything, since you became Chair, about this. Did it take a *Wall Street Journal* article so you were publicly outed for this disgusting work culture? Why when you had the earlier report in your hands did you not do anything about it?

Mr. GRUENBERG. Well, Senator, if I may say, that earlier report had 15 recommendations, all of which the agency resolved to the satisfaction of the IG.

Senator LUMMIS. Did it change the culture?

Mr. GRUENBERG. No, I think it probably did not, and I think candidly that is the underlying issue here. And I raised that earlier, that it is not simply a matter of policies and procedures, but trying to get at the underlying issues that make it challenging for employees to utilize them, and that management has a responsibility to enable employees to do that, and I think that is what we want to focus on.

Senator LUMMIS. OK, so you know that people were either puking off of roofs and peeing in elevators, or vice versa.

Mr. GRUENBERG. Well, that was certainly in the report, and that is certainly things we will be looking at.

Senator LUMMIS. OK, you are—you know, if that happened in my office, I would be doing a lot more than looking at it.

Mr. GRUENBERG. Well, we——

Senator LUMMIS. I mean that is so far beyond the pale of what would be acceptable human behavior anywhere, let alone in what is supposed to be a respected Federal agency, that just looking at it, or having a third party come in and evaluate, that is bureaucratic mumbo-jumbo for we are doing nothing, and nothing is going to improve. And I think this is so far beyond the pale that I am just going to say, you sure as heck better do something about this.

Now I want to switch and ask one question about Basel III. The largest banks have already said that these onerous restrictions will decrease their lending activity. So, to all of you, what is more likely, that overall consumer lending will drop, such as people who want to buy a house or a small business, or that lending will migrate to nonbank entities that are more opaque?

Mr. BARR. Senator, our expectation is that given the very small nature of the credit changes in the rule, that credit would not significantly change under the rule. But we are open to public comment on this, and we are happy to receive comment. Earlier, the gentleman mentioned one such comment. We are open to all comments, and we would be happy to take them into account.

Senator LUMMIS. Thank you. My time has expired. Thank you.

Thank you, Senator Lummis. Senator Warner from Virginia.

Senator WARNER. Well, thank you, Mr. Chairman, and it is great to see all of you. Thank you all very much for your service. I think about the fact that when I first got on this Committee when Chris Dodd was chairman, we got right into the middle of a financial crisis, and I would actually argue to all of my colleagues that the resulting legislation of Dodd-Frank actually has stood the test of time. We went through COVID. We have gone through SVB. We have gone through digital asset issues. But I also think one of the things we at least learned from SVB is, you know, there is no single tool that is going to solve all the banking crises, and particularly when you have got a run in a 6-hour period that takes 25 cents on every depository dollar, frankly, no capital requirements in the world are going to meet that.

Chair Gruenberg and Vice Chair Barr, I have met with you and want to continue meeting with you. I have raised privately, I am going to raise publicly some of my concerns now with the Basel III rule, not only in terms of the capital required—I do want to get into more of the comments some of you have made that are number of the major G–SIBs are already meeting those new capital requirements—but I do feel like this could be the moment of a perfect storm, where you have got the challenges around rising interest rates, you have got quantitative tightening, you have the challenge that I have been concerned about for some time is that this may actually result in pushing more lending outside the regulatory perimeter. Layer on top of that we have got a lot of geopolitical risk, and I do think—and I appreciate what you have both said to me, that you are going to look very carefully at the comments. I worry a little bit about the schedule, that the comments may not come in until after the rule gets close to finalization, and again I really want to make sure that you are listening to legitimate concerns.

Let me also acknowledge to my friends on the Banking side of the house that anytime—I have heard since I have been on this Committee that no matter what happens, any new regulation is going to lead to this dramatic decline in lending, that Chicken Little approach that every new regulation is going to be the end of lending on Main Street, really lessens your cause, when this may actually be the time when—and as we have seen from some of the civil rights organizations, real concerns about that lack of lending in the mortgage field. So, I do want to also bring to the table an issue I do not think that has been really raised yet, and that is as we think about how we strengthen our system, and before we think about adding a whole lot of new tools, one of the things I think we really ought to look at are some of the tools that frankly have not been used. You know, back when the Federal Reserve was created, we created the discount window, and in many cases, usage of that by banks could have potentially alleviated this crisis. Particularly SVB was clear; they did not even know how to do it. And I think it has been clear that the idea that kind of instead of using the discount window, we are going to go to the Federal Home Loan Bank, that is just not a good enough alternative.

So, I appreciate what the Fed put out this summer in terms of encouraging more usage. One of the things I have raised with both of you—and I know I am going about asking Mr. Barr and Mr.

Gruenberg to comment—should we go beyond this encouragement of using the discount window and actually require some level of mandating. How you do that, the devil would be in the details. But unless we can make this a normal course of operation—and I do not have any sympathy for banks who then say, well, that would put us under the stigma from the market. Well, you cannot complain about regulations and then not use the tools that are already in existence. So, how much further could we go to make sure that the discount window, in terms of liquidity issues, is used in a more effective way? And I would ask both of you to comment.

Mr. BARR. Thank you very much, Senator, and I have very much enjoyed our conversations over the many years now on these sets of topics. I have learned a great deal and continue to learn. We look forward to the comments on all of the aspects of the rule that you have indicated. With respect to the discount window, we really are encouraging banks to use the discount window, as well as the Bank Term Funding Program that we set up during the March banking stress. Both of those kinds of programs are really essential for providing liquidity to the system, and use of the discount window and the BTFP really calmed the situation down in March and prevented the kind of massive liquidity flows.

We are looking broadly at our liquidity rules to see whether we might make improvements. We are looking at the kinds of issues you raised with respect to making sure that banks are prepared to use the discount window, they have good contingency funding plans, they test those plans, and they use the discount window. So, I think you raise an excellent point.

Senator WARNER. Mr. Chairman, I have got 20 seconds more. I would like to go, but just go ahead quickly, Marty, if you——

Mr. GRUENBERG. Senator, I agree with the points that Vice Chair Barr just made. I think the discount window is the reliable source of liquidity for short-term liquidity under stress. We want to try to address any stigma attached to it. Management of collateral and timely management of collateral to access the window is critical. And the notion that you raise about either prepositioning collateral or requiring some periodic use to demonstrate the capability to utilize the discount window is something we might take a look at.

Senator WARNER. Thank you both, and I will not ask another question, but I do want to make one quick point. I have spent a whole lot of time on artificial intelligence, maybe not as much as Senator Rounds. I cannot think of a subject that is less linear, at least for me, in terms of time spent. Does not mean I am getting smarter on it, but one of the issues—and Senator Kennedy has agreed to work with me on this—is I am extraordinarily concerned that AI could lead to massive market manipulation now. And if there was ever an issue that seems tailor-made for FSOC, and I would love to come back at a different time and pose that to you all. Thank you, Mr. Chairman.

Chair BROWN. Senator Daines from Montana is recognized.

Senator DAINES. Chairman, thank you. I want to talk a bit about what is going on in the current economy, certainly a historic moment. Inflation, saw a better report here this morning, which is encouraging. Still a long ways to go. Combating inflation, as we have seen what the Fed has done in the last couple of years. They had no choice but to raise interest rates and attempt to counteract what was happening. We talked at length in several committees. It was kind of a blue jersey/red jersey exercise before some of these massive spending bills were passed here in Washington that this would be a potential inflation risk, and the chickens did come home to roost.

So, on top of that, we saw the bank failures earlier this year, I believe in large part due to regulators being asleep at the switch. As we have probed in great depth in many of these failures, it is clear these failures were not due to insufficient capital. Nevertheless, you are moving forward with a flawed Basel III Endgame Proposal. This proposal will limit credit availability to small businesses. I am hearing it in both ears from our businesses back home, across Montana. We had four Montana small business owners in the office here this morning who flew in to express their frustration with this regulation. Look, we are from a State that is a small business State. We are not the land of massive C Corps. We are the land of small businesses. In fact, 99 percent of our businesses are small businesses. I think we have one of the highest percentages of small businesses in the Nation. And when they take a hit, they have to pass these increased costs on to consumers or they go under. So, we are either looking at higher inflation or loss of jobs, which is two very difficult outcomes.

I am happy to have joined nearly 40 Republican senators, including every Republican Member of this Committee, urging this proposal to be withdrawn. Vice Chair Barr, if banks are required to keep even more money on the sidelines, as this proposal requires, that is going to have a direct impact on businesses across my State. We are hearing it from our banks. Additionally—and by the way, these are not the G–SIBs; we are hearing it from the little, the smaller banks. Additionally, the public listing requirements will further exacerbate the problem, as most small businesses are not publicly traded companies. They do not have massive compliance departments. Other jurisdictions, such as the EU and the U.K., have seen the negative consequences firsthand, and they have dropped the public listing requirements.

Has there been any cost-benefit analysis for this, and why are you continuing to push something that has already been proven to be so detrimental? Vice Chair Barr.

Mr. BARR. Thank you, Senator. First of all, let me just say we take these concerns seriously. We want a capital rule that works for small businesses. We want a capital rule that works all over the country, for different kinds of communities. We do not anticipate that this current rule will have adverse effects on small businesses, based on the analysis. A very small part of the rule actually affects credit. Most of it is about trading and derivative activities. But we do pay attention to these issues. We appreciate the comments. If we can improve the rule such as you suggested with respect to the listing requirement, we will do that. Under the rule, for the first time, small businesses——

Senator DAINES. I mean, so—thanks for that. So, you will do that, or you will look at doing that?

Mr. BARR. We will have to review the comments. We are in a public——

Senator DAINES. OK, I heard you say you will do that. OK. All right.

Mr. BARR. We are in a public comment period.

Senator DAINES. OK.

Mr. BARR. If it turns out that the comments show that we should make changes to the rule based on small business input, we will do that. So, I need to of course be completely open, and am completely open to hearing those comments. I will not prejudge the outcome of those comments.

Senator DAINES. I wonder how many small businesses are cheering this on right now. I would be curious if you kind of looked at the, you know, poll the audience here. I cannot imagine too many small businesses saying, this is a great idea.

Mr. BARR. You know, as I have said, Senator, in response to other questions, this rule only affects the largest 37 banks in the country. It does not affect any banks in Montana, does not affect any community banks. The small business provisions of the rule actually provide more flexibility for a lower risk weight than is currently under the law. Right now, our current rules have 100 percent risk weight for small businesses. Under this proposal, which is more risk-sensitive, small businesses can actually have a lower risk weight. That means banks hold less capital against them than they do now.

Senator DAINES. Yes. It is getting harder and harder, say for our banks back home—having spent most of my career not in a suit and tie here but as part of small businesses, it is getting harder and harder to get capital at the moment. It just is, and this is a real concern about when they look for alternatives to find capital—they cannot get it with local banks—this becomes a real issue for businesses to keep growing here, and I have heard it again, very clearly, articulated well, from my small businesses.

Last question, I know I am out of time. You yourself have said many times the U.S. financial system is strong and well capitalized. In fact, that is the consensus from everyone on this panel today. Chair Powell has rightly stressed that the Fed is and should be a consensus organization. However, it appears that despite wide disagreement on the scope of their proposal, you are determined to see it through, regardless of the impact this will have on the financial system, which I might add has not even been sufficiently studied, given the lack of consensus. I mean hopefully, you would try to get consensus, but this is turning into a very, very partisan kind of outcome, and it is dividing versus uniting. Are you going to be substantially altering or resubmitting the Basel III Proposal to better reflect the concerns of other members of the Board, in the spirit of trying to get consensus?

Mr. BARR. Thank you, Senator Daines. As I have said previously, I am a big believer in trying to reach broad consensus on the Board. I do not know that we can get unanimity on every rule, but broad consensus. Of the 50 rules or supervisory actions that have come up since I have been at the board, of those 50, almost all of them have been unanimous decisions. So, I do very much value that, but it is an issue that I will continue to work on.

Senator DAINES. Chairman, thank you.

Chair BROWN. Senator Warren from Massachusetts is recognized.

Senator WARREN. Thank you, Mr. Chairman. I should not have to say this in 2023—sexual harassment is never all right, never. It is important that the FDIC leadership gets to the bottom of this and holds harassers accountable. Now last spring, the second- and third- and fourth-biggest bank failures in United States history occurred. Those failures cost the FDIC over $30 billion. In other words, the investors and executives took on big risks, they made big money, and then they left the U.S. Government on the hook when they could not cover the outstanding deposits. That is not supposed to happen.

After the crash of 2008, regulators were supposed to put in place rules to require big banks to have enough capital to cover financial shocks so that taxpayers will not have to do that. And now here we are 15 years later, and regulators are finally, finally near the finish line. In July, they put out proposed rules for stronger capital requirements, including the so-called Basel III Endgame rules. But Wall Street executives do not want to have to put up more capital. Higher capital standards make banks safer, but they also nip into profits and make it harder for CEOs to pull in multimillion-dollar bonuses.

So, the CEOs and their big-time investors have hired an army of lobbyists to stop the new capital standards from ever seeing the light of day. Their leading argument right now is that stronger capital requirements would hurt lending to small businesses all across America. I think we have heard some of that this morning. Vice Chair Barr, how many insured depository institutions would the rule apply to?

Mr. BARR. Thirty-seven.

Senator WARREN. Thirty-seven. So, there are almost 4,700 insured depository institutions in the United States. If I have my math right, that means the capital rules for more than 99 percent of the Nation's banks, including the community banks, that serve small businesses, farms, and American families, those rules are not going to change one bit. So, Vice Chair Barr, for the 1 percent of banks that are covered by these rules, will stronger capital requirements make it harder for them to extend credit to small businesses?

Mr. BARR. We do not believe so under the current proposal. The effects on the credit side of the house are very, very small as a portion of this rule, but we are of course open to comment on that issue.

Senator WARREN. So, am I understanding that you are saying that most of the capital standards are related to non-credit activity, that is, not to small business lending?

Mr. BARR. That is correct. Most of the increases result from trading and derivative activities, and operational risk associated from nonlending activities.

Senator WARREN. OK. So, the lobbyists for the big-bank CEOs claim that stronger capital standards will really hurt lending, which just is not true. But where are the lobbyists for the American people? Remember, if we do not get tougher capital requirements, the next time there is a problem, it is taxpayers who will be forced to pick up the slack. As I read the new capital standards, they apply, for example, to trading in risky financial products, like derivatives. They also apply to things like operational risks for fraud or processing errors.

Vice Chair Barr, have big banks ever lost money on risky financial products and activities?

Mr. BARR. Yes, Senator, they have. You know, for example, in the worst quarter of the financial crisis, banks lost about $38 billion from those kinds of trading losses.

Senator WARREN. OK, and what about operational risks? Have big banks ever lost money because of those?

Mr. BARR. Yes, unfortunately banks have lost significant sums from operational risks, rogue trading activity, activity related to illegal sales practices, misselling practices in retail brokerage and otherwise.

Senator WARREN. And that is where you have focused the increased capital standards. Am I right?

Mr. BARR. That is correct.

Senator WARREN. So, the Fed is focused with surgical precision on raising capital standards for the 1 percent of banks that pose the biggest risk to the economy, and on the specific banking activities that pose substantial risks. I understand that the lobbyists for that 1 percent of banks do not like it, but we do not work for them. The proposed rule is now 15 years overdue. I urge you to finalize it and put strong capital requirements in place as soon as possible. Thank you.

Chair BROWN. Thank you, Senator Warren. Senator Warnock of Georgia is recognized.

Senator WARNOCK. Thank you very much, Mr. Chair. I share the concerns raised by my colleagues of these awful reports we are hearing, and I look forward to working with the Chair to address the culture of sexual harassment and unconscionable behavior.

Mr. GRUENBERG. Thank you, Senator.

Senator WARNOCK. People across the country are facing higher borrowing costs to purchase homes, to start businesses, as a result of rising interest rates. Many large banks have made minimal adjustments to the interest that they pay customers on deposits, and families' checking and savings accounts. This means that while borrowing has clearly become more expensive for families, banks continue to borrow cheaply from their depositors to lend out at these higher rates that all of us are seeing in the marketplace. So, families are not getting more for their money. Mr. Barr, why have banks kept the interest rates they pay the customers so low?

Mr. BARR. Thank you, Senator. Banks are paying up a bit in relation to the rising interest rates that we see. The rates that we are seeing follow a kind of normal pattern, which is that banks do not fully pass through interest rate increases to consumers, but we are seeing essentially somewhat of a paying-up in that environment.

Senator WARNOCK. Are you satisfied with the increases that they are passing on to their customers?

Mr. BARR. We do not get involved in any way, either positively or negatively, with respect to pricing decisions of banks. That is a——

Senator WARNOCK. So, let me ask you a different question. Are these spreads abnormally large compared to high interest periods that we have seen in the past?

Mr. BARR. They are about in line with prior historical experience.

Senator WARNOCK. Are you taking measures to encourage banks to offer better yields?

Mr. BARR. As I said, we do not get involved in any way in pricing decisions that banks make.

Senator WARNOCK. All right. Let me just say that I think it is unfair that families are facing higher borrowing costs while banks enjoy the advantage of borrowing at low rates from the public, and we need a system where both consumers and banks share costs and the benefits proportionately.

I am going to move on to another topic. I mean these same banks are finding other ways to increase their pay at the cost of customers. As of last week, customers at several of the largest banks in the country were still unable to access their paychecks after a payment processing error on November 2nd disrupted the direct deposit process. Mr. Barr, who was responsible for this error that has left too many Americans without access to their deposits, and in many cases without the ability to pay their rent or their bills?

Mr. BARR. My understanding, Senator, is that a private payment clearinghouse was responsible for the error. We have urged banks that have affected customers to work with those customers, given that error.

Senator WARNOCK. Thank you so much. As Chair of the Financial Institutions and Consumer Protections Subcommittee, last year I held a hearing to examine the consequences of bank overdraft fees on working families, and I am proud to say that after our hearing, four of the twenty largest commercial banks in the United States reduced or eliminated their overdraft fees. This summer, I convened a separate hearing to examine the tactics used by unscrupulous financial institutions to extract more money from consumers using surprise and unnecessary junk fees.

Today I am concerned that customers affected by the recent ACH payment processing error may be stuck in a difficult financial crunch through no fault of their own. I am concerned that banks may unfairly penalize them by charging overdraft fees or nonsufficient fund fees when they try to pay for basic living expenses using money from their hard-earned paychecks that they reasonably expected to receive, but may not be there due to a processing error clearly out of their control.

Mr. Hsu, Mr. Gruenberg, Mr. Barr, if we could just go down the line with a quick yes or no. The Baptist preacher is the one senator who is going to stay within his time. Yes or no, are you encouraging banks to waive their overdraft and nonsufficient fund fees for customers affected by this processing error?

Mr. HSU. We do encourage banks to work with their customers and make sure that their issues are addressed——

Senator WARNOCK. Yes.

Mr. HSU. So, my understanding is that they are working with them.

Senator WARNOCK. Great.

Mr. GRUENBERG. Senator, the answer is yes, and I believe the banks are doing that.

Mr. BARR. The same response.

Senator WARNOCK. Thank you so much.

Chair BROWN. Senator Butler of California is recognized.

Senator BUTLER. Thank you so much, Mr. Chair, and let me just start by appreciating our conversation yesterday, Chairman Gruenberg. It was almost immediate that you and I were on the phone talking about the toxic culture, sexual harassment challenges that have long been, according to the report, long been alleged as a part of the FDIC environment. I look forward to our follow-up conversations, particularly as a number of the complaints were emanating out of the California offices, and the regional investigation and review that emerges, I do look forward to us staying in conversation.

Mr. Chairman, I am going to try to keep my questions brief and relative to one topic. On November 5th, there was a *New York Times* article that outlined and made reference to challenges that customers were facing with their accounts being closed because of algorithmic and/or other technology challenges that prevented, on another instance prevented depositors from being able to access their funds, pay their bills. Here is a first-start question. Can each of you talk about any steps your agency has taken to examine its risk management practices that would ensure that banks and credit unions are not, unintentionally or intentionally, closing the accounts of customers who are engaged truly in lawful activities?

Mr. HSU. Thank you very much——

Senator BUTLER. They are all looking at you, sir.

Mr. HSU. Yes, that is OK. Thank you very much for the question, Senator Butler. I am not exactly sure which article you are referring to. There is a couple of different issues that have arisen recently. I will say if it is related to the issue that Senator Warnock rose with regards to the payments, TCH, we understand the root cause analysis of that is ongoing, but we understand that that was the responsibility of a particular private entity that serves as a clearinghouse for payments. It does highlight the importance of operational risk management and operational resiliency. And that is something that we expect all banks to have appropriate risk management around those issues. That is very, very important, especially as banks increasingly rely on technology for those processes.

Senator BUTLER. And let me just follow up, Mr. Hsu, because I appreciate you raising that, the operational risk management and the highlight there. Is it your intention, then, to issue new guidance or revise current guidance that would help the institutions to actually alleviate these kinds of practices, or better manage this kind of risk?

Mr. HSU. Sure. So, there is existing guidance right now in terms of operational resilience in risk management. We promote those, and we support those. We are constantly thinking about, do we need to take steps to strengthen that? And that is a conversation that we have internally, and as well across the agencies.

Mr. GRUENBERG. Senator, if I may say, I think you raise a very important issue. Algorithmic lending activity can have, let us say, unintended consequences, both in terms of cutting off people from their access, as well as having fair lending issues associated with it as well. And it is the subject of supervisory attention in the course of our examination process, and I think it is a growing issue and one we need to pay attention to.

Senator BUTLER. Thank you for picking up on the point, Chair Gruenberg, that was mentioned by my colleagues earlier, the growth and breadth of the influence of artificial intelligence. And there have been many hearings and conversations in this building, and in others, about the potentially unintentional bias built into the artificial intelligence tools. And to take into consideration how that bias shows up in our financial systems I think is an important place for us to do some real work to maintain the trust of our consumers as we move our economy forward. Thank you, Mr. Chair.

Chair BROWN. Senator Smith of Minnesota is recognized.

Senator SMITH. Thank you, Mr. Chair. Thanks to all of you for being here. I want to talk a little bit about the impact of technology on what happens when there is a crisis. And Chair Gruenberg, you and I talked about this a little bit when we spoke a day or so ago. So, the smartphone era appears to have given new meaning to the term bank run. Social media and mobile banking certainly was not the cause of the failures of Silicon Valley Bank and Signature Bank, and as both the Fed and the FDIC noted in your reports, both banks had far deeper issues, yet technology did help to facilitate the unprecedented speed, both of the runs on both banks and kind of the impact of it. And it seems to me that this is something that we should be looking at as regulators and banks reckon with this.

So, Vice Chair Barr and Chair Gruenberg, could you tell me how you are rethinking or thinking about your regulatory approach in light of your findings, and what we need to do looking forward to manage the impact of this technology risk?

Mr. BARR. Thank you, Senator Smith. I think you raise an important point. I agree with you that the underlying issues at these institutions were deeper, but of course in the moment of crisis, there was a very, very quick set of bank runs. So, we are looking across the range of tools we have, our supervisory tools. We want to make sure that banks are prepared with good, sound contingency funding plans. We want to make sure that those plans, where appropriate, include access to the discount window. If the contingency funding plan includes access to the discount window, that they are testing that, that they make sure that they understand how to use the discount window. And many institutions have responded to this by prepositioning collateral at the discount window, which is a very strong and good and prudent risk management practice we are encouraging institutions to do.

We are going to look more broadly at our liquidity rules, our approach to liquidity management, and I expect we will have more to say about that in the coming months.

Senator SMITH. Thank you very much. Chair Gruenberg.

Mr. GRUENBERG. Senator, we learned a lot about liquidity risk earlier this year. We learned about concentrations of uninsured deposits and how quickly they can run. We learned how large depositors can withdraw those deposits at the push of a button, and we have also seen how social media can amplify concerns about institutions very quickly. And the last one was probably a secondary but contributing factor. I do think it is, in a sense, a new kind of liquidity risk that both the banks and the regulators need to pay attention to. A bank really needs to monitor what is being said about it on social media. It may be accurate, or it may not. And similarly, as regulators, we need to monitor what is being said about the institutions we supervise on social media, and we actually are looking at utilizing different means of technology to try to do that, but I do think that is an additional liquidity risk challenge that we are presented with.

Senator SMITH. So, it is interesting; you both see this as a different kind of liquidity risk and something that we need to monitor and plan for. And it also seems to me that with the proliferation of misinformation and disinformation, that the financial institutions are also potentially vulnerable to a malign effort to disrupt their operations with something that just is not true. Mr. Harper, did you want to join in?

Mr. HARPER. I was just going to add to what Chairman Gruenberg said. This underscores the importance for the NCUA of having an enhanced Central Liquidity Facility, because institutions below $250 million generally do not belong to the liquidity facility. Statutory enhancements would help that also to—we do have issues with our ability to assess third-party vendors, and technology; unlike the other regulators, we do not have that authority. Certainly getting that authority from Congress would help us to have better oversight of this area and better protect the Share Insurance Fund.

Senator SMITH. Great, thank you. Thank you very much. I want to just bring up one thing quickly before I close out. I know you have all been here for quite a while. I was really happy to see the Fed and the FDIC and OCC issue their final Community Reinvestment Act rulemaking last month. You all know that this is something I am quite interested in, and I gather that it has come up a little bit today. My view of it is this is a very important update to CRA regulations, and it addresses decades of changes and of evolution in the banking sector, and I think helps to bring the core purposes of the CRA back into focus.

Just maybe quickly, my question is, given that it has taken so long to get this update done, have you given thought to establishing some sort of a process to review and update these regulations more regularly so that this does not become a thing again?

Mr. BARR. Let me just say, right now we are really focused on the implementation of these rules. We want to make sure to get that right. I think the final rule is really a win for banks and a win for communities. We want to keep that partnership going through the implementation stage, make sure that banks and communities have the online tools they need to be effective and efficient in deploying the rule. Make sure that examiners have the training and guidance they need. So, really our focus is on that, and we have set up a process to make sure that as questions come in on the rule, you know, is this activity covered, is it not covered, that we provide clarity on that.

Senator SMITH. Sort of a real-time way of getting feedback so that banks can understand what it means to get the rules right. Yes. I know, Mr. Chair, my good colleague from Maryland is eager to ask his questions, so thank you very much.

Thank you, Senator Smith. Senator Van Hollen of Maryland is recognized.

Senator VAN HOLLEN. Thank you, Mr. Chairman. Great to see all of you. I am actually going to start where Senator Smith left off, really, in commending all of you for working together, all those involved with updating the CRA rule. Because as we all know, the banking system has evolved dramatically since it was first passed, and it is very important that we have rules that adapt to the changes so that we meet the original intent of the CRA.

I also do want to commend you for just earlier this month removing the Trump-era barriers to designating nonbank system entities as SIFIs, as systemically risky, if it bears that out. That is something I have been urging for a long time, and I was very glad to see all of those agencies represented here who have a vote, vote to clear the way so that we can move in that direction, and look forward to talking with all of you further about that.

I do want to say something about real-time payments and FedNow, something I have been pushing for for years. A number of us introduced legislation to try to accelerate that effort. According to Aaron Klein of Brookings, had the United States implemented real-time payments when the Bank of England did in 2007, lower-income consumers, people living paycheck to paycheck, would have saved over $100 billion on overdraft fees, check-cashing, and payday lending. That is a $100 billion tax on people who can least afford it, so I am glad this is finally kicking into gear. Mr. Barr, if you could just speak to what you are doing to make sure that banks fully participate so that we can maximize this benefit.

Mr. BARR. Thank you, Senator, and thanks for your long-time support of this initiative. As you noted, FedNow launched this summer. We expect it will take some time to build full bank participation. We have built the underlying rails; we really need banks now to come in and participate. We think it will be a very attractive option for many banks to join in to be able to offer this service to their customers and businesses. We have a very active outreach program, working with banks to encourage them to participate. We have a very active outreach program to third-party service providers that work with particularly community banks. But I think this is something we are going to have to keep at month after month after month. It is going to take a long time to get right, and we promise we are going to stick to it.

Senator VAN HOLLEN. Well, I appreciate that. Any help you need pushing from here, from the Senate, let us know, because again, we were late to this game. We were late getting started, and now we have to maximize our efforts to get participation.

If I could just raise some of my concerns with a certain aspect of the Basel III regulations as they relate to potentially being a drag on the deployment of clean energy. Last month, the three banking oversight agencies represented here issued joint principles with respect to climate risks and the transition from a fossil fuel economy to a clean energy economy. And of course one of the devices we use to try to accelerate and manage that transition has been clean energy tax credits, so I have been concerned with the treatment of those tax credits in the most recent Basel III discussions. Mr. Hsu, we talked about this prior to the hearing. Do you share those concerns, and if so, what efforts are underway to address them? And then I would just like a brief response from the others.

Mr. HSU. So, we have also heard those concerns and that feedback, and we are going to be very open-minded to the comments. We are in the comment period now, and so we look forward to getting those comments and the analysis, and we will take that into consideration as we move forward.

Mr. GRUENBERG. Senator, I think this is a pretty good example of why you have a public comment period. I think we have received comments that raise attention to this issue that we may not have fully appreciated, and I am hopeful. We obviously are going to review all the comments so we can be responsive and address this on the final rulemaking.

Senator VAN HOLLEN. Thank you.

Mr. BARR. Thank you, Senator. I also look forward to the comments on this. The kinds of comments that are most helpful on this and in other areas are comments that let us understand better the underlying risk. So, some people have said, for example, that these tax credits are lower risk because investors are being repaid from a stream of the tax credits. That is the kind of information that is useful to us as we analyze whether changes would be appropriate in this circumstance.

Senator VAN HOLLEN. Well, thank you. I am going to interpret those responses in a positive way, and let me leave it this way—if you are not going to address some of these concerns, I would appreciate the opportunity to weigh in before any final decisions are made. And I thank you all.

Chair BROWN. Thank you. Senator Fetterman of Pennsylvania is recognized.

Senator FETTERMAN. Thank you, Mr. Chairman. Thank you. And thank you for allowing me the opportunity to talk to people much, much smarter than I am. And today's meeting, it is Protecting Main Street Over Wall Street. So, I want to talk about Silicon Valley Bank, because it does not seem like they were protecting Main or Wall Street, quite honestly. And I am astonished, because it does not seem like there are a lot of people talking about this, and this almost effectively was going to blow up the economy, you know, and it is astonishing. And as far as I know—I have not read about any kind of charges or anything like that, and you know, that dude was back to Hawai'i, to his gigantic house. And again, it is astonishing that there seems to be more outrage on that as well, too. And to me, it is also astonishing that you can have one bank, one bank could crash the entire economy, and once they realized what was available, is that the White House and everybody all agreed that we have to act very decisively and quickly as well.

Blows my mind that that is even made possible, and my question to anyone on here—and I do not mean that to be aggressive; it is an honest question, because I, I really do not know—so what was behind Silicon Valley Bank's crash? Was it greedy? Was it incompetent? Or they do not care, because the Government is going to be there to clean up this kind of a mess? Or is it one, some, or all of them or whatever, honestly? Because I do not understand what it actually is, so I want people, experts and much smarter than me, to know what it was.

Mr. BARR. Senator, first of all let me say I appreciate your, and agree with your outrage about what happened with respect to Silicon Valley Bank. There was significant bank mismanagement of interest rate risk and——

Senator FETTERMAN. Yes, that is a wonderful euphemism.

Mr. BARR. ——liquidity risk.

[Laughter.]

Senator FETTERMAN. Mismanagement, you know. But yes, I am sorry.

Mr. BARR. And they engaged in activities such as eliminating hedges that would have helped them deal with interest rate risk in order to increase short-term profits. Their incentive compensation was not appropriate. It was not aligned with making sure that they took care of risk. There were enormous failures at that institution, and I share your outrage about the conduct.

Mr. GRUENBERG. Senator, I think the short answer to your question is all of the above. I mean this bank touched all the bases——

Senator FETTERMAN. All of the above? Right, OK, yes.

Mr. GRUENBERG. ——and it was positioned so that when it experienced stress because of its reliance on uninsured deposits, that had a contagion effect on other institutions that really did for a moment put the system at risk, and that was the larger issue that was revealed here, I think.

Mr. HARPER. I will just say that I generally agree with both of my colleagues here on the panel. Certainly the events of March were a reminder to us all of the need to be risk-focused and ready to act expeditiously.

Mr. HSU. The only thing I would add is that there was very aggressive growth at that institution, without the commensurate controls, and that is why we as safety and soundness credential supervisors, we pay very special attention to that and put a lot of emphasis on that.

Senator FETTERMAN. I want to clarify. So, there was aggressive growth. Is that greed, a nice way of saying greed? Because it seems to me, and I am not meaning that, you know. But I guess my last question, because I have less than a minute left, but it is like should one relatively kind of a smaller bank be in the position to crash the economy? It is astonishing that, one, that is even possible, but now when it has actually happened, you know, why is this not like every day until we make sure this can never happen again? And I mean I guess you effectively agree. I am assuming that, but of course I am asking.

Mr. BARR. Senator, I agree with you. I think it is a wakeup call that we need strong capital in the system. We need strong liquidity in the system. We need strong supervision. I think the kind of contagion we saw suggests that there is a higher probability of default and loss given default in our banking system because of that contagion. We need to have strong capital, and we need to have strong liquidity.

Mr. GRUENBERG. And Senator, it also underscores the interconnectedness of the banking system. So, we had a bank—$200 billion is not little, but it is not near the top, either—but it was in a position to cause real financial stability risk.

Senator FETTERMAN. Another 30 seconds, Mr. Chairman?

Chair BROWN. Of course.

Senator FETTERMAN. Thank you, sir. And for the other—I am very, honestly interested in—yes?

Mr. HARPER. Certainly Marty is right on the interconnectedness issue within the system. It also highlights the need for us on the Financial Stability Oversight Council to coordinate and ensure that we are effectively working to protect against the risks so that one institution does not bring down the system.

Mr. HSU. I think the incident underscores the importance of us keeping our eye on the ball with regard to safety and soundness. That is what drives our missions. That is where we need to drive toward.

Senator FETTERMAN. And thank you, Mr. Chairman.

Chair BROWN. Thank you, Senator Fetterman. I think Senator Fetterman's last question and the summary from each of you really summarizes the hearing as well, so John, thank you for that. Thanks to the witnesses. We will continue to work to strengthen our financial system. Senators who wish to submit questions for the hearing record, those questions are due 1 week from today, Tuesday, November 21st. To the agencies, please submit your responses to questions for the record 45 days from the day you receive them. Thanks again for your testimony and for your public service. The Committee is adjourned.

[Whereupon, at 12:19 p.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF CHAIR SHERROD BROWN

Today we'll hear testimony from the heads of the four Federal agencies responsible for protecting our banking and credit union system and making sure it serves everyone: the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation or FDIC, the National Credit Union Administration or NCUA, and the Office of the Comptroller of the Currency or OCC.

Welcome to you all and thank you for being here today.

Earlier this year, we witnessed three of the largest bank failures in U.S. history.

These failures reminded us that bankers' hubris, greed, and negligence continue to pose grave threats to our financial system, and to American workers and small businesses.

This time our system bent, but fortunately it did not break.

To avoid breaking, however, the Treasury Department and your agencies had to intervene and invoke the systemic risk exception and guarantee all deposits at Silicon Valley Bank and Signature Bank.

It should never have gotten that far.

The bank failures exposed weaknesses in the supervision of the banking system, disrupted the financial system's stability, and reminded many Americans that they just don't trust Wall Street.

A disconcerting finding in the aftermath of the failures was that your agencies did identify the risks at these institutions, and you called them out. But that failed to result in real action from the banks' management to actually do anything to mitigate those risks.

It's as predictable as it is unacceptable, after years of lobbying for weaker rules and lax oversight, including by SVB and Signature Bank executives.

We must turn the lessons of this year into action.

That means improving bank supervision and holding bank executives accountable for risky behavior that drives their banks into the ground. And it means strengthening rules, so that banks are serving their communities and have the capital necessary to continue serving their communities during stress events.

These are things that we should all agree about.

It's why, in the wake of this bank crash, we worked together to take the first real action in more than a decade to rein in risky behavior by bank executives.

Congress must finish the job and pass our bipartisan RECOUP Act, to hold senior bank executives accountable when they gamble with customers' money.

The turmoil in the financial industry earlier this year reminded us about the policies and actions that continue to make the biggest banks even bigger, and leave the financial system vulnerable to the ever-expanding balance sheets of the largest institutions in the country.

We have created a financial system where just a handful of the largest banks now hold $14.75 trillion in assets—more than half the Nation's GDP.

Fewer and larger banks mean consumers have less choice in the marketplace for banking services.

Less competition means banks pay depositors less and charge higher fees.

Mergers and acquisitions also serve as justification for branch closures, particularly in rural areas and working-class communities. We've seen that far too often in Ohio.

And we know that drives more consumers out of the banking system toward high-fee, predatory nonbank financial companies—like check cashers and payday lenders and fintech apps.

Banking consolidation also means reduced access to credit for small businesses and increased borrowing costs.

And fundamentally, it means that more power in our economy ends up concentrated in the hands of a tinier and tinier number of big bankers on Wall Street.

We've seen over and over what a problem that is, and the harm the Wall Street business model does in places like Ohio—encouraging everything from inflation to outsourcing to lax safety.

We need strong action now from your agencies on this issue, because these trends impose real and direct costs on Americans.

With less competition, less choice, and less access, it is more important than ever that we ensure banks are meeting the needs of their entire community.

That is why I was encouraged to see that the FDIC, Federal Reserve, and OCC were able to come together last month and finalize the new Community Reinvestment Act rules.

The Community Reinvestment Act was enacted in 1977 to ensure that banks meet the credit needs of all the communities in which they do business.

The CRA regulations last received a significant refresh in 1995.

Since 1995, the internet and mobile technology have fundamentally altered how Americans interact with the banking system.

This modernization effort is critical to ensuring that banks are fulfilling the promise of the Community Reinvestment Act by serving and investing in their communities.

I thank your agencies for working through this very complex rulemaking and delivering a final rule that will encourage banks to meet the credit needs of their entire community.

In addition to the Community Reinvestment Act, the FDIC, Federal Reserve, and OCC also issued what's known as the Basel III Endgame capital proposal—for anyone not steeped in financial regulations, that's an actual rule critical to protecting the economy, not the latest video game or Marvel movie.

These capital rules represent the final—and long, long overdue—plank in the post-Financial Crisis overhaul of our regulatory capital framework.

It's about ensuring that the largest banks have enough capital to address the risks that are unique to their institutions, and weather crises and emergencies and other sudden events that affect their banks.

The proposal also recognizes the systemic importance of banks that are large, just not quite as massive as the Wall Street megabanks—banks like Silicon Valley, before it collapsed. As we saw this spring, mismanagement and risky bets at those banks can still threaten the financial system—they also need to have enough capital to prevent the kind of threat to the economy we worried about earlier this year.

Of course, we know the complaints that are coming—in fact, they started before we even saw the proposal.

The industry has relentlessly attacked it with the same old tired arguments.

Compliance will cost too much, we won't be competitive, we already have enough capital, we won't be able to lend to small business.

We've heard it all before.

Let's be clear: The largest banks will need to redirect a tiny fraction of their enormous profits over a period of several years to get to the new capital levels.

Every single bank that would be impacted by this proposal has the capacity to comply with the new capital levels and extend credit to small businesses and working class and middle class families—all while remaining wildly profitable.

I trust that your agencies see these arguments for what they are: the same old Wall Street whining.

And that you will deliver a strong capital rule—one that prioritizes the American people and their communities over quarterly profits of the banking industry.

Finally, as we have discussed on this Committee, illicit finance continues to pose a serious threat to the United States and the world. We've of course seen it most recently with the funding Hamas was able to raise for its terrorist attacks on Israel.

I implore your agencies to be vigilant when it comes to all the risks associated with illicit finance and the banking and credit union system.

You are all public servants, responsible for making sure that the financial system operates in a safe and sound manner and works for the American people.

Do not let us down.

PREPARED STATEMENT OF MICHAEL BARR

VICE CHAIR FOR SUPERVISION, FEDERAL RESERVE

NOVEMBER 14, 2023

Chairman Brown, Ranking Member Scott, and other Members of the Committee, thank you for the opportunity to testify on the Federal Reserve's supervisory and regulatory activities. Accompanying my testimony is the Federal Reserve's semiannual *Supervision and Regulation Report*. Today, I will discuss current conditions in the banking sector, supervision, and some of our recent regulatory proposals.

Banking Conditions

Our banking system is sound and resilient. The acute stress that occurred in March has receded, and banking organizations continue to report capital and liquidity ratios above minimum regulatory levels. Earnings performance has remained solid and in line with prepandemic levels, despite recent pressure on net interest margins.

Regulatory capital ratios increased during the first half of 2023. While liquidity levels have come down from their peak in 2021, they remain above prepandemic levels and, as applicable, above minimum regulatory levels, leaving the banking system well positioned to mitigate liquidity pressures that may arise.

The failures of Silicon Valley Bank, Signature Bank, and First Republic Bank reflected, to varying degrees, excessive interest rate risk in their long-duration assets and an over-reliance on uninsured deposits. While the three failed banks were extreme cases, there are other banks that invested heavily in fixed-rate, long-duration assets when long-term interest rates were low. These banks have recorded sizable declines in the fair value of those assets as interest rates have increased, putting pressure on tangible capital. The banks are actively managing the resulting set of risks, but these could take some time to address. Additionally, some banks that have high reliance on uninsured deposits are using more expensive funding sources to manage their liquidity risk.

Lending has continued to grow this year, albeit at a slower pace relative to 2022, due in large part to both reduced loan demand and tighter lending standards, according to respondents to the recent Federal Reserve Senior Loan Officer Opinion Surveys. Loan delinquency rates remain low overall, and banks have increased credit loss provisions to mitigate potential future losses in response to increased delinquencies for loans related to commercial real estate (CRE) and some consumer sectors.

Looking forward, preserving a sound and resilient banking system requires continued attention to address identified vulnerabilities and vigilance to changing conditions.

Supervision

Starting with supervision, since the bank failures earlier this year, the Federal Reserve has been moving forward with ways to improve the speed, force, and agility of supervision as appropriate. Supervision must intensify at the right pace, especially as a firm grows in size or complexity, and critical issues that present safety and soundness concerns should be addressed quickly by banks and supervisors. In considering improvements to supervision, we are very mindful of the differences in size, risk, and complexity of supervised institutions and the importance of maintaining the strength and diversity of banks of all sizes that serve communities across the country.

Furthermore, supervisors have been focused on addressing material risks presented by the current economic environment as well as the rapid pace of innovation. This includes conducting targeted reviews at banks exhibiting higher interest rate and liquidity risk profiles and conducting focused training and outreach on supervisory expectations about these risks. The Federal Reserve is also monitoring for potential credit deterioration, particularly within the consumer and CRE lending segments. Additionally, the Federal Reserve has implemented a new novel bank supervision program to improve oversight of banks engaged in nontraditional financial-technology-related activities.

However, neither banks nor supervisors can anticipate all emerging risks. That is why it is also important to help ensure that our regulatory framework sets a strong baseline for resilience, regardless of how or where the risk originates.

Capital

A key component of this resilience is capital. Banks rely on both debt (such as deposits) and capital to fund loans and other assets. Capital allows banks to absorb losses on those assets while continuing to serve households and businesses. Additionally, capital is loss-absorbing regardless of the source of the loss. That is, whatever the vulnerability or the shock, capital is able to absorb the resulting losses and, if sufficient, allows banks to keep serving their critical role in the economy.

In the Global Financial Crisis, the effects of woefully undercapitalized banks had a devastating impact on our economy and resulted in the worst recession since the Great Depression. It took 6 years for employment to recover, more than 10 million people fell into poverty, and 6 million families lost their homes to foreclosure. And these costs occurred even with substantial support from the Government.

In the years following the Global Financial Crisis, the Federal Reserve Board (Board) adopted a set of reforms to increase the quantity and quality of capital, ran annual supervisory stress tests, and set a capital surcharge on global systemically important banks (G–SIBs) to reflect the greater risk these firms pose to U.S. financial stability. These reforms have greatly strengthened our banking system, and capital ratios of the largest banks have more than doubled since 2009. At the same time, the U.S. banking system has grown from $12 trillion in assets in 2009 to $23 trillion today, while showing strong profitability and overall market valuation. U.S. banks have enhanced their position as leaders in global capital markets activity. Importantly, these reforms have served the U.S. economy well. Our economy has grown substantially with the continued support of robust lending from a stronger banking system.

The reforms to the capital requirement framework we proposed earlier this year are the last stage of those postcrisis capital reforms. It has been long recognized that work remains to improve how banks measure risk, which is critically important because the riskier a bank's assets are, the more capital it needs to protect against those risks. To address these and other issues, the Board, along with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), proposed a rule in July that would further reduce the likelihood of future financial crises. The proposed rules would apply to banks with at least $100 billion in assets, less than 40 of the over 4,000 banks in our banking system. Community banks would not be affected by this proposal.

First, for a firm's lending activities, the proposed rules would end the practice of relying on each bank's own internal estimates of its credit risk and instead use a standardized, risk-based measure of credit risk. Standardized credit risk approaches are designed to approximate observed risks through economic cycles, which internal models tend to underestimate. Such an approach also ensures consistency across banks to avoid the material variability that has been identified with internal models across institutions. Variability reduces transparency and comparability and results in the same loan being treated differently among banks. The proposed standardized approach to credit risk is generally consistent with—but more risk-sensitive than—the standardized approach the banking agencies have been using for decades.

Second, for operational losses—losses from inadequate or failed processes, such as from fraud, illegal conduct, or cyberattacks—the proposed rules would replace the use of banks' internal models to measure operational risk with a standardized measure.

Third, for a firm's trading activities, where modeled approaches are more reliable, the proposed rules would require more granular methods for measuring market risk, which is the risk of loss from movements in market prices, to correct for gaps in the current rules and improve risk capture. For instance, the current market-risk framework could result in capital requirements increasing during stress rather than requiring a higher amount of capital in advance of stress.

Fourth, the proposal would improve the capital requirements for the credit risk of derivatives activities by introducing a standardized, risk-sensitive measure.

Most aspects of this proposal have been under development for many years. Partly in response to the bank stress this spring, the proposal would extend the requirement of including unrealized gains and losses from available-for-sale securities in capital ratios beyond the largest, most complex banks to all large banks above $100 billion in assets.

The proposed rules are anticipated to increase capital requirements for large banks, but the effects for each bank would vary based on its activities and risk profile. Notably, the increases would be most substantial for the largest and most complex banks, and the bulk of the estimated rise is attributable to trading and other nonlending activities.

The comment period is an important part of the rulemaking process. I want to reiterate that we are interested in public input. We have recently announced an extension of the comment period. With this extension, we are providing the public nearly 6 months to review the proposal, so they can provide meaningful comments. We have already heard concerns that the proposed risk-based capital treatment for mortgage lending, tax credit investments, trading activities, and operational risk might overestimate the risk of these activities. We welcome all comments that provide the agencies with additional data and perspectives to help ensure the rules accurately reflect risk.

Long-Term Debt

I would also like to highlight our long-term debt proposal. In October of last year, the agencies issued an advance notice of proposed rulemaking requesting comments about possible extension of long-term debt requirements to more banking organizations beyond the largest and most complex. The failures of three large banks in the spring resulted in losses to the deposit insurance fund and financial stability concerns that could have been mitigated in part by requirements for additional long-term debt.

Following those events, in August, the agencies proposed a rule that would expand long-term debt and resolution planning requirements to additional large banks. The proposal's goal is to increase the potential options available for resolving depository institutions and to enhance overall financial stability. Importantly, the proposed requirements would be calibrated at a lower level relative to the largest and most complex banks in recognition of the lower systemic risk profiles of applicable banks. Additionally, because these banks already issue some long-term debt and the proposal provides for a long phase-in period, banks generally would only need to issue debt incrementally to meet the proposed requirements.

As with the capital rules I mentioned above, I would like to emphasize that these are proposed rules, and we look forward to hearing the public's comments.

Community Reinvestment Act

As for other material rulemakings, the agencies recently finalized a rule that strengthens and modernizes the regulations that implement the Community Reinvestment Act (CRA). The revised rule will better encourage banks to help meet the credit needs of their entire communities, including low- and moderate-income neighborhoods.

The final rule is the result of many years of public engagement and several rounds of rulemaking by the Board, FDIC, and OCC. I appreciate the level of engagement from both banks and community and civil rights stakeholders. The many perspectives we have heard have assisted the agencies in further refining the approach from the proposed to final rule.

Key elements of the final rule include supporting minority depository institutions and community development financial institutions as well as adapting the rule to mobile and online banking. Fair lending is safe and sound lending. The new CRA regulations will encourage financial inclusion in important ways, helping to make the financial system safer and fairer.

Thank you. I am happy to take your questions.

Supervision and Regulation Report

November 2023

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

The Federal Reserve System is the central bank of the United States. It performs five key functions to promote the effective operation of the U.S. economy and, more generally, the public interest.

The Federal Reserve

- **conducts the nation's monetary policy** to promote maximum employment and stable prices in the U.S. economy;
- **promotes the stability of the financial system** and seeks to minimize and contain systemic risks through active monitoring and engagement in the U.S. and abroad;
- **promotes the safety and soundness of individual financial institutions** and monitors their impact on the financial system as a whole;
- **fosters payment and settlement system safety and efficiency** through services to the banking industry and U.S. government that facilitate U.S.-dollar transactions and payments; and
- **promotes consumer protection and community development** through consumer-focused supervision and examination, research and analysis of emerging consumer issues and trends, community economic development activities, and administration of consumer laws and regulations.

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Preface

The Federal Reserve promotes the safety and soundness of individual financial institutions and monitors their impact on the financial system. It is responsible for supervising—monitoring, inspecting, and examining—certain financial institutions of varying size and complexity to ensure that they comply with rules and regulations, and that they operate in a safe and sound manner. The Federal Reserve supervises bank holding companies, savings and loan holding companies, the U.S. operations of foreign banking organizations, and state member banks.

The Federal Reserve Board publishes its semiannual Supervision and Regulation Report to inform the public and provide transparency about its supervisory and regulatory policies and actions, as well as current banking conditions. Previous reports are available at https://www.federalreserve.gov/publications/supervision-and-regulation-report.htm.

For more information on how the Federal Reserve Board promotes the safety and soundness of individual financial institutions and the financial system see *The Fed Explained: What the Central Bank Does* at https://www.federalreserve.gov/aboutthefed/the-fed-explained.htm and visit the Supervision and Regulation web page on the Board's public website at https://www.federalreserve.gov/supervisionreg.htm.

Abbreviations

ACL	allowance for credit losses
AI	artificial intelligence
AML	anti-money laundering
API	application programming interface
BTFP	Bank Term Funding Program
BHC	bank holding company
BSA	Bank Secrecy Act
CA	Consumer Affairs
CBLR	Community Bank Leverage Ratio
CBO	community banking organization
CDS	credit default swap
CECL	current expected credit loss
CET1	common equity tier 1
CFP	contingency funding plan
CLD	construction and land development
CRE	commercial real estate
C&I	commercial and industrial
DLT	distributed ledger technology
FASB	Financial Accounting Standards Board
FBO	foreign banking organization
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FHLB	Federal Home Loan Bank
Fintech	financial technology
GAAP	generally accepted accounting principles
G-SIB	global systemically important banking organization
HELOC	home equity line of credit
IHC	intermediate holding company
IT	information technology

IRR	interest rate risk
LBO	large banking organization
LFBO	large and foreign banking organization
LISCC	Large Institution Supervision Coordinating Committee
MRAs	matters requiring attention
MRIAs	matters requiring immediate attention
NBA	nonbank assets
NMB	nonmember state bank
OCC	Office of the Comptroller of the Currency
RBO	regional banking organization
RRE	residential real estate
SEC	U.S. Securities and Exchange Commission
SHC	securities holding company
SHLC	savings and loan holding company
SMB(s)	state member bank(s)
SR	Supervision and Regulation
U.S. G-SIB	global systemically important banking organization headquartered in the United States
wSTWF	weighted short-term wholesale funding

Executive Summary

The banking sector remains sound overall, and most banks continue to report capital levels above regulatory requirements. Nevertheless, some banks have experienced sizeable declines in the fair value of some fixed-rate assets reflecting the increase in interest rates over the past two years. Recent earnings performance has been in line with pre-pandemic levels, and returns on average assets and equity for the first half of 2023 exceeded their 10-year averages. Overall, banks have ample liquidity and limited reliance on short-term wholesale funding. Loan delinquencies are rising in some segments but are still low.

The Federal Reserve is taking steps to enhance the speed, force, and agility of its supervision, as appropriate, to reflect lessons learned from the recent large U.S. bank failures and its supervision of Silicon Valley Bank. These include improving its supervision of liquidity and interest rate risks by conducting targeted reviews at banks exhibiting higher interest rate and liquidity risk profiles, as well as conducting focused training and outreach on supervisory expectations for interest rate and liquidity risk management for banks and examiners. The Federal Reserve is committed to taking additional steps to strengthen its supervisory efforts.

The Federal Reserve is also monitoring for potential credit deterioration, particularly within the consumer and commercial real estate (CRE) lending segments. Additionally, the Federal Reserve has implemented a new novel bank supervision program to improve oversight of banks engaged in nontraditional and financial technology-related activities.

This report focuses on developments in three areas:

1. Banking System Conditions provides an overview of the financial condition of the banking sector.
2. Regulatory Developments outlines the Federal Reserve's recent regulatory policy work.
3. Supervisory Developments highlights the Federal Reserve's current supervisory programs and priorities.

Banking System Conditions

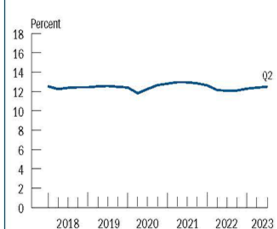
The banking system remains sound overall. Banking organizations continue to report capital and liquidity levels above regulatory minimums. Earnings performance has remained solid and in line with pre-pandemic levels, despite recent pressure on net interest margins. Deposit declines related to the March banking stresses have slowed. Loan delinquency rates remain low overall. However, delinquencies for CRE and some consumer sectors have increased from their low levels, and banks have increased credit loss provisions. Liquidity and interest rate risks also remain elevated for some banks, partially attributed to the increased funding costs and significant fair value losses on investment securities.

Banking Firms Increased Regulatory Capital, but Tangible Capital Remains Depressed

Regulatory capital ratios increased during the first half of 2023. The industry's aggregate common equity tier 1 (CET1) capital ratio rose to 12.5 percent as of June 30, 2023, a fourth consecutive quarterly increase (figure 1). This reflects over $2 trillion in CET1 capital across the banking system.

However, tangible capital levels, which include declines in the fair values of securities but exclude intangible assets such as goodwill, remained under pressure for many banks. As of the second quarter of 2023, banks' balance sheets reflected declines in fair value of $248 billion in available-for-sale securities, which are reflected in tangible capital. In addition, banks reported more than $310 billion in declines in the fair value of held-to-maturity securities.

Figure 1. Aggregate common equity tier 1 (CET1) capital ratio



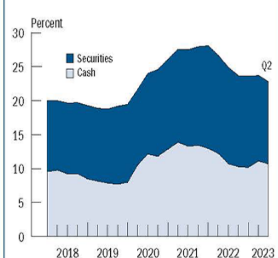
Note: CET1 capital ratio is the ratio of common equity tier 1 capital to risk-weighted assets. See appendix A for further information. Community banks can opt into the community bank leverage ratio framework. Thirty-seven percent of community banks have done so and are excluded from the figure.

Source: Call Report and FR Y-9C.

Accounting standards do not require banks to reflect declines in the fair value of held-to-maturity securities within equity capital.[1] However, substantial declines in the fair value of securities are still a concern for banks facing liquidity constraints, which could force some of these banks to sell securities at a loss.

Liquidity Risks Persist for Some Banks

Figure 2. Liquid assets as a share of total assets



Note: Liquid assets are cash plus estimates of securities that qualify as high-quality liquid assets, as defined by the Basel III liquidity coverage ratio requirement.

Source: FR Y-9C.

Liquidity levels have come down from their peak in 2021 but remain above pre-pandemic levels. Firms reported a slight drop in liquid assets in the first half of 2023, as a decline in investment securities was partially offset by an increase in cash balances over this period (figure 2).

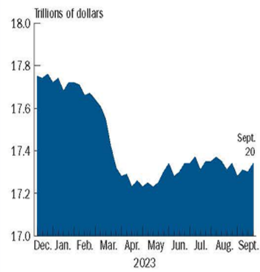
After reaching a historic high of $18 trillion in April 2022, deposits declined steadily through February 2023 as interest rates increased and some depositors sought higher returns in non-deposit investments. Deposit declines accelerated during the first half of 2023 following the failures of three large U.S. banks. Deposits at commercial banks fell by nearly $400 billion from the start of March through April (figure 3), with most of the decline concentrated in March. Between May and the end of August, deposit levels stayed largely stable.

As deposit levels have declined, banks have increased their use of wholesale funding sources from historic lows seen in early 2022 (figure 4).[2]

1 For held-to-maturity securities that were transferred from the available-for-sale category, declines in fair value that existed at the date of the transfer are reported within equity capital.

2 Wholesale funding levels are now in line with their 10-year average.

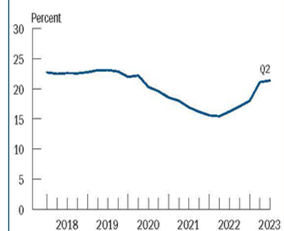
Figure 3. Deposits



Note: Data are for all commercial banks and are seasonally adjusted.

Source: H.8, "Assets and Liabilities of Commercial Banks in the United States."

Figure 4. Wholesale funding as a share of total assets



Note: Wholesale funding is defined as the sum of brokered deposits under $250,000, federal funds purchased, securities sold under agreements to repurchase, subordinated notes, and other borrowed money.

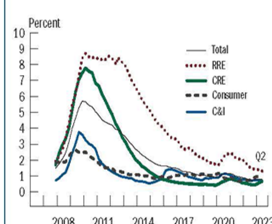
Source: Call Report and FR Y-9C.

Loan Growth Slowed and Delinquencies Increased for Some Sectors

The pace of loan growth has slowed relative to 2022. Total loan balances grew just 0.7 percent in the first half of 2023, compared with 3.8 percent in the first half of 2022. According to respondents to recent Federal Reserve Senior Loan Officer Opinion Surveys, both reduced loan demand and tighter lending standards contributed to a lending slowdown.[3]

Loan delinquency rates remain low. However, delinquency rates for CRE and consumer loans increased slightly during the first half of 2023 (figure 5). For the largest firms, the CRE office loan segment showed the largest increase in delinquency rates (figure 6).

Figure 5. Loan delinquency rates

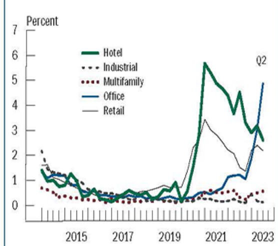


Note: Delinquent loans are those 90+ days past due or in nonaccrual status.

Source: Call Report and FR Y-9C.

[3] Board of Governors of the Federal Reserve System, "The April 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices" (Washington: Board of Governors, 2023), https://www.federalreserve.gov/data/sloos/sloos-202304.htm; and "The July 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices" (Washington: Board of Governors, 2023), https://www.federalreserve.gov/data/sloos/sloos-202307.htm.

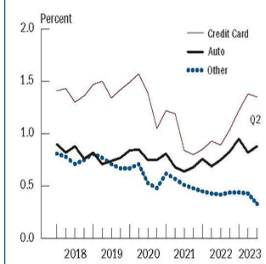
Figure 6. Income-producing CRE loan delinquency rates by property type



Note: Delinquent loans are those 30+ days past due or in nonaccrual status.

Source: FR Y-14Q.

Figure 7. Consumer loan delinquency rates



Note: Delinquent loans are those 90+ days past due or in nonaccrual status.

Source: Call Report and FR Y-9C.

Within the consumer loan segment, credit card loan delinquencies have increased post-pandemic. After falling to near-record lows in the second half of 2021, credit card delinquency rates rose over the second half of 2022. The overall credit card delinquency rate reached 1.4 percent in the second quarter of 2023, roughly in line with pre-pandemic levels (figure 7). The increase in credit card delinquencies was concentrated among subprime and near-prime borrowers, whose delinquency rates have slightly exceeded pre-pandemic levels in 2023.[4]

Higher Interest Expense and Rising Provisions Moderated Earnings

Bank earnings performance during the first half of 2023 remained sound. Return on average assets and return on equity remained above their 10-year averages (figure 8). Higher noninterest income helped offset lower net interest income and increased provisions. The industry's noninterest income included nonrecurring gains related to the acquisitions of three large, failed banks, adding about 16.2 percent and 4.0 percent to bank earnings in the first and second quarter, respectively.[5] Even after excluding these gains, earnings were comparable with pre-pandemic levels.

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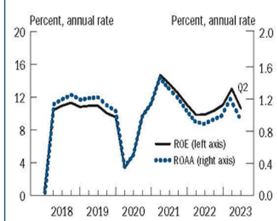
[4] Andrew Haughwout, Donghoon Lee, Daniel Mangrum, Joelle Scally, and Wilbert van der Klaauw, "Credit Card Markets Head Back to Normal after Pandemic Pause," *Liberty Street Economics* blog, Federal Reserve Bank of New York, August 8, 2023, https://libertystreeteconomics.newyorkfed.org/2023/08/credit-card-markets-head-back-to-normal-after-pandemic-pause/.

[5] Nonrecurring gains on the acquisitions of failed banks contributed to higher noninterest income at certain large banking organizations.

Net interest margins measure the difference between interest income and the amount of interest paid for funding, expressed as a share of average earning assets. These margins declined from 3.4 percent in the fourth quarter of 2022 to 3.2 percent in the second quarter of 2023 as increased rates paid on deposits and wholesale funding were not fully offset by growth in interest income (figure 9).

In the second quarter of 2023, many U.S. banks also increased provisions for credit losses. Provisions increased from an annual rate of 0.65 percent of average loans and leases in the first quarter of 2023 to an annual rate of 0.73 percent of average loans and leases in the second quarter of 2023.

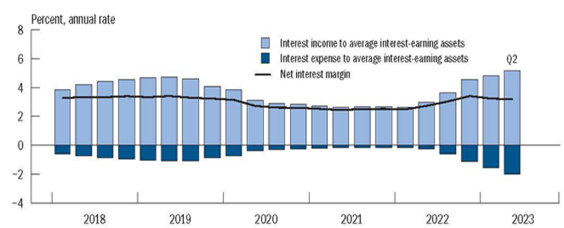
Figure 8. Bank return on average assets (ROAA) and return on equity (ROE)



Note: ROE is net income divided by average equity capital, and ROAA is net income divided by average assets. The dip in ROE and ROAA in the fourth quarter of 2017 was driven by a one-time tax effect associated with the Tax Cuts and Jobs Act of 2017.

Source: Call Report and FR Y-9C.

Figure 9. Net interest margin



Note: Net interest margin is net interest income divided by average interest-earning assets, annualized. Net interest income is interest income minus interest expense.

Source: Call Report and FR Y-9C.

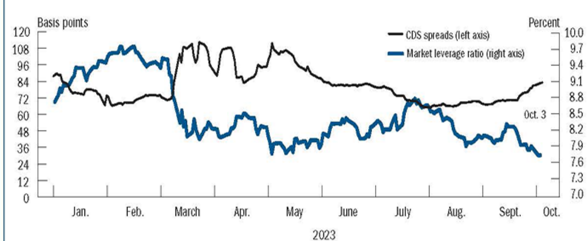
Bank Market Indicators Show Mixed Signals

Market assessments of bank risk, including the market leverage ratio and credit default swap (CDS) spreads, provide a forward-looking assessment of the strength of the banking system. The market leverage ratio is a measure of a firm's financial position that considers the relationship between a firm's market capitalization and its liabilities. Lower stock prices reduce the ratio of a firm's market capitalization to its debt, which indicates less market confidence in a firm's financial strength. Conversely, higher stock prices produce a higher ratio, reflecting a higher degree of confidence in a firm's financial strength. As a complement to market leverage, CDS spreads track the price of insurance against a default by a given firm. If a firm's CDS spread rises, it means the market has lower confidence in a firm's creditworthiness. Lower CDS spreads indicate higher confidence in a firm's creditworthiness, according to the market.[6]

During 2023, the average market leverage ratio for the largest banks has declined, remaining lower than levels seen at the beginning of the year. The average CDS spread for the largest banks also worsened between the start of March and early May. The average CDS spread has since fallen below its levels at the start of the year, though it is still elevated relative to pre-pandemic levels (figure 10).

Credit rating downgrades from Moody's and S&P Global in August contributed to pressure on some bank stock prices. These two credit agencies downgraded credit ratings or lowered outlooks for more than 20 banks, affecting all but the largest tier of banks. Both Moody's and S&P Global referenced the higher interest rate environment and CRE exposure as considerations in the downgrades.

Figure 10. Average credit default swap (CDS) spread and market leverage ratio (daily)



Note: The market leverage ratio is the ratio of a firm's market capitalization to the sum of market capitalization and the book value of liabilities. Averages are calculated from available observations for the eight LISCC firms (Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., The Goldman Sachs Group, JPMorgan Chase & Co., Morgan Stanley, State Street Corporation, and Wells Fargo & Company).

Source: Federal Reserve staff calculations using Bloomberg data.

[6] See appendix A for additional information on market indicators.

Third-Quarter 2023 Earnings at Large Firms

This section provides a recap of banking sector conditions for the third quarter of 2023, based on earnings results for 22 large U.S. bank holding companies and one large savings and loan holding company.[7] While such trends are indicative, it should be noted that the sample may not necessarily be representative of the banking sector.

In the third quarter of 2023, aggregate large bank profitability, as measured by return on equity, approximated 12 percent, roughly the same level as reported in the second quarter of 2023. As compared with the second quarter, large banks reported lower net interest income, which was offset by higher capital markets fees and a smaller credit loss provision.

Large banks generally reported that deposit costs continued to rise but at a slower pace than experienced in each of the first two quarters in 2023. Most also reported that deposit balances were stable during the third quarter of 2023.

Large banks modestly built credit loss allowances during the third quarter of 2023, and loan growth was muted. Loan loss rates were largely unchanged quarter-over-quarter but were higher than those experienced in the third quarter of 2022.

The aggregate CET1 capital ratio for large banks approximated 12 percent on September 30, 2023, which was higher than the level seen at June 30, 2023, and at the end of 2022. Higher CET1 capital ratio levels reflect targeted efforts by bank management teams to build CET1 capital and control risk-weighted-asset growth.

[7] The sample includes Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; Capital One Financial Corporation; The Charles Schwab Corporation; Citigroup Inc.; Citizens Financial Group, Inc.; Discover Financial Services; Fifth Third Bancorp; The Goldman Sachs Group, Inc.; Huntington Bancshares Incorporated; JPMorgan Chase & Co.; KeyCorp; M&T Bank Corporation; Morgan Stanley; Northern Trust Corporation; The PNC Financial Services Group, Inc.; Regions Financial Corporation; State Street Corporation; Truist Financial Corporation; U.S. Bancorp; and Wells Fargo & Company. Data are unadjusted for mergers and acquisitions.

Regulatory Developments

The Federal Reserve has taken several policy actions since the publication of the May 2023 *Supervision and Regulation Report*. Significant actions are detailed in table 1 below. All Supervision and Regulation (SR) and Consumer Affairs (CA) letters are available on the Federal Reserve Board's public website.[8]

Table 1. Federal Reserve or interagency rulemakings/statements (proposed and final)

From 04/29/2023 to 10/31/2023	
Date issued	**Rule/guidance**
6/1/2023	Agencies request comment on quality control standards for automated valuation models proposed rule. Joint press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230601a.htm
6/6/2023	Agencies issue final guidance on third-party risk management. Joint Press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230606a.htm
6/8/2023	Agencies propose interagency guidance on reconsiderations of value for residential real estate valuations. Joint press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230608a.htm
6/29/2023	Agencies finalize policy statement on commercial real estate loan accommodations and workouts. Joint press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230629a.htm
7/27/2023	Agencies request comment on proposed rules to strengthen capital requirements for large banks. Joint press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm
7/27/2023	Federal Reserve Board announces the individual capital requirements for all large banks, effective on October 1 Press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727b.htm
7/28/2023	Agencies update guidance on liquidity risks and contingency planning. Joint press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230728a.htm
8/8/2023	Federal Reserve Board provides additional information on its program to supervise novel activities in the banks it oversees and activities that involve crypto-assets and distributed ledger or "blockchain" technology. Press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230808a.htm
8/29/2023	Agencies request comment on proposed rule to require large banks to maintain long-term debt to improve financial stability and resolution. Joint press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230829a.htm
8/29/2023	Agencies propose guidance to enhance resolution planning at large banks. Joint press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230829b.htm
10/6/2023	Federal Reserve Board finalizes a rule establishing capital requirements for insurers supervised by the Board. Press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231006a.htm
10/24/2023	Agencies issue principles for climate-related financial risk management for large financial institutions. Joint press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231024b.htm

[8] The Federal Reserve publishes SR and CA letters to address significant policy and procedural matters related to the Federal Reserve System's safety and soundness and consumer compliance supervisory responsibilities, respectively. SR letters are available on the Board's public website at https://www.federalreserve.gov/supervisionreg/srletters/srletters.htm, and CA letters are available on the Board's public website at https://www.federalreserve.gov/supervisionreg/caletters/caletters.htm.

Basel III Capital Framework

In July, the bank regulatory agencies invited public comment on a proposal to modify large bank capital requirements.[9] The changes would implement the final components of the Basel III agreement, also known as the Basel III endgame.

The proposal seeks to apply a broader set of capital requirements to an increasing number of large banking organizations—generally applying them to banking organizations with $100 billion or more in total assets.

Most banks currently would have enough capital to meet the proposed requirements. The proposal is estimated to result in an aggregate 16 percent increase in CET1 capital requirements for all large banks, with the increase principally affecting the largest and most complex banks. The effects would vary for each banking organization based on its activities and risk profile. Under the proposal, large banks would begin transitioning to the new framework on July 1, 2025, with full compliance starting July 1, 2028.

Separately, the Federal Reserve Board requested comment on a proposal that would make certain adjustments to the calculation of the risk-based capital surcharge for global systemically important banking organizations (G-SIBs), also known as the G-SIB surcharge. The changes would better align the surcharge to each banking organization's systemic risk profile, including by measuring indicators of a banking organization's systemic importance over the entire year, instead of only at the end of the year.[10]

Comments on both proposals were initially due by November 30, 2023, though that was extended to January 16, 2024 to allow interested parties more time to analyze the issues and prepare their comments.[11]

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[9] See Board of Governors of the Federal Reserve System, "Agencies Request Comment on Proposed Rules to Strengthen Capital Requirements for Large Banks," news release, July 27, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm.

[10] See Board of Governors of the Federal Reserve System, "Agencies Request Comment on Proposed Rules to Strengthen Capital Requirements for Large Banks," https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm.

[11] See Board of Governors of the Federal Reserve System, "Agencies Extend Comment Period on Proposed Rules to Strengthen Large Bank Capital Requirements," news release, October 20, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020a.htm.

Long-Term Debt

In August, the agencies requested public comment on a proposal to enhance the resolvability of large banks that are not G-SIBs. G-SIBs are already subject to substantial resolution-related requirements under existing rules.[12]

The proposal would require non-G-SIB large banks with at least $100 billion in total assets to issue and maintain a minimum amount of long-term debt, which could be used to absorb losses and to increase the options available to resolve such banks in case of failure. By reducing the risk that depositors would face losses, long-term debt also could reduce the speed and severity of bank runs and limit contagion when a bank is under stress. The proposal includes transition and phase-in provisions and would allow for certain outstanding long-term debt to apply toward the minimum requirements to provide in-scope banks with a reasonable period to comply with the requirements.

Comments on this proposal are due by November 30, 2023.

Discount Window Preparedness

In July, the agencies updated their existing guidance on liquidity risks and contingency planning.[13] The updated guidance indicates that depository institutions should regularly evaluate and update their contingency funding plans. It further notes that the discount window is an important tool that depository institutions can utilize in managing liquidity risk, and that the agencies encourage depository institutions to incorporate the discount window as part of their contingency funding arrangements.

The guidance also reinforces the supervisory expectation that if the discount window is part of a depository institution's contingency funding plans, the depository institution should establish and maintain operational readiness to use the discount window, including by conducting periodic transactions.

[12] See Board of Governors of the Federal Reserve System, "Agencies Request Comment On Proposed Rule To Require Large Banks to Maintain Long-Term Debt to Improve Financial Stability and Resolution," news release, August 29, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230829a.htm.

[13] See Board of Governors of the Federal Reserve System, "Agencies Update Guidance on Liquidity Risks and Contingency Planning," news release, July 28, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230728a.htm.

Supervisory Developments

This section provides an overview of recent supervisory efforts to assess institutions' safety and soundness and compliance with laws and regulations. There are separate subsections for large financial institutions with assets of $100 billion or more and community and regional banking organizations. Supervisory approaches and priorities differ by a financial institution's size and complexity.

The Federal Reserve is responsible for overseeing the implementation of certain laws and regulations relating to consumer protection and community reinvestment. The scope of the Federal Reserve's supervisory jurisdiction varies based on the consumer law or regulation and on the asset size of the state member bank. Consumer-focused supervisory work is designed to promote a fair and transparent marketplace for financial services and to ensure supervised institutions comply with applicable federal consumer protection laws and regulations.

More information about the Federal Reserve's consumer-focused supervisory program can be found in the Federal Reserve's *109th Annual Report 2022*.[14]

Federal Reserve Supervision

Supervisors conduct examinations to evaluate a banking organization's activities, risk management, and financial condition.[15] Examinations include assessments of capital adequacy, asset quality, earnings strength and quality, liquidity position and funding sources, sensitivity to interest rate risks, and the quality of board and management oversight. Supervisors may also decide whether to further focus examinations on a firm's known and potential risks. For example, examiners may undertake additional credit quality and credit risk management testing at a bank with a rapidly growing concentration in CRE loans.

If supervisors find risk management or financial condition to be deficient, they provide direction and require the bank to correct its weaknesses. This direction takes the form of confidential supervisory findings: matters requiring attention (MRAs) and, for more significant issues that

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[14] See Board of Governors of the Federal Reserve System, *109th Annual Report of the Board of Governors of the Federal Reserve System* (Washington: Board of Governors, July 2023), https://www.federalreserve.gov/publications/files/2022-annual-report.pdf.

[15] See "Understanding Federal Reserve Supervision," https://www.federalreserve.gov/supervisionreg/how-federal-reserve-supervisors-do-their-jobs.htm.

must be corrected on a priority basis, matters requiring immediate attention (MRIAs). These are communicated to a banking organization's management and board of directors in a written exam or inspection report. If a bank does not address these supervisory findings or the findings are significant enough to pose an immediate threat to a bank's safety and soundness, supervisors may also lower the bank's supervisory rating or pursue an enforcement action against the bank.

Supervisory ratings, which are confidential, provide an assessment of a firm's risk management and financial condition, based on examination results, supervisory findings, and other information collected from banking organizations and monitored throughout the year. These ratings reflect examiners' overall judgment of the firm's safety and soundness. Supervisory ratings are generally issued once a year for larger banking organizations and every 18 months for smaller firms but may also be issued in the interim if circumstances warrant.

Supervised Institutions

The Federal Reserve supervises bank holding companies, savings and loan holding companies, state member banks, and foreign banking organizations operating in the United States of varying size and complexity. The Federal Reserve follows a risk-focused approach by scaling supervisory work to the asset size and complexity of an institution.

- The Large Institution Supervision Coordinating Committee (LISCC) program supervises firms that pose elevated risk to U.S. financial stability.
- The Large and Foreign Banking Organization (LFBO) program supervises U.S. firms with total assets of $100 billion or more and all foreign banking organizations operating in the United States regardless of asset size.
- The Regional Banking Organization (RBO) program supervises U.S. firms with total assets between $10 billion and $100 billion.
- The Community Banking Organization (CBO) program supervises U.S. firms with less than $10 billion in total assets.

Table 2 provides an overview of the organizations supervised by the Federal Reserve by portfolio, including the number of institutions and total assets in each portfolio.

Table 2. Summary of organizations supervised by the Federal Reserve, as of 2023:Q2

Portfolio	Definition	Number of institutions	Total assets ($ trillions)
Large Institution Supervision Coordinating Committee (LISCC)	Eight U.S. global systemically important banks (G-SIBs)	8	14.8
State member banks (SMBs)	SMBs within LISCC organizations	4	1.2
Large and foreign banking organizations (LFBOs)	Non-LISCC U.S. firms with total assets $100 billion and greater and FBOs	171	10.5
Large banking organizations (LBOs)	Non-LISCC U.S. firms with total assets $100 billion and greater	18	5.1
Large FBOs (with IHC)	FBOs with combined U.S. assets $100 billion and greater	11	3.2
Large FBOs (without IHC)	FBOs with combined U.S. assets $100 billion and greater	6	1.0
Small FBOs (excluding rep offices)	FBOs with combined assets less than $100 billion	103	1.2
Small FBOs (rep offices)	FBO U.S. representative offices	33	0.0
State member banks	SMBs within LFBO organizations	9	1.1
Regional banking organizations (RBOs)	Total assets between $10 billion and $100 billion	101*	2.7
State member banks	SMBs within RBO organizations	32	1.0
Community banking organizations (CBOs)	Total assets less than $10 billion	3,483**	2.9
State member banks	SMBs within CBO organizations	655	0.6
Insurance and commercial savings and loan holding companies (SLHCs)	SLHCs primarily engaged in insurance or commercial activities	6 insurance 4 commercial	0.9

* Includes 100 holding companies and 1 state member bank that does not have a holding company.
** Includes 3,430 holding companies and 53 state member banks that do not have holding companies.

Current Supervisory Priorities

During 2023, the Federal Reserve intensified examination efforts on assessing banks' preparedness for managing liquidity, interest rate, and credit risks. In addition, supervisors initiated continuous monitoring for a small number of firms with a risk profile that could result in funding pressures for the firm.

In August, the Federal Reserve established a Novel Activities Supervision Program to enhance the supervision of novel activities conducted by banking organizations supervised by the Federal Reserve. The program helps ensure that the risks associated with innovative activities are appropriately supervised and reviewed by examiners with expertise and experience in overseeing such activities.[16] The program focuses on novel activities related to crypto-assets, distributed ledger technology, and complex, technology-driven partnerships with nonbanks to deliver financial services to customers. The program is risk-focused and will work in partnership with existing Federal Reserve supervisory teams to strengthen the oversight of novel activities.

[16] See Board of Governors of the Federal Reserve System, "Creation of Novel Activities Supervision Program," SR Letter 23-7 (August 8, 2023), https://www.federalreserve.gov/supervisionreg/srletters/SR2307.htm.

Large Financial Institutions

This section of the report discusses the supervisory approach for large financial institutions—namely, U.S. firms with total assets of $100 billion or more, and foreign banking organizations with combined U.S. assets of $100 billion or more. These firms are either within the LISCC portfolio or the LFBO portfolio. Large financial institutions are subject to regulatory requirements that are tiered to the risk profiles of these firms. Appendix A provides an overview of key regulatory requirements. Supervisory efforts for large financial institutions focus on four components:

1. capital planning and positions,
2. liquidity risk management and positions,
3. governance and controls, and
4. recovery and resolution planning.

The Financial Condition of Large Financial Institutions

Large financial institutions' capital positions remain above minimum regulatory ratios, although unrealized losses on securities and other assets have weighed on their tangible capital. As of June 30, 2023, their aggregate CET1 capital ratio was 12.3 percent. Supervisors continue to closely monitor capital levels and, in June, completed the annual stress test for 23 large financial institutions. This year, the supervisory severely adverse scenario included a severe global recession accompanied by a period of heightened stress in commercial and residential real estate, as well as corporate debt markets. The stress test results show that the 23 large banks subject to the test this year have sufficient capital to absorb more than $540 billion in losses and continue to lend to households and businesses under stressful conditions.[17]

The Board also conducted an exploratory market shock on the trading books of the largest banks, testing them against greater inflationary pressures and rising interest rates. While not contributing to banks' capital requirements, the exploratory stress test was used to further understand the risks of bank trading activities and to assess the potential for testing banks against multiple scenarios in the future.

Large financial institutions' profitability, as measured by return on average assets and return on equity, remained at solid levels, with both measures staying above their 10-year average during the first half of 2023. However, net interest margins declined slightly because of slower lending activity, increases in deposit costs, and greater reliance on higher cost wholesale funding. Large financial institutions also increased credit loss provisions. Loan delinquencies remain low, but there have been recent increases in past due balances of CRE and consumer loans.

[17] See Board of Governors of the Federal Reserve System, *2023 Federal Reserve Stress Test Results* (Washington: Board of Governors, 2023), https://www.federalreserve.gov/publications/files/2023-dfast-results-20230628.pdf.

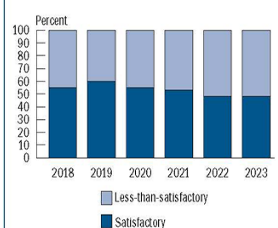
Liquidity positions remain substantially above regulatory minimums. However, liquidity positions have declined overall, and some large financial institutions have experienced deposit declines in an increasingly competitive deposit market.

Trends in Supervisory Ratings and Findings

Federal Reserve supervisors summarize their assessments of large financial institutions using the LFI rating system.[18] The LFI rating system evaluates whether a firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations and comply with laws and regulations, including those related to consumer protection, through a range of conditions.[19] It includes three components: (1) capital planning and positions; (2) liquidity risk management and positions; and (3) governance and controls. Each component is rated based on a four-point non-numeric scale: Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2. A firm is considered to be in satisfactory condition if all of its component ratings are "Broadly Meets Expectations" or "Conditionally Meets Expectations."

As of June 30, 2023, most large financial institutions were meeting supervisory expectations with respect to capital planning and positions and liquidity risk management and positions. However, some firms continue to face challenges meeting supervisory expectations related to governance and controls, mainly because of deficiencies in the management of risks related to operational resilience, cybersecurity, and BSA/AML compliance. As a result, only about half of the large financial institutions had satisfactory ratings across all three LFI rating components (figure 11).

Figure 11. Ratings for large financial institutions



Note: Financial institutions are rated on a composite basis from components based upon risk management, operational controls, regulatory compliance, and asset quality. The 2023 value is as of the end of 2023:Q2. Key identifies bars in order from top to bottom.

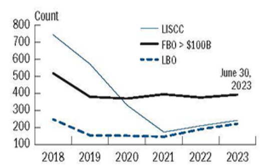
Source: Internal Federal Reserve supervisory databases.

Outstanding supervisory findings at large financial institutions have increased over the last year (figure 12). Governance and controls findings represent approximately two-thirds of outstanding issues (figure 13). More recently, matters requiring attention related to liquidity and interest rate

[18] See Board of Governors of the Federal Reserve System, "Large Financial Institution (LFI) Rating System," SR Letter 19-3/CA Letter 19-2, (February 26, 2019), https://www.federalreserve.gov/supervisionreg/srletters/sr1903.htm.

[19] See Board of Governors of the Federal Reserve System, *Supervision and Regulation Report* (Washington: Board of Governors, November 2019), https://www.federalreserve.gov/publications/files/201911-supervision-and-regulation-report.pdf.

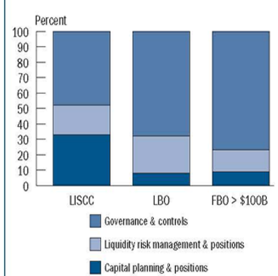
Figure 12. Outstanding number of supervisory findings, large financial institutions



Note: Values prior to 2023 are as of year-end. The 2023 value is as of the end of 2023:Q2. The findings count data are subject to revisions as issues are reviewed, updated, and finalized; this could result in minor historical count fluctuations.

Source: Internal Federal Reserve supervisory databases.

Figure 13. Outstanding supervisory findings by category, large financial institutions



Note: As of 2023:Q2, total supervisory findings by portfolio were: LISCC—241; LBO—221; and FBO > $100B—392. Key identifies bars in order from top to bottom.

Source: Internal Federal Reserve supervisory databases.

risk management have increased. This stems from the effects of higher interest rates on the market value of banking organizations' asset holdings, particularly investment securities. Because unrealized losses diminish the ability of banks to sell securities to meet liquidity needs without incurring losses, these unrealized losses can increase liquidity risks and require closer management of contingency funding arrangements. Higher rates for deposit and wholesale funding also increase firms' interest costs and reduce earnings.

Supervisory Focus

During 2023, the Federal Reserve completed examinations to assess liquidity and heightened monitoring of liquidity risk management and liquidity positions at the largest banking organizations. This included reviewing contingency funding plans, access to secured funding, liquidity stress test projections, and intraday liquidity risk management practices. Supervisors also directed additional attention to evaluating firms' interest rate risk positions and management.

Large financial institution supervisors initiated horizontal reviews to assess interest rate risk management practices across the large firms. Horizontal reviews include a series of examinations focused on a single supervisory issue at several firms. This allows examiners to compare risk management practices at different firms, identify gaps in practices at specific firms, and promote sound practices across the industry. These reviews assess the adequacy of firms' risk management processes to identify, measure, monitor, and, as needed, mitigate interest rate and related liquidity risks. To the extent gaps are identified, supervisors issue MRAs or MRIAs to direct banks to address these issues.

Although loan delinquencies remain low, large financial institutions have recently increased provisions for credit losses. Some firms have indicated in public earnings releases that they expect increased loan losses, particularly within the office segment of CRE.[20] Supervisors, therefore, continue to closely monitor underwriting and loan quality. Recent efforts include a horizontal review to address exposures to potential deterioration in CRE markets. Supervisors are centering the review on evaluating credit risk monitoring and measurement, internal loan risk rating accuracy, steps taken to mitigate the risk of losses on CRE loans, and CRE risk reporting to firms' boards of directors and senior management.

Supervisors also continue to focus on monitoring credit risk associated with consumer loans as delinquency and charge-off rates return to pre-pandemic levels. They are also conducting work to assess the level and quality of loans to nonbank financial institutions, given a substantial increase in lending to this segment in recent years.

See below for additional detail on large financial institutions' supervisory priorities for the coming months.

Large Financial Institution Supervisory Priorities

Capital

- financial risks in the current economic environment, including
  - interest rate risk
  - market and counterparty credit risk
  - consumer and commercial credit risk
- risk-management practices in credit, market, and interest rate risk
- implementation of regulatory requirements (e.g., capital for counterparty credit exposure rules)

Liquidity

- internal liquidity stress tests
- contingency funding plans and intraday liquidity risk management
- changes in deposit behaviors and resulting effects on liquidity positions and risk-management practices

[20] Matt Tracy, "U.S. Banks Increase Reserves for Commercial Real Estate Exposure," Reuters website, July 21, 2023, https://www.reuters.com/business/finance/us-banks-increase-reserves-commercial-real-estate-exposure-2023-07-21/.

- asset/liability management and stress testing
- liquidity risk management at foreign banking organization branches

Governance and Controls

- operational resilience, including cybersecurity, novel banking, and information technology risks
- third-party vendor risk management
- compliance, internal loan review, and audit
- firm remediation efforts on previous supervisory findings

Recovery and Resolution Planning

- recovery and resolution planning, including biannual resolution plan review for the G-SIBs
- remediation of and follow-up on resolution plan shortcomings and exam findings, as necessary
- international coordination among global supervisors

Community and Regional Banking Organizations

This section of the report discusses the financial condition and supervisory approach for banking organizations with assets of less than $100 billion, including community banking organizations (CBOs), which have less than $10 billion in total assets, and regional banking organizations (RBOs), which have total assets between $10 billion and $100 billion.

The Financial Condition of CBOs and RBOs

CBOs and RBOs generally remain in sound financial condition, though increased funding costs are narrowing net interest margins.

Nearly all CBOs and RBOs remain well-capitalized. However, as interest rates have risen, some banks have experienced sizeable declines in the fair value of their securities investments and, as a result, have also seen their tangible equity levels decline. Federal Reserve examiners are closely monitoring tangible equity levels and their impact on banks' cost of funding.

Asset quality remains sound, and the level of problem loans remains low.[21] CBOs and RBOs, however, hold a high proportion of the banking sector's CRE loans. Some CRE market segments have recently been under stress, particularly office. As a result, Federal Reserve examiners are closely monitoring conditions and engaging with bank management to assess the degree to which banks with high levels of CRE loans are prepared for potential changes in market conditions.

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[21] "Problem loans" are composed of 90-day-or-more past due loans, non-accrual loans, impaired loans, renegotiated or restructured loans, and loans that are internally criticized or classified by a bank, as well as loans that were classified by examiners during the previous examination.

Liquidity remains satisfactory for most CBOs and RBOs, but liquidity at several RBOs was adversely affected by the banking stresses in the first half of 2023. For some RBOs, deposit declines were material and required these banks to seek new wholesale funding. These wholesale funding sources tend to be more costly and have put pressure on net interest margins for some RBOs, as well as some CBOs.

Federal Reserve examiners are closely monitoring liquidity risk management practices and contingency funding plans, and examiners are assessing banks' preparedness to manage unexpected deposit outflows. They are also encouraging CBOs and RBOs to maintain actionable and diversified funding sources to help them manage the competitive deposit and funding environment. Examiners are emphasizing that funding sources should be highly reliable and that banks should have sufficient collateral pledged so they can quickly access funding when needed.

Trends in Supervisory Ratings and Findings

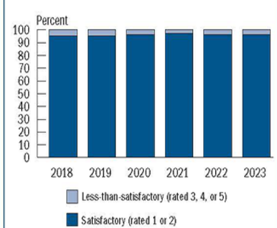
The Federal Reserve and the other federal and state banking agencies utilize the Uniform Financial Institution Rating system (referred to as "CAMELS") to present the examiner's conclusions regarding the overall condition of the bank. The CAMELS composite rating represents an overall appraisal of six key assessment components covered under the CAMELS rating system: Capital Adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.

For the inspection of a holding company with less than $100 billion in total consolidated assets, the Federal Reserve utilizes the RFI rating system to present the examiner's conclusions regarding the overall condition of these holding companies. The RFI composite rating represents an overall appraisal of three components covered under the RFI rating system: Risk management, Financial Condition, and Impact of the non-depository entities on the subsidiary depository institutions.

The CAMELS and RFI rating systems are assigned based on a "1 to 5" numeric scale. A "1" numeric rating indicates the highest rating, strongest performance and practices, and least degree of supervisory concern. A "5" numeric rating indicates the lowest rating, weakest performance, and highest degree of supervisory concern. Banks and holding companies that are rated "1" or "2" are generally in satisfactory condition, while banks that are rated "3", "4", or "5" are in less-than-satisfactory condition.

Based on supervisory ratings as of June 2023, the vast majority of CBOs and RBOs remain in satisfactory condition with effective risk management practices (figure 14). However, the financial trends described above have resulted in an increase in the number of supervisory ratings downgrades.

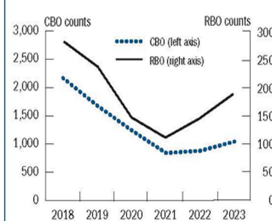
Figure 14. Top-tier ratings for CBO and RBO firms



Note: Includes composite ratings for consolidated top-tier holding companies and SMBs without holding companies for CBO and RBO firms. The 2023 value is as of the end of 2023:Q2. Key identifies bars in order from top to bottom.

Source: Internal Federal Reserve supervisory databases.

Figure 15. Outstanding supervisory findings, CBO and RBO firms



Note: Values prior to 2023 are as of year-end. The 2023 value is as of the end of 2023:Q2. The findings count data are subject to revisions as issues are reviewed, updated, and finalized; this could result in minor historical count fluctuations.

Source: Internal Federal Reserve supervisory databases.

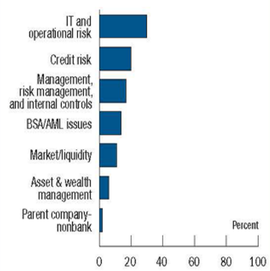
The number of supervisory findings outstanding at CBOs and RBOs increased in the first half of 2023 (figure 15). The number of findings per examination also increased in 2023 relative to 2022. For the first half of 2023, information technology weaknesses and operational risk were the most cited supervisory issues for CBOs and RBOs (figures 16 and 17). Credit risk issues remained elevated, and issues with market risk, liquidity risk, and BSA/AML compliance were an increasing share of issues compared with prior years.

Supervisory Focus

During 2023, the Federal Reserve intensified monitoring of CBOs and RBOs that appeared most vulnerable to funding pressures. In many cases, Federal Reserve examiners issued findings requiring bank management to improve access to contingent funding, increase liquid asset buffers, and revalidate the deposit outflow assumptions in a bank's contingency funding plans. Examiners have also increased their focus on ensuring that banks understand the nature of their deposit concentrations and accurately assess the stability of each deposit segment.

Federal Reserve examiners are also closely monitoring real estate markets and banks with large CRE concentrations. While credit quality conditions currently remain stable, examiners are closely monitoring banks' asset quality metrics for emerging deterioration. Banks with larger CRE credit concentrations are expected to have robust risk management practices including, but not

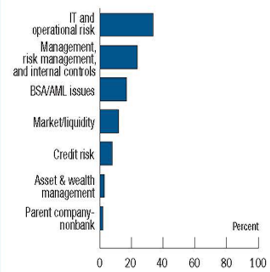
Figure 16. Outstanding supervisory findings by category, CBO firms



Note: As of 2023:Q2, there were 1,012 total supervisory findings for CBO firms.

Source: Internal Federal Reserve supervisory databases.

Figure 17. Outstanding supervisory findings by category, RBO firms



Note: As of 2023:Q2, there were 189 total supervisory findings for RBO firms.

Source: Internal Federal Reserve supervisory databases.

limited to, the ability to quantify the impact of changing economic conditions on their earnings, asset quality, and capital.

Finally, Federal Reserve examiners are focused on the impact of rising interest rates on banks' capital and earnings. In general, examiners expect banks to preserve capital when they are experiencing financial difficulties or when the macroeconomic outlook for their primary sources of earnings have deteriorated.

See below for additional detail on CBO and RBO supervisory priorities for the coming months.

CBO and RBO Supervisory Priorities

Credit Risk

- high-risk loan portfolios and debt service coverage capacity in a changing interest rate environment
- credit concentrations, particularly in CRE loan portfolios
- impact of rising capitalization rates and real estate valuation uncertainty
- implementation of Current Expected Credit Losses (CECL) for CBOs in 2023

Liquidity Risk

- contingency funding plans
- liquidity coverage of uninsured deposits

Other Financial Risks

- interest rate risk
- declines in the fair value of securities and low tangible equity levels
- capital adequacy

Operational Risk

- information technology and cybersecurity preparedness
- fintech and banking-as-a-service activities
- third-party risk management

Appendix A: Sources and Terms

Data Sources

The Supervision and Regulation Report includes data both on institutions supervised by the Federal Reserve System and some institutions outside Federal Reserve supervision. The report reflects data through October 3, 2023. This appendix details these sources.

FFIEC Call Reports

The FFIEC Consolidated Reports of Condition and Income, also known as the Call Report, is a periodic report that is required to be completed by every national bank, state member bank, insured nonmember bank, and savings association as of the last day of each calendar quarter. The details required to be reported depend on the size of the institution, the nature of the institution's activities, and whether it has foreign offices. Call Report data are a widely used source of timely and accurate financial data regarding a bank's financial condition and the results of its operations. The data collected on the Call Report are used to monitor the condition, performance, and risk profiles of reporting institutions individually and as an industry.

FR Y-9C

The Consolidated Financial Statement for Holding Companies, also known as the FR Y-9C report, collects basic financial data from domestic bank holding companies (BHCs), savings and loan holding companies (SLHCs), U.S. intermediate holding companies of foreign banking organizations (U.S. IHCs), and securities holding companies (SHCs). Initiatives to reduce reporting costs for firms led to increases in the minimum asset size thresholds for reporting from $500 million to $1 billion, and from $1 billion to $3 billion, effective March 2015 and September 2018, respectively. In addition, BHCs, SLHCs, U.S. IHCs, and SHCs meeting certain criteria may be required to file this report, regardless of size. However, when such BHCs, SLHCs, U.S. IHCs, or SHCs own or control, or are owned or controlled by, other BHCs, SLHCs, U.S. IHCs, or SHCs, only top-tier holding companies must file this report for the consolidated holding company organization. The information contained in the report is as of the last day of each calendar quarter.

FR Y-14Q

The FR Y-14Q report is part of the Capital Assessments and Stress Testing information collection (FR Y-14). The FR Y-14 data collection is used to assess the capital adequacy of large firms using forward-looking projections of revenue and losses and to support supervisory stress test models and continuous monitoring efforts, as well as to inform the Federal Reserve's operational decision-making and implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010). The FR Y-14Q collects detailed data on BHCs', IHCs', and SLHCs' various asset classes, capital components, and categories of pre-provision net revenue.

H.8 Assets and Liabilities of Commercial Banks in the United States

The H.8 release provides an estimated weekly aggregate balance sheet for all commercial banks in the United States. The H.8 release is primarily based on data that are reported weekly by a sample of approximately 875 domestically chartered banks and foreign-related institutions. Data for domestically chartered commercial banks and foreign-related institutions that do not report weekly are estimated at a weekly frequency based on quarterly Call Report data.

Notes on Data Sources and Terms

CAMELS Ratings

Following an examination of a commercial bank, the examiner's conclusions regarding the overall condition of the bank are summarized in a composite rating assigned in accordance with guidelines provided under the Uniform Financial Institution Rating system (referred to as "CAMELS"). The composite rating represents an overall appraisal of six key assessment areas (components) covered under the CAMELS rating system: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.

In addition to and separate from the interagency Uniform Financial Institutions Rating System, the Federal Reserve assigns a risk-management rating to all SMBs. The summary, or composite, rating, as well as each of the assessment areas, including risk management, is delineated on a numerical scale of 1 to 5, with 1 being the highest or best possible rating. Thus, a bank with a composite rating of 1 requires the lowest level of supervisory attention while a 5-rated bank has the most critically deficient level of performance and, therefore, requires the highest degree of supervisory attention.

When appraising the six key assessment areas and assigning a composite rating, the examiner weighs and evaluates all relevant factors for downgrades and upgrades of supervisory ratings.

Current Expected Credit Losses Methodology (CECL)

In 2016, the Financial Accounting Standards Board (FASB) announced significant changes to credit loss accounting under U.S. generally accepted accounting principles (GAAP). Refer to Accounting Standards Update (ASU) No. 2016-13, Financial Instruments—Credit Losses, Topic 326, Measurement of Credit Losses on Financial Instruments.

CECL replaced the incurred loss methodology for financial assets measured at amortized cost. For these assets, CECL requires banking organizations to recognize lifetime expected credit losses. Further, banking organizations are required to incorporate reasonable and supportable forecasts in developing their estimate of lifetime expected credit losses, while also considering past events and current conditions.

Supervised institutions that are SEC filers, excluding smaller reporting companies, were required to adopt CECL on January 1, 2020. All other institutions were required to implement CECL by January 1, 2023. For additional information, refer to the Federal Reserve's CECL Resource Center (https://www.supervisionoutreach.org/cecl).

Commercial Real Estate Loans

Commercial real estate loans are the sum of construction, land development, and other land loans; loans secured by multifamily residential properties; and loans secured by nonfarm nonresidential properties.

Note: H.8 commercial real estate data include loans secured by farmland.

Common Equity Tier 1 (CET1)

Common equity capital is currently evaluated using a CET1 capital ratio, which was introduced into the regulatory capital framework in 2014, consistent with international Basel III reforms. The CET1 capital ratio is defined as CET1 capital, which consists primarily of common stock and retained earnings, as a percent of risk-weighted assets. Advanced approaches institutions are required to report risk-weighted assets using an internal model-based approach and a standardized approach. An advanced approaches institution is subject to the lower of the ratios. CBOs that have opted into the community bank leverage ratio (CBLR) framework are not required to report a CET1 capital ratio and risk-weighted assets.

From 2006 through 2013, tier 1 common capital was used to measure common equity capital for all firms. In 2014, both tier 1 common capital (for non-advanced approaches firms) and CET1 capital (for advanced approaches firms) were used. From 2015 to present, CET1 capital has been used for all firms.

Community Bank Leverage Ratio Framework

The CBLR framework, which became effective January 1, 2020, allows qualifying CBOs to adopt a simple leverage ratio to measure capital adequacy. To qualify for the framework, a CBO must have less than $10 billion in total consolidated assets, have limited trading activity and off-balance-sheet exposure, meet the leverage ratio requirement, and not be part of an advanced approaches banking organization. The leverage ratio requirement for the CBLR framework was temporarily lowered to 8 percent beginning in the second quarter of 2020 through the remainder of calendar year 2020. The requirement was set at 8.5 percent for calendar year 2021 and returned to its previous 9 percent level beginning January 1, 2022.

The leverage ratio requirement for the CBLR framework is defined with respect to tier 1 capital as a percent of average total consolidated assets for the quarter as reported on Schedule RC-K on the Call Report or Schedule HC-K on Form FR Y-9C, as applicable. A CBLR banking organization with a ratio above the requirement will not be subject to other capital and leverage requirements.

Consumer Loans

Consumer loans include credit cards, other revolving credit lines, automobile loans, and other consumer loans including single-payment loans, installment loans excluding automobile loans, and student loans.

Contingency Funding Plan

A Contingency Funding Plan (CFP) is a bank's strategy for addressing contingent liquidity events. Contingent liquidity events are unexpected situations or business conditions that may increase liquidity risk. These events may be institution-specific or arise from external factors. A CFP should contain policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. CFPs should be commensurate with an institution's complexity, risk profile, and scope of operations. CFPs should address both the severity and duration of contingent liquidity events. CFPs should be regularly tested and updated to ensure that they are operationally sound.

Credit Default Swap Spread

The five-year credit default swap spread is the premium payment expressed as a proportion of the notional value of the debt that is being insured against default (typically $10 million in senior debt) in basis points. Data are based on daily polls of individual broker-dealers worldwide. Note that these broker quotes are typically not transaction prices. Data provided are for LISCC firms only.

Credit Loss Reserves

Credit loss reserves represent the allowance for credit losses on a bank's portfolio of financial instruments carried at amortized cost (including loans held for investment, held-to-maturity debt securities, trade receivables, reinsurance receivables, and receivables that relate to repurchase agreements and securities lending agreements), net investment in leases as a lessor, and off-balance-sheet credit exposures not accounted for as insurance or derivatives. Credit loss reserves are recorded on a bank's balance sheet.

Delinquent Loans

Delinquent loans are the sum of 90+ days past due loans and nonaccrual loans.

Note: FR Y-14Q delinquent loans are the sum of 30+ days past due loans and nonaccrual loans.

Liquid Assets

Liquid assets are cash plus estimates of securities that qualify as high-quality liquid assets, as defined by the Board's liquidity coverage ratio rule.

Market Leverage Ratio

The market leverage ratio is defined as the ratio of the firm's market capitalization to the sum of market capitalization and the book value of liabilities. This ratio can be considered a market-based measure of a firm's capital (expressed in percentage points). Data provided are for LISCC firms only.

Net Interest Margin

Net interest margin measures a bank's yield on its interest-bearing assets after netting out interest expense.

Prime Brokerage

Some large banks offer a suite of services to large investment funds known as prime brokerage. These services include the ability to borrow securities or cash, cash management, and access to research, as well as provide introductions to potential investors. Lending is an important aspect of these services. The investment funds typically obtain loans secured by equities or other securities through the prime broker.

Provisions

Provisions represent the amount necessary to adjust credit loss reserves to reflect management's current estimate of expected credit losses. Provisions are recorded as an expense item on the bank's income statement.

Residential Real Estate Loans

Residential real estate loans refer to loans secured by 1 to 4 family residential properties, including: revolving, open-end loans secured by 1 to 4 family residential properties and extended under lines of credit; closed-end loans secured by first liens on 1 to 4 family residential properties; and closed-end loans secured by junior (i.e., other than first) liens on 1 to 4 family residential properties.

Top Holder

All data, unless otherwise noted, refer to the top-holder data. This population generally comprises top-tier Call Report filers and top-tier FR Y-9C filers, including depository SLHCs and foreign banking organizations. In instances where a top-tier holding company does not file the FR Y-9C, we combine financial data of subsidiary banks/thrifts to approximate the consolidated financial data of the holding company. Commercial and insurance SLHCs, cooperative banks, and non-deposit trust companies are excluded from the top-holder population.

Tiering of Regulation

In October 2019, the Federal Reserve Board adopted rules that tier its regulations for domestic and foreign banks and holding companies to match their risk profiles more closely. The rules establish a framework that sorts institutions with $100 billion or more in total assets into four categories based on several factors, including asset size, cross-jurisdictional activity, reliance on weighted short-term wholesale funding (wSTWF), nonbank assets (NBA), and off-balance-sheet exposure (table A.1).

Table A.1. List of domestic and foreign firms, by category, as of 2023:Q2

Firm type	Category I U.S. G-SIBs	Category II >=$700b total assets or >=$75b in cross-jurisdictional activity	Category III >=$250b total assets or >=$75b in NBA, wSTWF, or off-balance-sheet exposure	Category IV Other firms with $100b to $250b total assets
Domestic firms				
U.S. domestic banking organization	Bank of America Bank of New York Mellon Citigroup Goldman Sachs JPMorgan Chase Morgan Stanley State Street Wells Fargo	Northern Trust	Capital One Charles Schwab PNC Financial Truist Financial U.S. Bancorp	Ally Financial American Express Citizens Financial Discover Fifth Third First Citizens Huntington KeyCorp M&T Bank Regions Financial Synchrony Financial
Foreign firms (standards vary by legal entity)				
Intermediate holding company			Barclays US Credit Suisse USA Deutsche Bank USA DWS USA TD Group US UBS Americas	BMO Financial BNP Paribas USA HSBC North America MUFG Americas RBC US Santander Holdings USA
Combined U.S. operations		Barclays US MUFG Sumitomo Mitsui UBS	Bank of Montreal BNP Paribas Deutsche Bank Mizuho Royal Bank of Canada Toronto-Dominion	Banco Santander Bank of Nova Scotia Canadian Imperial HSBC Societe Generale

Notes: NBA is nonbank assets, wSTWF is weighted short-term wholesale funding. Credit Suisse IHC is now owned by UBS. First Citizens became a Category IV firm as of 2022:Q4. SVB Financial became a Category IV U.S. domestic firm as of 2022:Q4. This bank failed on March 10, 2023.
Source: FR Y-15.

PREPARED STATEMENT OF MARTIN J. GRUENBERG

CHAIR, FEDERAL DEPOSIT INSURANCE CORPORATION

NOVEMBER 14, 2023

Chairman Brown, Ranking Member Scott, and Members of the Committee, I am pleased to appear at today's hearing on "Oversight of Financial Regulators: Protecting Main Street Not Wall Street". I appreciate the opportunity to report on the Federal Deposit Insurance Corporation's (FDIC) recent work in protecting insured deposits, supervising State chartered banks that are not members of the Federal Reserve system for safety and soundness and consumer protection, and in resolving failed insured depository institutions.

My statement discusses the lessons learned from the regional bank failures this spring and proposed improvements in regulation and bank supervision that could help prevent similar bank failures or mitigate their impact in the future. In addition to proposals focused on large regional banks, my testimony discusses other important regulatory activities at the FDIC, including the publication of the Basel III Notice of Proposed Rulemaking (NPR) and the adoption of the final rule modernizing and strengthening the Community Reinvestment Act (CRA). Finally, I will discuss the FDIC's efforts to support Minority Depository Institutions (MDIs) and Community Development Financial Institutions (CDFIs).

State of the Banking Industry

The banking industry has proven to be quite resilient despite the period of stress earlier this year. In the second quarter, key banking industry measures of performance remained favorable. Net income remained high by historical measures, asset quality measures were stable, and the industry remained well capitalized. [1] However, banks reported lower net interest margins and higher funding pressures for a second consecutive quarter. Higher market interest rates and mortgage rates caused market values for debt to generally fall during the second quarter, resulting in higher unrealized losses on securities. [2] While the FDIC Quarterly Banking Profile data will not be available until later this month, early reports from third quarter 2023 indicate that the banking industry remains profitable and well-capitalized, that asset quality metrics continue to normalize from the historic lows reached during the pandemic, and that funding cost challenges have persisted, especially for small- and mid-sized banks.

As of June 30, 2023, deposits continued to decline for the fifth consecutive quarter, as depositors continue to seek higher yields. However, deposit outflows moderated substantially from the large outflows reported in the first quarter when the industry experienced significant stress and two regional banks failed. In the second quarter, uninsured deposits declined by 2.5 percent, far less than the 8 percent decline reported in the first quarter. By contrast, insured deposits increased by 0.8 percent during the second quarter, driven by higher insured brokered deposits and reciprocal deposits.

There has been a great deal of discussion about deposit flows to the Nation's larger banks, primarily under the assumption that deposits have flowed from regional banks to the largest banks. While deposit balances may have suggested that such flows occurred on a limited basis toward the end of the first quarter, that does not appear to have been the case in the second quarter. The Nation's global systemically important banks reported a decline in total deposits, primarily driven by a decline in uninsured deposits. Rather than a simple story of deposits flowing to the largest banks, the second quarter's deposit story appears to have been more about depositors seeking higher yields, often at nonbank financial institutions, particularly money market mutual funds. Many banks have increased deposit rates to compete, resulting in higher cost of funds.

In addition, higher interest rates reduce the value of assets that yield a fixed interest rate. Loans and securities with longer maturities and locked-in lower yields may pressure earnings in coming quarters. These longer-term balance sheet holdings further limit the ability of banks to lend, raise capital, or restructure. Market

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[1] In the second quarter, the banking industry's net income was $70.8 billion, a decrease of $9.0 billion from first quarter. But after excluding nonrecurring accounting gains on failed bank acquisitions that occurred in the first and second quarters, net income was roughly flat from the prior quarter—and in fact from fourth quarter 2022 as well. See "FDIC Quarterly Banking Profile: Second Quarter 2023", available at *https://www.fdic.gov/analysis/quarterly-banking-profile/*.

[2] Unrealized gains (losses) on securities solely reflect the difference between the market value as of quarter-end and the book value of nonequity securities.

rates continued to increase through the third quarter, likely putting downward pressure on the value of securities portfolios.

The banking industry continues to face significant downside risks from the effects of inflation, rising market interest rates, and geopolitical uncertainty. Moreover, the economic outlook remains uncertain, despite relatively solid growth and low unemployment so far this year. These risks could cause credit quality and profitability to weaken, loan growth to slow, provision expenses to rise, and liquidity to become more constrained. Commercial real estate (CRE) loan portfolios, particularly loans backed by office properties, face challenges when loans mature as demand for office space remains weak and property values continue to soften. Banks have tightened underwriting standards over the past year across a range of household and business loans, and they may continue to tighten further this year.[3]

The FDIC will continue to monitor prevailing trends in the banking industry and will publicly release data for the third quarter of this year as part of the Quarterly Banking Profile.[4]

Condition of the Deposit Insurance Fund

As of June 30, 2023, the Deposit Insurance Fund (DIF) balance totaled $117.0 billion, down $11.3 billion (8.8 percent) from year-end 2022, primarily resulting from an increase in loss provisions associated with the failures of Silicon Valley Bank (SVB), Santa Clara, California; Signature Bank (Signature), New York, New York; and First Republic Bank (First Republic), San Francisco, California, in the first half of 2023.[5] The decline in the DIF balance coupled with strong growth in estimated insured deposits resulted in a decline in the reserve ratio of 15 basis points from 1.25 percent as of December 31, 2022, to 1.10 percent as of June 30, 2023.[6]

A total of five banks have failed so far in 2023, resulting in a combined estimated loss of $34.2 billion.[7] As of June 30, 2023, the FDIC estimated the cost for the failures of SVB and Signature Bank to total $18.5 billion.[8] Of that estimated total cost of $18.5 billion, the FDIC estimated that approximately $15.8 billion was attributable to the cost of covering uninsured deposits as a result of the systemic risk determination made on March 12, 2023, following the closures of SVB and Signature Bank. As with all failed bank receiverships, losses will be periodically adjusted as assets are sold, liabilities are satisfied, and receivership expenses are incurred.

By statute, the FDIC is required to recover the $15.8 billion estimated loss through one or more special assessments.[9] Accordingly, the FDIC issued a proposed rule to implement this special assessment.[10] In implementing the special assessment, the law requires the FDIC to consider the types of entities that benefit from any action taken or assistance provided as well as economic conditions, the effects on the industry, and other factors deemed appropriate and relevant.[11] In general, large banks with large amounts of uninsured deposits benefitted the most from the systemic risk determination. Under the proposal, the FDIC would apply an annual special assessment rate of approximately 12.5 basis points to an assessment base that would equal an insured depository institution's (IDI) estimated uninsured deposits reported as of December 31, 2022, adjusted to exclude the first $5 billion in estimated uninsured deposits from the IDI, or at the banking organization level for IDIs that are part of a holding company with one or more subsidiary IDIs. Under

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[3] Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices, July 2023. *https://www.federalreserve.gov/data/sloos/sloos-202307.htm*

[4] See FDIC Quarterly Banking Profile available at *https://www.fdic.gov/analysis/quarterly-banking-profile/*.

[5] The decline in the DIF balance does not include the cost of protecting uninsured deposits pursuant to the systemic risk determination announced following the failures of SVB and Signature Bank in March 2023, as the FDIC is required by statute to recover those losses through special assessments. See 12 U.S.C. 1823(c)(4)(G)(ii).

[6] The reserve ratio is calculated as the ratio of the net worth of the DIF (fund balance) to the value of the aggregate estimated insured deposits at the end of a given quarter. See 12 U.S.C. 1813(y)(3).

[7] Estimated loss as of the end of the second quarter of 2023, except for Heartland Tri-State Bank which closed in July 2023 and resulted in an estimated $54.2 million loss in the third quarter (FDIC PR-58-2023), and Citizens Bank which closed in November 2023 and resulted in an estimated $14.8 million loss in the fourth quarter (FDIC PR-91-2023).

[8] Descriptions of the loss estimates for SVB and Signature Bank and the estimated special assessment amount are available on page 32696 of the Notice of Proposed Rulemaking on Special Assessments Pursuant to Systemic Risk Determination, available at *https://www.fdic.gov/news/board-matters/2023/2023-05-11-notice-dis-a-fr.pdf.*

[9] 12 U.S.C. 1823(c)(4)(G)(ii)(I).

[10] See Notice of Proposed Rulemaking on Special Assessments Pursuant to Systemic Risk Determination, available at *https://www.fdic.gov/news/board-matters/2023/2023-05-11-notice-dis-a-fr.pdf.*

[11] 12 U.S.C. 1823(c)(4)(G)(ii)(III).

the proposal, no banking organizations with total assets under $5 billion would pay the special assessment. Under the proposal, the FDIC estimates banking organizations with total assets over $50 billion would pay over 95 percent of the special assessment. The effect of the proposed special assessment on the dollar amount of Tier 1 capital is estimated to be minimal, measuring less than one percent, on average. The FDIC Board will consider a final rule later this week.

The remaining estimated loss from the failures of SVB and Signature Bank of $2.7 billion and additional estimated losses of $15.6 billion from the May 2023 closure of First Republic Bank, directly impacted the DIF balance in the first half of 2023.[12]

Despite recent outflows for total deposits, accelerated by the stress experienced in the banking industry in March, insured deposit balances increased by 2.2 percent in the first quarter and 0.8 percent during the second quarter, bringing year-over-year insured deposit growth to 4.7 percent, slightly above the long-term historical average of 4.5 percent.[13] As required by the Federal Deposit Insurance Act (FDI Act),[14] the FDIC has been operating under a Restoration Plan since September 15, 2020,[15] which aims to restore the DIF to the statutory minimum reserve ratio of 1.35 percent within 8 years. Notwithstanding the recent losses due to bank failures and growth in insured deposits, the DIF remains on track to meet the statutory minimum reserve ratio of 1.35 percent by the 8-year deadline of September 30, 2028.[16]

Update on Resolution Activities

Regional Bank Receiverships

The FDI Act requires the FDIC, when acting as a receiver, to manage and market assets in a manner that: maximizes returns and minimizes losses; ensures adequate competition and fair and consistent treatment of potential buyers of assets; prohibits discrimination in the sales process; and maximizes the preservation of the availability and affordability of residential real property for low- and moderate-income individuals. To date, the FDIC has made progress toward meeting these statutory obligations in all five of the receiverships from this past year.

Silicon Valley Bank—The FDIC retained securities with a face value of $87 billion (approximately $75 billion market value) and an additional $3 billion of other assets including assets of SVB's foreign branches. To date, the FDIC has collected $1.1 billion in regular principal payments by securities issuers and undertaken a gradual and orderly sale of nearly $74 billion (face value) of the securities while minimizing the potential for adverse impact on market functioning by taking into account daily liquidity and trading conditions. The FDIC expects to substantially conclude sales of the securities by the end of the year. The FDIC is also monitoring the shared loss agreement with the acquiring institution covering approximately $61 billion of outstanding commercial loans and up to approximately $50 billion of unfunded commitments.

Signature Bank—With respect to the resolution of Signature Bank, approximately $60 billion of the bank's loans and $27 billion in securities were retained by the FDIC. Receivership staff have been overseeing the servicing and collection of the retained loans and have collected approximately $13 billion in principal and interest payments from borrowers since March 2023, net of advances made to borrowers over the same period. The FDIC has completed the competitive sales of two Signature loan portfolios totaling approximately $19 billion, recovering over 99 percent of the book value of an $18 billion portfolio of "capital call" loans to investment funds and receiving over 85 percent of the book value of a $631 million pool of loans to technology and life science companies backed by venture capital sponsors.

In addition, on September 5, 2023, the FDIC announced the start of a marketing process for the approximately $33 billion commercial real estate (CRE) loan portfolio. This portfolio represents substantially all remaining loans retained in the Signature receivership. Marketing of the former Signature Bank's CRE portfolio is taking place over the fourth quarter of 2023.

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[12] For estimated cost of the failure of First Republic Bank, see page 31 of the "FDIC Quarterly Banking Profile: Second Quarter 2023", available at *https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2023jun/qbp.pdf#page=1.*

[13] Long-term historical average is from 1991 through 2019.

[14] Section 7(b)(3)(E) of the Federal Deposit Insurance Act, 12 U.S.C. 1817(b)(3)(E), available at *https://www.fdic.gov/regulations/laws/rules/1000-800.html#fdic1000sec.7b.*

[15] 2020 FDIC Restoration Plan, 85 FR 59306 (Sept. 21, 2020), available at *https://www.fdic.gov/news/board-matters/2020/2020-09-15-notice-dis-a-fr.pdf.*

[16] Section 7(b)(3)(E) of the FDI Act, 12 U.S.C. 1817(b)(3)(E), available at *https://www.fdic.gov/regulations/l/rules/1000-800.html#fdic1000sec.7b.*

The majority of the CRE loan portfolio is comprised of multifamily properties, primarily located in New York City. A large portion (approximately $15 billion) of the CRE loans is secured by multifamily residences that are rent stabilized or rent controlled. As mentioned, the FDIC has a statutory obligation to maximize the preservation of the availability and affordability of residential real property for low- and moderate-income individuals. Since March, the FDIC has been working closely with city and State authorities, as well as with community organizations where the properties securing these loans are located, to inform them of the FDIC's efforts and seek their input as it develops its marketing and disposition strategy. To help fulfill this obligation, the FDIC will place the rent stabilized or rent controlled loans into one or more joint ventures (JV) with the FDIC retaining a majority equity interest in the JV.

Aside from loans, FDIC retained securities of Signature Bank with a face value of approximately $27 billion. The FDIC has conducted a gradual and orderly sale of approximately $24 billion (face value) of these securities, as of October 5, 2023.

FDIC also competitively marketed Signature's equity investment, trademarks, and contracts related to the "Signet" platform, a blockchain-based digital payments platform. The FDIC sold the trademarks and preferred stock to the highest bidders for a total of $152,000. Bidders included banks as well as nonbank financial firms. No bids were received for the master servicing contract, so it was subsequently repudiated by the Receiver to extinguish the liability.

First Republic Bank—In the resolution of First Republic, the FDIC transferred essentially all of the assets to an assuming institution, which also assumed all of the deposits of the failed bank. The FDIC retained $4 billion of First Republic's assets and entered into a Shared Loss Agreement with the assuming institution, JPMorgan Chase Bank, N.A. (JPMC), on the First Republic loans that JPMC purchased. The Shared Loss Agreement covers approximately $164 billion of commercial and residential loans and $46 billion of unfunded loan commitments.

Heartland Tri-State Bank—Heartland Tri-State Bank of Elkhart, Kansas, was closed by the Kansas Office of the State Bank Commissioner on July 28, 2023, and the FDIC was appointed as receiver. As of March 31, 2023, Heartland Tri-State Bank had approximately $139 million in total assets and $130 million in total deposits. To resolve the bank, FDIC entered into a Purchase and Assumption Agreement with Dream First Bank, National Association, of Syracuse, Kansas, to assume all of the deposits and essentially all of the assets of Heartland Tri-State Bank. The FDIC estimates that the cost to the DIF will be $54 million.

Citizens Bank—Citizens Bank, Sac City, Iowa, was closed on November 2, 2023, by the Iowa Division of Banking, which appointed the FDIC as receiver. As of September 30, 2023, Citizens Bank had approximately $66 million in total assets and $59 million in total deposits. To resolve the bank, the FDIC entered into a Purchase and Assumption Agreement with Iowa Trust & Savings Bank, Emmetsburg, Iowa, to assume all of the deposits and essentially all the assets of Citizens Bank. The FDIC estimates that the cost to the DIF will be $14.8 million.

Efforts To Improve Regional Bank Resilience and Resolvability

The failure of three large regional banks this spring demonstrated clearly the risk to financial stability that large regional banks can pose. The Federal banking agencies are taking action to address these vulnerabilities with jointly proposed rulemakings that would facilitate the readiness and resolvability of insured depository institutions in the event of their insolvency and improve the protection of depositors in the event of a failure.

On August 29, 2023, the FDIC Board approved three complementary proposals that together will greatly strengthen the ability of the FDIC to manage a resolution of a large complex financial institution: Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions; [17] Resolution Plans Required for Insured Depository Institutions With $100 Billion or More in Total Assets; Informational Filings Required for Insured Depository Institutions With at Least $50 Billion But Less Than $100 Billion in Total Assets; [18] and Guid-

[17] Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions, 88 FR 64524 (September 19, 2023).

[18] Resolution Plans Required for Insured Depository Institutions With $100 Billion or More in Total Assets; Informational Filings Required for Insured Depository Institutions With at Least $50 Billion But Less Than $100 Billion in Total Assets, 88 FR 64579 (September 19, 2013).

ance for Resolution Plan Submissions of Domestic Triennial Full Filers [19] and Foreign Triennial Full Filers. [20]

The Long-Term Debt proposal, published jointly with the Board of Governors of the Federal Reserve System (Federal Reserve) and the Office of the Comptroller of the Currency (OCC), would require a layer of loss-absorbing capacity at large IDIs. This long-term debt requirement can mitigate the resolution challenges encountered in the failure of large regional banks and bolster financial stability. The long-term debt absorbs losses before the depositor class—uninsured depositors and the FDIC—take losses. This lowers the incentive for uninsured depositors to run. Protecting depositors and the DIF, helping to make their resolution more orderly, and creating additional options for the FDIC in resolution makes it more likely that a closing weekend sale could comply with the statutory least-cost test and avoid the need for a systemic risk exception.

The revised resolution plan regulation for IDIs under the FDI Act would improve the FDIC's knowledge of a troubled large IDI and preparation for the resolution of the large IDI. The revised resolution plan regulation would require an IDI with at least $100 billion in assets to provide a strategy that is not dependent on an over-the-weekend sale, including by explaining how the IDI could be placed into a bridge depository institution, how operations could continue while the IDI separates itself from its parents and affiliates, and the actions that would be needed to stabilize a bridge depository institution, among others. The revised resolution plan regulation would also require all IDIs subject to the rule to demonstrate capabilities essential to an orderly resolution, such as establishing a virtual data room and populating it with enough information for interested parties to bid on the bank or certain of its assets and operations.

Finally, guidance for resolution plans required under Title 1 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), proposed with the Federal Reserve, would allow Title 1 resolution planning to better reflect the lessons learned in dealing with domestic and foreign financial firms that are just below the size threshold of the U.S. Global Systemically Important Banks (G–SIBs). The proposed guidance addresses certain capabilities that are essential for firms to have to effect an orderly resolution such as those necessary to project the capital and liquidity needed to carry out their plan; operational capabilities related to payment, clearing and settlement activities; collateral; management information systems; and shared and outsourced services.

All of these proposals, individually and taken together, are tailored to account for the differences that exist among institutions while leveraging the improvements and advances to resolution preparedness and planning that have been made since the financial crisis of 2008. The comment period for these proposals closes on November 30, 2023.

Basel III Notice of Proposed Rulemaking

On July 27, 2023, the FDIC Board approved a Notice of Proposed Rulemaking (NPR) that would revise and strengthen the capital requirements applicable to the largest banking organizations. [21] The proposed framework would generally be consistent with international capital standards issued by the Basel Committee on Banking Supervision, commonly known as the Basel III reforms. The NPR was also approved by the Federal Reserve and the OCC.

The NPR is a continuation of the Federal banking agencies' efforts to revise the regulatory capital framework for our Nation's largest financial institutions, which were found to be undercapitalized and over-leveraged during the global financial crisis of 2008. Following the 2008 crisis, the Federal banking agencies strengthened the banking system through an initial set of revisions to the capital framework. Those revisions raised the quality and quantity of risk-based capital and included the introduction of an enhanced supplementary leverage ratio for our largest, most systemic banking organizations. However, there remain areas of the regulatory capital framework that need improvement.

The NPR would make important changes to address the capital weaknesses identified in the 2008 financial crisis, enhance the resilience and stability of the banking system, and enable the banking system to better serve the U.S. economy. For example, the proposal would address critical areas of the risk-based capital framework

[19] Guidance for Resolution Plan Submissions of Domestic Triennial Full Filers, 88 FR 64626 (September 19, 2023).

[20] Guidance for Resolution Plan Submissions of Foreign Triennial Full Filers, 88 FR 64641 (September 19, 2023).

[21] Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 FR 64028 (September 18, 2023).

related to credit risk, operational risk, market risk, and financial derivative risk. For credit risk, the proposal would eliminate the use of banking organizations' internal models to set regulatory capital requirements and in its place apply a simpler, standardized framework. Similarly, for operational risk, the proposal would introduce a standardized framework in lieu of the existing model-based approach, thereby enhancing transparency and comparability. With respect to market risk, the proposal includes a more robust methodology to capture potential stress events, using a so-called expected shortfall methodology. This is in response to significant losses incurred in large banking organizations' trading portfolios during the global financial crisis. Lastly, the proposal would strengthen capital requirements with respect to financial derivative risk. Taken together, these changes would bolster the financial resilience of our Nations' largest banking organizations.

A key consideration with respect to these revisions is the scope of application—in other words, which banks are subject to the proposed rule. Historical experience has demonstrated the impact individual banking organizations can have on the stability of the U.S. banking system, in particular large banking organizations. With this in mind, the proposal would apply to banking organizations with total assets of $100 billion or more and to other banking organizations with significant trading activity. Consistent with this scope of application, the proposal would also align the calculation of regulatory capital for large banking organizations; that is, all banking organizations with more than $100 billion in total assets would include net unrealized holding losses on securities categorized as available-for-sale in the calculation of regulatory capital. As the agencies have learned from recent experience with bank failures, this change would help ensure that the regulatory capital ratios of large banking organizations better reflect their capacity to absorb losses. Notably, the NPR would not change the capital requirements applicable to community banks.

By addressing weaknesses in the existing regulatory framework, the proposal is expected to increase capital requirements in the aggregate. It is estimated that the proposal would increase common equity tier 1 capital requirements by 16 percent for holding companies and 9 percent for insured depository institutions. A change to capital requirements comes with associated costs and benefits. The FDIC, together with the other banking agencies, is carefully considering these trade-offs to inform the various components of the rule.

It is expected that the impact would vary meaningfully by institution, depending on each banking organization's activities and risk profile. The majority of banks that would be subject to the proposed rule currently have enough capital to meet the proposed requirements. For those large holding companies with shortfalls, we estimate that these banking organizations would be able to achieve compliance with the revisions through earnings over a short timeframe, even while maintaining their dividends.

The proposed changes would be phased in over a 3-year transition period. Any final rule, following careful consideration of comments received, is not expected to take effect until July 1, 2025. Taking the effective date and transition period together, the capital requirements under a final rule would not be fully effective until the second half of 2028.

The NPR included a 120-day comment period ending November 30, 2023. The agencies have already started receiving comments from the industry and other related parties and have also begun meeting with industry representatives. For example, we have heard concerns related to the proposed treatment for residential mortgage exposures, certain tax credit equity investments, trading activities, and banking activities that generate large amounts of fee-based revenue. The agencies recently announced an extension of the comment period until January 16, 2024, to allow interested parties more time to analyze the issues and prepare their comments. The feedback to-date has been extremely helpful, and the FDIC looks forward to receiving additional comments and feedback.

Other Enhancements to the Supervision of Large Regional Banks

The three regional banks that failed this spring had different business models and various common attributes that made them vulnerable to disruptions: overreliance on uninsured deposits; rapid growth, and weak interest rate and liquidity risk management; and for two of the banks, unrealized losses. In response to the failures, the FDIC is reviewing options to improve the supervision of these key areas. For example, we are updating examiner guidance to be more explicit about analyses of uninsured deposit concentrations and have reemphasized to examiners the importance of forward-looking indicators of risk, such as high growth rates and breaches of internal risk limits. Additionally, we have strengthened our instructions for examiners on timely escalation of supervisory responses when management has been unable or unwilling to effect corrective action, or when financial conditions deteriorate rapidly, or both. All of these options are consistent with the areas for consideration outlined by the FDIC's Chief Risk Officer in his reports on the failed FDIC-supervised institutions. [22]

Other Regulations and Guidance

Modernizing and Strengthening the Community Reinvestment Act

On October 24, 2023, the FDIC, the Federal Reserve, and the OCC adopted a final rule to strengthen and modernize the CRA. The final rule represents an ambitious effort to adapt CRA to the dramatically changed nature of the banking business since the law's enactment in 1977 and the last major rule change in 1995.

To begin with, banks today no longer serve their customers exclusively through a branch-based network around which CRA assessment areas are currently drawn. While bank branches continue to play a critical role in serving communities, some banks have only one branch or no branch at all. Yet, they engage in large scale lending across the country. Banks increasingly interact with customers either online or through mobile phones in areas in which the banks may not have a physical presence. Lending by banks in such areas is not currently subject to a CRA evaluation.

This final rule adapts to this new banking reality by requiring large banks to establish Retail Lending Assessment Areas (RLAAs) in those geographies outside of their physical footprint where they originate significant numbers of closed-end mortgage loans or small business loans.

Under the final rule, the loans in these new assessment areas will be subject to CRA review and evaluation for the first time, ensuring that large banks serve all segments of the communities in which they are chartered to do business, including low- and moderate-income communities, as the law requires. This represents a critically important adaptation of CRA to the changing nature of the business of banking.

Consistent with this objective, the final rule will give banks credit for community development activities on a nationwide basis, not just in their traditional, branch-based assessment areas. This will recognize banks for their community development financing activities in rural and other underserved areas, including Native Land areas, many of which are so-called "banking deserts." This final rule will give them, for the first time, consideration for channeling capital into areas that may be particularly desperate for banking services.

Second, the final rule establishes a series of metrics and benchmarks against which banks will be measured for CRA performance for lending and community development. This will add important rigor to the CRA evaluation process. It will allow the banking agencies to establish specific standards for bank performance to achieve a particular CRA rating that will provide an incentive for increased lending to underserved communities. It will also provide greater clarity, transparency, and predictability for the banks and the public, as well as consistency among the agencies.

Third, the final rule tailors CRA evaluations and data collection to bank size, complexity, and business type. All banks are not the same, and all communities are not the same. The final rule tailors the CRA tests and data collection to each bank size category—small, intermediate, and large. For instance, small banks would continue to be evaluated under the existing regulatory framework but would have the option to be evaluated under aspects of the new regulation.

There would be no new data collection or reporting requirements for small or intermediate banks. Overall, the agencies sought to leverage existing data as much as possible. However, large banks with assets over $2 billion will have to collect and report community development data, and large banks over $10 billion in assets will have additional data requirements relating to deposits and retail banking products.

Fourth, the final rule recognizes the importance of minority depository institutions (MDIs), Treasury Department-certified Community Development Financial Institutions (CDFIs), Women's Depository Institutions (WDIs), and Low Income Credit Unions (LICUs) in providing financial access to underserved consumers and communities.

For example, the final rule creates a specific community development definition for eligible activities, such as investments, loan participations, and other ventures conducted by all banks with these institutions, including by other MDIs, WDIs, or CDFI banks. All community development activities conducted by banks with these entities will get credit under the final rule.

[22] See "FDIC's Supervision of Signature Bank (April 28, 2023)", available at: *https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf*, and "FDIC's Supervision of First Republic Bank (September 8, 2023)" available at *https://www.fdic.gov/news/press-releases/2023/pr23073a.pdf*.

Fifth, in furtherance of the agencies' objective to promote transparency, the final rule will require the disclosure of the distribution of home mortgage loan originations and applications of large banks in each of the bank's assessment areas by income, race and ethnicity utilizing publicly available data under the Home Mortgage Disclosure Act (HMDA). This aspect of the final rule is intended to provide transparent information to the public in regard to the bank's lending to communities of color. Although the data disclosed would not have an impact on the CRA ratings of the bank, it would allow the public to compare lending by a bank in those communities to other communities, as well as allow comparisons to other banks.

Sixth, while we know that technology has led to significant changes in the provision of bank services, bank branches continue to play a crucial role for consumers and communities. For example, just over three-quarters of closed-end mortgages originated by large banks in recent years were located in branch-based assessment areas. These branch-based assessment areas remain a foundation of CRA. Under the final rule, each banking agency will be required to evaluate a bank's record of opening and closing branches to inform the degree of accessibility of banking services to low and moderate income communities.

Further, access involves more than the availability of a branch. A consumer must also have access to products and services that are affordable and responsive to their needs. Expanding consumer access to federally insured banks has been a priority of the FDIC. The final rule will provide positive CRA consideration to large banks for the offering and demonstrated consumer usage of low-cost transaction accounts—accounts with low or no minimum balance requirements and no overdraft fees—such as Bank On Certified accounts.

Finally, the rule gives credit to community development activities designed to strengthen disaster preparedness and weather resiliency in low- and moderate-income communities.

Examples of eligible activities could include supporting the establishment of flood control systems in a flood prone area; and retrofitting affordable housing to withstand future disasters or climate-related events.

Since its enactment, CRA has become the foundation of responsible financing for low- and moderate-income communities in the United States. This final rule will significantly expand the scope and rigor of CRA and will assure its continued relevance for the next generation.

Reviewing the Bank Merger Process

Although there has been a significant amount of consolidation in the banking sector over the last 30 years, facilitated in part by mergers and acquisitions, there has not been a significant review of the implementation of the Bank Merger Act (BMA)[23] by the banking agencies in that time. Additionally, the prospect for continued consolidation among both large and small IDIs remains significant.

On March 31, 2022, the FDIC published a Request for Information and Comment on Rules, Regulations, Guidance, and Statements of Policy Regarding Bank Merger Transactions (RFI)[24] that solicited comments regarding the effectiveness of the existing bank merger application framework. The comment period ended on May 30, 2022. The FDIC is evaluating and considering the comments received as it considers changes to the merger review framework, as appropriate.

Finally, the FDIC is coordinating with the Federal Reserve, the OCC, and the Department of Justice regarding an interagency review of the existing laws, regulations, guidance and processes used by the Federal banking agencies under the BMA. These discussions, which are ongoing, are consistent with Presidential Executive Order on Promoting Competition in the American Economy.

Evaluating Financial Risks Posed by Climate Change

On October 24, 2023, the FDIC, Federal Reserve, and OCC adopted interagency guidance on principles for climate-related financial risk management for large financial institutions.[25] The guidance provides a high-level framework for the safe and sound management of exposures to climate-related financial risks and is designed to help financial institutions make progress toward incorporating climate-related financial risks into risk management frameworks in a manner consistent with safe and sound practices. They provide general principles with respect to governance; policies, procedures, and limits; strategic planning; risk management; data, risk

[23] Section 18(c)of the FDIC Act, 12 U.S.C. §1828(c).

[24] Request for Information and Comment on Rules, Regulations, Guidance, and Statements of Policy Regarding Bank Merger Transactions, 87 FR 18368 (March 31, 2022).

[25] See Interagency Guidance of FDIC, OCC and FRB "Principles for Climate-Related Financial Risk Management for Large Financial Institutions", 88 FR 74183 (October 30, 2023).

measurement, and reporting; and scenario analysis. They also provide guidance on how climate-related financial risks can be addressed in the management of traditional risk areas, such as credit, liquidity, operational risk, and legal and compliance risks.

Although all financial institutions, regardless of size, may have material exposures to climate-related financial risks, these principles are intended for the largest financial institutions, those with over $100 billion in total consolidated assets. The FDIC understands smaller institutions, including community banks, may have limited resources and may experience the impacts of climate-related financial risks in a manner that differs from large financial institutions.

The FDIC's role with respect to climate change is centered on the financial risks that climate change may pose to the banking system, and the extent to which those risks impact the FDIC's core mission and responsibilities. As stated in the interagency guidance, the FDIC will not be involved in determining firms or sectors with which financial institutions should do business. These types of credit allocation decisions are the responsibilities of financial institutions. Financial institutions should fully consider climate-related financial risks—as they do all other risks—and continue to take a risk-based approach in assessing individual credit and investment decisions. The FDIC expects financial institutions to manage climate-related financial risks in a manner that will allow them to continue to prudently meet the financial services needs of their communities, including low- and-moderate-income and other underserved consumers and communities.

Evaluating the Risk of Crypto Assets to the Banking System

The FDIC, in coordination with the other Federal banking agencies, has taken steps to closely monitor crypto-asset-related activities of banking organizations. For example, the FDIC has issued statements to assist banking organizations in ensuring that they have put in place appropriate measures and controls to identify and manage risks and comply with all relevant laws.

More specifically, in April 2022, the FDIC issued a financial institution letter [26] and requested that all FDIC-supervised institutions that are considering engaging in, or are already engaged in, crypto-asset-related activities notify the FDIC and provide all necessary information that would allow the FDIC to assess the safety and soundness, consumer protection, anti-money laundering/countering the financing of terrorism, and financial stability risks in order to provide supervisory feedback to the institution.

In addition, the FDIC issued an advisory letter to all FDIC-insured institutions in July 2022 to address concerns about the risks of consumer confusion or harm arising from crypto assets offered by, through, or in connection with insured depository institutions. These concerns were elevated as a result of certain misrepresentations about FDIC deposit insurance by some crypto companies. [27] Inaccurate representations about deposit insurance by nonbanks, including crypto companies, may confuse the customers and cause them to mistakenly believe that these investments are protected by deposit insurance. Along with the advisory letter, the FDIC also released consumer education materials advising the public that crypto assets are not deposits insured by the FDIC. [28] Over the course of 2022 and 2023, the FDIC has issued several cease and desist letters that resulted in companies removing misrepresentations about the insured status of crypto products. [29]

More recently, in early 2023, the FDIC, along with the Federal Reserve and the OCC, issued two joint statements on crypto-assets. The first, issued in January 2023, addressed "Crypto-Asset Risks to Banking Organizations," and it enumerated several risks posed by crypto-assets that banking organizations should be aware of including significant volatility in crypto-asset markets; risk management and governance practices in the crypto-asset sector exhibiting a lack of maturity and

[26] See FDIC, "Notification and Supervisory Feedback Procedures for FDIC-Supervised Institutions Engaging in Crypto-Related Activities", (April 7, 2022), available at *https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html.*

[27] See FDIC, "Advisory to FDIC-Insured Institutions Regarding FDIC Deposit Insurance and Dealings with Crypto Companies" (July 29, 2022), available at *https://www.fdic.gov/news/financial-institution-letters/2022/fil22035.html.*

[28] See FDIC, "FDIC Issues a Fact Sheet to the Public on FDIC Deposit Insurance and Crypto Companies", (July 29, 2022), available at *https://www.fdic.gov/news/press-releases/2022/pr22058.html*; see also FDIC Consumer News, "The Importance of Deposit Insurance and Understanding Your Coverage", (August 2022), available at *https://www.fdic.gov/resources/consumers/consumer-news/2022-08.html*; see also FDIC Podcasts Episode 22, "Deposit Insurance Explained (Part One)", (August 17, 2022), available at *https://www.fdic.gov/news/podcasts/*.

[29] See, for example, FDIC, "FDIC Issues Cease and Desist Letters to Five Companies for Making Crypto-Related False or Misleading Representations About Deposit Insurance", (August 19, 2022), available at *https://www.fdic.gov/news/press-releases/2022/pr22060.html.*

robustness; and inaccurate or misleading representations or disclosures by crypto-asset companies. This joint statement listed several additional risks.[30] In the second joint statement, issued in February 2023, the agencies highlighted key liquidity risks associated with certain sources of funding from crypto-asset-related entities of which banking organizations should be aware.[31]

The agencies continue to emphasize that banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation.

Supporting Minority Depository Institutions and Community Development Financial Institutions

The preservation and promotion of MDIs remains a long-standing priority for the FDIC.[32] The FDIC supervises approximately two-thirds of the 312 FDIC-insured MDIs and CDFIs (collectively, mission-driven banks). In addition to its supervisory activities, the FDIC's Office of Minority and Community Development Banking supports the agency's ongoing strategic and direct engagement with MDIs and CDFIs.

Over the past 5 years, six de novo MDIs opened their doors (two Asian, one Native American, one African American, and two multiracial) and 17 existing institutions became newly designated MDIs due to changes in control or in board composition. These additions to the MDI list mostly offset removals from the list due to mergers, changes in control, or other events that caused institutions to lose their MDI eligibility, resulting in the total number of FDIC-insured MDIs decreasing from 152 to 147. In support of its statutory requirement to encourage the creation of new MDIs, in 2022 the FDIC issued a Financial Institution Letter that outlines the process by which FDIC-supervised institutions or applicants for deposit insurance can make a request to be designated as an MDI.[33]

As significant new sources of private and public funding have become available to support FDIC-insured MDIs and CDFIs, the FDIC has supported these institutions access to this funding through regulatory changes[34] and technical assistance training.

This week the FDIC is hosting an interagency conference with the OCC and the Federal Reserve to facilitate potential partnerships among FDIC-insured MDIs and CDFIs and large and regional banks supervised by the FDIC, OCC, and Federal Reserve. The conference will feature an overview of the new CRA rule and benefits for partnering with mission-driven banks. More than 100 FDIC-insured MDIs and CDFI banks are participating, in addition to over 65 FDIC-insured large and regional banks.

Conclusion

I appreciate the opportunity to provide you with an update of the FDIC's efforts to fulfill its core mission to maintain stability and public confidence in the U.S. financial system through its responsibilities for deposit insurance, banking supervision, and the orderly resolution of failed banks.

The FDIC remains committed to engaging with the public, industry stakeholders, and members of Congress on the policies and priorities outlined in my testimony. I look forward to answering your questions.

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[30] See "Joint Statement on Crypto-Asset Risks to Banking Organizations", (January 3, 2023), available at *https://www.fdic.gov/news/press-releases/2023/pr23002.html.*

[31] See "Joint Statement on Liquidity Risks to Banking Organizations Resulting From Crypto-Asset Market Vulnerabilities", (February 23, 2023), available at *https://www.fdic.gov/news/financial-institution-letters/2023/fil23008.html.*

[32] See Section 308 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, title III, §308. Aug 9, 1989, as amended by Pub. L. 11-203, title III, §367(4), July 21, 201, 124 Stat. 1556, codified at 12 U.S.C. 1463 note.

[33] FDIC Financial Institution Letter, FIL-24-2022, Minority Depository Institution (MDI) Designation (May 19, 2022) available at *https://www.fdic.gov/news/financial-institution-letters/2022/fil22024.html.*

[34] See FDIC, "Federal Bank Regulators Issue Rule Supporting Treasury's Investments in Minority Depository Institutions and Community Development Financial Institutions", available at *https://www.fdic.gov/news/press-releases/2021/pr21018.html.*

PREPARED STATEMENT OF TODD HARPER

CHAIR, NATIONAL CREDIT UNION ADMINISTRATION

NOVEMBER 14, 2023

Chairman Brown, Ranking Member Scott, and Members of the Committee, thank you for inviting me to discuss the work of the National Credit Union Administration (NCUA).

The NCUA insures deposits at federally insured credit unions, protects credit union members, and charters and regulates Federal credit unions. The NCUA also protects the safety and soundness of the credit union system by identifying, monitoring, and managing risks to the National Credit Union Share Insurance Fund (Share Insurance Fund). In my testimony today, I will discuss the state of the credit union system, recent efforts by the agency to strengthen the system, and several legislative requests.

State of the Credit Union System

The credit union system over the last year has remained largely stable in its performance and relatively resilient against economic disruptions. However, during the last few quarters, the NCUA has seen growing signs of financial strain on credit union balance sheets and in household budgets. Economists are also forecasting an economic slowdown as the lagged effects of elevated interest rates take hold. Each of these developments could affect credit union performance in the coming quarters.

Over the same period, the NCUA has also seen growing stress within the system because of a rise in interest rate and liquidity risks. In fact, this financial stress is reflected in the increasing number of composite CAMELS code 3, 4, and 5 credit unions.[1] Assets in composite CAMELS code 3 institutions increased sizably in the second quarter, especially among those complex credit unions with more than $500 million in assets. Such increases may well continue in future quarters. We have additionally seen more credit unions fall into the composite CAMELS code 4 and 5 ratings during the second quarter.

Credit Union System Performance

As of June 30, 2023, the system's net worth ratio stood at 10.63 percent. There was continued year-over-year growth in assets and lending, with system assets surpassing $2.2 trillion and outstanding loans at more than $1.5 trillion. Although insured shares and deposits decreased slightly compared to the previous quarter, they stood almost 2 percent higher than one year earlier.

Second quarter data also demonstrate some indications of growing consumer financial stress. The delinquency rate for loans rose slightly to 63 basis points, although it remains below historic averages. Credit cards and automobile loans, however, show increased delinquency levels at 154 and 67 basis points, respectively. Additionally, net charge-off levels have risen over the last year, returning to prepandemic averages.

Additionally, funding costs for credit unions have increased significantly in the rising interest rate environment. Credit unions have increased their issuances of time deposits, leading to total interest expenses growing substantially over the year. However, the industry's return on average assets remains sound at 79 basis points. Together, these numbers show the credit union system continues to rest on a solid footing.

External Factors Affecting the System

The NCUA is closely monitoring the financial markets and the economy as the current environment has created challenges for some consumers and credit unions. Inflation and interest rates are affecting household budgets, which could lead to an increase in credit risk in future quarters. In addition, the prevalence of hybrid work environments has placed pressure on commercial real estate lending. While the credit union system overall has modest exposure to this type of lending, the NCUA is closely monitoring individual credit unions with material exposure to commercial real estate.

The rise in interest rates has also increased liquidity and interest rate risks in the credit union system, including at several of the 421 federally insured credit unions with more than $1 billion in assets. Accordingly, the NCUA has emphasized

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[1] The CAMELS rating system is based upon an evaluation of six critical elements of a credit union's operations: Capital adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk. The CAMELS rating system is designed to consider and reflect all significant financial, operational, and management factors examiners assess in their evaluation of a credit union's performance and risk profile.

the importance of liquidity risk management and contingency planning in its industry communications and will continue to ensure credit unions conduct liquidity and asset-liability management planning to address current challenges and future uncertainties.

With respect to all these risks and to protect the Share Insurance Fund against potential losses, the NCUA will continue to vigilantly monitor credit union performance through the examination process, offsite monitoring, and tailored supervision. The NCUA will also, when appropriate, take action to protect credit union members and their deposits.

Share Insurance Fund Performance

Backed by the full faith and credit of the United States, the Share Insurance Fund provides insurance coverage for individual accounts at federally insured credit unions up to $250,000.[2] As of June 30, 2023, the Share Insurance Fund insured $1.7 trillion in deposits and shares. Notably, the Share Insurance Fund protects nearly 92 percent of total share deposits in the credit union system. In comparison, uninsured shares and deposits equaled approximately $160 billion in the second quarter or 8 percent of total share deposits.

The Share Insurance Fund continues to perform well, with no premiums currently expected. As of June 30, 2023, the Share Insurance Fund reported a year-to-date net income of $79 million, a net position of $20.3 billion, and an equity ratio of 1.27 percent.[3] The NCUA projects that the equity ratio of the Share Insurance Fund will end the year at 1.27 percent, which is sufficient but below the 1.33 percent normal operating level target set by the NCUA Board.

Given the liquidity events in 2023, economic conditions, and the growing stress in the credit union system from liquidity and interest rate risks, the NCUA Board decided to build up the liquidity position of the Share Insurance Fund to a targeted amount of $4 billion. The Share Insurance Fund reached that target in September. The NCUA Board continues to monitor liquidity in the Share Insurance Fund.

State of the Central Liquidity Facility

The COVID–19 pandemic, inflationary pressures, interest rate volatility, and liquidity risk have all underscored the importance of the NCUA's Central Liquidity Facility (CLF).[4] The CLF is an important tool and acts as a shock absorber when unexpected liquidity events occur.

Under the NCUA's regulations, credit unions with assets more than $250 million must have access to a Federal emergency liquidity source as part of their contingency funding plans. This Federal emergency liquidity backstop can be the CLF, the Federal Reserve's Discount Window, or both. Credit unions with less than $250 million in assets are not required to have membership with a contingent Federal liquidity source; however, they must identify external sources as part of their liquidity policy.[5]

As of September 30, 2023, the CLF had 399 consumer credit union members, providing $19.8 billion in lending capacity. These credit unions range in asset size from less than $50 million to more than $10 billion. Their access to the CLF helps protect approximately $360 billion in credit union members' assets.

The more members the CLF has, the more effective it is as a liquidity facility. As of December 2022, the CLF had a much greater total membership of 3,673 consumer credit unions with a combined $537 billion in member assets and a lending

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[2] As established in statute, the Share Insurance Fund insures individual accounts at federally insured credit union up to $250,000, and a member's interest in all joint accounts combined is insured up to $250,000. The Share Insurance Fund also separately protects IRA and KEOGH retirement accounts up to $250,000. The fund is administered by the NCUA and is backed by the full faith and credit of the United States. See *https://ncua.gov/files/publications/guides-manuals/NCUAHowYourAcctInsured.pdf.*

[3] The equity ratio is the overall capitalization of the Share Insurance Fund to protect against unexpected losses from the failure of credit unions. When the equity ratio falls, or is projected within 6 months to fall, below 1.20 percent, the Federal Credit Union Act requires the NCUA Board to assess a premium or develop a restoration plan. When the equity ratio exceeds the normal operating level and available assets ratio at year-end, the Share Insurance Fund pays a distribution.

[4] Established by statute, the CLF is a mixed-ownership Government corporation created to improve the general financial stability of credit unions by serving as a liquidity lender to credit unions experiencing unusual or unexpected liquidity shortfalls. Member credit unions, which may include both federally insured and non-federally insured credit unions, own the CLF, which exists within the NCUA. The CLF's president manages the facility under the oversight of the NCUA Board.

[5] 12 CFR Part 741.12.

capacity of $27.5 billion. This rapid decline in membership assets followed the expiration of the temporary statutory enhancements that:

- Increased the CLF's maximum legal borrowing authority;
- Permitted access for corporate credit unions, as agent members, to borrow for their own needs;
- Provided greater flexibility and affordability to agent members to join the CLF to serve smaller groups of their covered institutions; and
- Gave the NCUA Board the clarity and flexibility about the loans it can approve by removing the phrase, "the Board shall not approve an application for credit the intent of which is to expand credit union portfolios."

Among other benefits, these statutory provisions facilitated agent membership of corporate credit unions. These enhancements, however, ended on January 1, 2023, resulting in 3,322 credit unions with less than $250 million in assets losing access to the CLF. Consequently, the CLF's borrowing capacity has decreased by almost $10 billion.

To address this expiration and growing liquidity risks, the NCUA Board has unanimously requested that Congress allow corporate credit unions to purchase capital stock in the CLF to help smaller credit unions access to the facility. This change would make the CLF more affordable for corporate credit unions subscribing for a subset of their members. The Congressional Budget Office has scored the CLF reforms at no cost to taxpayers.[6]

NCUA's Efforts To Protect and Strengthen the Credit Union System

In recent months, the NCUA has undertaken several actions to respond to cybersecurity risk; support minority depository institutions; enhance the credit union system's and the NCUA's diversity, equity, and inclusion efforts; and consider and adopt new rules to strengthen the system.

Enhancing Cybersecurity

Cybersecurity threats within the financial services industry are high and expected to remain so for the foreseeable future. To maintain vigilance against these threats, the NCUA is committed to ensuring consistency, transparency, and accountability in its cybersecurity examination program and related activities.

Earlier this year, the NCUA deployed its updated, scalable, and risk-focused Information Security Examination (ISE) procedures. The ISE examination initiative offers flexibility for credit unions while providing examiners with standardized review steps to facilitate advanced data collection and analysis. Together with the agency's voluntary Automated Cybersecurity Evaluation Toolbox maturity assessment, the new ISE procedures will assist the NCUA in protecting the credit union system from cyberattacks.

In addition, the NCUA's recently implemented cyber incident reporting rule has proven to be helpful to the agency and credit union industry.[7] The final rule requires a federally insured credit union to report a substantial cyber incident to the NCUA as soon as possible but no later than 72 hours after the credit union reasonably believes a reportable cyber incident has occurred. In the first 30 days after the rule became effective, the NCUA received 146 incident reports, more than it had received in total in the previous year. More than 60 percent of these incident reports involve third-party service providers and credit union service organizations (CUSOs).

The NCUA also actively communicates with credit unions about the increased likelihood of cyberattacks resulting from geopolitical and other cyber events. Credit unions of all sizes are a part of the U.S. critical infrastructure and should implement appropriate controls in the technology they use to deliver member services.

Maintaining Consumer Financial Protection

An important part of the NCUA's mission is to examine credit unions with less than $10 billion in assets for compliance with consumer financial protection laws. The agency's consumer compliance efforts are integral to maintaining a safe-and-sound credit union system.

In 2023, the agency's consumer financial protection supervisory priorities have included overdraft protection, fair lending, residential real estate appraisal bias, and Truth in Lending Act and Fair Credit Reporting Act compliance. The NCUA also prioritized examining credit union compliance with the Flood Disaster Protection Act, including disclosure requirements.

[6] S.544, 118th Cong., 1st Sess. (2023).
[7] 12 CFR Part 748.

In addition, the agency increased its review of overdraft programs and nonsufficient funds fee practices at credit unions to assess whether providing those services and charging the fees are potentially unfair practices. The NCUA's supervision of the services aims to create a more equitable system that supports financial stability for credit union members, improves transparency, and advances the statutory mission of credit unions to meet the credit and savings needs of their members, especially those of modest means.[8]

Furthermore, the NCUA conducts targeted fair lending examinations and supervision at Federal credit unions to assess compliance with Federal fair lending laws and regulations. These reviews are critical to identifying discrimination and fostering financial inclusion. In August 2023, the NCUA encouraged the industry to review and comply with previously issued guidance addressing prohibited discriminatory practices in automated underwriting systems. Specifically, the agency encouraged credit unions to review system parameters to ensure compliance with the Equal Credit Opportunity Act and its implementing regulation.

In addition to appraisal bias oversight examinations, the NCUA joined with the other Federal Financial Institution Examination Council agencies in June to issue proposed guidance for reconsideration of value for residential real estate valuations. The proposed guidance advises on policies that financial institutions may implement to allow consumers to provide information that may not have been considered during an appraisal or if deficiencies are identified in the original appraisal.

As part of its consumer financial protection efforts, the NCUA's Consumer Assistance Center also resolves consumer complaints against Federal credit unions with total assets up to $10 billion and, in certain instances, federally insured, State-chartered credit unions. In 2022, the Consumer Assistance Center responded to 10,589 written complaints, 1,842 inquiries, and 30,232 telephone calls from consumers and credit unions concerning consumer financial protection regulations.

Finally, the NCUA regularly presents webinars promoting financial literacy and financial inclusion. Over the past year, the agency has hosted webinars on appraisal bias, elder financial abuse, and minority depository institutions. In addition, the agency participates in national financial literacy initiatives, including the interagency Financial Literacy and Education Commission.

Supporting Minority Depository Institutions

Supporting minority depository institution (MDI) credit unions is a longstanding priority for the NCUA. MDI credit unions represent approximately 10 percent of federally insured credit unions, and there are presently 498 such credit unions. These MDIs have more than five million members and exceed $66 billion in assets.

In 2015, the NCUA established its MDI Preservation Program and has since sought new ways to assist MDI credit unions, their members, and the communities they serve. In 2022, the NCUA launched the Small Credit Union and MDI Support Program, allocating resources to assist MDIs in addressing operational challenges such as staff training, examinations, and improving earnings. In 2023, the NCUA allocated 10,000 staff hours across its three regional offices for the program.

This year, the agency also issued customized guidance to examiners to provide insights into MDIs' unique business models and members' needs. The guidance assists examiners in understanding MDIs' distinct business model compared to other mainstream financial institutions by providing instruction on how to use MDI peer metrics instead of traditional peer metrics.

Notably, while MDIs tend to be smaller institutions, they have relatively strong financial performance. As of the end of the second quarter of this year, MDIs averaged about $133 million in total assets, yet their return on average assets and net worth ratios were higher than federally insured credit unions overall and equal to credit unions with assets exceeding $1 billion. Meanwhile, their charge-off levels were consistent with the levels reported for both larger credit unions and credit unions overall.

Congress recently authorized all MDIs to be eligible for Community Development Revolving Loan Fund grants and loans. Previously, MDIs required the low-income credit union designation to qualify. In the 2023 grant round, 42 MDIs received more than $1.4 million in technical assistance grants. The amount of funding MDIs received was a five-fold increase from the level of funding provided in 2022.

Finally, the NCUA in October hosted an MDI Symposium that discussed how the agency can better serve these institutions. The MDI Symposium brought together MDI credit unions and industry stakeholders to learn about the challenges faced by MDIs. Sessions included case studies of successful MDI business models for replication. The NCUA plans to leverage this information to further support its MDI Pres-

[8] 12 U.S.C. 1751.

ervation Program. And, as part of the NCUA's Diversity, Equity, and Inclusion Summit for credit unions in early November, the NCUA held a session that discussed MDI challenges and strategies for success.

Advancing Diversity, Equity, and Inclusion

The NCUA is fully committed to fostering diversity, equity, and inclusion (DEI) within the agency and the credit union system.

The agency uses data from the Federal Employee Viewpoint Survey, including the Office of Personnel Management's Diversity, Equity, Inclusion, and Accessibility index, to inform its data-driven DEI strategies and activities.[9] The agency's internal practices to promote DEI are also wide-ranging. For example, the NCUA's employee resource groups serve more than 30 percent of agency staff, surpassing the industry standard membership goal of 10 percent. Further, the NCUA's special emphasis program educates staff on cultural diversity and provides dedicated support for employees and managers with disabilities.

In addition, the NCUA routinely recruits employees with diverse backgrounds and seeks to ensure broad applicant pools for vacancies. These diversity recruitment efforts are aimed at attracting and retaining highly qualified individuals from underrepresented groups, including Hispanics and candidates with disabilities. In 2023, the NCUA conducted a targeted barrier analysis to identify hiring and retention challenges for women and Hispanic employees. In addition, the agency has consistently exceeded the Federal employment rate goals for employees with disabilities and targeted disabilities since 2017.[10] Slightly more than 59 percent of the NCUA's managers are women.

The NCUA has additionally built a diverse supplier network to obtain innovative solutions and the best value, particularly in technology and IT solutions. During 2022, the agency awarded $32.8 million of reportable contract dollars to minority and women-owned businesses. That figure represents 45 percent of the agency's contracting dollars, an increase of 8 percentage points from the prior year.

Credit unions may also assess their DEI policies and programs through a voluntary credit union diversity self-assessment offered annually.[11] Credit union submissions of their self-assessment have no bearing on their CAMELS rating, and examiners cannot access the data. The NCUA reports credit union diversity data only in the aggregate. The agency encourages credit unions to use this tool to support their DEI efforts.

In 2022, 481, or 10 percent of all credit unions, submitted a self-assessment. The figure represents an all-time high for submissions to the NCUA. Of those submissions, 302 were federally chartered credit unions, 178 were federally insured and State-chartered, and one was a non-federally insured, State-chartered credit union. The number of CUDSA responses in 2022 is twice as much as the 240 self-assessments submitted in 2021.

Finally, to support credit union accomplishments in DEI and provide further guidance, the NCUA hosted its fourth DEI Summit in Washington, DC, in early November. This now annual event provided a forum for hundreds of credit union stakeholders to network, share best practices, and meet with thought leaders on ways to expand their DEI efforts. The event also highlighted the importance of allyship in helping to achieve the NCUA's and credit unions' DEI goals and improve the financial prospects and futures of families across the country.

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[9] Office of Personnel Management, "U.S. Office of Personnel Management Releases Government-wide Diversity, Equity, Inclusion, and Accessibility Annual Report", news release, February 15, 2023. *https://www.opm.gov/news/releases/2023/02/release-us-office-of-personnel-management-releases-government-wide-diversity-equity-inclusion-and-accessibility-annual-report/*

[10] The Office of Personnel Management defines "targeted disabilities" on Standard Form-256, Self-Identification of Disability. Targeted disabilities include developmental disabilities (e.g., autism spectrum disorder; traumatic brain injury); deaf or serious difficulty hearing (e.g., benefiting from American Sign Language, CART, hearing aids, a cochlear implant and/or other supports); blind or serious difficulty seeing even when wearing glasses; missing extremities (arm, leg, hand and/or foot); significant mobility impairments that benefit from the use of a wheelchair, scooter, walker, leg brace(s) and/or other supports; partial or complete paralysis; epilepsy or other seizure disorders; intellectual disabilities; significant psychiatric disorders (e.g., bipolar disorder, schizophrenia, PTSD, or major depression; dwarfism; and significant disfigurement (e.g., caused by burns, wounds, accidents, or congenital disorders). See *https://www.opm.gov/forms/pdf-fill/sf256.pdf.*

[11] The NCUA developed the voluntary Credit Union Diversity Self-Assessment in 2016 to comply with Section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which requires certain agencies to assess the diversity and inclusion practices of their respective regulated entities (credit unions, in the NCUA's case).

Rulemaking Activities

Since May, the NCUA Board has engaged in several rulemakings on topics like MDI preservation, member expulsion, financial innovation, fair hiring, and charitable donations. These rulemakings have aimed to implement laws required by Congress and strengthen the credit union system.

In May, the NCUA Board approved a proposed rule that would add “war veterans’ organizations” to the definition of a “qualified charity” that a Federal credit union may contribute to using a charitable donation account. The NCUA Board approved the proposed rule noting the attributes of “veterans’ organizations” as defined by section 501(c)(19) of the Internal Revenue Code are aligned with the purposes of the current charitable donation account rule. A “qualified charity” is a section 501(c)(3) entity defined by the Internal Revenue Code and must be both a nonprofit and be organized for a charitable purpose. The final rule will be considered on November 16.

In June, the NCUA Board approved proposed changes to the interpretive ruling and policy statement on the agency’s Minority Depository Institution Preservation Program. The proposal would amend an existing interpretive ruling and policy statement to update the program’s features, clarify the requirements for a credit union to receive and maintain an MDI designation, and reflect the transfer of the MDI Preservation Program administration from the agency’s Office of Minority and Women Inclusion to its Office of Credit Union Resources and Expansion. Proposed amendments to the interpretive ruling and policy statement also include incorporating recent program initiatives, providing examples of technical assistance an MDI may receive, establishing a new standard for MDIs to assess their designation periodically, and updating how the NCUA will review an MDI’s designation status, among other changes. This rule is pending.

Additionally, the Board finalized a rule in July to implement requirements of the Credit Union Governance Modernization Act of 2022.[12] This regulation streamlines procedures for credit unions to expel a member in cases of serious misconduct.

In September, the NCUA Board approved a financial innovation final rule that provides flexibility for federally insured credit unions to utilize advanced technologies and opportunities offered by the financial technology sector. The final rule specifically provides credit unions with options to participate in loans acquired through indirect lending arrangements and financial technology. With the adoption of this final rule, the limits previously found in the NCUA’s regulations are replaced with policy, due diligence, and risk-management requirements that can be tailored to match each credit union’s risk levels and activities.

Lastly, the NCUA Board in October approved a proposed rule that would incorporate the NCUA’s Second Chance Interpretive Ruling and Policy Statement, and statutory prohibitions imposed by Section 205(d) of the Federal Credit Union Act into the agency’s regulations. This proposed rule would allow people convicted of certain minor offenses to work in the credit union industry without applying for the NCUA Board’s approval. It would also amend requirements governing the conditions under which newly chartered or troubled federally insured credit unions must notify the NCUA of proposed changes to their board of directors, committee members, or senior executive staff. The comment period closes on January 8, 2024.

Legislative Requests

While the credit union system continues to perform well overall, several amendments to the Federal Credit Union Act would provide the NCUA with greater flexibility to effectively regulate the credit union system and protect the Share Insurance Fund in light of an evolving economic environment, a changing marketplace, and technological advancements.

Central Liquidity Facility Reforms

As noted previously, the NCUA Board unanimously supports a statutory change to restore the ability of corporate credit unions to serve as CLF agents on behalf of a subset of their member credit unions. Such legislation would better allow the CLF to serve as a shock absorber for liquidity events within the credit union system.

On February 28, 2023, lawmakers introduced bipartisan legislation that would allow corporate credit unions to purchase CLF capital stock on behalf of a subset of their members.[13] This legislation would permit corporate credit unions to contribute capital to provide coverage for smaller members with less than $250 million in assets. Liquidity risks within the credit union system are rising, and timely con-

[12] Pub. L. 117-103 (Mar. 15, 2022).
[13] S.544, 118th Cong. 1st Sess. (2023).

sideration of this bill would better protect the credit union system from future liquidity events.

Restoration of Third-Party Vendor Authority

The risks resulting from the NCUA's lack of vendor authority are real, expanding, and potentially dangerous for the Nation's financial infrastructure. Other independent entities, including the Government Accountability Office, the Financial Stability Oversight Council, and the NCUA's Office of Inspector General, have identified this deficiency as inhibiting the NCUA from fulfilling its mission to safeguard credit union members and the financial system. And, it is the NCUA Board's continuing policy to seek third-party vendor authority from Congress.[14]

The agency is working within its current authority to address this growing regulatory blind spot, but it is evident that additional authority is needed. There has also been a shift in credit union leaders' understanding of the value of the NCUA having the same vendor authority as the Federal banking agencies. The benefits include credit union access to NCUA examination information when conducting due diligence of vendors, fewer requests from the NCUA to credit unions to intervene with vendors experiencing problems, and fewer losses to the Share Insurance Fund.

The potential for such resulting losses to the Share Insurance Fund is real. The NCUA's Office of Inspector General stated that between 2008 and 2015, nine CUSOs contributed to material losses to the Share Insurance Fund. The report noted one of the CUSOs caused losses in 24 credit unions, some of which failed. According to NCUA staff calculations, at least 73 credit unions incurred losses between 2007 and 2020 as losses at CUSOs roll onto credit union ledgers and lead to liquidations.[15]

The absence of third-party vendor examination authority limits the NCUA's ability to assess and mitigate potential risks associated with these vendors. Vendors typically decline these requests or refuse to implement recommended actions. This limitation exacerbates any exposure credit unions have to the operational, cybersecurity, and compliance risks that can arise from these relationships. Without the authority to enforce recommended corrective actions, the NCUA is unable to effectively protect credit unions and their members.

Furthermore, the growing reliance on third-party services in the credit union industry poses a systemic risk to the credit union system. Five core banking processors, for example, handle more than 90 percent of the credit union system's assets. A failure of one of these critical third parties could cause hundreds of credit unions and potentially tens of millions of their members to lose access to their funds simultaneously. Such a vendor failure, in turn, may result in a loss of confidence in the financial sector. Ensuring proper oversight is imperative, as CUSOs and third-party vendors are poised to capitalize on financial institutions' growing appetite for artificial intelligence and real-time payment services.

If granted third-party vendor authority, the NCUA would implement a risk-based examination program focusing on services that relate to safety and soundness, cybersecurity, Bank Secrecy Act and Anti-Money Laundering Act compliance, consumer financial protection, and areas posing significant financial risk for the Share Insurance Fund.

Additional Flexibility for Administering the Share Insurance Fund

The recent turmoil in the banking sector, growing liquidity risks within the credit union system, and rising interest rate risk all highlight the need for the NCUA to have additional flexibility for administering the Share Insurance Fund.

Specifically, the NCUA requests amending the Federal Credit Union Act to remove the 1.50 percent ceiling for the Share Insurance Fund's equity ratio from the current statutory definition of "normal operating level," which limits the ability of the Board to establish a higher normal operating level for the Share Insurance Fund. A statutory change should also remove the limitations on assessing Share Insurance Fund premiums when the equity ratio of the Share Insurance Fund is greater than 1.30 percent and if the premium charged exceeds the amount necessary to restore the equity ratio to 1.30 percent.[16]

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[14] 86 FR 59289.

[15] Office of Inspector General, OIG-20-07, "Audit of the NCUA's Examination and Oversight Authority Over Credit Union Service Organizations and Vendors", *www.ncua.gov/files/audit-reports/oig-audit-cusos-vendors-2020.pdf.*

[16] As part of the Federal Deposit Insurance Reform Act of 2006, Congress ended the prohibition on the FDIC's charging of risk-based premiums to well-capitalized institutions (which constituted most of the industry) when the reserve ratio was at or above its target. See section 2107(a) of Pub. L. No. 109-171 (Feb. 8, 2006). Compare with §1782(c)(2)(B) (providing in relevant part: "The [NCUA] Board may assess a premium charge only if—(i) the [Share Insurance]

Together, these amendments would bring the NCUA's statutory authority over the Share Insurance Fund more in line with the FDIC's authority as it relates to administering the Deposit Insurance Fund. These amendments would also better enable the NCUA Board to proactively manage the Share Insurance Fund by building reserves during economic upturns so that sufficient money is available during economic downturns. This more countercyclical approach to managing the Share Insurance Fund would better ensure that credit unions will not need to impair their one percent contributed capital deposit or pay premiums during times of economic stress, when they can least afford it.

Conclusion

The NCUA stands ready to address the impact of the evolving economic and business cycles within the credit union system. The NCUA will continue to monitor credit union performance and coordinate with other Federal financial institution regulators, as appropriate, to ensure the overall resiliency and stability of our Nation's financial services system and economy.

Thank you again for the invitation to testify about the NCUA's programs and operations. I look forward to your questions.

PREPARED STATEMENT OF MICHAEL HSU

ACTING COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

NOVEMBER 14, 2023

Introduction

I am pleased to testify before the Committee on Banking, Housing, and Urban Affairs to provide an update on the activities underway at the Office of the Comptroller of the Currency (OCC) as we seek to ensure that national banks and Federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.

The OCC charters, supervises, and regulates more than 1,050 national banks, Federal savings associations and Federal branches and agencies of foreign banks (collectively, "banks"). These institutions range in size from very small community banks to the largest, most globally active banks operating in the United States. The vast majority of these institutions have less than $1 billion in assets, while 55 have greater than $10 billion in assets. Together, OCC-supervised financial institutions hold more than $15 trillion in assets—almost 66 percent of all assets held in commercial U.S. banks.

My written statement provides a general overview of the State of the Federal banking system, an update on the OCC's work to advance the four critical agency priorities that I initiated after becoming Acting Comptroller more than 2 years ago, and a description of recent key regulatory developments.

State of the Federal Banking System

The overall condition of the Federal banking system is sound. Despite the significant market stresses earlier this year which started with the failures and liquidation of several State-chartered banks and a challenging interest rate environment, banks in the aggregate continue to have strong levels of regulatory capital and healthy levels of profitability while maintaining sufficient liquidity buffers.

The OCC closely monitors the condition of the institutions it supervises and engages directly with them to ensure they are appropriately managing their risks. The OCC provides heightened supervisory attention to banks with elevated levels of risk, such as high levels of unrealized losses and uninsured deposits, or a significant concentration in commercial real estate exposure.

Banks must remain vigilant in managing risk. The OCC's Bank Supervision Operating Plan for 2024 [1] summarizes the agency's exam priorities for next year and highlights asset liability management, credit risk and allowance for credit losses, cybersecurity, operational risk, and consumer compliance risk, among others, as key areas of focus.

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cont'd—Fund's equity ratio is less than 1.30 percent; and (ii) the premium charge does not exceed the amount necessary to restore the equity ratio to 1.30 percent.").

Statement Required by 12 U.S.C. §250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily present the views of the President.

[1] See: Fiscal Year 2024 Bank Supervision Operating Plan, Office of the Comptroller of the Currency, Committee on Bank Supervision (occ.gov).

Update on Agency Priorities

Guarding Against Complacency by Banks

Guarding against complacency is essential to building and maintaining trust in the banking system. It has been a priority for the OCC since I took over as the Acting Comptroller in May of 2021.

The large bank failures in the spring of this year and resulting market disruption serve as a reminder that stress at banking organizations can affect financial stability and public trust in the Nation's financial system. In particular, this highlighted the dangers of complacency by bank management and boards of directors.

While there has been relative calm since then, the OCC expects the banks we supervise to remain vigilant and stay "on the balls of their feet" regarding risk management. Banks need to successfully manage traditional, "blocking-and-tackling" risks, such as credit, liquidity, and interest rate risks, as well as prepare for emerging risks and tail risk events.

To assist banks, the OCC has updated guidance and provided transparency around our expectations. For example, in response to increasing risk in commercial real estate, the OCC, Federal Reserve Board, the FDIC, and the National Credit Union Administration, in consultation with State bank and credit union regulators, published the "Policy Statement on Prudent Commercial Real Estate (CRE) Loan Accommodations and Workouts".[2] The statement replaces the 2009 interagency guidance on CRE loan workouts and reflects the OCC's commitment to build trust by collaborating with other agencies to ensure consistent supervision and to provide timely guidance that reflects current best practices.

In addition, the Federal Financial Institutions Examination Council (FFIEC) also updated several sections of the FFIEC BSA/AML Examination Manual to reinforce the risk-focused approach to BSA/AML examinations. The updates reflect my commitment, as the current Chair of the FFIEC, to improving the effectiveness of the BSA/AML and reducing undue burdens on banks.[3]

Reducing Inequality in Banking

Another priority essential to building and maintaining trust in the banking system is reducing inequality in banking. Ensuring that financial services are offered responsibly and fairly takes continued effort and vigilance by banks, regulators, members of the public and other stakeholders. Public trust in banks can enable a virtuous cycle between banks and the communities they serve.

On October 24, 2023, the Federal banking agencies issued an interagency final rule implementing the Community Reinvestment Act (CRA). The CRA was enacted in 1977 to prevent redlining and to encourage banks and savings associations to help meet the credit needs of all segments of the communities in which they operate, especially low- and moderate-income (LMI) neighborhoods and individuals. The final rule adopted by the Federal banking agencies modernizes and strengthens the CRA. It modernizes the CRA by recognizing banking activities that take place beyond physical branches and ATMs, being significantly more data driven and objective, and providing for greater transparency. It strengthens the CRA by addressing concerns related to "grade inflation" in CRA ratings, and by better incentivizing CRA lending and investments in LMI communities.

The rule will provide clarity and consistency for all banks, but also tailors evaluations and data collection to bank size so that community banks do not have additional burden. The agencies also responded to commenters by providing a 24-month phase-in period to allow banks and regulators time to prepare for it. The OCC will now turn its efforts to perhaps the most important step toward reducing inequality, which is the implementation of the new rule.

Earlier this year, we issued guidance to address the risks associated with overdraft protection programs. These programs can present a variety of risks, including compliance, operational, reputation, and credit risks. In particular, the guidance highlighted certain practices that may present heightened risk of violating Federal prohibitions against unfair or deceptive acts or practices. These include assessing overdraft fees on "authorize positive, settle negative" transactions and charging a fee each time an item is presented for payment after being returned for nonsufficient funds. It also describes practices that may help banks control risks with overdraft programs, as well as provides information about programs that assist consumers in meeting short-term liquidity and cash-flow needs.

[2] See OCC Bulletin 2023-23, "Credit Administration: Final Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts".

[3] See OCC Bulletin 2023-26, "Bank Secrecy Act/Anti-Money Laundering: Updated Sections of the FFIEC BSA/AML Examination Manual".

This fall, the OCC hosted a public Special Purpose Credit Program (SPCP) Roundtable with the Department of Housing and Urban Development, the Federal Housing Finance Agency, and the Consumer Financial Protection Bureau to highlight the availability of SPCPs to help meet the credit needs of eligible individuals. The roundtable brought together diverse stakeholders for a discussion about how SPCPs can help meet the credit needs of underserved consumers and reduce the racial wealth gap. SPCPs are a long-established tool under the Equal Credit Opportunity Act and its implementing Regulation B, and a way for creditors to expand access to credit for economically or socially disadvantaged consumers and commercial enterprises. The roundtable served to support banks' exploration around the establishment or expansion of such programs.

I also want to recognize the continued progress of the OCC's Project REACh—or Roundtable for Economic Access and Change—which is focused on removing barriers to financial inclusion. For instance, initiatives targeting credit invisibles are bringing new entrants into the mainstream financial system and providing them with credit scores and access to credit. Investments of talent and financial resources in Minority Depository Institutions have resulted in increased partnerships, exchange programs, training and capital. Efforts to promote home ownership for the underserved and for those on tribal lands are underway, as are investments in minority small businesses and awareness of special purpose credit programs.

Adapting to Digitalization

Banks' relationships with third parties, including financial technology (fintech) companies, continue to expand. The use of third parties has significant potential benefits, but poor third-party risk management can hurt consumers, weaken banks, and contribute to an unlevel playing field.

Recently, the OCC and other regulators jointly issued "Interagency Guidance on Third-Party Relationships: Risk Management".[4] This document builds on the OCC's guidance from 2013 and reminds banks of their responsibility to operate in a safe and sound manner and in compliance with applicable laws and regulations regardless of whether their activities are performed in-house or outsourced. The guidance also recognizes that not all third-party relationships reflect the same level of risk and therefore not all require the same level of risk management.

The OCC recognizes the considerable interest by the banking industry in artificial intelligence (AI). To date, banks have generally approached machine learning and AI cautiously across a range of use cases The potential benefits of more widespread adoption of AI are significant, but so are the risks, which we expect banks to manage appropriately.

In the digital asset space, attention is shifting from crypto to the tokenization of real-world assets and liabilities. In contrast to crypto, tokenization is driven by solving real-world settlement problems and can be developed in a safe, sound, and fair manner. Next February, the OCC will host a public symposium on tokenization to take stock of developments, help enable strong foundations, and promote public discussion.

Managing Climate-Related Financial Risks to the Federal Banking System

On September 24, 2023, the OCC, along with the Federal Reserve and FDIC, approved principles for climate-related financial risk management for large banks. These principles build upon the OCC's initiative as the first U.S. Federal banking agency to propose for public comment principles for large banks nearly 2 years ago.

The principles are focused exclusively on risk management of climate-related financial risks. They are needed because the increased frequency and severity of extreme weather events impact individuals, businesses, and communities. As with all risks, large banks need to be ready and to have effective risk management capabilities. At the same time, these principles recognize and respect that industrial policy and climate policy are outside of the scope of bank safety and soundness. The principles do not tell bankers what customers or businesses they may or may not bank. Rather, they clarify how large banks can maintain effective risk management and keep their balance sheets sound and continue to be a source of strength to their customers and communities through a range of scenarios.

To date, the OCC has worked with the large banks it supervises to better understand their work to identify, manage and control climate-related financial risks. Going forward, we plan to monitor the development of large banks' climate-related financial risk framework for safety and soundness and engage with bank manage-

[4] See OCC News Release 2023-53, "Agencies Issue Final Guidance on Third-Party Risk Management".

ment and other regulators to better understand the challenges banks face in this effort.

As with all emerging risks, it is critical that banks prepare for climate-related financial risks. They should not wait for disaster to strike before they act—prudence demands that regulators and the industry adapt as risks emerge. This philosophy underpins these principles, as well as prudent risk management and our mission to ensure bank safety and soundness.

The OCC Supports Community Banks and MDIs

The OCC is committed to promoting a vibrant and diverse banking system to match and support the diversity of the U.S. economy. The banking system needs to be diverse in order to meet the wide range of individual consumer and community financial needs across this country. A diverse banking system also enables healthy competition and the ability to adapt to change and adversity. A vibrant and diverse system is comprised of a broad spectrum of institutions, including community banks and minority depository institutions, community development financial institutions, mutual savings associations, and FSAs. Supporting them is critical to our mission and vision.

We are mindful of concerns from community bankers that requirements for large banks should not trickle down to smaller banks, as such requirements can pose an undue burden and unnecessarily tie up scarce personnel and other resources. The OCC will remain diligent in guarding against such outcomes and tailor our supervisory expectations while ensuring the Federal banking system remains safe, sound, and fair. We plan to continue to engage directly with each community bank that we supervise, and our two Federal Advisory Committees, the Minority Depository Institution Advisory Committee, and the Mutual Savings Association Advisory Committee, will continue to assist in this effort.

Additional Recent Key Regulatory Developments

The OCC has been engaged in developing and finalizing several proposals to promote the resiliency, resolvability, and inclusiveness of the Federal banking system.

Revisions to Capital Rules for Large Banks

Last July, the OCC joined the Federal banking agencies to issue a proposal to update the risk-based capital requirements applicable to large banking organizations and banking organizations with significant trading activity. This so-called "Basel endgame" NPR is intended to replace the current risk-based capital framework, which was adopted in response to the 2008–2009 financial crisis and helped facilitate the recapitalization of large banks after the crisis. The purpose of the NPR is to finish the job by establishing a durable risk-based capital framework for large banks that adequately captures all material risks and utilizes methodologies that are consistent and reliable.

Like building codes, we need our capital framework to be prudent and robust, so that large banks—like large buildings—can withstand a wide range of shocks and stresses. Gathering public input on the proposal is critical. We will consider all comments, including alternative approaches. The comment period for the proposal was recently extended until January 16, 2024.

Enhancements to Long-Term Debt Requirement for Large Banks

On August 29, 2023, I approved an interagency proposal to establish a long-term debt requirement for large banks with $100 billion or more in assets. The purpose of the rule is to help ensure that a large bank's losses are borne by its investors in the first instance. The failures of Silicon Valley Bank and Signature Bank earlier this year highlight the importance of securing this safeguard for all large banks, not just the global systemically important banks (G–SIBs). As with the Basel endgame NPR, I look forward to reviewing the comments provided on this rulemaking.

Conclusion

I am committed to ensuring that OCC-supervised banks operate in a safe, sound, and fair manner, meet the credit needs of their communities, treat all customers fairly, and comply with laws and regulations. As we work to ensure that the Federal banking system remains a source of strength to the U.S. economy, we will continue to advance key agency priorities to ensure the Federal banking system is well positioned to respond to community and consumer needs well into the future.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Chairman Sherrod Brown:

1. **How does the BASEL III Endgame capital proposal strengthen the capital requirements associated with risky trading and derivatives? What impact would the capital proposal have on lending, particularly to small businesses and low- and moderate-income borrowers?**

The capital proposal aims to strengthen the resilience of the banking system by updating our rules to better align capital requirements with risk. A safe and sound banking system is critical to a healthy economy, and capital is foundational to safety and soundness.

For trading and derivatives, it is important to have a capital framework that enhances market functioning. This includes making sure that banks are resilient and can continue to serve as strong and reliable market intermediaries even in stressful times. This was a significant issue during the global financial crisis and remains a significant unfinished reform.

For a bank's trading activities, the proposal would require more granular methods for measuring market risk, which is the risk of loss from movements in market prices, to correct for gaps in the current rules and improve risk capture. For example, the capital proposal would better capture the risks of illiquid exposures and risks of losses in extreme, but plausible, stress scenarios. It would also establish improved restrictions on the use of firms' internal models and introduce a new standardized approach, which would provide a fallback for cases where the model used by a firm's trading desk does not sufficiently capture the market risk of its exposures. The proposal would also improve the capital requirements for the credit risk of derivative activities—the risk that a borrower or counterparty will fail to perform on an obligation—by introducing a standardized, risk-sensitive measure.

The proposal would generally increase capital requirements for trading and other non-lending activities where banks have had large losses. For most forms of retail, commercial, and small business credit, the analysis in the proposal suggests that capital requirements would increase only modestly. In addition, most banks subject to the proposal already have enough capital to meet the proposed requirements.

For a bank's lending to small businesses and low- and moderate-income (LMI) borrowers, the analysis in the proposal suggests that there would be limited impact on lending, including on small business lending or lending to LMI borrowers.

Following the proposal, the Federal Reserve requested additional data to gather more information from banks based on the specific requirements of the proposal. We are evaluating the additional data to better understand the estimated effects of the proposal and inform our efforts moving forward. We intend to make summaries of the data public.

Public engagement is an important part of the rulemaking process, as it helps ensure we consider the effects of our rules. For the capital proposal, we provided an extended comment period to help ensure that stakeholders had time to review the proposal and submit comments. We also conducted a significant degree of outreach as part of the comment process, and we are carefully considering these comments.

2. **Earlier this year, JPMorgan acquired First Republic's assets after its failure. This acquisition further increased the concentration of assets among the largest institutions in this country and decreased competition in the banking sector. What is the Federal Reserve doing to update its guidelines for reviewing merger and acquisition transactions to ensure that the banking sector remains a competitive market that serves the needs of the American people?**

The Federal Reserve is currently reviewing its bank merger framework to determine whether any adjustments would be appropriate to improve our merger analysis. This includes a review of each of the statutory factors that the Federal Reserve must consider in evaluating merger proposals, including financial stability, competition for banking products and services, the financial and managerial resources and the future prospects of the institutions involved, and the combined firm's ability to meet the convenience and needs of the communities it serves.

As part of this process, Federal Reserve Board (Board) staff have been engaging in discussions with staff of the other banking agencies regarding our bank merger frameworks, and with staff of the U.S. Department of Justice (DOJ) regarding its ongoing review of the joint bank merger guidelines.

3. **Please explain whether there are vulnerabilities in the financial system related to banks' exposure to commercial real estate. What is the Federal Reserve doing to ensure banks are mitigating those risks?**

The Federal Reserve continues to monitor the performance of commercial real estate (CRE) loans. While credit quality conditions remain stable, fundamentals in the market for office properties remain weak with higher vacancy rates and slower rent growth. In addition, a large portion of outstanding CRE loans is expected to mature in the coming two to three years. Therefore, we expect segments of the CRE market to face challenges over the next several years and continue to monitor the potential for property price corrections.

There are some stabilizing factors occurring in the CRE market. We did not observe a debt boom leading into the current situation and the current loan to value ratios of outstanding CRE loans allow some room for price correction. Certain CRE segments, such as hotels, have recovered to some extent. This will give lenders, borrowers, and markets time to work through emerging issues, renegotiate loan terms, and build reserves and capital.

We are watching CRE risk at banks closely and continue to devote significant supervisory resources to CRE, particularly for banks with high levels of CRE loans. In the 2023 stress test, the Federal Reserve tested the impact of a sharp decline in CRE property values and found that large banks have sufficient capital to withstand stressful economic conditions, including a 40 percent decline in CRE prices. More broadly, in June 2023, the Federal Reserve together with the other federal financial institution regulatory agencies, issued guidance to banks on commercial real estate loan accommodations and workouts.[1] Examiners are engaging with bank management to assess banks' preparedness for potential changes in market conditions and the robustness of their risk management programs to identify and mitigate the risk of losses on CRE loans.

4. Do interest rates, liquidity, and unrealized losses in banks' investment portfolios continue to pose a risk to the financial system, particularly in light of the bank failures earlier this year? What is the Federal Reserve doing to mitigate those risks?

The acute stress that occurred in March 2023 has receded, and banking organizations continue to report capital and liquidity ratios above minimum regulatory levels. Our banking system is sound and resilient; however, liquidity and interest rate risks remain elevated at some banks.

To mitigate these risks the Federal Reserve intensified examination efforts on assessing banks' preparedness for managing liquidity and interest rate risks. Efforts include closely evaluating liquidity risk management practices and contingency funding plans, assessing banks' preparedness to manage unexpected deposit outflows, and initiating continuous monitoring for a small number of firms with a risk profile that could result in funding pressures for the firm.

Examiners are emphasizing that funding sources should be highly reliable and that banks should have sufficient collateral pledged so they can quickly access funding when needed. It is crucial that banks have a diversified range of liquidity sources that they are able to access in a variety of conditions.

Examiners are also paying close attention to firms reporting high levels of unrealized losses on securities and other assets to ensure they are taking steps to preserve and maintain adequate liquidity and capital as needed. When warranted, the Federal Reserve is conducting targeted examinations at banks with higher levels of unrealized losses on securities. We have communicated with supervised banks regarding the interest rate environment and the impact on investment securities market values. Examiners also conducted horizontal reviews to assess interest rate risk management practices across large firms. These reviews assessed the adequacy of firms' risk management processes to identify, measure, monitor, and, as needed, mitigate interest rate and related liquidity risks.

More broadly, we are continuing to focus on the lessons learned from the events last spring and are continuing to review policy options to improve the supervision and regulation of interest rate risk and liquidity risk.

5. Banks have previously argued that the implementation of higher capital ratios would disadvantage them relative to their international peers, yet the largest financial institutions in this country continue to operate with global footprints and remain profitable. If the capital proposal was adopted as proposed, is there any concern that

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[1] *See* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230629a.htm.

the largest banks in this country would not remain competitive with their international peers?

The Basel process is a way of building consensus with other jurisdictions on minimum standards, including with respect to capital. It is helpful to make sure we have minimum standards that are comparable around the world to support financial stability and prevent a regulatory race to the bottom. At the same time, U.S. regulators propose and finalize rules appropriate to U.S. firms using our normal notice and comment rulemaking process.

International comparisons can be difficult due to differences in jurisdictions, but we are closely monitoring how other jurisdictions are implementing the final Basel III reforms. Generally, the United States has had more stringent capital requirements than many other jurisdictions, and U.S. banks have continued to thrive, and in many ways outperform their global peers. Specifically, large U.S. banks have remained highly competitive and play an important role in global capital markets. I would expect this to continue after implementation.

6. **Some have argued that the capital proposal will drive risky activities to less regulated portions of the financial sector. While I have long been concerned about risks in the unregulated shadow banking system, we need strong capital requirements in place for banks that have the public backing of deposit insurance and the Federal Reserve's discount window. Please explain how the capital proposal will help prevent risky activities occurring at nonbank entities from threatening our banking system. Please also discuss other regulatory tools and authorities available to mitigate risks in the nonbank financial sector.**

The goal of our regulatory framework is to ensure a strong and resilient financial system that supports households and businesses, while appropriately balancing the benefits and costs of regulation. Banks are part of a broader financial system, which includes nonbank financial intermediaries. The nonbank sector plays an important role in the U.S. financial system. Roughly two-thirds of household debt is held outside the banking system—and this has not changed much in recent years. We monitor the migration of activities from banks to the nonbank sector carefully.

The proposal would better reflect the risk exposure of banking organizations to nonbank entities, including through improvements to how a bank measures the risks of its trading activities and the capital treatment for derivatives activities.

Finally, strengthened capital requirements for banks' activities should be complemented by greater transparency and stronger oversight for nonbanks. I support continued efforts to boost resilience of the entire financial system.

7. **In addition to the BASEL III Endgame rulemaking, the Federal Reserve, FDIC, and OCC have also proposed related rulemakings covering the global systemically important bank (or G-SIB) surcharge, long-term debt issuances, and resolution planning. How would these rulemakings, in concert with the capital proposal, strengthen our financial system?**

The proposals are intended to strengthen the resilience of large banking organizations and reduce the likelihood of a financial crises, which can inflict significant harm on families and businesses. The global systemically important bank (GSIB) surcharge proposal would improve the calculation of the GSIB surcharge to better reflect a firm's systemic footprint. The long-term debt proposal would improve the resolvability and resilience of large non-GSIB banking organizations by improving the range of options available to the resolution authority and mitigating the potential for contagion. The resolution planning guidance proposals would enhance and further develop the resolution plans of large non-GSIB banking organizations by setting forth expectations on key areas of potential vulnerability such as capital, liquidity, and operational capabilities that the firms would need in resolution. Each of these proposals, along with the capital proposal, would contribute to strengthening the financial system.

We are carefully considering the comments we have received on these proposals.

8. **On November 3, 2023, a manual processing error by The Clearing House's Electronic Payments Network led to a widespread Automated Clearing House (ACH) outage disrupting 1% of the daily volume or approximately 867,000 transactions. This disruption impacted hundreds of financial institutions and thousands of customers. There have been prior instances of payment disruptions by financial market utilities, including multiple disruptions by banks on the Zelle payment network over the past year. The ACH system processes about 74 million transactions daily, totaling nearly $155 billion. In 2022, ACH processed $38.7 trillion in payments. As financial institutions adopt real-time payment networks and more payment networks become available to consumers, outages will have a detrimental impact on banks, consumers, and businesses. The Federal Reserve has supervisory responsibilities over financial market utilities as defined by Regulation HH. Following the recent ACH outage, what guidance has the Fed provided to The Clearing House and impacted banks to remediate disrupted payments and make their customers whole? How is the Federal Reserve utilizing its supervisory authority to promote the safety and soundness of the payments system? What action is the Federal Reserve taking to ensure the resiliency the payments system against both cyber events and cyber attacks?**

The Board supervises certain financial market utilities (FMU) that the Financial Stability Oversight Council has designated as systemically important. These FMUs are subject to ongoing Federal Reserve supervision and comprehensive risk-management requirements set out in the Board's Regulation HH.

Under the Bank Service Company Act (BSCA), banking agencies have authority to supervise and regulate certain services, including payments-related services, performed for depository institutions by third party service providers. Our focus under the BSCA is to ascertain that services being provided to depository institutions are being conducted in a safe and sound manner.

The Federal Reserve has long been focused on operational resilience in the financial sector, working with the U.S. Department of the Treasury (Treasury), market participants and other agencies to ensure readiness for cyber breaches.

With regard to the disruption referenced in your question, to date, the impact of this incident appears to be contained. We monitored the situation closely and were in regular communication with the Treasury and other agencies with primary supervisory and regulatory responsibilities. In addition, the Federal Reserve encouraged banks to work quickly to resolve issues for customers experiencing delays in receiving payments as a result of operational issues at this private sector payments provider.

This incident highlights the potential costs of an incident and underscores the importance of financial institutions remaining vigilant to cyber risk. Moreover, we will use this experience to further strengthen our collective response practices and resilience of the financial system.

9. **Please describe the Federal Reserve's process for developing and approving the issuance of the BASEL III Endgame rulemaking? Did the Federal Reserve satisfy all Administrative Procedure Act (APA) requirements in developing, adopting, and publishing the BASEL III Endgame rulemaking? In what ways did the Federal Reserve exceed APA requirements? Has the Federal Reserve provided the public more time to comment on this proposal than it has in the past, particularly in comparison to other capital proposals following the passage of S. 2155? Please explain.**

I am committed to a rulemaking process that is transparent, deliberative, and thoughtful. The Board diligently adheres to all applicable law, including the Administrative Procedure Act. The preamble to the proposal describes the expected impact of the proposal and economic analyses, and the Federal Reserve requested additional data to gather more information from banks based on the specific requirements of the proposal. The additional data will further clarify the estimated effects of the proposal and inform our efforts moving forward. We intend to make summaries of the data public.

Public engagement is an important part of the rulemaking process, as it helps ensure we consider the effects of our rules. For the capital proposal, we provided a comment period of nearly six months to help ensure that stakeholders had time to review the proposal and submit comments. This reflects our commitment to public engagement and openness to views and goes beyond the standard comment period length. We also collected additional data to help refine our estimates of the proposed rule's effects and conducted a significant degree of outreach as part of the comment process. We are currently carefully considering the comments we have received.

10. **Please explain how the changes to the measurement of operational risk in the capital proposal are necessary to improve the resiliency of our financial system.**

Operational risk is the risk of loss due to inadequate or failed processes and systems. It can result, and has resulted, in substantial losses to banks, for example, in instances of cyber events, rogue trading, and improper business practices. Operational risk is a key risk in banking, separate from credit and market risk, and our capital rules should ensure that it is appropriately capitalized. The proposal would introduce a consistent methodology for capitalizing for all operational risks for the largest banking organizations.

11. On March 8, Silicon Valley Bank indicated their intention to restructure their balance sheet, and as a part of that effort, their plan to raise $2.25 billion in additional capital. This restructuring raised concerns about the soundness of Silicon Valley Bank and triggered significant deposit outflows that ultimately resulted in Silicon Valley Bank's failure. How do the reforms proposed in the BASEL III Endgame rulemaking protect the financial system against the risk of failure of institutions like Silicon Valley Bank?

The agencies have been working on the capital proposal for many years, with the goal of addressing shortcomings identified during the global financial crisis by better aligning capital requirements with risk. The capital proposal also would address certain additional vulnerabilities exposed by the banking stress last spring, such as significant accumulation of unrealized losses from available-for-sale securities. All large banks would be required to reflect unrealized gains or losses from available-for-sale securities in their regulatory capital, to better reflect these firms' actual loss-absorbing capacity.

More broadly, Silicon Valley Bank's (SVB) failure confirms the importance of strong levels of bank capital. While the proximate cause of SVB's failure was a liquidity run, the underlying issue was concern about its solvency—the bank's ability to absorb the losses on its securities and repay its depositors and other creditors. Strong capital helps guard against the risks that we may not fully appreciate today and reduce the costs of bank failures over time.

12. Please explain how the Federal Reserve intends to ensure that artificial intelligence (AI) technology is deployed at banks in a safe and sound manner?

For several years, the Federal Reserve has been monitoring banks' use of artificial intelligence (AI) in general, and more recently have been assessing banks' potential use of generative AI. Our supervisory objective is to help ensure banks are using AI in a manner that is consistent with safety and soundness and compliant with applicable laws and regulations, including those related to consumer protection. As a general matter, this involves assessing the governance, risk management, and controls banks have developed around AI.

AI can offer significant benefits; however, the use of AI can also introduce certain risks such as potential data challenges, explainability, bias, cybersecurity, and consumer protection. Data play an integral role with AI, including with generative AI, but it can be more difficult to employ sound data governance over the very large datasets used with generative AI.

We also are collaborating with the other financial regulators to share views on banks' emerging effective practices and risk management for AI, including generative AI.

13. Does the Federal Reserve have the workforce and technological resources necessary to supervise institutions that are deploying AI technology across their operations at an increasing rate?

Whatever technology banks are employing—including AI—our supervisors are focused on evaluating whether banks are using it in a safe-and-sound manner and in compliance with laws and regulations, including related to consumer protection. This means that we want to ensure banks have proper governance, risk management, and controls to allow responsible use of AI.

Federal Reserve staff have been monitoring use of AI at banks for several years now, and we are calibrating our supervisory approach to the intensity of usage we see. A key element of confirming that our banks are using AI properly is to have supervisory staff with the requisite skills sets and experience with the technology. The Federal Reserve has experts with specific skills and experience related to AI and have also provided training to existing staff. Additionally, staff are familiarizing themselves with AI technologies directly to gain a better understanding of how they function and the potential risks.

14. The use of AI in high-stakes decisions like deciding the outcomes of credit applications can propagate or exacerbate bias and discrimination. Existing laws, such as the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act, provide financial regulators with mechanisms to respond to lending discrimination, particularly in response to a pattern or practice of discrimination. How is the Federal Reserve *proactively* preventing discrimination, particularly by AI and particularly in creditworthiness assessments?

The Federal Reserve's fair lending examinations are an important tool to proactively prevent discrimination and to ensure compliance with fair lending laws. These examinations are rigorous and technology-neutral and are designed to identify discrimination risks regardless of whether the bank uses AI or traditional methods in its creditworthiness and pricing assessments. Specifically, the Federal Reserve bases its fair lending examination of any model, tool, or process on the risk factors set forth in the Interagency Fair Lending Examination Procedures. The Federal Reserve evaluates these risk factors with respect to potential discrimination in pricing, underwriting, redlining, and steering. In our redlining reviews, the fair lending examinations closely review whether a bank is at risk of targeting advertisements in a discriminatory manner, including when AI is deployed.

At times, additional analyses of a bank's policies and practices to assess the bank's compliance with fair lending laws and management of fair lending risk are required. A bank may also be asked to provide additional data and information.

When we find a violation, we cite it, and when we find a pattern or practice violation, we refer it to the DOJ as required by statute. Where we do not find a violation of law but are still concerned about potential fair lending risk, the Federal Reserve issues supervisory findings directing banks to take corrective actions to strengthen their compliance management systems and prevent future violations.

15. ECOA specifically requires an explanation for any adverse credit actions. However, it is notoriously difficult or even impossible to faithfully explain the decision-making of a complex AI model. Does ECOA preclude the use of complex AI models in credit assessments? If not, why not?

The Consumer Financial Protection Bureau (CFPB) has sole interpretive authority over the Equal Credit Opportunity Act (ECOA). In September 2023, the CFPB issued guidance about certain legal requirements under ECOA that lenders must adhere to when using AI and other complex models. The guidance describes how lenders must use specific and accurate reasons when taking adverse actions against consumers.

16. U.S. Securities and Exchange Commission Chair Gary Gensler has voiced concerns over the use of AI platforms developed by a handful of dominant technology firms, the consolidation of data used for financial decision making, and the potential for "herding" behavior to disrupt financial stability. What is the Federal Reserve's perspective on these concerns? Is the Federal Reserve adopting any precautions or recommending the implementation of any precautions, and, if so, what are these precautions?

The concentration in the market for AI platforms and consolidation of certain data raises concerns similar to those related to other types of technology being used by banks. Further, some technologies and data sources have the potential to propagate or exacerbate certain market behavior systematically and with wide scope and scale. The Federal Reserve will continue to monitor such risks broadly and work to promote supervised entities' resilience to a wide range of shocks.

17. Is the advancement of AI in the financial services industry further enabling consolidation or otherwise threatening small banks and credit unions?

Banks of all sizes, including small banks, are exploring how they can use new technologies, including AI. While smaller banks may lack the internal resources to develop AI solutions in-house, there are many existing and new third-party solutions available, which banks of all sizes may employ, so long as the risks are appropriately managed. The banking agencies' third-party risk management guidance sets forth principles for effectively managing third party relationships, including those related to AI.[2]

18. AI is increasingly being used as a tool for setting pricing, and even dynamic and personalized pricing (opening, additionally, concerns of bias). How is the Federal Reserve overseeing dynamic pricing for financial products and services, where the same financial product or services can be more expensive for some consumers, specifically focusing on consumers who have been historically overcharged for access to credit? Further, how is the Federal Reserve overseeing this emerging concern and its potential for anticompetitive effects, which is exacerbated by the ease of scaling and adapting AI models?

The Federal Reserve evaluates risk factors related to potential discrimination in pricing as part of the fair lending risk evaluation that occurs in every consumer compliance examination. This risk assessment is based on the risk factors set forth in the Interagency Fair Lending Examination Procedures and, when applicable, includes an analysis of the bank's loans and whether the bank uses pricing that is not based on objective criteria or applied consistently, among other pricing

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[2] *See* SR 23-4: Interagency Guidance on Third-Party Relationships: Risk Management.

risks.[3] When we find a pattern or practice of pricing discrimination, such as a finding that a bank's policy or practice of permitting the exercise of discretion in pricing led to higher prices for protected classes, we refer it to the DOJ as required by statute.

The Federal Reserve has conducted outreach regarding potential fair lending risks related to charging different prices to consumers for the same products.[4] One key goal to such outreach is to highlight fair lending risks so that banks can take steps on their own to strengthen their compliance management systems and effectively manage fair lending risk.

The Federal Reserve evaluates all transactions within its purview for potential anticompetitive effects on the market for banking products and services, consistent with its statutory mandate.

19. What action is the Federal Reserve taking to fulfill its statutory mandate as a regulator charged with supervising financial institutions and service providers, specifically involving the identification and mitigation of risks associated with the development and deployment of AI in financial services? Has the Federal Reserve identified any regulatory gaps? If so, what are those gaps?

The Federal Reserve is taking a deliberate approach to supervising banks' use of AI and seeking a wide range of input on AI's benefits and risks and potential regulatory gaps. In response to a March 2021 request for information on financial institutions' use of AI, which was issued by the Board and four other federal financial regulatory agencies,[5] we received feedback from a range of respondents, including consumer advocates, banks, and academics. We are closely monitoring how banks are using AI and confirming that proper controls are in place in addition to referring to existing laws, regulations, and guidance that have applicability to AI—such as IT handbooks, model risk management guidance, third-party risk management guidance, and consumer laws and regulations. Additionally, Federal Reserve staff work closely with staff of other regulatory agencies to track and learn more about emerging practices regarding banks' use of AI and related risk management.

20. Is the Federal Reserve using AI internally, particularly in any supervisory efforts? Please provide details on the design and application of AI in the Federal Reserve's supervisory process. Please also explain if the Federal Reserve is utilizing any AI-generated predictions, the application of those predictions, and how are those

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[3] *See* Interagency Fair Lending Examination Procedures at 9 (August 2009) contained in the 'Revised FFIEC Fair Lending Examination Procedures and Use of Specialized Examination Techniques,' Federal Reserve Consumer Affairs Letter 09-6 (2009), available at www.federalreserve.gov/boarddocs/caletters/2009/0906/09-06_attachment.pdf.

[4] *See*, e.g., July 2018, Consumer Compliance Supervision Bulletin, available at https://www.federalreserve.gov/publications/files/201807-consumer-compliance-supervision-bulletin.pdf; '2014 Federal Interagency Fair Lending Hot Topics: Target Pricing for Mortgages-An Emerging Fair Lending Risk,' Consumer Compliance Outlook Live (2014), available at www.consumercomplianceoutlook.org/outlook-live/2014/federal-interagency-fair-lending-hot-topics/; '2013 Interagency Fair Lending Hot Topics: Pricing for Mortgages and Non-Mortgages,' Consumer Compliance Outlook Live (2013), available at www.consumercomplianceoutlook.org/outlook-live/2013/interagency-lending-hot-topics/.

[5] *See* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210329a.htm.

predictions being evaluated. Please also address whether any form of AI is being used or has been used in any forecasting efforts around setting interest rates, and how this forecasting is evaluated.

In addition to monitoring banks' use of AI, the Federal Reserve is taking a deliberate and careful approach to the internal use of AI and seeking a wide range of input on the benefits and risks of AI, particularly generative AI. In the supervisory process, the Federal Reserve is focused on finding opportunities to use innovative technology to enhance our supervision technology and increase efficiency. We are not utilizing AI in forecasting efforts around setting interest rates.

21. In the Acting Ranking Member's opening remarks, and in various comments made by Committee Members in the course of their individual questioning of each of the witnesses, there was a vein of skepticism about efforts each of your agencies has made to consider climate change and its associated risks in your regulatory and supervisory work.

As you seek to protect depositors, investors, workers, and the American economy as a whole, it is important for Congress to understand the complexity of your work. It is incumbent on agencies under the jurisdiction of the Banking, Housing, and Urban Affairs Committee to provide Members with insights into: (1) why you seek to collect and analyze particular bits of information and data; (2) why you and your staffs take pains to understand the challenges to the institutions under your respective authority presented by various factors; and (3) how a lack of attention to these factors by both regulated entities and their regulators might have cascading effects outside individual institutions and across the broader economy.

As such, please respond to the entire Committee to the following questions:

a. Why are the risks associated with climate change of concern given your agency's mandate?

b. What potential effects to individual companies or the broader economy might result from ignoring those risks?

c. Can you explain how more complete and more transparent information regarding the risks posed by climate change to the institutions over which you have authority would tend to help protect workers, investors, depositors, and the larger American economy?

d. Are there risks to American workers, investors, or depositors, or to this economy because corporations operating in multiple jurisdictions are not currently required to disclose some information to U.S. regulators that they routinely disclose to regulators in other jurisdictions?

e. Are there data or other information you need to adequately address climate risk the collection or analysis of which are currently outside your statutory authority, and if so, what additional tools should Congress provide?

The Federal Reserve's responsibilities with respect to climate change are important, but narrow. These responsibilities are tightly linked to our responsibilities for bank supervision and financial stability. From a supervisory perspective, our primary focus is to evaluate whether banks operate in a safe and sound manner and manage all material risks, including climate-related financial risks. From a financial stability perspective, we are focused on how climate change may increase financial sector vulnerabilities.

There are two broad categories of climate-related financial risks: physical risks and transition risks. Physical risks represent the harm to people and property that may result from climate-related events, while transition risks represent stresses that may result from the transition to a lower carbon economy. Physical and transition risk drivers may affect households, communities, businesses, and governments through damages to property, shifts in business activity, or changes in the values of assets and liabilities. Both physical and transition risks can manifest as traditional risks for banks, such as credit, market, operational and liquidity risk.

To support large banking organizations—those with $100 billion or more in total assets—in their efforts to understand, measure, and manage climate-related financial risks, the federal banking agencies recently finalized a set of principles that provide a high-level framework on the management of exposures to climate-related financial risks for such large institutions.[6] The Federal Reserve also conducted an exploratory pilot climate scenario analysis exercise with six of the nation's largest banking organizations to learn about large banking organizations' climate risk-management practices and challenges and to enhance the ability of both large banking organizations and supervisors to identify, measure, monitor, and manage climate-related financial risks.

Our work in this area will remain grounded in data and tightly linked to our statutory responsibilities. The Federal Reserve is not a climate policymaker and does not prohibit or discourage financial institutions from providing services to law-abiding customers of any specific class or type, as permitted by statute or regulation.

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[6] *See* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231024b.htm.

<u>Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Ranking Member Tim Scott:</u>

1. **During the hearing you appeared to state there is no formal documentation in existence of your "holistic capital review." Can you confirm that there is in fact no such documentation?**

    a. **If there was documentation, was that documentation shared with any other members of the Fed Board?**

        i. **If so, with whom was it shared, and when?**

    b. **Can you detail what, if any, information was provided to other members of the Fed Board related to your holistic capital review?**

Upon my arrival at the Federal Reserve Board of Governors (Board), I initiated a review of capital standards at large banks. This is a prudent first step for any Vice Chair for Supervision, and consistent with the actions taken by my predecessor. This review was focused on capital requirements for large banks with more than $100 billion in total assets.

During the review, I engaged with a wide range of parties: policymakers and staff from the Federal Reserve and other agencies, banks and financial sector groups, public interest groups, members of Congress, and academics to get a broad perspective on how the Federal Reserve's capital standards interact with each other and the result they together achieve. The process did not result in the production of a specific document, but rather helped to inform my thinking that in turn helped to shape the specific bank capital proposals that have been presented to the Board.

2. **Additionally, during the Hearing you stated, in summary, that your "holistic capital review" was an internal review, that there is not a document that is the result of that review, and that the result of that process was a decision to move forward with the Basel III Endgame proposal. If there is no formal documentation of this "holistic capital review," what did you base your decision to move forward with the Basel III Endgame proposal and on?**

    a. **Please provide any and all documentation supporting your decision, including formal and informal findings, summaries, and analyses accompanying your "holistic capital review."**

As I noted above, when I arrived at the Federal Reserve, I initiated a review of the Board's capital tools to understand how they support the resilience of the financial system, individually and in combination.

Since capital requirements are multi-layered with different components, it was important to understand how the requirements function as a system—each component treats risks and associated capital needs differently, but all components together result in a certain amount of capital required. As part of the review, I looked at risk-based capital requirements, the stress capital buffer, the global systemically important bank (GSIB) surcharge, the counter cyclical capital buffer, the enhanced supplementary leverage ratio, and long-term debt requirements. As detailed in my speech last summer, I believe that the existing approach to capital requirements is sound, but work remains to update risk-based capital requirements better reflect credit, trading, and operational risk.[1] The capital proposal is one part of this important work.

3. What, if any briefings were provided to members of the Fed Board regarding the Basel III Endgame proposal and when did these briefings take place?

a. What Federal Reserve staff participated in any such briefings?

b. Did you participate in any such briefings? If so, on what dates and for which of your fellow Board members?

c. Please provide any and all documentation provided to members of the Fed Board in any such briefings.

I routinely have discussions with my fellow Board members on supervisory and regulatory matters. Every Board member receives extensive information related to every rulemaking proposal before any vote is taken. On the capital proposal, an interdisciplinary team of staff who worked on all aspects of the rulemaking were made available for briefings and to answer any questions from Board members related to the draft proposal. Board member briefings and committee consideration began in the spring of 2023.

4. During the confirmation hearing for Governors Cook and Jefferson, Senator Hagerty asked whether either Governor had seen the capital proposal, to which Governor Cook noted she had not yet received the Basel III Endgame proposal. That confirmation hearing took place on June 21st. The proposed rule was released on July 27. However, during the hearing on November 14, you told Senators Rounds and Britt that the governors had, "an extensive period of time... many weeks..." to review the proposal. A month does not seem like many weeks or an extensive amount of time to review a proposal that is over 1,000 pages long and has major ramifications for the economy.

a. What are the exact dates in which you provided the final proposal to your fellow Governors?

b. In your view, is a month long enough for other Governors to provide their input and have it incorporated in a proposal of this magnitude?

c. What if any changes were made to the proposal at the request of your fellow governors? Please explain in detail.

Please see my response to question 3.

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[1] *See* https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm.

5. Has Fed staff conducted any interagency quantitative impact analysis on the combined effects of all prudential agency proposals since July 2023?

a. If yes, please provide me and my staff with complete copies of any such analysis.

b. If not, why have you not performed such an important analysis?

The Federal Reserve seeks to understand the benefits and costs of its proposals and understands that a balance must be struck between increased safety and soundness of institutions, financial stability, and the cost of compliance on banking organizations and the broader economy. The notice of proposed rulemaking for a particular proposal will include consideration of these issues based on the changes that the particular proposal would make to the existing regulatory framework. We have also solicited comment on, and are committed to carefully considering the interactions between, these proposals.

6. Has the Federal Reserve staff discussed the Basel III Endgame proposal with consumers that will be ultimately impacted by the proposal, such as small businesses, future homeowners, and other such consumers?

Public input, including from small businesses, future homeowners, and consumers, is a critical part of our rulemaking process, as it helps ensure we consider the effects of our rules. For the capital proposal, we provided an extended comment period to help ensure that stakeholders had time to review the proposal and submit comments. We also conducted a significant degree of outreach as part of the comment process.

We take comments we receive on the proposal very seriously. These comments will help us make sure we have factored all potential effects, and result in an appropriate final rule.

7. Are you concerned that the Basel III Endgame proposal's increase of retail risk weights in combination with charging for unused balances of credit lines and the gross punitive operational risk requirement could negatively affect low- to moderate-income Americans by pushing them to less regulated sectors of the financial system and less protected sources of credit? Please explain why you supported the proposal as drafted.

a. Are you concerned that increases in capital requirements under the Basel III Endgame proposal for card credit borrowing lines are likely to reduce the amount of credit available to consumers to meet unanticipated or emergency expenses?

The goal of our regulatory framework is to ensure a strong and resilient financial system that supports households and businesses, while appropriately balancing the benefits and costs of regulation.

The proposed changes are expected to have only a very modest effect on the price of credit. The economic impact analysis in the proposal assessed the impact of the proposed capital requirements on asset class-level funding costs (including for the retail asset class, which includes credit cards) and found that they would change by only a few basis points. The estimates of impact used in this analysis included the proposed credit risk requirements plus the proposed operational risk capital requirements resulting from net interest income.

As I noted above, we are carefully considering comments to the proposal.

8. Some institutions have reported that the Basel III Endgame proposal will increase their capital requirements by upwards of thirty percent. This increase is due in large part to the treatment of fee- and commission-income as part of operational risk. Given that these increases may have significant negative consequences for credit card and capital markets lending, what alternative approaches to accounting for fee- and commission-income in the services component of the operational risk requirement are the agencies considering?

Fee-based activities often have a limited balance sheet footprint and, therefore, generally do not result in meaningful credit or market risk requirements. Yet, fee-based activities can result in substantial losses due to operational risk. For example, large banks lost large sums due to settlements relating to improper business practices around mortgage securitization following the 2007-08 financial crisis. The proposal would introduce a consistent methodology for capitalizing for all operational risks for the largest banking organizations.

We recognize that different business models may be affected differently by operational risk requirements, and the proposal requests specific comment on whether the services component (which includes fee-based income) should be adjusted or limited.

Commenters have raised concerns related to the proposed risk-based capital treatment for specific activities, including activities that generate fee-based income. We are carefully considering these comments.

9. To what extent, if any, are you concerned that the Basel III Endgame proposal could harm FBO competitiveness and cause them to retreat to their home markets, decreasing competition and sources of credit for U.S. consumers?

The safety and soundness of both domestic and foreign banks operating in the United States is important for the stability of the U.S. financial system. The capital proposal would apply consistent requirements to large U.S. firms and the U.S. operations of large foreign banks operating in the United States. Foreign banks are expected to be subject to similar requirements in their home countries, as their home countries also implement the Basel standard.

10. The Federal Reserve, including Chairman Powell, prides itself on being a consensus driven organization. Will you commit to ensure that there is full consensus on the Basel III Endgame proposal?

   a. You stated during the hearing that you would look for broad consensus. How do you define broad consensus?

b. Do you believe that a proposal of this magnitude should only have broad consensus, rather than full consensus of the board?

i. If so, why?

The Board is carefully considering all the comments on the capital proposal, and I will work to achieve broad consensus among the Board's members on any final rulemaking. As was the case during the preparation of the notice of proposed rulemaking, I will continue to have regular discussions with fellow Board members on the proposal, and all Board members will continue to have extensive opportunities to receive briefings and provide input.

11. During the Covid-19 pandemic, it has been reported that much of the Federal Reserve's examination staff began offsite exams, as opposed to onsite. What percentage of exams are currently still being conducted offsite?

a. In the last six months, what percentage of exams were conducted offsite?

Exams are typically not performed fully offsite or onsite. Prior to the onset of the COVID-19 pandemic, examinations, and even portions within a single examination, were conducted both onsite and offsite and those practices have continued.

12. It has now been nine months since Silicon Valley Bank, Signature Bank, and First Republic Bank failed. During our hearing in May, I asked you if you would fire anyone who was found to be accountable in the lack of supervision surrounding the bank failures. Since then, there has been a great deal of finger pointing at everyone, except you. Have you fired anyone from the Federal Reserve as a result of the spring bank failures?

a. If so, how many individuals were fired and when?

b. Have you demoted anyone at the Federal Reserve in connection with the bank failures?

i. If so, how many individuals were demoted and when?

The Federal Reserve has not dismissed any staff member because of the events leading to the failure of Silicon Valley Bank. We are focused on addressing structural problems in supervision and regulation.

13. Governor Waller stated in his dissent of the Basel III Endgame proposal, "Finally, as this proposal applies to all firms with more than $100 billion in assets, I am concerned that we are headed down a road where we would be no longer in compliance with section 165 of the Dodd-Frank Act, as amended by the Economic Growth, Regulatory Relief, and Consumer Protection Act, which mandates tailoring for firms above $100 billion in assets and provides that firms with between $100 billion and $250 billion in assets are not subject to enhanced prudential standards unless a standard is

affirmatively applied to such firms based on specific factors set out by Congress. It is unclear to me whether this proposal meets that statutory bar."[1] Do you agree with Governor Waller?

[1] *See*, Statement by Governor Christopher J. Waller, July 27, 2023, https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm.

a. If not, why?

I am committed to maintaining the strength and diversity of the banking system, so that it can continue to provide financial services and access to credit for households and businesses. Community and regional banks serve important sectors of the economy that are often not the focus of many other financial institutions, including small businesses, middle market businesses, and consumers in rural communities. I am attentive to making sure we retain this diversity, and that our regulation and supervision reflect the size and risks associated with different firms.

Differentiating regulatory requirements based on the characteristics of banking organizations has long been an important feature of the Board's regulatory framework.

The capital proposal would apply only to banking organizations with at least $100 billion in assets, which would include fewer than 40 of the more than 4,000 banks in our financial system. For these firms, the proposal would more closely tie capital requirements to the activities of individual banking organizations by increasing the risk sensitivity of capital requirements to specific activities. It would not change capital requirements for smaller, less complex firms.

In addition, while the proposal would make changes to the current framework, it would retain important differentiation among covered banking organizations; for example, the GSIB capital surcharge and enhanced supplementary leverage ratio standards would continue to apply only to the very largest and most complex U.S. banking organizations.

Public engagement is an important part of the rulemaking process, as it helps ensure we strike the right balance between the costs and benefits of our rules. For this proposal, we provided an extended comment period to help ensure that stakeholders had time to review the proposal and submit comments. We also conducted a significant degree of outreach as part of the comment process, and we are carefully considering these comments.

14. The Financial Stability Oversight Council ("FSOC") finalized guidance on a framework to evaluate non-bank financial firms for designation as a threat to financial stability. If a company meets FSOC's new framework, it would be designated as a systemically important financial institution (or SIFI) and would be subject to Federal Reserve supervision and regulation.

In 2019, FSOC issued a commonsense proposal on this matter, however, this new guidance seeks to undo the commonsense provisions sought in 2019. In fact, the 2019 guidance evaluated firms based on their business activities, required a consideration of

the firm's financial health, and perhaps most importantly, would have required the government to conduct a cost-benefit analysis. This new guidance, however, provides FSOC with broad latitude to designate firms largely at their own discretion, and for partisan justifications such as climate-related risks.

Many financial firms in the U.S. not currently subject to Federal Reserve oversight, such as asset managers, are still subject to a great deal of regulation and oversight, often from the SEC or CFTC. Can you explain why this new guidance is justified and why you don't believe a cost-benefit analysis is necessary in the designation process?

The Financial Stability Oversight Council's (FSOC) recent guidance on nonbank designation provides important additional transparency into the FSOC's views on financial stability and the tools that are available to the FSOC to address financial stability risk. The guidance strikes the appropriate balance between the activities-based approach and preserving designation as a tool that is available to the FSOC.

15. At the Federal Reserve, there is a special subcommittee, chaired by Governor Bowman, that specifically deals with community and smaller regional banks. The point of this subcommittee is to understand effects that the policies that are proposed and implemented by the Federal Reserve have and would have on smaller institutions. Have you consulted with Governor Bowman and this subcommittee on how Basel III will affect smaller institutions?

   a. Does this subcommittee have specific views on the proposal, and if so, can you please provide us with these views?

The capital proposal would only apply to the country's largest banks—those with total assets of $100 billion or more or that have significant trading activity, which is fewer than 40 out of the more than 4,000 banks in our system. Community and regional banks would continue to be subject to the same capital requirements as they are today.

However, I routinely have discussions with my fellow Board members on supervision and regulatory matters, including the capital proposal.

16. Are you currently, or have you ever been, the subject of an EEOC or Ethics investigation or complaint—or any other agency investigation or complaint—during your time in the federal government?

   a. If so, please describe every such instance, to include the nature of the complaint or investigation, when it occurred, and its resolution.

I am not aware of any complaint or investigation of me at any point in my career.

<u>Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator Robert Menendez:</u>

1. **During your confirmation process, you made a commitment to develop a transparent process with meaningful public input on the selection of Federal Reserve Leadership. I suggested six ideas to strengthen the Reserve Bank director and president section process, and you agreed with all of them.**

    a. **What specific changes have you made to the Federal Reserve Bank President Selection process since your confirmation, and how have those changes been implemented in recent searches?**

The Federal Reserve has a strong commitment to increase the diversity of gender, race, and ethnicity, as well as breadth of background, expertise, and points of view of individuals serving throughout the organization. I remain committed to enhancing such diversity at all levels across the Federal Reserve System as it will meaningfully strengthen our ability to successfully carry out our mandate on behalf of the American people.

Under the Federal Reserve Act, the eligible members of the Federal Reserve Bank board of directors appoint the Federal Reserve Bank president, subject to the approval of the Federal Reserve Board of Governors (Board).[1] Specifically, the Federal Reserve Act provides that only Class B and C directors (that is, directors not affiliated with a bank or institution regulated by the Federal Reserve) are eligible to participate in the selection of the Federal Reserve Bank president.

Pursuant to its oversight role, the Board has communicated clear expectations to the Federal Reserve Banks to ensure that the search process is robust, transparent, fair, and inclusive, and generally conforms to best practices. Board members meet regularly with the Federal Reserve Bank search committees throughout the process to ensure that these expectations are met in practice. Reflecting these expectations, search committees over the past several years have incorporated enhancements to their processes including:

- Diverse representation among Class C and B directors;
- Diverse search committees, leadership, and interview panels;
- A clear and public description of the position and search process (including through dedicated webpages on the Reserve Banks' public websites)
- Public solicitation of candidates;
- Proactive outreach to District communities and constituencies (including through advisory committees and public webinars);
- Public engagement to explain, answer questions on, and solicit input regarding the search process;
- Retention of search firms that are committed to compiling diverse slates of candidates, and with a demonstrated track record of success in that regard;

[1] *See* 12 U.S.C. § 341.

- Diverse pools of candidates; and
- Providing an orientation to the Federal Reserve System for external candidates to ensure they are well prepared for the formal interview process.

All of these expectations have been standard in recent searches, although they may be tailored as appropriate across Districts.

b. What other changes are you working on or considering?

Within the framework outlined above, the Federal Reserve Banks continue to refine and enhance their approach to public outreach. While we see value to having a framework that reflects minimum standards for public engagement and outreach, we also see value in individual Federal Reserve Banks tailoring their approaches to local conditions and, where this leads to constructive innovation, adopting and further developing these ideas.

2. While your proposed capital rule only directly applies to banks with over $100 billion in assets, I have heard concerns that the rule might not only affect direct lending by banks, it might also push them away from holding mortgage backed securities and extending warehouse lines of credit. This could push smaller lenders that aren't directly subject to the new rule, including those that make FHA and VA loans, away from mortgage lending.

a. Have you analyzed this possibility?

b. Will you commit to working to ensure that the final rule doesn't indirectly negatively impact mortgage lending by banks that aren't subject to the rule?

The Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency want to ensure that the proposal does not unduly affect mortgage lending, including mortgages to underserved borrowers.

Commenters have raised concerns related to the proposed risk-based capital treatment for specific actives, including mortgage lending. We take comments we receive on the proposal very seriously. These comments will help us make sure we have factored all potential effects and result in an appropriate final rule.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator Mike Crapo and Senator Mark Warner:

Last year, this Committee helped advance into law the Financial Data Transparency Act (FDTA) which requires your agency to adopt specified data standards with respect to format, searchability, and transparency. The FDTA will require FSOC agencies to apply uniform data standards for the information they collect. All FSOC agencies are to draft rules about a future data standard to be available for review and comment by June 2024.

1. **What have you done to ensure your agency can and will be able to provide such standards that meet the requirements set forth in the law by June 2024?**

Staff from across the Federal Reserve System (System) are collaborating on this rulemaking. We are cataloguing our data collection and data sharing practices across the System and assessing the impact of the Financial Data Transparency Act (FDTA) on those collections and practices.

In addition, the Federal Reserve Board (Board) actively participates in an interagency working group of Financial Stability Oversight Council agencies that have been deliberating on potential standards and is targeting the release of a notice of proposed rulemaking by June 2024, in accordance with the requirements of the FDTA. As part of that process, Board staff has attended meetings with a range of external stakeholders.

2. **Are you confident all required FSOC agencies are making uniform data standards a priority?**

The interagency working group includes staff from all eight agencies required by the FDTA to jointly establish data standards working together to propose a rule by June 2024.

3. **Will you provide us an update on your progress by no later than February 28th, 2024?**

We remain committed to releasing a notice of proposed rulemaking by June 2024 in accordance with the requirements of the FDTA.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator Elizabeth Warren:

1. **Has Congress appropriated a precise dollar amount that the Federal Reserve Board must spend in a given year?**

The Federal Reserve Board (Board) does not receive appropriated funds from Congress.

2. **Is the Federal Reserve Board legally required to spend the entire amount appropriated to it by Congress?**

Please see my response to question 1.

3. **Have the annual earnings of the Federal Reserve System ever exceeded the Board's annual budget? In that event, how are surplus funds used or handled?**

Annualized earnings of the Federal Reserve System (System) have exceeded the System's annual expenditures. The Federal Reserve Act requires the Federal Reserve Banks to remit excess earnings to the U.S. Treasury after providing for operating costs, payments of dividends, and any amount necessary to maintain surplus.

4. **Is Congress's appropriation of funds to the Federal Reserve Board limited to a particular timeframe?**

Please see my response to question 1.

5. **Does the Federal Reserve Board possess both policymaking and law enforcement authority?**

The Board conducts its operations in accordance with the statutory authorities granted to it by Congress. Thus, to the extent Congress has granted the Board policymaking and authority to enforce Acts of Congress, the Board carries them out in accordance with the parameters established by Congress under the relevant statutory provisions.

6. **Does the Federal Reserve Board exercise executive powers?**

The Board exercises the powers given to it by Congress.

7. **On November 16, 2023, the Wall Street Journal reported that "Wells Fargo is struggling with its regulatory obligation to monitor financial crime…[and] [r]egulators have issued the bank formal orders to be better at catching criminals who may be using its accounts or products."[1] I am concerned about these reports, which, if true, would provide additional evidence that Wells Fargo has still not addressed its chronic problems.**

[1] Wall Street Journal, Regulators Say Wells Fargo Isn't Doing Enough to Police Customers Crimes," Nov. 16, 2023, https://www.wsj.com/finance/banking/regulators-say-wells-fargo-isnt-doing-enough-to-police-customer-crimes-0809281d.

a. **Wells Fargo is currently under a consent order with the Federal Reserve that caps the bank's growth. What is the current status of this consent decree?**

b. **Will the Federal Reserve consider these new allegations as it reviews the status of the consent decree?**

c. **If Wells Fargo is unable to address its company-wide problems related to risk management, customer service, and compliance with the Bank Secrecy Act and anti-money laundering laws, what additional actions can the Federal Reserve take on top of the current consent decree?**

The Board imposed an asset cap on Wells Fargo because of the firm's long-standing, serious governance, risk management and control issues. We are continuing to hold the firm accountable for its deficiencies with the unprecedented asset cap that will stay in place until the firm has comprehensively fixed its problems. If the firm is unable to fix its problems, including any new deficiencies that arise, we are prepared to take additional actions to address the risk to consumers and to the financial system.

<u>Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator Catherine Cortez Masto:</u>

1. **In a recent report, *FHLBanks at 100: Focusing the Future*[1], the Federal Housing Finance Agency stated, "FHLBanks cannot functionally serve as the lender of last resort, particularly for large, troubled members that have significant borrowing needs over a short period of time." The FHFA plans to provide guidance to FHLBanks to coordinate with their members and their members' primary regulators to ensure they have established protocols to borrow from the Federal Reserve's discount window."**

   [1] https://www.fhfa.gov/PolicyProgramsResearch/Programs/Pages/FHLBank-Focusing-on-the-Future.aspx.

   a. **How is the Federal Reserve working with the Federal Home Loan Banks to ensure banks and credit unions establish protocols to borrow from the Federal Reserve's discount window prior to a time of stress?**

   b. **How will proposed changes by the FHFA to require more mission-focused advances by member financial institutions affect bank examination practices of your institution?**

   c. **How will proposed changes to strengthen member risk management and improve member creditworthiness[2] affect bank examination practices of your institution?**

      [2] Ibid, page. 34.

Federal Reserve lending to depository institutions (the discount window) plays an important role in supporting the liquidity and stability of the banking system and the effective implementation of monetary policy. By providing ready access to funding, the discount window helps depository institutions manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress. Thus, the discount window supports the smooth flow of credit to households and businesses. Providing liquidity in this way is one of the original purposes of the Federal Reserve System and other central banks around the world.

To encourage depository institutions to incorporate the discount window as part of their contingency funding plans, in July 2023, the federal financial institution regulatory agencies updated their existing guidance on liquidity risks and contingency planning.[1] Consistent with other contingency funding sources, the guidance reinforces the supervisory expectation that if the discount window is part of a depository institution's contingency funding plans, the depository institution should establish and maintain operational readiness to use the discount window, which includes conducting periodic transactions. To that end, examiners should ensure banks understand all operational steps and lender requirements to access funding quickly and

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[1] *See* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230728a1.pdf.

effectively, especially in emergency situations. Banks should also understand what circumstances would impact funding access and include scenarios in their contingency funding plans in which access to key funding sources is reduced or eliminated.

Many of our supervised institutions use Federal Home Loan Bank (FHLB) advances as part of their contingency funding plans. Examiners plan to work with any banks that could be affected by any change in FHLB lending policy, including by emphasizing the importance of updating contingency funding plans. This includes identifying reliable contingent funds providers, routinely testing access to those providers, and thoroughly understanding of processes and timing for moving any prepositioned collateral from a FHLB to identified reliable contingent funds providers.

d. Do you see any opportunities to align Community Reinvestment Act goals with FHFA's mission-focused investments by the Federal Home Loan Banks? For example, should Community Investment Cash Advances or Community Investment Program advances qualify for CRA credit?

The Community Reinvestment Act (CRA) requires the Federal Reserve Board of Governors (Board), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) (collectively, the agencies) to assess a bank's record of meeting the credit needs of its entire community, including low- and moderate-income (LMI) neighborhoods. The CRA final rule is intended to provide greater clarity and consistency in the application of the CRA regulations, including by increasing specificity around which activities qualify as community development activities. The agencies expect that many activities financed by mission-focused investments by the FHLBs would qualify for consideration under the CRA final rule as community development activities.

Specifically, as it relates to activities financed by FHFA's Community Investment Cash Advances and Community Investment Program Advances, such activities could qualify for CRA consideration when meeting the requirements set out in the final rule.[2] For example, activities under the economic development category of the Community Investment Program may align with the eligibility criteria of the revitalization or stabilization category of community development under the CRA final rule as both include targeting of LMI geographic areas. However, in seeking consideration under the CRA final rule, activities financed by FHFA mission-focused investments would require a case-by-case review, as there are some differences in the eligibility standards, and therefore not all activities will qualify.[3]

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[2] *See* Report on 2022 Federal Home Loan Bank Targeted Mission Activities at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2022-FHLBank-Targeted-Mission-Activities-Report.pdf.

[3] For example: The standards for housing under FHFA's Community Investment Program include household incomes up to 115 percent of area median income, while CRA generally provides community development consideration for affordable housing that benefits or serves residents up to 80 percent of area median income. *See* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/frn-cra-20231024.pdf.

In addition to increasing specificity around which activities qualify as community development activities, the CRA final rule establishes a confirmation process through which any bank can request a determination as to whether a particular activity would be eligible for CRA consideration as a community development activity. Although this confirmation process has not yet been implemented, a bank that has a question about a particular FHLB program will be able to utilize that process to confirm eligibility.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator John Fetterman:

1. What has your agency done since the Silicon Valley Bank collapse to ensure something similar collapses won't happen again?

Since the bank failures last spring, the Federal Reserve has been moving forward with ways to improve the speed, force, and agility of supervision as appropriate. Supervision must intensify at the right pace, especially as a firm grows in size or complexity, and critical issues that present safety and soundness concerns should be addressed quickly by banks and supervisors. In considering improvements to supervision, we are mindful of the differences in size, risk, and complexity of supervised institutions and the importance of maintaining the strength and diversity of banks of all sizes that serve communities across the country.

Furthermore, supervisors have been focused on addressing material risks presented by the current economic environment as well as the rapid pace of innovation. To mitigate these risks, in 2023, the Federal Reserve intensified examination efforts on assessing banks' preparedness for managing liquidity and interest rate risks. Efforts include closely evaluating liquidity risk management practices and contingency funding plans, assessing banks' preparedness to manage unexpected deposit outflows, and initiating continuous monitoring for a small number of firms with a risk profile that could result in funding pressures for the firm.

It is crucial that banks have a diversified range of liquidity sources that they are able to access in a variety of conditions. Examiners are emphasizing that funding sources should be highly reliable and that banks should have sufficient collateral pledged so they can quickly access funding when needed.

Examiners are also paying close attention to firms reporting high levels of unrealized losses on securities and other assets to ensure they are taking steps to preserve and maintain adequate liquidity and capital as needed. When warranted, the Federal Reserve is conducting targeted examinations at banks with higher levels of unrealized losses on securities. We have communicated with supervised banks regarding the interest rate environment and the impact on investment securities market values. Examiners also conducted horizontal reviews to assess interest rate risk management practices across large firms. These reviews assessed the adequacy of firms' risk management processes to identify, measure, monitor, and, as needed, mitigate interest rate and related liquidity risks.

2. Banks and credit union regulators have the power to remove bad actors and ban them from working in the industry. How often do you use this power?

The Federal Reserve relies on its statutory authority to remove an individual from a banking institution and prohibit them from working at other financial institutions under specific circumstances. In order to impose a removal and prohibition sanction, the Federal Reserve must consider whether each of three statutory criteria are met: misconduct (typically, a violation of law, unsafe and unsound practice, or breach of fiduciary duty), culpability (the individual must knowingly or recklessly participate in the conduct or the conduct must evidence personal dishonesty) and effect (the misconduct caused or is likely to cause financial loss or other damage to the institution, prejudiced the interests of depositors, or resulted in financial gain to the individual). The Federal Reserve's removal and prohibition orders are publicly available at https://www.federalreserve.gov/supervisionreg/enforcementactions.htm.

3. **Crypto isn't money. You can't fill up your gas tank and pay in crypto. However, it's apparently pretty useful for funding Hamas terrorism. Would you ever invest in crypto?**

Under the Investment & Trading Policy for Federal Open Market Committee (FOMC) Officials, senior FOMC officials are prohibited from investing in a wide range of financial assets to ensure public confidence in the impartiality and integrity of the FOMC's work including Treasury bonds and notes; agency securities; cryptocurrencies; commodities; or foreign currencies.[1] In compliance with this policy, I do not own any cryptocurrencies.

4. **Do you think banks can really evaluate the risks of crypto or should they stay out of it entirely?**

The crypto-sector has been marked by significant volatility and vulnerabilities. The Federal Reserve Board (Board) has highlighted in recent public statements key risks associated with crypto-assets and crypto-asset sector participants of which banking organizations should be aware. We have also reminded banking organizations of these risks and of their responsibility to ensure that the activities they engage in are conducted in a safe, sound, and legally compliant manner. It is important that banks engaging with this new sector understand and manage associated risks.

Banks must put in place appropriate controls to mitigate risks and ensure compliance with laws and regulations. The Board will continue working with other bank regulatory agencies to monitor and assess the risks and benefits associated with crypto-asset-related activities.

5. **Bank and credit union employees are excluded from whistleblower protections under the new anti-money laundering whistleblower law. Do you believe we should change the current whistleblower laws to give employees as much protection as possible when they call out fraud and money laundering?**

The Federal Reserve encourages all persons to report information regarding any banking organization the Federal Reserve supervises or any director, officer, or employee of such banking organization that may have engaged in unsafe or unsound practices, violations of law or regulation, or violations of any orders or written agreements issued by the Federal Reserve.

The Federal Reserve is also authorized to provide monetary incentives to individuals who come forward to report possible violations of certain federal banking laws.

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[1] *See* https://www.federalreserve.gov/monetarypolicy/files/FOMC_InvestmentPolicy.pdf.

The extent to which the statutory protections should be enhanced for whistleblowers is ultimately a determination for Congress.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator Mike Rounds:

1. **Earlier this year, the Securities and Exchange Commission proposed the "Safeguarding Advisory Client Assets" rule which would expand the role of qualified custodians when registered investment advisers take custody of assets on behalf of their investors. As drafted, the proposal would ultimately transform the way in which a bank holds client cash, requiring banks to segregate cash deposits. As proposed, mandatory cash segregation would significantly increase the cost and complexity of providing custody services. What studies has the Fed completed on the impact and costs associated with mandatory cash segregation?**

We are aware of the Securities and Exchange Commission's (SEC) proposal related to safeguarding customer assets and its proposed cash segregation requirement for client funds of registered investment advisers. The proposed rule would, if adopted, require a significant change in custody practices at depository institutions. The Federal Reserve has been in contact with the SEC regarding the proposed rule to share our views and technical knowledge. Ultimate rulemaking authority under the federal securities laws, however, rests with the SEC.

2. **What official correspondence and coordination did the Federal Reserve have with SEC, OCC, or FDIC in advance of the Safeguarding Proposal on the treatment of cash segregation?**

Please see my response to question 1.

3. **What did your "holistic capital review" consist of?**

When I arrived at the Federal Reserve, I initiated a review of our capital tools to understand how they support the resilience of the financial system, individually and in combination. This is a prudent first step for any Vice Chair for Supervision, and consistent with the actions taken by my predecessor. This work focused on whether changes to the capital requirements for large banks with more than $100 billion in assets would be appropriate to better align capital requirements with risk-taking to help ensure that our banking system is sufficiently resilient to serve its vital role in the U.S. economy. Since capital requirements are multi-layered with different components, it was important to understand how the requirements function as a system—each component treats risks and associated capital needs differently, but all components together result in a certain amount of capital required. As part of the review, I looked at risk-based capital requirements, the stress capital buffer, the globally systemically important bank surcharge, the counter cyclical capital buffer, the enhanced supplementary leverage ratio, and long-term debt requirements. The conclusions are detailed in my speech at the Bipartisan Policy Center last summer.[1]

4. **If the "holistic capital review" was not a document and since it has been used a justification for the Basel III Endgame Proposed Rule, please provide a list of all the**

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[1] *See* https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm.

meetings you took during this process and include whether fellow board members where invited.

During the review, I engaged with a wide range of parties: policymakers and staff from the Federal Reserve and other agencies, banks and financial sector groups, public interest groups, members of Congress, and academics to get a broad perspective on how the Federal Reserve's capital standards interact with each other and the result they together achieve.

5. How many days did Governors have access to the Basel III Endgame Proposal outside of the blackout periods that occur prior to FOMC Meetings?

Every member of the Federal Reserve Board (Board) receives extensive information related to every rulemaking proposal before any vote is taken. On the capital proposal, an interdisciplinary team of staff who worked on all aspects of the rulemaking were made available for briefings and to answer any questions from Board members related to the draft proposal. Board member briefings and committee consideration began in the spring of 2023.

6. The Basel III Endgame proposal's corporate exposures provision would assign a higher risk weight for corporate exposures to investment grade non-public companies versus their public companies. Have you taken into account non-public companies that require a strong disclosure regime by state regulators – such as insurance companies?

The proposal aims to increase the strength and resilience of the banking system by updating our rules to better align capital requirements with risk.

For corporate exposures, the proposal would introduce a more risk-sensitive standardized approach that would allow certain exposures to qualify for lower risk weights. In particular, corporate exposures that are deemed to have very high credit quality and that are also subject to enhanced transparency and market discipline from being listed on a public exchange would be eligible for a lower risk weight.

Commenters have raised concerns related to the proposed risk-based capital treatment for specific activities, including exposures to non-public companies. We are in the process of reviewing and assessing the data and comments received.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator John Kennedy:

1. **Vice Chair Barr, the goal of the Basel Committee was to achieve a greater level of predictability and standardization of banking regulation across international jurisdictions. We've seen through the proposal, and by what the E.U. and British banking authorities have put forth, that the implementation of the Basel III reforms will not be standard across the world and that implementation in the United States will be much stricter than the regulations that were agreed to, and brokered by, the U.S. representatives to the Basel Committee.**

    a. **Vice Chair Barr, the proposal did not provide a clear justification or rationale for imposing stricter requirements than our peers. Given U.S. banks are already held to higher capital standards than Europe and the UK, could you explain why you are trying to impose even higher requirements than our competitors and the standard you agreed to? Have you analyzed the impacts this disparate regulation will have on the competitiveness of American businesses compared to their European counterparts? Did you study the decrease in US economic growth and competitiveness as part of the proposal?**

    b. **Vice Chair Barr, other jurisdictions have also decided to delay the implementation of their Basel III proposals even further so that their regulators can better study the negative economic impacts and revise their proposals to mitigate them. Why are U.S. regulators forging ahead despite warnings from sectors such as the housing industry, agriculture, and small businesses that the proposal will have devastating effects on their access to banking?**

The Basel process is a way of building consensus with other jurisdictions on minimum standards, including with respect to capital. Minimum standards that are comparable around the world support financial stability and prevent a regulatory race to the bottom.

International comparisons can be difficult due to differences in jurisdictions, but we are closely monitoring how other jurisdictions are implementing the final Basel III reforms. Generally, the United States has had more stringent capital requirements than some other jurisdictions, and U.S. banks have continued to thrive, and in many ways outperform their global peers. Specifically, large U.S. banks have remained highly competitive and play an important role in global capital markets. I would expect this to continue after implementation.

Following the proposal, the Federal Reserve launched a data collection to gather more information from banks aligned with the specific requirements of the proposal. The additional data will further clarify the estimated effects of the proposal and inform our efforts moving forward. We intend to make summaries of the data public.

2. **Vice Chair Barr, your assertion that the Basel III Endgame proposal's impact is limited to the 37 financial institutions you referenced in the hearing is troubling. The 37 banks subject to the proposal hold 81 percent of U.S. banking assets meaning that every**

customer or client of those banks will be affected by higher capital requirements. Not only do these banks provide vital retail, mortgage, and small business lending, they also support investments in smaller financial institutions, provide underwriting and market making, among many other services. These banks don't exist in a vacuum, and by increasing funding costs through higher credit, trading, and operational risk capital requirements, American families and businesses will end up paying more.

Vice Chair Barr, what analysis have you done which shows that there will be no trickle-down effect of the costs of this proposal to smaller banks and financial institutions such as CDFIs or MDIs?

I am committed to maintaining the strength and diversity of the U.S. banking system so that it can continue to provide financial services and access to credit for households and businesses. Community and regional banks serve important sectors of the economy, including small businesses, middle market businesses, and consumers in rural communities. I expect the proposal to enhance the overall resilience of the financial system, which would benefit market participants including community banks.

Community and regional banks are not subject to the capital proposal and would continue to be subject to the same capital requirements as they are today. This includes the option available to qualifying community banks to comply with a simplified community bank leverage ratio requirement. In addition, community banks are not typically dependent on large banks for funding, so the proposal is not expected to have a meaningful impact on community banks' access to funding.

Many commenters raised concerns related to the impact of the proposal on broader economic activity, outside of the affected banks. We are carefully considering these comments.

3. **There has been a lot of discussion around the impact to small business lending from this proposal. Under the Basel III Endgame proposal, small and mid-size businesses would be disadvantaged as loans to unlisted private companies would be subject to higher capital requirements. The vast majority of American businesses, not just small businesses, aren't publicly traded and instead rely on banks for funding. Under the new capital proposal, banks would likely charge more or be incentivized to cut lending to these otherwise-creditworthy small businesses. Other jurisdictions like the UK or EU have recognized this issue and have chosen to drop the public listing requirement.**

    a. **In light of the solution that other Basel jurisdictions have implemented, is there a particular reason why the U.S. proposal hasn't addressed the public listing requirement disparity despite the fact it will unfairly punish our main street businesses?**

    b. **Given the lack of rationale for this punitive treatment of otherwise creditworthy businesses, have you conducted in depth cost-benefit analysis to determine the detrimental impact this could have on America's small and mid-size businesses and to our economy?**

We recognize the importance of small businesses in the U.S. economy, and that banks are an important provider of financial services to small businesses.

For small business exposures, the capital proposal would introduce a more risk-sensitive standardized approach that would allow certain exposures to qualify for lower risk weights. Small business lending tends to entail limited individual exposures spread across a diversified set of borrowers or to be secured by real estate. Our impact analysis indicates that small business loans meeting either of these criteria would generally have flat or slightly lower capital requirements, inclusive of the operational risk requirement.

Loans not meeting these criteria, generally meaning a particularly large loan to a small business, would continue to be classified as a corporate exposure. For corporate exposures, the proposal would introduce a more risk-sensitive standardized approach that would allow certain exposures to qualify for lower risk weights. In particular, corporate exposures that are deemed to have very high credit quality and that are also subject to enhanced transparency and market discipline from being listed on a public exchange would be eligible for a lower risk weight.

The proposal requested specific comment on this treatment and what else the agencies could consider for purposes of identifying lower risk corporate exposures. We are in the process of reviewing and assessing the data and comments received.

4. **Historically the Federal Reserve has been a consensus driven organization--previous capital and other regulatory proposals generally have been agreed to by the whole board. Chair Powell recently said the final Basel III Endgame rule would be consensus driven and gain broad support. When the Basel III Endgame proposal was put out for comment, multiple board members expressed either deep concerns with the rationale and content of the proposal, or reservations about its potential impacts. It has been heartening to hear that Chair Powell is reaffirming a commitment to consensus and broad support from the Board. Trust in the Federal Reserve is based in that commitment and the historical precedent that has governed to this point.**

    a. **Vice Chair Barr, will you consider substantially altering, or reproposing the Basel III Endgame proposal to better reflect the concerns of your fellow board members?**

    b. **Will you commit to allowing the public to have the full results of the still-ongoing quantitative impact study in hand in order to fully consider the impacts of the proposal when commenting? Will you commit to reproposing the rule if comments suggest major changes are necessary, as is included in the APA?**

We are carefully considering all the comments on the capital proposal, and I will work to achieve broad consensus among the Board's members on any final rulemaking. As was the case during the preparation of the notice of proposed rulemaking, I will continue to have regular discussions with fellow Board members on aspects of the proposal, and all Board members will continue to have extensive opportunities to receive briefings and provide input.

The Federal Reserve launched a data collection to gather more information from banks aligned with the specific requirements of the proposal. The additional data will further clarify the estimated effects of the proposal and inform our efforts moving forward. We intend to make summaries of the data public.

I am confident that our rulemaking process is transparent, deliberative, thoughtful, and consistent with the Administrative Procedure Act. We welcomed comments on all aspects of the proposal and continue to review and assess those comments.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator Bill Hagerty:

1. **The operational risk requirement, as currently structured, would particularly penalize income generated by fees and commission as compared to other forms of revenue. Unlike interest income (which is both capped and netted) and trading revenue (which is netted), a bank must include the gross amount of fee- and commission-based income (or expense) in the services component of the operational risk requirement. This approach would significantly overcapitalize fee- and commission-based business lines relative to their underlying risks, and make it more challenging for Americans to access the credit and the capital markets—at a time when access to credit is already harder to come by. The Basel Committee itself acknowledged the problem with the overcapitalization of fee and commission income in the services component but, unfortunately, abandoned efforts to fix it without providing a rationale. To address the overcapitalization of fee and commission income in the services component, what alternative approaches, such as netting fee and commission income from expense or weighting the fee and commission income associated with different business lines based on historical losses associated with each business line, are the agencies considering?**

Fee-based activities often have a limited balance sheet footprint and, therefore, generally do not result in meaningful credit or market risk requirements. Yet, fee-based activities can result in substantial losses due to operational risk. For example, large banks lost large sums due to settlements relating to improper business practices around mortgage securitization following the 2007-08 financial crisis. The proposal would introduce a consistent methodology for capitalizing for all operational risks for the largest banking organizations.

We recognize that different business models may be affected differently by operational risk requirements, and the proposal requested specific comment on whether the services component (which includes fee-based income) should be adjusted or limited.

Commenters have raised concerns related to the proposed risk-based capital treatment for specific activities, including activities that generate fee income. We are in the process of reviewing and assessing the data and comments received.

2. **In the International Banking Act of 1978, Congress explicitly requires "national treatment" as a guiding principle in the regulation of internationally headquartered banks operating in the U.S., which gives them with the same competitive opportunities as domestically headquartered institutions. This also facilitates U.S. banking organizations' ability to expand into non-U.S. markets where they would expect comparable national treatment applied to them. In the Basel III Endgame proposal, however, the Operational Risk charges will disproportionately impact internationally headquartered banks without adequate justification. Given the disproportionate impact on international banks, it appears there has been a policy shift at the Federal Reserve. Can you comment on the Federal Reserve's current views on national treatment? Are you worried about the potential for regulatory retaliation abroad for U.S headquartered banks operating in other jurisdictions?**

The safety and soundness of both domestic and foreign banks operating in the United States is important for the stability of the U.S. financial system, and the proposal would apply consistent requirements to large U.S. firms and the U.S. operations of large foreign banks operating in the United States. Foreign banks are expected to be subject to similar requirements in their home countries, as their home countries also implement the Basel standard. We requested comment on the proposal, and we are in the process of reviewing and assessing the data and comments received.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator Katie Britt:

1. **On October 25th, the Federal Reserve, FDIC and OCC issued a 1,500-page final rule to reform the Community Reinvestment Act. In doing so, your agencies classified all banks that have over $2 billion in assets as "large banks" subject to new and complex tests – making no distinction between a $2 billion community bank operating in Huntsville, Alabama from a $2 trillion Wall Street bank. The rule will leave the smallest institutions to face considerable compliance costs, burdens, and a reduced ability to offer credit.**

   I have heard directly from banks in Alabama that they will have to take steps to restrict credit availability outside of an immediate market area in order to avoid the likely penalties and increased tests to which they will be subject under this rule. I have also heard that many of these community banks that have already served the needs of their communities satisfactorily will likely be downgraded simply by being subject to these new tests.

   a. **Could you please explain the rationale and justification for this 1,500-page exercise?**

   b. **What studies did the Federal Reserve conduct to understand the effects of this rule on community banks and their ability to offer credit to consumers and small businesses in Alabama and across the country?**

In developing the final rule, the Federal Reserve Board of Governors (Board), the Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (together, the agencies) sought to balance the compliance burden associated with the final rule's requirements with the agencies' objectives in modernizing the CRA rule. As described further in the preambles to the proposed and final rules, the agencies' objectives were the following:

- Strengthen the achievement of the core purpose of the statute;
- Adapt to changes in the banking industry, including the expanded role of mobile and online banking;
- Provide greater clarity and consistency in the application of the regulations;
- Tailor performance standards to account for differences in bank size and business models and local conditions;
- Tailor data collection and reporting requirements and use existing data whenever possible;
- Promote transparency and public engagement;
- Confirm that CRA and fair lending responsibilities are mutually reinforcing; and
- Promote a consistent regulatory approach that applies to banks regulated by all three agencies.

In balancing these objectives with concerns, several features of the final rule are tailored to account for differences in bank size, business models, and local conditions. For instance, certain new data requirements in the final rule apply only to large banks with over $10 billion in assets, and there are no new data requirements for small and intermediate banks.

The agencies have conducted a multi-year public engagement process to understand the effects of modernizing the CRA rule, beginning with the Board's Advanced Notice of Proposed Rulemaking in 2020. The preamble to the final rule contains analyses of the compliance impact of the final rule on banks, as required by law. In addition, as described in the preamble to the final rule, the agencies used historical data to estimate the distribution of Retail Lending Test conclusions that intermediate and large banks would have received had the final rule been in effect from 2018-2020, including in new types of assessment areas. The analysis concludes that Retail Lending Test conclusions of 'Low Satisfactory' or higher are generally attainable.

2. **In your written testimony for the Senate Banking Committee hearing on November 14, 2023, you stated that "community banks will not be affected by this proposal," in regards to the Basel III endgame proposed rule.**

    a. **What research did the Federal Reserve conduct, and which community banks did your agency speak to directly to inform this conclusion?**

    b. **Understanding that the new capital requirements will only directly apply to banks with over $100 billion in assets, do you disagree that the heightened requirements will directly impact overall U.S. market liquidity and lending activity, which could encompass small institutions, businesses and consumers?**

    c. **Do you believe that there will be zero impact to community banks – even if indirectly – as a result of this rule, as is stated in your testimony?**

I am committed to maintaining the strength and diversity of the U.S. banking system so that it can continue to provide financial services and access to credit for households and businesses. Community and regional banks serve important sectors of the economy, including small businesses, middle market businesses, and consumers in rural communities. I expect the proposal to enhance the overall resilience of the financial system, which would benefit market participants including community banks.

Community and regional banks are not subject to the capital proposal and would continue to be subject to the same capital requirements as they are today. This includes the option available to qualifying community banks to comply with a simplified community bank leverage ratio requirement. In addition, community banks are not typically dependent on large banks for funding, so the proposal is not expected to have a meaningful impact on community banks' access to funding. The Board requested comment on all aspects of the proposal, including the effects of the proposed changes applicable to larger banking organizations on smaller banking organizations. We are carefully considering these comments.

3. **Do you anticipate the Federal Reserve's recent proposed rule to lower Regulation II's Debit Card Interchange fees will inhibit community banks' ability to reach the**

unbanked in their communities through free checking offerings, as these programs are funded directly by interchange revenues?

The Dodd-Frank Wall Street Reform and Consumer Protection Act directs the Board to establish standards for assessing whether the amount of any interchange fee that an issuer may receive or charge with respect to a debit card transaction is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. The Board established such standards in 2011 by adopting a cap on the interchange fee that a large debit card issuer can receive for most debit card transactions. The amount of the cap was based on data reported to the Board by large debit card issuers concerning the costs those issuers incurred in connection with debit card transactions in 2009.

To ensure that the interchange fee cap continues to fulfill the statutory mandate, the Board issued a proposal on October 25, 2023, to update the interchange fee cap. Specifically, the proposal would update the cap to reflect the significant changes since 2009 in the costs incurred by large debit card issuers in connection with debit card transactions. The proposal would also establish a regular process for updating the interchange fee cap every other year going forward based on data reported to the Board in the future by large debit card issuers.

As provided by the statute, small issuers—those with consolidated assets of less than $10 billion—are exempt from the interchange fee cap. As such, any revisions to the interchange fee cap would not apply to community banks.

Based on this experience, the Board does not anticipate that the proposed changes to the interchange fee cap would affect community banks' interchange fee revenue and, by extension, should not alone have implications for efforts to reach the unbanked in their communities. The proposal seeks feedback from the public on the potential economic impact of the proposal. The Board looks forward to reviewing feedback from all stakeholders on this topic.

4. **During the Senate Banking Committee hearing on November 14, 2023, we discussed concerns regarding the cumulative impact of the Basel III proposed rule and other concurrent proposals, like those related to long-term debt, debit fee caps, and resolution planning. You indicated a willingness to extend the comment periods for the long-term debt and resolution planning proposals.**

    a. **Do you plan to extend these comment periods??**

The agencies extended the comment period on the long-term debt proposed rule to January 16, 2024. The agencies did not extend the comment period for the resolution planning proposals. The Board extended the comment period on the Debit Card Interchange Fees and Routing proposed rule to May 12, 2024.

    b. **Did your agencies conduct a cumulative impact analysis to understand the combined impacts of these rules, and will you release this information to the public?**

The Federal Reserve seeks to understand the effects of its proposals and understands that a balance must be struck between increased safety and soundness of institutions, financial stability, and the cost of compliance on banking organizations and the broader economy. The agencies have performed economic impact analysis of the capital proposal, long-term debt, and debit fee cap proposals, which were included in their respective preambles. The capital and the long-term debt proposals include analysis of the interactions of the proposals with other regulatory requirements.

5. **During the Senate Banking Committee hearing on November 14, 2023, you argued that the Basel III proposed rule will not have a significant effect on credit conditions, and that most of the proposal deals with trading and other non-lending activity.**

   In reality, because the economics of the credit card business is based on the combination of lending and fees, the operational risk charge as it applies to credit cards will increase the cost of that business, which will increase the cost of credit card lending and restrict the amount of credit that banks can provide U.S. consumers. This is because the operational risk requirement unjustifiably penalizes banks that earn income primarily from fees and commission as compared to other forms of revenue.

   a. **Please explain your determination that the operational risk charge, as it relates to fee-income, would not have an effect on credit card lending?**

The economic impact analysis in the proposal assessed the impact of the proposed capital requirements on asset class-level funding costs (including for the retail asset class, which includes credit cards) and found that they would only change by a few basis points. The estimates of impact used in this analysis included the proposed credit risk requirements plus the proposed operational risk capital requirements resulting from net interest income.

The Federal Reserve requested additional data to gather more information from banks based on the specific requirements of the proposal. We are evaluating the additional data to better understand the estimated effects of the proposal and inform our efforts moving forward. We intend to make summaries of the data public.

We take comments we receive on the proposal very seriously, including those on the calibration of the proposed rules. These will help us make sure we have factored all potential effects, and result in an appropriate final rule.

   b. **What alternative approaches are you considering to address concerns over the overcapitalization of fee- and commission-based business under the operational risk requirement?**

Fee-based activities often have a limited balance-sheet footprint and, therefore, generally do not result in meaningful credit or market risk requirements. Yet, fee-based activities can result in substantial operational losses due to, among other factors, improper business practices and process failures. For example, large banks lost large sums due to settlements relating to improper business practices around mortgage securitization following the 2007-08 financial crisis. The proposal would introduce a consistent methodology for capitalizing for all operational risks for the largest banking organizations, based on a firm's business volume and history of operational losses, and would use fee-income as a proxy for business volume in fee-based activities.

We recognize that different business models may be affected differently by operational risk requirements, and the proposal requests specific comment on whether the services component (which includes fee-based income) should be adjusted or limited. We take comments we receive on the proposal very seriously. These comments will help us make sure we have factored all potential effects, and result in an appropriate final rule.

6. **At a time when access to credit is already constrained, I am deeply concerned that the Basel III proposed rule will further push lower-income individuals out of the traditional banking system and to payday lenders or other high-cost alternatives. For example, the proposal gold-plates retail credit exposures, such as credit cards, student loans, auto loans and home loans likely making these products more unattainable for higher-risk borrowers. The mortgage facet of the proposed rule goes well beyond what was agreed to in the 2017 Basel III Framework and beyond what other jurisdictions, like the EU and UK, are implementing.**

    a. **What exactly do you believe is deficient in the Basel III agreement and what is deficient in U.S. banks that necessitates gold-plated regulations that will make homeownership more difficult for everyone, particularly minority and first-time homebuyers?**

The capital proposal would apply only to large banks with at least $100 billion in assets and banks with significant trading activities. To ensure that both large banks and small banks not subject to the proposal maintain, on average, similar levels of capital for key credit portfolios, the proposal contains adjustments relative to the international Basel Capital Accord. The large banks subject to the capital proposal would continue to also be subject to the same U.S. standardized approach as applicable to all firms, in order to maintain competitive equity across the full range of providers of credit. We have sought comment on this approach to competitive equity in light of the U.S. standardized approach requirement and the generally higher overall calibration of the proposed requirements.

The proposal would not change the credit risk treatment for loans securitized through Fannie Mae or Freddie Mac, or those securitized by Ginnie Mae and guaranteed by the Federal Housing Administration or the Veterans Affairs, which are targeted to lower wealth first-time homebuyers. These securitized loans constitute the majority of mortgage lending in our country. The proposal would ensure that banks maintain appropriate capital for the operational risk of originating and securitizing loans, including litigation risk from fair lending violations and putback risk due to underwriting practice misrepresentations.

Commenters have raised concerns related to the proposed risk-based capital treatment for specific activities, including mortgage lending. As I noted above, we take comments we receive on the proposal very seriously. These comments will help us make sure we have factored all potential effects, and result in an appropriate final rule.

7. **The largest driver of higher capital in the Basel III proposed rule comes from the new operational risk framework. According to the Federal Reserve, operational risk accounts for nearly 90 percent of the increase in capital, which will increase the cost of all bank products and services. The proposed operational risk capital requirements not only double count the risks that are already incorporated in stress tests and other supervisory tools, but it is also gold-plated from what was agreed to by the Basel Committee in 2017.**

    a. **What specific gaps do you see in the existing stress testing and model approach, which already accounts for operational losses, that warrants the double counting of risks?**

Our system of capital requirements uses multiple measures of risk, which work collectively to achieve an overall level of resilience. Minimum capital requirements, which the capital proposal would amend, establish a minimum level of capital to allow a firm to remain a viable lender and counterparty. Stress testing measures a bank's resilience against a hypothetical stress scenario. The stress capital buffer (SCB) requirement aims to ensure a large bank can withstand such a hypothetical stress scenario and remain above its minimum capital requirements. The minimum capital requirements and stress testing requirements serve complementary roles in ensuring resilience of large firms.

Operational risk is the risk of loss due to inadequate or failed processes and systems. It has resulted in substantial losses due to, for example, cyber events, rogue trading, or improper business practices. Operational risk is a key risk in banking, separate from credit and market risk, and our capital rules should ensure that it is appropriately capitalized. The capital proposal would introduce a consistent methodology for capitalizing for all operational risks for the largest banking organizations. The proposal would set minimum capital requirements based on a comprehensive view of the risks of a bank's activities. The minimum requirements are generally calibrated at a level that would allow a firm to remain a viable lender and counterparty. These changes will complement the stress test's approach to estimating operational risk.

    b. **Can you explain why you made the decision to replace a risk-sensitive model-based approach with a standardized one-size-fits-all approach that will ultimately punish borrowers?**

The capital proposal aims to improve how our capital framework captures the risks of firms' activities and to increase the consistency of requirements across firms. Internal models depend on a firm's modeling assumptions and can result in variability of requirements across firms. Banks' use of internal models when evaluating identical loans or assets often results in different capital requirements. The Basel Committee has published analysis illustrating the variability of credit-risk-weighted assets across banks. One finding was that required capital for an identical wholesale portfolio could vary by as much as 30 percent across banks based on banks' internal models.

The proposal would generally use risk-sensitive standardized requirements and thus strengthen the consistency of capital requirements across large firms. During the 2007-08 financial crisis, market participants did not trust ratios based on banks' internal models. By ensuring consistency across banks, the proposal improves transparency, which increases the credibility of requirements.

As I noted above, we take comments we receive on the proposal very seriously. These will help us make sure we have factored all potential effects, and result in an appropriate final rule.

8. Members of Congress and market participants have raised significant concerns regarding the impact the Securities and Exchange Commission's (SEC) "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer" proposal will have on the Treasury market and the ability of the government to fund itself. The SEC did not assess the proposal's impact on the ability of the government to fund itself. Has the Federal Reserve conducted a detailed analysis of this proposal's impact on Treasury liquidity and the impact on government funding? If not, will the Federal Reserve commit to conducting such an analysis prior to the SEC finalizing the Rule?

The Federal Reserve participates with the Securities and Exchange Commission (SEC), U.S. Treasury, the Commodity Futures Trading Commission, and the Federal Reserve Bank of New York in discussing issues related to Treasury markets. Federal Reserve staff regularly communicate with SEC staff on a variety of topics, including the definition of dealer in relation to government securities dealers. Ultimate rulemaking authority, however, rests with the SEC.

Questions for The Honorable Michael Barr, Vice Chair for Supervision, Federal Reserve, from Senator Steve Daines:

1. **Vice Chair Barr, the Basel III Endgame proposal will have a significant impact on the Montana agriculture sector due to changes in the Credit Valuation Adjustment model with respect to derivatives. This will increase the cost for farmers and ranchers to hedge their risks, which is critical in such an uncertain industry.**

    a. **What analysis was done with respect to the impact this would have on the agriculture sector?**

    b. **What impact will these changes have on the broader economy if farmers and ranchers can no longer hedge their risk?**

The agricultural sector is a critical part of the U.S. economy, and the capital proposal is intended to ensure that banks can serve the agricultural and other sectors in a resilient and reliable way. A safe and sound banking system is critical to a healthy economy, and strongly capitalized banking organizations are best able to support U.S. households and businesses through the economic cycle.

It is important for market participants, including end users, to have the ability to hedge their risks, and derivatives are one tool for doing that. One of the goals of the proposed rule is to help ensure that banks that facilitate hedging activities for their customers are able to serve in this role in a resilient and reliable way, in bad times as well as good. Public input, including from consumers and small businesses, such as farmers and ranchers, is a critical part of our rulemaking process.

Commenters have raised concerns related to the proposed risk-based capital treatment for specific activities, including derivatives activities. We take comments we receive on the proposal very seriously. These will help us make sure we have factored all potential effects and result in an appropriate final rule.

2. **Vice Chair Barr, Basel III Endgame's corporate exposures provision makes a peculiar distinction between public and non-public companies, especially in regard to highly regulated industries like insurance. Like publicly traded companies, all U.S. insurers are subject to periodic submissions of audited financial statements to regulators which are fully accessible public information. In the life insurance industry, the insurers with the highest financial strength ratings are all mutual or fraternal companies, not publicly traded ones. Despite this, Basel III Endgame would discourage banks from purchasing life insurance from these non-public insurers by claiming they are less creditworthy.**

    a. **Will this approach increase risk in the banking system by pushing banks to do business with life insurers with lower financial strength ratings solely on the basis they're publicly traded?**

The capital proposal aims to increase the strength and resilience of the banking system by updating our rules to better align capital requirements with risk.

For corporate exposures, the proposal would introduce a more risk-sensitive standardized approach that would allow certain exposures to qualify for lower risk weights. In particular, corporate exposures that are deemed to have very high credit quality and that are also subject to enhanced transparency and market discipline from being listed on a public exchange would be eligible for a lower risk weight.

Commenters have raised concerns related to the proposed risk-based capital treatment for specific activities, including corporate exposures. We take comments we receive on the proposal very seriously. These will help us make sure we have factored all potential effects and result in an appropriate final rule.

3. **Vice Chair Barr, I am concerned that the operational risk requirement under the Basel III Endgame proposal significantly overcapitalizes fee- and commission-based services like retail brokerage, custody, and other low risk capital markets activities. In 2014 and 2016, the Basel Committee itself acknowledged this problem, and I've heard from various institutions that the operational risk requirement charge alone will increase their capital requirements by upwards of 30 percent—significantly higher than your agencies have estimated.**

    a. **Please provide the empirical basis for implementing the operational risk requirement as it applies to asset management, wealth management, retail brokerage and custodial services.**

Fee-based activities often have a limited balance-sheet footprint and, therefore, generally do not result in meaningful credit or market risk requirements. Yet, fee-based activities can result in substantial operational losses due to, among other factors, improper business practices and process failures. For example, large banks lost large sums due to settlements relating to improper business practices around mortgage securitization following the 2007-08 financial crisis. The proposal would introduce a consistent methodology for holding capital for all operational risks for the largest banking organizations.

I recognize that different business models may be affected differently by operational risk requirements, and the proposal requests specific comment on whether the services component (which includes fee-based income) should be adjusted or limited. We take comments we receive on the proposal very seriously. These will help us make sure we have factored all potential effects and result in an appropriate final rule.

4. **Vice Chair Barr, in your testimony, you said you did not believe that the Basel III Endgame proposal will have a significant effect on credit, or credit conditions. However, a recent Bank Policy Institute blog post, entitled, "The Basel Proposal: What It Means for Retail Lending," noted that under the proposal, "the risk weight for the credit risk of consumer cards would increase from the current 100 percent to 111 percent, due to the new capital charge for unused credit lines. The addition from the**

stress test would contribute another 63 percentage points to these risk weights, elevating the cumulative risk weight to 174 percent." The post went on to say that "The newly introduced risk weight for credit card operational risk is estimated to vary between 20 percent to over 100 percent. This variation largely hinges on whether card revenues are reported as gross amounts or whether the operational risk charge calculation permits the netting of credit card-related expenses, which is arbitrary. Combined, the capital requirements for operational and credit risk of consumer cards can range between about 200 percent and 250 percent."

a. In light of these massive capital increases, is it really correct to argue that proposal will not have a significant effect on credit conditions?

The analysis in the capital proposal suggests that the increase in capital requirements for most forms of retail, commercial, and small business credit would change only modestly under the capital proposal. The bulk of the rise in required capital anticipated in the proposed rule is attributed to trading and other activities besides lending-activities that have generated outsized losses at large banks and areas where our current rules have shortcomings. We recognize that the cost of funding for a specific loan would depend on the specific risk weight for that activity, and that there may be other channels by which higher capital requirements could matter.

It is also important to consider the benefits of the proposal. Well-capitalized banks have more capacity to support the economy by continuing to lend to households and businesses through stressful conditions. A well-capitalized banking system reduces the probability that stressful conditions result in financial crises, which inflict economic costs and suffering for families and businesses in the trillions of dollars.

Commenters have raised concerns related to the proposed risk-based capital treatment for specific activities—including mortgage lending, tax credit investments, trading activities, and activities that generate fee-based income. We take comments we receive on the proposal very seriously. These comments will help us make sure we have factored all potential effects and will result in an appropriate final rule.

5. Vice Chair Barr, the payday lending sector grew after banking regulators imposed limits on small-dollar borrowing in the aftermath of the financial crisis—inadvertently increasing systemic and consumer risk.

a. To what extent have you considered the impact that the Basel III Endgame's proposal's gold plating for retail risks weights in combination with the charge for unused credit lines and operational risk requirements will have on the declining position of the banking sector in the consumer market?

The goal of our regulatory framework is to ensure a strong and resilient financial system that supports households and businesses, while appropriately balancing the benefits and costs of regulation.

Banks are part of a broader financial system, which includes nonbank financial intermediaries. The nonbank sector plays an important role in the U.S. financial system. Roughly two-thirds of household debt is held outside the banking system—and this has not changed much in recent years. We monitor the migration of activities from banks to the nonbank sector carefully.

Additionally, strengthened capital requirements for banks' activities should be complemented by greater transparency and stronger oversight for nonbanks. I support continued efforts to boost resilience of the entire financial system.

Questions for the Record from Chairman Brown for
The Honorable Martin J. Gruenberg
Chair, Federal Deposit Insurance Corporation
November 14, 2023 Hearing entitled "Oversight of Regulators: Protecting Main Street Not Wall Street."
Senate Committee on Banking, Housing, and Urban Affairs

1. **Following the bank failures earlier this year, has the FDIC observed an uptick in derivatives activity at community banks to manage interest rate risk? If so, does the FDIC have the necessary resources to supervise this activity in community banks?**

Response:
The Federal Deposit Insurance Corporation (FDIC) has not identified a material increase in community bank interest rate derivatives activity as of year-end 2023. According to the Consolidated Reports of Condition and Income (Call Report) data for the fourth quarter 2023, approximately 20 percent of FDIC-supervised community banks reported interest rate derivative activity for purposes other than trading. This estimate is in line with prior years. However, due to Call Report limitations most community banks do not report the specific types of interest rate derivative products used. Generally, most community banks seek to mitigate interest rate risk (IRR) by rebalancing earning asset and liability durations, proactively managing non-maturity deposits, and increasing capital rather than employing derivatives.

The FDIC has the necessary resources to supervise IRR and related derivatives activity at community banks. Entering into interest rate derivatives is a potentially complex activity that can have unintended consequences, including amplified losses, if used incorrectly. Accordingly, the FDIC encourages FDIC-supervised institutions to exercise appropriate due diligence and oversight. During safety and soundness examinations or targeted reviews, derivatives activities are comprehensively reviewed. The reviews focus on the institution's derivative and hedging exposures, policies and risk tolerance limits, risk management processes, hedge effectiveness and related monitoring efforts, and the accuracy of applicable financial reporting. Examiners have the requisite training and experience to enable a holistic review of the institution's derivatives and IRR mitigation strategies. Further, the FDIC's supervisory process and enforcement tools provide an effective assessment and remediation framework to address outsized IRR or derivative exposures.

2. **Is the FDIC observing any vulnerabilities in the financial system related to banks' exposure to commercial real estate?**

Response:
The commercial real estate (CRE) market is composed of several broad property types such as office, retail, hotel, industrial, and multifamily properties. Conditions in the U.S. CRE market vary by property type and geography. Broadly speaking, vacancy rates are rising in the office, multifamily, and industrial sectors. In some cities office vacancy rates are high (approximately 16 percent) and much higher than their pre-pandemic levels and well above the national average. An increase in vacant space could pressure rent growth. When this occurs at the same time as a

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property's loan comes due, its leases expire, and interest rates are elevated, it could make refinancing more difficult and challenge a borrower's repayment ability. This can pressure the credit quality of banks' CRE loans.

Asset quality metrics for the banking industry remain favorable overall, though the noncurrent and net charge-off rates increased modestly in fourth quarter 2023. The total loan noncurrent rate increased four basis points from the third quarter to 0.86 percent, driven in part by increases in nonfarm, nonresidential CRE noncurrent balances (which were up 11 basis points to 1.15 percent). The industry's total loan noncurrent rate is well below its 1.28 percent pre-pandemic average rate.[1]

There are concerning trends starting to materialize in non-owner-occupied nonfarm, nonresidential property loans in bank portfolios. The volume of noncurrent non-owner occupied nonfarm, nonresidential CRE loans increased by $2 billion, or 12.9 percent, quarter over quarter, driven by office properties. In addition, these loans had a noncurrent rate of 1.46 percent in the fourth quarter, up from 1.31 percent last quarter and 0.56 percent a year ago. This is the highest noncurrent rate reported for this loan portfolio since first quarter 2014.

Aggregate bank exposure to non-owner occupied nonfarm, nonresidential CRE is relatively modest. This category of loans makes up 9.4 percent of total industry loans, and the balance of noncurrent loans in this portfolio represents just 0.7 percent of total industry equity capital. However, aggregate figures do not fully reflect the exposure of smaller banks. About a third of all banks (33.2 percent) report a concentration in non-owner occupied nonfarm, nonresidential CRE (defined as loan balances greater than 100 percent of tier 1 capital and allowance for credit losses on loans).

3. **Do interest rates, liquidity, and unrealized losses in banks' investment portfolios continue to pose a risk to the financial system, particularly in light of the bank failures earlier this year? What is the FDIC doing to mitigate those risks?**

Response:
Financial institutions' investment portfolios and liquidity positions continue to be challenged by unrealized holding losses on debt securities that have persisted since market interest rates began to rise in early 2022. According to the FDIC's Quarterly Banking Profile for the fourth quarter 2023, net unrealized holding losses on available-for-sale and held-to-maturity debt securities totaled $477.6 billion. While this level represents a 30.2 percent decline from the prior quarter, unrealized holding losses remain well above historical averages. Many institutions use the investment portfolio as a source of income and liquidity. Unrealized holding losses may cause a

[1] The "pre-pandemic average" refers to the period of first quarter 2015 through fourth quarter 2019.

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drag on future earnings in the event funding costs increase, as the underlying securities tend to be long term and fixed rate. Unrealized holding losses on debt securities have also constrained liquid asset levels and access to funds providers in some cases. The factors have increased risk for a segment of the banking industry.

In March 2022, the FDIC expanded its offsite monitoring of institutions exposed to unrealized holding losses given the risk they pose to liquidity resilience, earnings performance, and capital adequacy. The FDIC has also strengthened examination and surveillance programs to address outsized risk to liquidity, funding, investment securities holdings, and earnings. Importantly, the FDIC has encouraged supervised institutions to revisit and enhance contingency funding plans to navigate prospective stress. To facilitate emergency funding needs, the FDIC encourages appropriate asset monetization strategies, including for held-to-maturity debt securities. The FDIC is also evaluating institutions' collateral prepositioning and operational readiness to access Federal Reserve facilities. Further, through offsite surveillance and ongoing supervision efforts, the FDIC is actively identifying, evaluating, and working with institutions that report large unrealized holding losses or undiversified funding profiles. In certain cases, supervisory reviews have resulted in the issuance of recommendations to strengthen the institutions' financial position and liquidity resilience.

The FDIC works with federal banking agencies and financial institution regulators on outreach to address asset-liability management issues that include liquidity, access to funding, and unrealized holding losses on debt securities. In 2023, the agencies held a bankers' webinar on funding and liquidity risk management,[2] and issued updated supervisory principles on contingency funding planning.[3] The FDIC has also conducted outreach to financial institutions and trade associations through our Directors' College, meetings with representatives of the banking industry, speaking engagements, and other programs. At the same time, the FDIC has been working internally and with the Federal Financial Institutions Examination Council (FFIEC) to conduct examiner training and enhance resources on liquidity and interest rate risk management.

[2] The federal and state banking supervisors jointly hosted an "*Ask the Regulators*" webinar on May 24, 2023, concerning funding and liquidity risk management.
[3] The Federal Financial Institutions Examination Council member agencies published *Updated Guidance: Interagency Policy Statement on Funding and Liquidity Risk Management on the Importance of Contingency Funding Plans* on July 28, 2023, to outline supervisory principles related to contingency funding strategies and related risk management.

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4. **Banks have previously argued that the implementation of higher capital ratios would disadvantage them relative to their international peers, yet the largest financial institutions in this country continue to operate with global footprints and remain profitable. If the capital rules were adopted as proposed, is there any concern that the largest banks in this country would not remain competitive with their international peers?**

Response:
The Basel III Notice of Proposed Rulemaking (NPR)[4] would make important changes to address the capital weaknesses identified in the 2008 financial crisis, enhance the resilience and stability of the U.S. banking system, and enable the banking system to better serve the U.S. economy. The proposal is not intended to result in the largest U.S. banks becoming less competitive relative to their international peers. Further, as you suggest, the largest financial institutions in the United States remain highly profitable and competitive on a global scale. Strong capital requirements aid their ability to serve their customers and communities during stressful periods. Indeed, this serves as a competitive advantage and also serves to support economic activity through business cycles.

5. **Some have argued that the BASEL III Endgame capital proposal will drive risky activities to less regulated portions of the financial sector. While I have long been concerned about risks in the unregulated shadow banking system, we need strong capital requirements in place for banks that have the public backing of deposit insurance and the Federal Reserve's discount window. Please explain how the capital proposal will help prevent risky activities occurring at nonbank entities from threatening our banking system. Please also discuss other regulatory tools and authorities to mitigate risks in the nonbank financial sector.**

Response:
Nonbank financial institutions have less transparency in their operations, as well as reliance on excessive leverage and volatile funding sources. When market shocks combine with these vulnerabilities, nonbank financial institutions can transmit risk into other parts of the financial system and seriously hamper the credit and financial intermediation needed to support the economy. This includes banking organizations, which often interact directly with nonbanks by providing funding to support nonbank activity. The resulting interconnections may amplify market stresses through feedback between the two sectors.

[4] 88 Fed. Reg. 64028 (Sept 18, 2023).

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A comprehensive strategy utilizing the authorities of individual agencies and the Financial Stability Oversight Council (FSOC) may address the financial stability risks posed by nonbank financial institutions. Such a strategy could include appropriately strong capital requirements for banks, complemented by greater transparency, stronger oversight and appropriate prudential requirements for nonbanks. The Basel III NPR seeks to increase the strength and resilience of the banking system by promoting strong levels of capital at the largest banking organizations available to absorb losses. One example where the Basel III NPR may mitigate the transmission of risk between nonbank financial institutions is the proposed framework for minimum collateral requirements on non-centrally cleared securities financing transactions, which would reflect the risk exposure of banking organizations to certain non-bank financial entities that employ leverage and engage in maturity transformation but that are not subject to prudential regulation. The comment period for the NPR has closed. The FDIC will carefully consider all comments submitted, including those related to the issues raised by your question.

6. **In addition to the BASEL III Endgame rulemaking, the FDIC, Federal Reserve, and OCC have also proposed related rulemakings covering the global systemically important bank (or G-SIB) surcharge, long-term debt issuances, and resolution planning. How would these rulemakings, in concert with the capital proposal, strengthen our financial system?**

Response:
These proposals would each play a role to strengthen the financial system. The Federal Reserve's G-SIB surcharge proposal would introduce greater sensitivity to the risks that the largest banks are taking, as would the Basel III NPR for large banks relative to the current standardized approach. Meanwhile, the Long-Term Debt proposal[5] would require a layer of loss-absorbing capacity at large banks, and the Resolution Planning proposal[6] would greatly strengthen the ability of the FDIC to manage a resolution of these large banks. These proposals would work to strengthen the financial system by ensuring that bank capital levels are commensurate with a bank's activities, and, in the case of a large bank insolvency, the resolution can be handled in the most cost-efficient manner with a reduced likelihood of contagion.

7. **Please explain how the FDIC intends to ensure that artificial intelligence (AI) technology is deployed at financial institutions in a safe and sound manner?**

Response:

[5] 88 Fed. Reg. 64524 (September 16, 2023).
[6] 88 Fed. Reg. 64579 (September 19, 2013).

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The mission of FDIC is to maintain stability and public confidence in the nation's financial system. In support of this goal, the FDIC insures deposits, examines and supervises financial institutions for safety and soundness and consumer protection, works to make large and complex financial institutions resolvable, and manages receiverships. The FDIC is neutral as to specific technologies used by the industry. The agency focuses on the outcomes produced by the technology, policies, procedures, and systems implemented by financial institutions to conduct its operations and deliver products and services. Regardless of the tools used by financial institutions, it is the responsibility of an institution's board and management to ensure that the institution is operating in a safe and sound manner, and in compliance with all applicable laws and regulations;[7] this includes the institution's use of any technology, including AI.

As part of its supervisory program, the FDIC uses a risk-focused examination approach to evaluate a bank's safety and soundness and consumer compliance. The examination approach focuses examiner resources on assessing management's ability to identify and control risks. For AI, this often includes assessing a bank's model risk management function. An institution's model risk management practices are expected to be commensurate with the institution's risk exposure, as well as the complexity and extent of its model use. The FDIC has hired relevant expertise to assist the FDIC in these supervisory processes. The FDIC has also issued guidance to the industry by adopting Supervisory Guidance on Model Risk Management[8] and issuing the Interagency Statement on Model Risk Management for Bank Systems Supporting Bank Secrecy Act/Anti-Money Laundering Compliance.[9]

8. Does the FDIC have the workforce and technological resources necessary to supervise institutions that are deploying AI technology across their operations at an increasing rate?

Response:
The FDIC is committed, and takes a number of measures, to ensure staff across the FDIC have the appropriate skillsets to perform their duties. This includes, but is not limited to, skillsets related to emerging technology, such as AI. These measures include workforce planning, the hiring process, training initiatives, and performance management processes, among others. The FDIC has established, and continues to develop, dedicated resources in a number of divisions to ensure appropriate skills are in place related to model risk management and AI. The FDIC's

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[7] See 12 CFR 364.
[8] See FDIC Financial Institution Letter (FIL)-22-2017, Adoption of Supervisory Guidance on Model Risk Management, June 7, 2017, https://www.fdic.gov/news/financial-institution-letters/2017/fil17022.html
[9] See FDIC FIL-27-2021, Bank Secrecy Act: Agencies Address Model Risk Management for Bank Models and Systems Supporting Bank Secrecy Act/Anti-Money Laundering and Office of Foreign Assets Control Compliance, April 2021 https://www.fdic.gov/news/financial-institution-letters/2021/fil21027.html

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approach to ensuring that appropriate skills are in place takes into consideration the FDIC's ongoing monitoring of industry trends.

While not specific to AI, in September 2023, GAO issued a report titled, *Financial Technology: Agencies Can Better Support Workforce Expertise and Measure the Performance of Innovation Offices* (Report) (GAO-23-106168). The Report examines the regulators' financial technology expertise. While the Report recognizes and reflects that the FDIC has incorporated leading workforce planning practices, the Report included a recommendation that the FDIC fully incorporate leading workforce planning practices for the primary offices involved in policymaking and oversight related to financial technology.[10] The Report included a similar recommendation to other agencies. In response to the Report, the FDIC has committed to considering additional workforce planning practices identified in the Report's recommendation.

9. **U.S. Securities and Exchange Commission Chair Gary Gensler has voiced concerns over the use of AI platforms developed by a handful of dominant technology firms, the consolidation of data used for financial decision making, and the potential for "herding" behavior to disrupt financial stability. What is the FDIC's perspective on these concerns? Is the FDIC adopting any precautions or recommending the implementation of any precautions, and, if so, what are these precautions?**

Response:
As noted above, the mission of FDIC is to maintain stability and public confidence in the nation's financial system, and is neutral as to specific technologies used by the industry. The agency focuses on the outcomes produced by the technology, policies, procedures, and systems implemented by financial institutions to conduct its operations and deliver products and services. Regardless of the tools used by financial institutions, their operations must be safe and sound, compliant with relevant laws and regulations, and conducted in a manner that is fair to consumers.

The use of AI by insured depository institutions presents opportunities and challenges for the industry and financial regulators. AI has the potential to augment business decision-making and enhance services available to consumers and businesses. However, AI also has the potential to increase risk. For instance, the use of AI could result in operational vulnerabilities, such as

[10] The Report (page 44) recommends that "The Chair of the Federal Deposit Insurance Corporation should fully incorporate leading workforce planning practices for the primary offices involved in policymaking and oversight related to financial technology by collecting staff skillset data and determining the critical financial technology skills the agency needs; developing targeted strategies to address financial technology-related skills gaps; and measuring the effectiveness of its financial technology related training in addressing skill needs."
https://www.gao.gov/products/gao-23-106168

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internal process or control breakdowns, cyber threats, information technology lapses, risks associated with the use of third parties, and model risk. The use of AI can also create or heighten consumer protection risks, such as risks of unlawful discrimination, unfair, deceptive, or abusive acts or practices under the Dodd-Frank Wall Street Reform and Consumer Protection Act, unfair or deceptive acts or practices under the Federal Trade Commission Act, or privacy concerns. Many of those potential risks are not unique to AI, but AI may present particular risk management challenges to financial institutions in the areas of explainability, data, and dynamic updating. Data plays a particularly important role in AI. In many cases, AI algorithms identify patterns and correlations in training data without human context or intervention, and then use that information to generate predictions or categorizations.

As advancements in AI continue to evolve, the FDIC's understanding of those benefits and risks to banks, the financial system, and consumers needs to continue to evolve. The FDIC has taken several approaches to continue to understand the evolution associated with AI, the level of adoption, and potential implications. Those approaches include hiring relevant expertise, issuing an interagency request for information on AI, monitoring supervised firm adoption levels through normal supervisory processes, and taking a risk-based approach to assessing risk management and compliance risk management frameworks.

10. Is the advancement of AI in the financial services industry further enabling consolidation or otherwise threatening small banks?

Response:

Technology in general has long been acknowledged as, and may continue to be, one of the underlying causes for consolidation in the banking sector. Continued digitalization of banking operations may continue to contribute to further consolidation, and to the extent AI is utilized to facilitate digitalization of operations, it may be a contributing factor. Based on current AI use cases and levels of adoption, we do not anticipate that AI alone will significantly change this pattern.

11. What action is the FDIC taking to fulfill its statutory mandate as a regulator charged with supervising financial institutions and service providers, specifically involving the identification and mitigation of risks associated with the development and deployment of AI in financial services? Has the FDIC identified any regulatory gaps? If so, what are those gaps?

Response:

As noted above, the FDIC uses a risk-focused examination approach to efficiently evaluate a bank's safety and soundness and consumer compliance. The examination approach focuses

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examiner resources on assessing management's ability to identify and control risks. For AI, this often includes assessing a bank's model risk management function. An institution's model risk management practices are expected to be commensurate with each institution's risk exposure, as well as the complexity and extent of its model use.

The FDIC has adopted Supervisory Guidance on Model Risk Management[11] and issued an Interagency Statement on Model Risk Management for Bank Systems Supporting Bank Secrecy Act/Anti-Money Laundering Compliance.[12] Along with the other Federal banking agencies, the FDIC has issued a Request for Information Request for Information and Comment on Financial Institutions' Use of Artificial Intelligence, including Machine Learning[13] to understand views on the use of AI by banks, as well as appropriate risk management, governance, and controls over AI. The FDIC continues to seek to understand the continuing evolution and advancements in AI, as well as the level of adoption by supervised institutions and potential implications.

12. How is the FDIC using AI internally, particularly in any supervisory efforts? Please provide details on the design and application of AI in the FDIC's supervisory process. Please also explain if the FDIC is utilizing any AI-generated predictions, the application of those predictions, and how are those predictions being evaluated.

Response:
The FDIC's use of AI and closely related technology in its supervisory program is currently limited to the automation of manual processes and the review of targeted supervisory and economic information. The use of this technology supports supervisory processes by improving the FDIC's ability to analyze and gain insight from large volumes of data. Example uses include automation of Reports of Examination research to identify common themes, development of offsite risk monitoring reports, and streamlining the processing of information from documents provided during examinations. The FDIC is not utilizing AI for automated prediction based decision-making. Rather, results from AI models inform human expert analysis and decision-making. The FDIC's use of this technology is subject to a range of risk controls, including independent model validation by external experts, accuracy monitoring, limitations on the use of results, and additional context-specific quality assurance measures.

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[11] See FDIC Financial Institution Letter (FIL)-22-2017, Adoption of Supervisory Guidance on Model Risk Management, June 7, 2017, https://www.fdic.gov/news/financial-institution-letters/2017/fil17022.html
[12] See FIL-27-2021, Bank Secrecy Act: Agencies Address Model Risk Management for Bank Models and Systems Supporting Bank Secrecy Act/Anti-Money Laundering and Office of Foreign Assets Control Compliance, April 2021, https://www.fdic.gov/news/financial-institution-letters/2021/fil21027.html
[13] See FIL-20-2021, Request for Information on Artificial Intelligence, March 2021, https://www.fdic.gov/news/financial-institution-letters/2021/fil21020.html

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13. In the Acting Ranking Member's opening remarks, and in various comments made by Committee Members in the course of their individual questioning of each of the witnesses, there was a vein of skepticism about efforts each of your agencies has made to consider climate change and its associated risks in your regulatory and supervisory work.

As you seek to protect depositors, investors, workers, and the American economy as a whole, it is important for Congress to understand the complexity of your work. It is incumbent on agencies under the jurisdiction of the Banking, Housing, and Urban Affairs Committee to provide Members with insights into: (1) why you seek to collect and analyze particular bits of information and data; (2) why you and your staffs take pains to understand the challenges to the institutions under your respective authority presented by various factors; and (3) how a lack of attention to these factors by both regulated entities and their regulators might have cascading effects outside individual institutions and across the broader economy.

As such, please respond to the entire Committee to the following questions:

a. Why are the risks associated with climate change of concern given your agency's mandate?

Response:
The FDIC's core mission is to maintain stability and public confidence in the U.S. financial system. The agency carries out this mission through its responsibilities for deposit insurance, banking supervision, and the orderly resolution of failed banks, including systemically important financial institutions. The agency's role with respect to climate change is centered on the financial risks that climate change may pose to the banking system, and the extent to which those risks impact the FDIC's core mission and responsibilities.

Changing climate conditions are bringing with them challenging trends and events, including rising sea levels, increases in the frequency and severity of extreme weather events, and other natural disasters. There is also the potential for past mitigation strategies to become less effective. For example, insurance policies can become more expensive or unavailable to cover climate-related losses in certain markets or for certain exposures, particularly those faced with increasing severity and frequency of weather events. These trends challenge the future resiliency of the financial system and, in some circumstances, may pose safety and soundness risks to individual banks. It is the goal of our work on climate-related financial risk to ensure that the financial system continues to remain resilient despite these rising risks.

b. What potential effects to individual companies or the broader economy might result from ignoring those risks?

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Response:
As noted above, the FDIC's role with respect to climate change is centered on the financial risks that climate change may pose to the banking system, and the extent to which those risks impact the FDIC's core mission and responsibilities. Climate-related financial risks associated with climate change could affect households, communities, businesses, and governments – damaging property, impeding business activity, affecting income, and altering the value of assets and liabilities. These risks may be propagated throughout the economy and financial system. As a result, the financial sector may experience credit and market risks associated with loss of income, defaults, and changes in the values of assets, liquidity risks associated with changing demand for liquidity, operational risks associated with disruptions to infrastructure or other channels, or legal risks. Weaknesses in how a financial institution identifies, measures, monitors, and controls the physical and transition risks associated with a changing climate could adversely affect a financial institution's safety and soundness. The adverse effects of climate change could also include a potentially disproportionate impact on the financially vulnerable, including low-and-moderate income and other underserved consumers and communities.

c. **Can you explain how more complete and more transparent information regarding the risks posed by climate change to the institutions over which you have authority would tend to help protect workers, investors, depositors, and the larger American economy?**

Response:
To aid in more transparency, the FDIC, Federal Reserve and OCC (collectively, "agencies") jointly issued *Principles for Climate-Related Financial Risk Management for Large Financial Institutions*,[14] which provide a high-level framework for the safe and sound management of exposures to climate-related financial risks. The principles are intended to promote a consistent understanding of the effective management of climate-related financial risks. The principles highlight that sound climate-related financial risk management depends on the availability of timely, accurate, consistent, complete, and relevant data, while also recognizing available data, risk measurement tools, modeling methodologies, and reporting practices continue to evolve at a rapid pace.

The FDIC recognizes risk management practices for climate-related financial risks are evolving and will continue to engage with other regulatory bodies and the industry on how best to address climate-related financial risk.

[14] 88 FR 74183 (Oct. 30, 2023).

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d. **Are there risks to American workers, investors, or depositors, or to this economy because corporations operating in multiple jurisdictions are not currently required to disclose some information to U.S. regulators that they routinely disclose to regulators in other jurisdictions?**

Response:
The FDIC will continue to engage with other regulatory bodies and the industry on how best to address climate-related financial risk, including how disclosure of such risks may promote a safe and sound banking system.

e. **Are there data or other information you need to adequately address climate risk the collection or analysis of which are currently outside your statutory authority, and if so, what additional tools should Congress provide?**

Response:
Sound climate-related financial risk management depends on the availability of timely, accurate, consistent, complete, and relevant data. The FDIC recognizes measurement methodologies, models, and data for analyzing climate-related financial risks continue to mature. The Climate-related Financial Risk Committee of the FSOC has identified work on data and methodologies as a priority. The FDIC is working with other FSOC member agencies to identify shared data needs, gaps, and limitations, as well as facilitate the sharing of climate-related data among FSOC members.

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1. **In the FDIC's internal review following the spring failure of Signature Bank, "FDIC's Supervision of Signature Bank", reports of examiner retention rates were cited as part of the reason the FDIC could not detect problems within the banks.[15] What, if anything, have you done since the issuance of this report to address these retention rate issues following this review? Please explain in detail.**

Response:
Nearly every employee in the FDIC's Division of Risk Management Supervision is a commissioned examiner. Examiners are highly specialized with a high level of expertise, requiring four years of intensive training to earn a basic examiner commission. Examiners for the largest, most complex banks generally have many more years of experience.

Like other agencies and private employers, the FDIC experienced a higher than normal level of separations among pre-commissioned examiners in 2021 and 2022. In response, the FDIC took steps to redirect and supplement examiner resources, implementing contingency operating measures allowing for temporary reassignment of qualified employees across the agency to assist with examinations; leave buybacks, leave rollover, and overtime to expand hours available for examination work; use of rehired annuitants; hiring of industry experts to assist with examination work; and pursuit of contracted assistance.

Since the issuance of the FDIC's internal review, *FDIC's Supervision of Signature Bank*, the FDIC has taken a number of actions to address examiner retention. Throughout 2023, examiner attrition returned to nearly historical levels from the heightened levels seen in 2021 and 2022, particularly among pre-commissioned examiner staff.

Another challenge has been filling dedicated examiner positions in high-cost areas, New York, NY in particular. In response to this challenge, the FDIC has taken a number of actions to enhance the attractiveness of the dedicated examiner position, including adding a corporate expert level examiner-in-charge, adding six deputy examiners-in-charge, increasing the grade of 21 examiner-in-charge positions, and instituting an incentive payment for dedicated examination team leaders; taken steps to address the high cost of living in San Francisco, New York, Seattle, and Los Angeles by adding a payment supplement to address the gap between the cost of labor and the cost of living; offered eligible examiners and case managers indicating their intent to retire before year-end a retention payment to stay for one or two additional years; and increased the career ladder for a journeyman examiner from CG 7 – CG 12, to CG 7 – CG 13 in recognition of increases in the complexity of the workload.

[15] *See,* FDIC's Supervision of Signature Bank, April 28, 2023, www.fdic.gov/news/press-releases/2023/pr23033a.pdf.

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2. **Recent reports from the Wall Street Journal cite a toxic culture at the FDIC and low workplace morale.[16]**

   a. **When did you first learn about claims of low morale at the FDIC?**

      i. **What did you learn?**

      ii. **Who told you?**

      iii. **What did you do to investigate, follow up, and/or address these claims yourself?**

   b. **When did you first learn about claims of toxic or hostile workplace culture issues at the FDIC?**

      i. **What did you learn?**

      ii. **Who told you?**

      iii. **What did you do to investigate, follow up, and/or address these claims yourself?**

   c. **When did you first learn that employees were making claims of harassment and ongoing harassment?**

      i. **What did you learn?**

      ii. **Who told you?**

      iii. **What did you do to investigate, follow up, and/or address these claims yourself?**

   d. **When did you learn that claims of harassment and ongoing harassment led many FDIC staff, including examiners, to quit their jobs?**

      i. **What did you learn?**

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[16] See, Strip Clubs, Lewd Photos and a Boozy Hotel: The Toxic Atmosphere at Bank Regulator FDIC, November 13, 2023, https://www.wsj.com/us-news/fdic-toxic-atmosphere-strip-clubs-lewd-photos-boozy-hotel-12c89da7?mod=Searchresults_pos5&page=1; FDIC Chair, Known for Temper, Ignored Bad Behavior in Workplace, November 16, 2023, https://www.wsj.com/politics/policy/fdic-chairman-martin-gruenberg-workplace-harassment-5cae85bc.

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ii. **Who told you?**

iii. **What did you do to investigate, follow up, and/or address these claims yourself?**

Response:
Fairness is a core value for the FDIC. Throughout my tenure, the FDIC has consistently maintained both an Equal Employment Opportunity (EEO) and Anti-Harassment Program in compliance with federal law.[17] Over the last ten years, the FDIC Office of Inspector General (FDIC OIG) has undertaken reviews of both the FDIC's EEO and Anti-Harassment Programs. When the FDIC OIG identified opportunities to implement improvements to those programs, the FDIC has made a diligent effort to implement those recommendations.[18] Notably, however, neither of these reviews nor the FDIC's Annual Federal EEO Statistical Reports of Discrimination Complaints[19] identified systemic or "toxic" cultural problems in the FDIC workplace.

The recent news reports regarding incidents of sexual harassment and misbehavior at the FDIC were deeply troubling, as they raise fundamental questions about the workplace culture that were not identified in previous program reviews or annual statistical reports. The FDIC takes these issues very seriously, and, in the time since the stories were first published, the FDIC has initiated and begun to execute a comprehensive, agency-wide effort to respond to these questions and ensure that every person at the FDIC feels safe, valued, and respected.

On December 1, 2023, the FDIC published a plan on the steps the FDIC will take to address workplace issues related to sexual harassment and misconduct and to ensure that all employees are provided a safe work environment.[20] The plan was prepared at my request by FDIC senior leadership and staff. The Plan reflects comments and suggestions received during listening sessions held with FDIC employees in November. The Plan also reflects input from a range of

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[17] Copies of the FDIC's Annual EEO Program Status Report (MD-715), which highlights FDIC activities undertaken in its EEO program under Title VII and its affirmative action obligations under the Rehabilitation Act are available at: https://www.fdic.gov/about/diversity/omwireports.html.
[18] See FDIC Office of Inspector General Report, *Preventing and Addressing Sexual Harassment*, EVAL-20-006, (July 2020) available at: https://www.fdicoig.gov/sites/default/files/reports/2022-08/EVAL-20-006.pdf; FDIC Office of Inspector General Report, *The FDIC's Efforts to Provide Equal Opportunity and Achieve Senior Management Diversity*, EVAL-15-001, (November 2014) available at: https://www.fdicoig.gov/sites/default/files/reports/2022-08/15-001EV.pdf.
[19] Copies of the FDIC's Annual Federal EEO Statistical Report of Discrimination Complaints (Form 462), which highlights the processing of FDIC EEO complaints under the various anti-discrimination laws are available at: https://www.fdic.gov/about/diversity/omwireports.html.
[20] See *Action Plan for a Safe, Fair, and Inclusive Work Environment* (Updated December 4, 2023), available at: https://www.fdic.gov/about/diversity/pdf/action-plan-12-4-23-v1.pdf.

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FDIC stakeholders, including the Chairman's Diversity and Inclusion Executive Advisory Council,[21] personnel in the Office of Minority and Women Inclusion, and both the Partnership of Women in the Workplace Employee Resource Group[22] and the Networking, Inclusion, and Advancement for African American Women Employee Resource Group.

On November 20, 2023, the FDIC Board of Directors established a Special Review Committee co-chaired by Director Jonathan McKernan and Director Michael J. Hsu to provide direction to and oversee an independent, third-party review of allegations of sexual harassment and interpersonal misconduct at the FDIC and management's response to harassment and misconduct.[23] The independent review will also review the FDIC's workplace culture, including any practices that might discourage or deter the reporting of or responding to sexual harassment and interpersonal misconduct. On December 8, 2023, the Special Review Committee selected the law firm Cleary Gottlieb Steen & Hamilton LLP (Cleary Gottlieb) to conduct the independent review. Under the direction of the Special Committee, Cleary Gottlieb has established several avenues for individuals to contact the law firm to share their experiences as part of the independent review, which has been communicated to all FDIC staff, including through a public release.

The FDIC is also cooperating fully with the FDIC Office of Inspector General, which has initiated a Special Inquiry and additional evaluations on the issues outlined in the recent reports of harassment and misbehavior.

There is no higher priority than ensuring that every person at the FDIC feels safe, valued, and respected, and that the agency is bringing all of its resources to bear to achieve this priority for everyone at the FDIC.

e. **Please provide any and all documentation for any complaints verbal, written, or otherwise filed to the FDIC, the EEOC, or any other governmental entity, such as the FDIC's Office of Inspector General.**

Response:
Information regarding complaints and settlements stemming from Equal Employment complaint activity is submitted on a fiscal year basis to the Congress as well as the Equal Employment Opportunity Commission (EEOC) and published to the FDIC's website.[24]

[21] The mission of the Chairman's Diversity Advisory Councils) is to provide advice to the FDIC Chairman, through the Office of Minority and Women Inclusion Director, on diversity and inclusion (D&I) issues and concerns.
[22] Employee Resource Groups are FDIC-recognized networks of employees with common goals, interests, or experiences which are established to foster and encourage equality of opportunity, respect, and fair treatment for all.
[23] See PR-93-2023, FDIC Board of Directors Establishes Special Committee to Oversee Independent Review of Agency Culture (November 21, 2023) available at https://www.fdic.gov/news/press-releases/2023/pr23093.html.
[24] *See https://www.fdic.gov/about/diversity/omwireports.html.*

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f. **Please provide the FDIC's policies and procedures for the filing, processing and/or review or handling of harassment claims.**

Response:
The FDIC is committed to providing a workplace that is free of harassment. To this end, the FDIC prohibits harassment in the workplace by or against any applicant, employee, or contractor. Similarly, the FDIC will not tolerate retaliation against any applicant, employee, or contractor, for opposing harassment, reporting harassment, or participating or assisting in any inquiry, investigation, lawsuit, or other proceeding concerning harassment.

A person claiming to have been harassed may bring a claim under the FDIC's EEOC Discrimination Complaint Process. Additionally, the person may report the harassment as provided in the Anti-Harassment Program Directive. The Anti-Harassment Program (AHP) provides an additional avenue for reporting sexual harassment outside of the EEOC Complaint Process. The AHP covers a broad scope of harassment, including harassment that does not give rise to a claim under the EEOC Discrimination Complaint Process. Copies of the EEOC and AHP procedures and other related anti-harassment and anti-discrimination policies are published annually as part of the FDIC No FEAR Act Report to Congress.[25]

g. **Please provide any delegations of authority associated with the filing, processing, and/or review of harassment claims.**

Response:

The Delegations of Authority for Personnel Actions are attached in Appendix A.

h. **What is the FDIC's process for briefing the Office of the Chairman, and the Chairman himself, on harassment claims? Please provide any policies or procedures, formal or informal, that speak to this process.**

Response:
Annually, the OMWI Director presents a State of the Agency briefing to the Chairman and Division and Office Directors, consistent with the Equal Employment Opportunity Commission's (EEOC's) guidance on implementing its Management Directive 715.[26] The

[25] *Ibid.*
[26] The Equal Employment Opportunity Commission's *Management Directive 715* provides to executive branch agencies guidance and standards for establishing and maintaining effective affirmative programs of equal employment opportunity under Section 717 of Title VII (PART A) and effective affirmative action programs under

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briefing addresses harassment complaints, among other complaints received and processed. The OMWI Director also provides the Chairman with a summary of key complaint statistics as part of the process for approving the EEOC reports.

i. **Please provide the FDIC's process, if any, for referring harassment complaints to the FDIC's Office of Inspector General.**

Response:
The FDIC refers to the FDIC Office of Inspector General (OIG) any suspected criminal activity discovered within its operations. If criminal activity is discovered in the investigation of a harassment claim made by an FDIC employee, the matter is referred to the OIG. If an allegation of harassment is made by an FDIC OIG employee, the matter is handled by the OIG.

3. **During the Senate Banking hearing on November 14, Senator John Kennedy asked you about the 2020 IG report indicating that the FDIC had not established an adequate sexual harassment prevention program. In response, you suggested that you were not to blame because you were not Chairman in 2020 when the IG report came out. However, you took over as Acting Chairman in 2022 and Chairman in 2023, and before that you were Chairman from 2012 to 2018. The IG report covers the period from 2015 to year 2019 and you were the Chair for much of this time. Will you now take responsibility for the failures that occurred under your leadership at the FDIC?**

    a. **If not, why?**

    b. **What have you done to address any inadequacies not addressed in this report or in response to this report, both in your role as Board Member and after becoming Acting Chairman in 2022 and Chairman in 2023?**

Response:
Fairness is a core value for the FDIC. Throughout my tenure, the FDIC has consistently maintained both an Equal Employment Opportunity (EEO) and Anti-Harassment Program in compliance with federal law. When these programs have come under review and opportunities to implement improvements to the FDIC's EEO or Anti-Harassment programs have been identified, the FDIC has made a diligent effort to implement recommendations.[27]

Section 501 of the Rehabilitation Act (PART B); available at https://www.eeoc.gov/federal-sector/management-directive/section-717-title-vii.

[27] See FDIC Office of Inspector General Report, *Preventing and Addressing Sexual Harassment*, EVAL-20-006, (July 2020) available at: https://www.fdicoig.gov/sites/default/files/reports/2022-08/EVAL-20-006.pdf; FDIC Office of Inspector General Report, *The FDIC's Efforts to Provide Equal Opportunity and Achieve Senior Management Diversity*, EVAL-15-001, (November 2014) available at: https://www.fdicoig.gov/sites/default/files/reports/2022-08/15-001EV.pdf.

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Following the FDIC OIG audit conducted in 2020, then-Director Gruenberg chaired the FDIC audit committee as a member of the Board, which received the report and recommendations while the FDIC's response was delegated to management under the direction of the then-Chairman.

4. **You have served on the FDIC Board since August 2005, more than 18 years. In response to questions from Senator Rounds before the Senate Banking Committee on November 14, you stated you were unaware of the allegations included in the WSJ's Monday, November 13 publication. Is it still your testimony that you were unaware of these reported claims of harassment and the widespread and abusive culture of the FDIC prior to the November 13 publication?**

    a. **If so, what does this say about your leadership at the FDIC that you could serve as Chairman, Acting Chairman, Vice Chairman, and as a Member of the Board for such an extensive period of time and yet be unaware of such claims of regarding the serious and widespread workplace issues at the FDIC for so long?**

    b. **If you were aware of these claims, when did you become aware?**

    c. **How did you become aware of these claims? Were you told over the phone, email, or in person, and if so, by whom?**

    d. **Who have you discussed these claims with inside of the FDIC and what have those discussions entailed?**

    e. **Who have you discussed these claims with outside of the FDIC and what have those discussions entailed?**

    f. **After being made aware of these claims, what actions have you taken and what actions do you plan to take to address these issues?**

    g. **The November 13 WSJ article states that the FDIC was given an opportunity to respond, but that the FDIC declined. Were you made aware of the WSJ's inquiry?**

        i. **If so, when?**

        ii. **If not, why?**

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iii. **What is the practice for making the Chairman aware of investigative reports?**

iv. **Who made the decision to decline to respond to the WSJ?**

Response:

It is the agency's prevailing practice that members of the FDIC Board are generally not informed of the specific facts or circumstances of individual disciplinary matters or of individual EEO claims. The FDIC's Office of Communications was provided with some information regarding the forthcoming stories prior to the publication of the reports in the *Wall Street Journal*, which is routine, but many specific elements of the stories were not known prior to publication.

5. **Will you commit to recusing yourself from any review of this matter and allowing the FDIC Board to effectively oversee any such review to ensure that it is thoroughly and holistically conducted? Please answer "yes" or "no."**

   a. **If no, why?**

Response:

On November 20, 2023, the FDIC Board of Directors established a Special Review Committee co-chaired by Director Jonathan McKernan and Director Michael J. Hsu to provide direction to and oversee an independent, third-party review of allegations of sexual harassment and interpersonal misconduct at the FDIC and management's response to harassment and misconduct.[28] The independent review will also review the FDIC's workplace culture, including any practices that might discourage or deter the reporting of or responding to sexual harassment and interpersonal misconduct. On December 8, 2023, the Special Review Committee selected the law firm Cleary Gottlieb Steen & Hamilton LLP (Cleary Gottlieb) to conduct the independent review.

6. **How was BakerHostetler chosen to conduct an outside review of this matter? For example, was a solicitation published, were multiple firms interviewed, does the FDIC have an existing relationship with BakerHostetler, or was this a new, single source selection? Please explain in detail.**

   a. **Do you or your deputies have personal contacts with this firm or members of this firm? If so, please list the names of any such contacts and provide appropriate**

[28] See PR-93-2023, FDIC Board of Directors Establishes Special Committee to Oversee Independent Review of Agency Culture (November 21, 2023) available at https://www.fdic.gov/news/press-releases/2023/pr23093.html.

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context regarding any such relationships with you or your deputies so that the Committee may assess any potential conflicts of interest.

b. **Have you or your deputies considered or discussed the potential that hiring a private firm to conduct this review could allow FDIC leaders to guide the direction of the report and/or protect or even influence its findings?**

Response:
On October 27, 2023, the FDIC Legal Division sent solicitations to five law firms that had preexisting Legal Services Agreements (LSAs) with the FDIC. Law firms with LSAs agree to be available to perform work for the FDIC pursuant to an agreed rate schedule and certify they will comply with FDIC conflict procedures.[29,] The FDIC sought to engage a law firm to gather information, survey employees at FDIC headquarters, in FDIC regional offices, and in FDIC field offices, and to provide legal advice to the Corporation on the existence and contours of any problems with sexual harassment. The five law firms were selected based on their ability to conduct a nationwide review. The Legal Division received proposals from all five firms and selected BakerHostetler LLP (BakerHostetler) on November 9, 2023 based on its experience, the ability to meet the FDIC's timeline, expertise of personnel assigned to the matter, proposed fees, and the existence and nature of any conflicts of interest.

On November 20, 2023, the FDIC Board of Directors chartered a Special Review Committee co-chaired by Director Jonathan McKernan and Director Michael J. Hsu to provide direction to and oversee an independent, third-party review of allegations of sexual harassment and interpersonal misconduct at the FDIC and management's response to harassment and misconduct.[30] The independent review will also review the FDIC's workplace culture, including any practices that might discourage or deter the reporting of or responding to sexual harassment and interpersonal misconduct. Because of the expanded scope of work to be conducted by the third-party reviewer and to ensure the independence of the review, the Special Review Committee re-solicited law firms to conduct the independent review.

On November 22, 2023, the Special Review Committee solicited an expanded set of thirty-three law firms. This included both firms that have LSAs and firms that did not have LSAs. This solicitation sought a capable and credible firm with the ability to address the expanded scope of the review and develop the factual record to support the full scope of the review's findings and recommendations. In addition, selection by the Special Review Committee ensures independent oversight of the review process from start to finish. The FDIC received twenty responses from

[29] *See* FDIC Outside Counsel Deskbook and accompanying information, *available at* https://www.fdic.gov/about/doing-business/outside-counsel/index.html. The FDIC currently has over 150 law firms with LSAs. *See* List of Outside Counsel Available by State, *available at* https://www.fdic.gov/about/doing-business/outside-counsel/us-firms-available-by-state.pdf.
[30] See PR-93-2023, FDIC Board of Directors Establishes Special Committee to Oversee Independent Review of Agency Culture (November 21, 2023) available at https://www.fdic.gov/news/press-releases/2023/pr23093.html.

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law firms. The Special Review Committee reviewed those responses focusing on each firm's experience, including experience with internal investigations (*e.g.*, Board-led or Board-committee led investigations), the ability to meet the FDIC's timeline, expertise of personnel assigned to the matter, proposed fees, and the existence and nature of any conflicts of interest.

On December 8, 2023, the Special Review Committee selected the law firm Cleary Gottlieb Steen & Hamilton LLP (Cleary) to conduct the independent review. The retention of Cleary was announced on December 11, 2023, after the firm entered into an LSA and completed the onboarding process.

7. **Will you commit to being fully transparent and cooperative with any and all Congressional inquiries, including from the Ranking Member, regarding this matter, including, but not limited to, answering all questions and providing all requested records pertaining to this matter? Please answer "yes" or "no."**

    a. **If no, why?**

Response:
The FDIC will fully cooperate with any Congressional investigation or oversight request consistent with the law.

8. **Will you commit to being fully transparent and cooperative with the FDIC Inspector General regarding this matter? If not, why?**

Response:
The FDIC is cooperating fully with the FDIC Office of Inspector General, which has initiated a Special Inquiry and additional evaluations on the issues outlined in the recent reports of harassment and misbehavior.

9. **Has the FDIC been made aware of or been asked for comment on any additional claims of harassment or toxic workplace environment by media outlets that have not been previously reported?**

Response:
The FDIC has not been made aware of additional claims by other media outlets.

10. **Are you currently, or have you ever been, the subject of an EEOC or Ethics investigation or complaint—or any other agency investigation or complaint—during your time in the federal government?**

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a. **If so, please describe every such instance, to include the nature of the complaint or investigation, when it occurred, and its resolution.**

Response:
It is my understanding that there has been one instance of an informal EEO complaint, but to my knowledge, I have not been the subject of an EEOC investigation.

Regarding any "Ethics investigation or complaint," the FDIC is not aware of any investigation or complaint implicating Chairman Gruenberg.

11. **The Financial Stability Oversight Council ("FSOC") finalized guidance on a framework to evaluate non-bank financial firms for designation as a threat to financial stability. If a company meets FSOC's new framework, it would be designated as a systemically important financial institution (or SIFI) and would be subject to Federal Reserve supervision and regulation. In 2019, FSOC issued a commonsense proposal on this matter, however, this new guidance seeks to undo the commonsense provisions sought in 2019. In fact, the 2019 guidance evaluated firms based on their business activities, required a consideration of the firm's financial health, and perhaps most importantly, would have required the government to conduct a cost-benefit analysis. This new guidance, however, provides FSOC with broad latitude to designate firms largely at its own discretion, and for partisan justifications such as climate-related risks. Many financial firms in the U.S. that are not currently subject to Federal Reserve oversight, such as asset managers, are still subject to a great deal of regulation and oversight, often from the SEC or CFTC.**

    a. **Can you explain why this new guidance is justified and why you don't believe a cost-benefit analysis is necessary in the designation process?**

Response:
In the aftermath of the 2008-09 financial crisis, Congress enacted, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), a set of authorities for regulators to use to reduce and respond to the potential systemic risk posed by nonbank financial institutions. These include authorities for FSOC to instruct the Office of Financial Research to collect information on nonbanks; to designate systemically important nonbanks to be supervised by the Federal Reserve and to prepare resolution plans; and to designate systemically important financial market utilities and payment, clearing, and settlement activities for additional risk-management standards. These authorities serve as a basis to begin to address the potential systemic risk concerns presented by nonbank financial institutions, many of which were a factor in causing the financial crisis — namely the lack of transparency, prudential supervision, and controls on the use of leverage.

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FSOC's Analytic Framework on Systemic Risk enhances the transparency of FSOC's process for considering financial stability risk. The Framework details common vulnerabilities and transmission mechanisms through which shocks can arise and propagate through the financial system. The Analytic Framework is relevant for all of FSOC's analyses, regardless of whether the risk emanates from a firm, sector, or activity, and which of FSOC's tools might be appropriate to address identified risks.

The revised Interpretive Guidance provides transparency on the process for FSOC's authority to designate nonbanks for heightened supervision and resolution planning requirements. The revised Interpretive Guidance advances FSOC's ability to address potential threats to financial stability from nonbank financial institutions by removing several constraints to FSOC designation, while retaining a multistage, deliberative process with opportunities for firm engagement. Several of those previous constraints – including mandatory exhaustion of activities-based responses, benefit-cost analysis, and an assessment of the likelihood to fail – were not included in the Dodd-Frank Act, and created barriers that impeded FSOC's ability to carry out its statutory duties. It is important for the FSOC to be willing and able to utilize all of the tools at its disposal to fulfill its statutory mandate to promote financial stability in the United States.

12. **Are you concerned that the Basel III Endgame proposal's increase of retail risk weights in combination with charging for unused balances of credit lines and the gross punitive operational risk requirement could negatively affect low- to moderate-income Americans by pushing them to less regulated sectors of the financial system and less protected sources of credit? Please explain why you supported the proposal as drafted.**

Response:
Relative to the current standardized approach, the Basel III NPR would increase the sensitivity of the credit-risk capital requirements applicable to retail exposures by assigning risk-weights that would vary based on product type and degree of portfolio diversification. Many exposures to consumers, including credit cards, would be assigned risk-weights under the proposal that are lower than under the current standardized approach. The lower retail risk weight would also be applicable to small businesses that meet certain criteria.

As stated in the Basel III NPR, the agencies are supportive of home ownership and do not intend the proposal to diminish home affordability or homeownership opportunities, including for low- and moderate-income home buyers or other historically underserved markets. The agencies included questions in the proposal seeking comment on whether the proposed framework for regulatory residential real estate exposures should be modified in any way to avoid unintended impacts on the ability of otherwise credit-worthy borrowers who make a smaller down payment to purchase a home. Additionally, the proposal seeks comment on alternatives to expand the

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application of lower risk weights for corporate exposures including small businesses. The comment period for the NPR has closed. The FDIC will carefully consider all comments submitted, including those related to credit access.

a. **Are you concerned that increases in capital requirements under the Basel III Endgame proposal for card credit borrowing lines are likely to reduce the amount of credit available to consumers to meet unanticipated or emergency expenses?**

Response:
As stated in the previous response, under the proposal many credit card loans would be assigned risk-weights that are lower than under the current standardized approach. However, the proposal seeks comments in this area, in particular how capital requirements are determined for unfunded commitments. The comment period for the NPR has closed. The FDIC will carefully consider all comments submitted, including those related to access to credit card lending.

13. **Some institutions have reported that the Basel III Endgame proposal will increase their capital requirements by upwards of thirty percent. This increase is due in large part to the treatment of fee- and commission-income as part of operational risk. Given that these increases may have significant negative consequences for credit card and capital markets lending, what alternative approaches to accounting for fee- and commission-income in the services component of the operational risk requirement are the agencies considering?**

Response:
The agencies intend for the operational risk requirement to reflect all operational risk to which a banking organization is exposed, regardless of the activity or legal entity in which the operational risk resides. The proposal asks many questions about various aspects of the proposed operational risk framework, such as impacts on specific business models. For example, question 74 seeks comment on any adjustments or limits the agencies should consider related to specific business lines, such as underwriting, wealth management, or custody, or to specific fee types, such as interchange fees. Question 74 also seeks comment on the appropriate treatment of fee income and expenses of charge cards. The comment period for the NPR has closed. The FDIC will carefully consider all comments submitted, including those related to the issues raised by your question.

14. **To what extent, if any, are you concerned that the Basel III Endgame proposal could harm FBO competitiveness and cause them to retreat to their home markets, decreasing competition and sources of credit for U.S. consumers?**

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Response:
The Basel III NPR would make important changes to address the capital weaknesses identified in the 2008 financial crisis, enhance the resilience and stability of the U.S. banking system, and enable the banking system to better serve the U.S. economy. The proposal is not intended to harm FBO competitiveness. The comment period for the NPR has closed. The FDIC will carefully consider all comments submitted, including those related to the issues raised by your question.

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1. **Since the collapse of Silicon Valley Bank and Signature Bank in March, it is my understanding that banks have been notified via mailed correspondence that their examination ratings have been downgraded outside of a formal examination process.**

   In most instances, these are strongly performing banks that show some change in status on a call report filing, and rather than engaging in the appropriate regulatory process, the FDIC is simply notifying them of the changed rating without due process. This directly impacts the cost of deposit insurance and a banks' audit-related requirements, seemingly in an attempt for the FDIC examiners to have cover in the event that the subject bank later faces financial trouble.

   a. **Are you concerned about the chilling effect of these actions on banks ability to offer much needed products and services to their communities?**

Response:
The three regional banks that failed in the spring of 2023 had several common attributes that made them vulnerable to disruptions: overreliance on uninsured deposits, rapid growth, and weak interest rate and liquidity risk management; and for two of the banks, unrealized losses on securities or significant declines in the values on longer term loans. The material loss reviews performed for the FDIC's Office of Inspector General (OIG) for Signature Bank and First Republic Bank indicated that the FDIC could have downgraded ratings sooner.[31] It should be noted that prior to failure both Signature Bank and First Republic Bank were well capitalized, and from publicly available information both appeared to be in generally sound condition.

The FDIC and other banking agencies have employed off-site monitoring systems since the 1970s to identify outliers among otherwise sound banks in between examinations. This off-site monitoring between examinations is especially important for the nation's community banks that are not subject to continuous examinations, like Signature Bank and First Republic. The off-site monitoring allows the FDIC and other banking agencies to identify and monitor banks that present "red flags" in between examinations, which among other things, allows the FDIC and other banking regulators to extend the 12-month examination cycle to 18 months, as permitted by statute, for certain well managed and well capitalized institutions.

Since March 1, 2023, the FDIC has not downgraded the overall composite rating of any bank without a corresponding examination or on-site visitation. Since March 1, 2023, less than 1 percent of the 2,930 institutions supervised by the FDIC have had one or more component

[31] https://www.fdicoig.gov/sites/default/files/reports/2023-12/EVAL-24-03.pdf
https://www.fdicoig.gov/sites/default/files/reports/2023-12/EVAL-24-02.pdf

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ratings downgraded on an interim basis without an on-site examination or visitation. These component ratings downgrades were generally related to changes to the Liquidity component from a strong (1) to a satisfactory (2) rating. Additionally, the aggregate of the total assets of these institutions represents only 1 percent of the total assets of FDIC supervised institutions ($48 billion out of $4.2 trillion as of December 30, 2023).

As a general matter, it is the policy of the FDIC and other banking agencies to rate insured institutions in accordance with the uniform CAMELS ratings definitions. Appropriate ratings help bank boards and management focus on areas of the bank that need to improve and also, in the case of a ratings upgrade, reflect areas that have been improved. Additionally, appropriate ratings are important to reflect risk to the Deposit Insurance Fund and accordingly, to determine appropriate deposit insurance assessments. The FDIC's off-site monitoring systems and process of reviewing ratings on an interim basis has been used for decades and we are not aware of any adverse impact on product and services offerings.

b. **Do you believe that overregulation of community banks is one of the primary reasons for consolidation of the industry?**

Response:
The FDIC does not believe that overregulation of community banks is a primary reason for consolidation within the banking industry. More than three decades of consolidation and growth have significantly reduced the number of smaller banking organizations and increased the number of large and systemically-important banking organizations. Large waves of consolidation have been driven by inter-company mergers, intra-company mergers, and failures. Three banking crises and the relaxation of restrictions on intra-state branching and interstate banking in the 1990's had a substantial effect on industry consolidation.[32] More recently, a slowdown in the pace of voluntary mergers and a continued slow pace of de novo bank formation have contributed to a declining rate of consolidation.[33]

With respect to voluntary mergers, these transactions, including those involving community banks, are pursued for a variety of reasons including: to achieve economies of scale, to increase legal lending limits, to address the lack of viable succession for management or ownership, to expand the customer base and geographic market area, to increase core deposits or alleviate reliance on wholesale funding, to achieve liquidity in the common stock, or to add products and

[32] Prior to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Public Law 103– 328, many states did not permit intra-state branching, and interstate branch branching was not permitted. Following the passage of this law, many bank holding companies chose to consolidate existing bank charters. Data is sourced from Consolidated Reports of Condition and Income.
[33] https://www.fdic.gov/resources/community-banking/report/2020/2020-cbi-study-full.pdf.

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services. It is FDIC's observation that business decisions relating to these considerations tend to be the primary reasons for merger activity.

Most community banks that are acquired merge with other community banks, which results in a community-banking sector composed of somewhat larger institutions that continue to provide essential financial services within a limited geographic market. Over the 20-year period from 2004 through 2023, approximately 93.0 percent (2,055) of bank-to-bank merger applications received and acted upon, and 95.0 percent of applications approved, were for institutions that were $10 billion or less in asset size following the proposed merger.

In 2022, the FDIC began evaluating and considering changes to the merger review framework. On March 31, 2022, the FDIC published a Request for Information and Comment on Rules, Regulations, Guidance, and Statements of Policy Regarding Bank Merger Transactions that solicited comments regarding the effectiveness of the existing bank merger application framework.[34] The comment period ended on May 31, 2022. The FDIC is evaluating and considering the comments received as it considers changes to the merger review framework. Moreover, the FDIC is working collaboratively with the other banking agencies and the Department of Justice on an interagency review of the bank merger application process. As a part of the review process, the FDIC is considering updates to the FDIC's Statement of Policy on Bank Merger Transactions.

As a Federal banking regulator, and the main regulator for community banks, the FDIC is continually focused on the impact of laws and regulations on banks' operations. The FDIC's Statement of Policy (Statement) titled "Development and Review of FDIC Regulations and Policies" establishes that "the FDIC evaluates benefits and costs, based on available information, and considers reasonable and possible alternatives."[35] Further the Statement establishes that "the FDIC seeks to minimize to the extent practicable the burdens which the proposed regulation or policy imposes on the banking industry and the public."

The FDIC is aware of the effect of the costs of regulations on community banks and looks for ways to reduce regulatory burden while continuing to provide risk-focused and effective oversight of the safety and soundness and consumer protection programs of institutions. Under Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA),[36] the FFIEC and its member agencies are directed to conduct a joint review of regulations every 10 years and consider whether any of those regulations are outdated, unnecessary, or unduly burdensome. The agencies, including the FDIC, recently began the decennial review and are seeking feedback from stakeholders.

[34] 87 FR 18740 (March 31, 2022).
[35] 78 FR 22771 (April 17, 2013).
[36] 12 U.S.C. § 3311.

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2. **In the original ANPR for the long-term debt rule released in the fall of 2022, it is my understanding that smaller regional banks were not included. In the proposed long-term debt rule issued in August of this year, Category IV banks were included, treating these institutions the same as institutions who are significantly larger. Furthermore, these smaller regional banks will face new regulatory requirements with far less time to prepare for their impact.**

    a. **Why did the agencies move forward with proposing requirements for the issuance of long-term debt that do not take into consideration the size or risk of a financial institution, particularly given the tailoring requirements included in the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (S. 2155)?**

Response:
The spring 2023 banking failures demonstrated that the failure of one or more large regional banks could have a negative impact on the U.S. financial system and the broader U.S. economy. The failures of these banks, all of which would have been within scope of the proposed rule, contributed to depositor outflows at other banking organizations. A contagion effect became apparent at these and other banks. There was clear evidence that the failure of a regional bank in which uninsured depositors faced losses could cause genuine systemic disruption.

Under the Long-Term Debt proposal, with respect to size, the proposed insured depository institution (IDI) level requirement uses the IDI's size metric in the proposal. Accordingly, the proposed rule inherently tailors requirements because a firm's proposed required amount of long-term debt would be determined by its size and capital requirements. While size is not the only indicator of complexity, it is readily observable, and the proposal invited public comment on multiple questions embedded in the NPR as to whether the proposed scope appropriately addresses the risks discussed above and what additional factors should be considered.[37] Responses to these questions will be considered as part of the final rulemaking process.

    b. **In addition to the lack of tailoring included in the rule, it also does not take into consideration the risk profile of the bank. Should the FDIC consider the percentage of uninsured deposits or the complexity of a bank's operations when determining the applicability and calibration of long-term debt requirements?**

[37] See, 88 FR 64524, 64532-33 (Sept. 19, 2023).

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Response:
In general, IDIs with assets above $100 billion tend to be more complex in terms of business models and operations, including their uninsured deposit profile; are more difficult to resolve; and have a smaller pool of potential acquirers, all of which can make these institutions costly for the FDIC to resolve. Again, as noted above, the Long Term Debt proposed rule inherently tailors requirements by taking into account a firm's size and capital requirements.

As discussed above, in the proposal, the agencies have asked several questions related to other considerations or factors that should be taken into account in the agencies' future rulemaking efforts. Responses to these questions will be considered as part of the final rulemaking process.

c. **Do you believe regulatory agencies should provide smaller regional banks longer than just the three-year phase-in period to meet any final LTD requirements?**

Response:
The agencies proposed to provide covered entities and covered IDIs the same three-year transition period. Three years would provide covered entities and covered IDIs adequate time to make necessary arrangements to comply with the final rule without creating undue burden that would have unreasonable adverse impacts for covered entities and covered IDIs. Importantly, the agencies may accelerate or extend this transition period in writing for the covered IDIs for which they are the appropriate federal banking agency, and the Board may accelerate or extend this transition period in writing for covered entities, subject to notice. The agencies have also invited public feedback on this provision, and specifically about its applicability to smaller large regional banks, for consideration in the final rulemaking.[38]

[38] See, 88 FR 64546 (Sept. 19, 2023).

Questions for the Record from Senator Catherine Cortez Masto for
The Honorable Martin J. Gruenberg
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1. **In a recent report, *FHLBanks at 100: Focusing the Future*[39], the Federal Housing Finance Agency recommended more mission-focused investments for members of the nation's eleven Federal Home Loan Banks.**

   a. **How will proposed changes by the FHFA to require more mission-focused advances affect bank examination practices of your institution?**

   b. **How will proposed changes to strengthen member risk management and improve member creditworthiness40 affect bank examination practices of your institution?**

Response to a. and b.:
The Federal Housing Finance Agency's (FHFA) report, *FHLBanks at 100: Focusing on the Future,* indicates that the Federal Home Loan Banks (FHLBanks) may be more focused on their housing and community development mission while continuing to provide a stable and reliable source of liquidity for creditworthy member institutions. The report also makes clear that FHLBanks do not have the capacity to serve as a lender of last resort. This was evidenced during the recent stress episode when FHLBanks were not able to accommodate intraday or short-term advance requests.

The FDIC's examination process considers all aspects of an institution's funds management, including the availability of borrowing lines and FHLBank capacity. If FHLBanks employ more conservative underwriting and member creditworthiness standards, some financial institutions (especially troubled institutions and those that do not emphasize real estate or community development lending) may face reduced capacity. The FDIC's current examination practices actively encourage supervised institutions to diversify secondary funding sources in addition to FHLBank access.

Prospective contingent funding strategies will likely center on a combination of highly marketable liquid assets and appropriate access to the Federal Reserve's discount window (or other reliable sources). The Federal Reserve has capacity to lend to eligible financial institutions and can be relied on as an emergency source of intraday funding in stress situations. On July 28, 2023, the federal banking agencies emphasized the need for strong contingency funding planning efforts and maintaining appropriate discount window capacity through an Addendum to the

[39] https://www.fhfa.gov/PolicyProgramsResearch/Programs/Pages/FHLBank-Focusing-on-the-Future.aspx
[40] Ibid, page. 34.

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Interagency Policy Statement on Funding and Liquidity Risk Management on the Importance of Contingency Funding Plans.[41]

c. **How should FDIC examiners consider advances from the Federal Home Loan Banks when determining if financial institutions have adequate liquidity?**

Response:
The FDIC has long encouraged institutions to maintain ample on-balance sheet liquidity and diversified funding programs that promote resilient, safe and sound banking operations. Financial institutions often rely on a stable deposit base supplemented by secondary funding sources such as FHLBank advances and Federal Reserve discount window facilities.

FDIC examiners will continue to consider an institution's use of FHLBank advances in the context of its overall funding strategy. Although deposits will drive a large portion of a given institution's funding structure, an institution can also use secondary sources such as FHLBanks and other providers to prudently supplement deposit-gathering efforts to address credit demand and cash flow needs. Importantly, prospective use of FHLBank advances may focus more on business-as-usual borrowings that help member institutions achieve real estate lending objectives rather than as contingency funding lines. We expect that emergency cash needs will largely be facilitated by financial institutions' asset monetization strategies and operationalized access to the Federal Reserve's discount window.

d. **Do you see any opportunities to align Community Reinvestment Act goals with FHFA's mission-focused investments by the Federal Home Loan Banks? For example, should Community Investment Cash Advances or Community Investment Program advances qualify for CRA credit?**

Response:
The goals of CRA and FHFA's mission-focused investments by FHLB member banks may certainly be aligned. Both seek to encourage lending and investments to lower-income individuals, communities, and other targeted underserved individuals and entities. Many FHLB/FHFA programs have qualified for CRA consideration over the years because they met criteria under the community development prong.

[41] https://www.fdic.gov/news/financial-institution-letters/2023/fil23039a.pdf.

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CRA was enacted to encourage banks to meet the credit needs of the neighborhoods in which they operate, including low- and moderate-income (LMI) communities. Banks are evaluated on their lending, investment and service performance in meeting the needs of their entire communities, including low-income individuals and geographic areas. Under the existing CRA regulations, activities that have a community development purpose qualify for CRA community development consideration. Under the new regulation, CRA consideration for affordable housing and other community and economic programs will continue to depend on whether the program meets certain criteria and/or target specific underserved geographic areas. Banks participating FHLB's Community Investment Cash Advance (CICA) or the Community Investment Program (CIP) programs may receive CRA consideration for community development activities they undertake with funding from those programs, depending on the details of the projects.

CRA and FHFA goals also seem to be aligned with respect to areas targeted for community development consideration. The new final CRA rule will include an impact and responsiveness review to ensure consideration of community development loans, investments, and serve that are particularly impactful or responsive. These factors help to identify activities that are particularly impactful and responsive to community needs. A few examples to highlight are activities that service persistent poverty counties and other high poverty areas; activities that support smaller small businesses with gross annual revenue of less than $250,000; investments in projects financed by Low-Income Housing Tax Credits and New Market Tax Credits; and activities that support Minority Depository Institutions, Women Depository Institutions, Low-Income Credit Unions or Community Development Financial Institutions. Under the final rule, activities that directly facilitate the acquisition, construction, development, preservation, or improvement of affordable housing in High Opportunity Areas are considered particularly impactful. A "High Opportunity Area" is defined as an area identified by the FHFA for purposes of the Duty to Serve Underserved Markets. This definition generally includes geographic areas where the cost of residential development is high and affordable housing opportunities can be limited. The agencies consider affordable housing in High Opportunity Areas to have a high level of impact and responsiveness. The agencies believe this impact factor would recognize qualifying homeownership opportunities for LMI individuals in High Opportunity Areas and may also include qualifying CRA activities that finance projects with high percentage of low-income tenants in high-cost-burdened geographical areas or areas with low vacancy rates.

e. **Please provide annual amounts of payments made to the Federal Home Loan Banks from the Deposit Insurance fund for failed banks. Please include prepayment penalties, interest and other charges.**

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Response:
See enclosed Appendix C for amounts paid to the FHLBs from 2006 through 2023.

Questions for the Record from Senator Mike Crapo and Senator Mark Warner
The Honorable Martin J. Gruenberg
Chair, Federal Deposit Insurance Corporation
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Last year, this Committee helped advance into law the Financial Data Transparency Act (FDTA) which requires your agency to adopt specified data standards with respect to format, searchability, and transparency. The FDTA will require FSOC agencies to apply uniform data standards for the information they collect. All FSOC agencies are to draft rules about a future data standard to be available for review and comment by June 2024.

1. **What have you done to ensure your agency can and will be able to provide such standards that meet the requirements set forth in the law by June 2024?**

Response:
In coordination with the other covered agencies, the FDIC has established an interagency working group that has been deliberating on potential standards and is working towards the release of a notice of proposed rulemaking by June 2024, in accordance with the requirements of the FDTA.

2. **Are you confident all required FSOC agencies are making uniform data standards a priority?**

Response:
The FDIC supports the tenets of the FDTA and makes uniform data standards a priority. We are unable to comment on the priorities of other covered agencies on their behalf.

3. **Will you provide us an update on your progress by no later than February 28th, 2024?**

Response:
We will keep you informed of our progress, as appropriate, as we move through the rulemaking process.

Questions for the Record from Senator John Fetterman for
The Honorable Martin J. Gruenberg
Chair, Federal Deposit Insurance Corporation
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1. **What has your agency done since the Silicon Valley Bank collapse to ensure something similar collapses won't happen again?**

Response:
The FDIC carefully considered the bases for failure and is strengthening its forward-looking approach to supervision so that supervisory concerns will be addressed in a more timely manner. On April 28, 2023, the FDIC's Chief Risk Officer delivered to the FDIC Board of Directors a report summarizing the results of his review of the FDIC's supervision of Signature Bank. The Report identified matters for further study and consideration relative to guidance, internal processes, and resources, and the FDIC has taken a number of responsive actions. The FDIC updated examiner guidance to be more explicit about analyses of uninsured deposit concentrations and reemphasized to examiners the importance of forward-looking indicators of risk, such as high growth rates and breaches of internal risk limits. Additionally, the FDIC strengthened instructions for examiners on timely escalation of supervisory responses when management has been unable or unwilling to effect corrective action, or when financial conditions deteriorate rapidly, or both. We have discussed changes at examiner training and plan to conduct additional examiner training in 2024. The FDIC has also taken steps to hire experienced practitioners such as credit specialists and retired examiners to address resources at large financial institution examinations.

In addition, the recent capital and resolution-related proposals seek to strengthen the financial system by ensuring that bank capital levels are commensurate with a bank's activities and, in the case of large bank insolvency, that resolution can be handled in the most informed and cost-effective manner to mitigate the likelihood of contagion risk.

2. **Banks and credit union regulators have the power to remove bad actors and ban them from working in the industry. How often do you use this power?**

Response:
Under section 8(e) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(e), the FDIC is authorized to prohibit institution-affiliated parties (IAPs), such as officers, directors, and/or employees of insured depository institutions (IDIs) from participating in the conduct of the affairs of any IDI when such IAPs have been determined to have engaged in certain types of actionable misconduct. The FDIC may issue a prohibition order under section 8(e) of the FDI Act with the consent of the IAP. Alternatively, if a stipulated settlement cannot be reached, the FDIC may file a formal Notice of Charges and hold a contested administrative enforcement proceeding, laying out the evidence of the IAP's misconduct. If, after such a hearing, the agency determines that the statutory factors set forth in section 8(e) of the FDI Act have been satisfied, the FDIC may issue an Order of Removal and Prohibition against the IAP.

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In the last 10 years, the FDIC has issued 627 prohibition orders against former IAPs after negotiation and consent. During this same period, the FDIC has issued 55 Notice of Charges against former IAPs seeking orders of prohibition through a formal administrative enforcement action.

3. **Crypto isn't money. You can't fill up your gas tank and pay in crypto. However, it's apparently pretty useful for funding Hamas terrorism. Would you ever invest in crypto?**

Response:
According to the 2022 National Terrorist Financing Risk Assessment,[42] crypto-related activities are vulnerable for use in terrorist financing because they can enable anonymous cross-border peer-to-peer funds transfers, which can occur without the involvement of a virtual asset service provider with anti-money laundering/countering the financing of terrorism (AML/CFT) obligations. Virtual asset service providers doing business in whole or part in the United States qualify as money transmitters, which means they are required to comply with AML obligations that apply to money services businesses, including registering with the Financial Crimes Enforcement Network (or FinCEN); maintaining an AML program; filing suspicious activity and currency transaction reports; and maintaining certain records. However, some virtual assets allow near instantaneous transactions without the involvement of a financial institution with AML/CFT obligations.

The U.S. Department of the Treasury published an action plan[43] to address and mitigate the digital-asset-related illicit finance and national security risks as identified in the U.S. government's 2022 National Risk Assessments for Money Laundering,[44] Terrorist Financing,[45] and Proliferation Financing.[46] The action plan notes "the most significant illicit financing risk associated with virtual assets stems from virtual asset service providers operating abroad with substantially deficient AML/CFT programs, particularly in jurisdictions where AML/CFT standards for virtual assets are nonexistent or not effectively implemented."

Additionally, on October 19, 2023, the U.S. Department of the Treasury and FinCEN announced a Notice of Proposed Rule Making (NPR) that identifies international Convertible Virtual Currency Mixing (CVC mixing) as a class of transactions of primary money laundering concern.

[42] https://home.treasury.gov/system/files/136/2022-National-Terrorist-Financing-Risk-Assessment.pdf
[43] https://home.treasury.gov/system/files/136/Digital-Asset-Action-Plan.pdf
[44] https://home.treasury.gov/system/files/136/2022-National-Money-Laundering-Risk-Assessment.pdf
[45] https://home.treasury.gov/system/files/136/2022-National-Terrorist-Financing-Risk-Assessment.pdf
[46] https://home.treasury.gov/system/files/136/2022-National-Proliferation-Financing-Risk-Assessment.pdf

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This NPRM highlights the risks posed by the extensive use of CVC mixing services by a variety of illicit actors throughout the world and proposes a rule to increase transparency around CVC mixing to combat its use by malicious actors including Hamas, Palestinian Islamic Jihad, and the Democratic People's Republic of Korea.

The FDIC supports innovations that are safe and sound, in compliance with laws and regulations, and fair to consumers. Crypto-related activities may pose significant money laundering, terrorist financing, and other illicit financial activity risks and concerns. These risks and concerns are evolving as crypto-related activities are not yet fully understood. For example, there are fundamental ownership issues, including whether it is possible for ownership to be clearly validated and confirmed.

The FDIC requested FDIC-supervised institutions that intend to engage in, or that are currently engaged in, any activities involving or related to crypto-assets notify the FDIC.[47]

4. **Do you think banks can really evaluate the risks of crypto or should they stay out of it entirely?**

Response:
The FDIC supports innovations that are safe and sound, in compliance with laws and regulations, and fair to consumers. Crypto assets and crypto-related activities are rapidly evolving, and risks of this area are not well understood given the limited experience with these new activities. As noted above, the FDIC requested that FDIC-supervised institutions that intend to engage in, or that are currently engaged in any activities involving or related to crypto-assets notify the FDIC and provide any information requested by the FDIC that will allow the agency to assess the safety and soundness, consumer protection, and financial stability implications of such activities. The FDIC will review the relevant information submitted by the FDIC-supervised institution related to crypto-related activities and provide relevant supervisory feedback to the institution, as appropriate.

In addition, the FDIC, along with the Board of Governors of the Federal Reserve System (Federal Reserve) and the Office of the Comptroller of the Currency (OCC), issued a Joint Statement on Crypto-Asset Risks to Banking Organizations.[48] This joint statement enumerated several risks posed by crypto-assets that banking organizations should be aware of, including significant volatility in crypto-asset markets; risk management and governance practices in the

[47] See FDIC FIL-16-2022, Notification of Engaging in Crypto-Related Activities, April 16, 2022, https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html.
[48] See FDIC FIL-01-2023, Joint Statement on Crypto-Asset Risks to Banking Organizations, January 5, 2023, https://www.fdic.gov/news/financial-institution-letters/2023/fil23001.html

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crypto-asset sector exhibiting a lack of maturity and robustness; and inaccurate or misleading representations or disclosures by crypto-asset companies, among others. The FDIC, Federal Reserve, and OCC also issued a Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities.[49] The joint statement highlights key liquidity risks associated with certain sources of funding from crypto-asset-related entities that banking organizations should be aware of. The statement reminds banking organizations to apply existing risk management principles and provides examples of practices that could be effective. The agencies also continue to emphasize that banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation.

5. **Bank and credit union employees are excluded from whistleblower protections under the new anti-money laundering whistleblower law. Do you believe we should change the current whistleblower laws to give employees as much protection as possible when they call out fraud and money laundering?**

Response
The anti-money laundering whistleblower statute, 31 U.S.C. § 5323, (AML Whistleblower Statute) provides protection from retaliation for AML whistleblowers who disclose violations to a broad set of actors including any person with supervisory authority over the whistleblower when they report concerns to another employee who the whistleblower reasonably believes has power to investigate or take action to address the potential misconduct, or to various federal regulatory and law enforcement agencies, or Congress.

The AML Whistleblower Statute excludes bank employees from its protection.[50] Instead, bank employee whistleblowers are protected under Section 33 of the Federal Deposit Insurance Act (Section 33 of the FDI Act), 12 USC § 1831j, but only when they disclose violations to a narrow set of actors (i.e., the Attorney General or a Federal banking agency). Even if the whistleblower reported the activity to a covered individual, the protections afforded under Section 33 of the FDI Act do not apply, if the whistleblower participated in the alleged violation of law or regulation.[51] The AML Whistleblower Statute contains no parallel exclusion.

If Congress wants to expand protection for bank employees, Congress could include bank employees under the AML Whistleblower Statute or could amend Section 33 of the FDI Act to

[49] See FDIC FIL-08-2023, Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities, February 23, 2023, https://www.fdic.gov/news/financial-institution-letters/2023/fil23008.html
[50] See 31 U.S.C. § 5323(g)(6).
[51] *See* 12 USC § 1831j(d)(1).

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align protections for bank employees with those provided to non-bank employees under the AML Whistleblower Statute.

To further incentivize whistleblowers, the award limitations under 12 USC § 1831k could be reconsidered. Presently, awards are discretionary and are capped at the lesser of 25 percent of the fine or $100,000. By contrast, the AML Whistleblower Statute mandates awards and contains no dollar cap (although the award must be between 10 and 30 percent of monetary sanctions).

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FDIC Guidelines for Corporate Governance and Risk Management

1. **Chair Gruenberg, why has the FDIC proposed corporate governance that are out of step with the FRB and OCC, in both scope of application and level of prescriptiveness? Did you pursue joint guidance with your fellow federal agencies in developing and proposing these standards?**

   Did you consult with the state regulators who charter and oversee the state nonmember banks subject to these guidelines?

Response:
The Board of Governors of the Federal Reserve System (Federal Reserve) and Office of the Comptroller of the Currency (OCC) each pursued individual rulemaking in 2014 according to their own legal authority. For example, in 2014 the Federal Reserve issued 12 CFR Part 252 Enhanced Prudential Standards (Regulation YY) to implement certain provisions of section 165 of the Dodd-Frank Act (12 U.S.C. 5365), which require the Federal Reserve to establish enhanced prudential standards for certain bank holding companies, foreign banking organizations, nonbank financial companies supervised by the Board, and certain other companies. Also in 2014, the OCC issued 12 CFR 30, Appendix D Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations as an appendix to its safety and soundness standards regulations.

The FDIC's proposed Guidelines[52] are drawn from the principles set forth in Section 39 of the Federal Deposit Insurance Act and would, if adopted, align the FDIC's supervisory framework more closely with the other Federal banking agencies. The FDIC believes that the proposed scope of application to institutions that present a higher risk profile is appropriate, as effective corporate governance and risk management practices should be tailored to the size of the institution and the nature, scope, and risk of its activities.

The FDIC did not consult state regulators when drafting the proposed guidelines; however, the FDIC extended the end of the comment period from December 11, 2023 to February 9, 2024 to provide additional opportunity for the public to consider the proposal and prepare comments, including to address the questions posed by the FDIC.

[52] 88 FR 70391 (October 11, 2023).

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FDIC Accusations

2. **Chair Gruenberg, in light of the recent Wall Street Journal articles, I would like to request that you provide all documentation including complaints, investigations, and reports in relation to any accusations of misconduct, discrimination, or harassment, including that which is sexual in nature, to me since the beginning of your time at the FDIC in 2005. It should also include the 2008 inquiry you referenced at the House Financial Services Committee on Wednesday, November 15, 2023.**

   I ask that this Congressional oversight request be fulfilled within two weeks.

Response:
Information regarding complaints and settlements stemming from Equal Employment complaint activity is submitted on a fiscal year basis to the Congress as well as the Equal Employment Opportunity Commission (EEOC) and published to the FDIC's website.[53] The FDIC's NO FEAR Act Reports as well as EEOC Form 462 for Reporting Period 2012 through the most recent year are also enclosed for your review as Appendix B. The full Report of Management Inquiry was provided to the Senate Banking Committee in late 2022 at the request of then-Ranking Member Toomey.

[53] See https://www.fdic.gov/about/diversity/omwireports.html.

Questions for the Record from Senator Cynthia Lummis for
The Honorable Martin J. Gruenberg
Chair, Federal Deposit Insurance Corporation
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1. **In the video you released on November 17th, you acknowledged that you are "ultimately responsible for the actions of our agency, both good and bad," and that you "bear responsibility for setting the tone for our culture." What remedial actions do you plan to personally take?**

Response:
Fairness is a core value for the FDIC. The FDIC has consistently maintained both an Equal Employment Opportunity (EEO) and Anti-Harassment Program in compliance with federal law.[54] Over the last ten years, the FDIC Office of Inspector General (FDIC OIG) has undertaken reviews of both the FDIC's EEO and Anti-Harassment Programs. When the FDIC OIG identified opportunities to implement improvements to those programs, the FDIC has made a diligent effort to implement those recommendations.[55] Notably, however, neither of these reviews nor the FDIC's Annual Federal EEO Statistical Reports of Discrimination Complaints[56] identified systemic or "toxic" cultural problems in the FDIC workplace.

The recent news reports regarding incidents of sexual harassment and misbehavior at the FDIC were, as a result, deeply troubling, as they raise fundamental questions about the workplace culture that were not identified in previous program reviews or annual statistical reports. The FDIC takes these issues very seriously, and, in the weeks since the stories were first published, the FDIC has initiated a comprehensive, agency-wide effort to respond to these questions and ensure that every person at the FDIC feels safe, valued, and respected.

On December 1, 2023, the FDIC published a plan on the steps the FDIC will take to address workplace issues related to sexual harassment and misconduct and to ensure that all employees are provided a safe work environment.[57] The plan was prepared at my request by FDIC senior leadership and staff. The Plan reflects comments and suggestions received during listening

[54] Copies of the FDIC's Annual EEO Program Status Report (MD-715), which highlights FDIC activities undertaken in its EEO program under Title VII and its affirmative action obligations under the Rehabilitation Act are available at: https://www.fdic.gov/about/diversity/omwireports.html.
[55] See FDIC Office of Inspector General Report, *Preventing and Addressing Sexual Harassment*, EVAL-20-006, (July 2020) available at: https://www.fdicoig.gov/sites/default/files/reports/2022-08/EVAL-20-006.pdf; FDIC Office of Inspector General Report, *The FDIC's Efforts to Provide Equal Opportunity and Achieve Senior Management Diversity*, EVAL-15-001, (November 2014) available at: https://www.fdicoig.gov/sites/default/files/reports/2022-08/15-001EV.pdf.
[56] Copies of the FDIC's Annual Federal EEO Statistical Report of Discrimination Complaints (Form 462), which highlights the processing of FDIC EEO complaints under the various anti-discrimination laws are available at: https://www.fdic.gov/about/diversity/omwireports.html.
[57] See *Action Plan for a Safe, Fair, and Inclusive Work Environment* (Updated December 4, 2023), available at: https://www.fdic.gov/about/diversity/pdf/action-plan-12-4-23-v1.pdf.

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sessions held with FDIC employees in November. The Plan also reflects input from a range of FDIC stakeholders, including the Chairman's Diversity and Inclusion Executive Advisory Council,[58] personnel in the Office of Minority and Women Inclusion, and both the Partnership of Women in the Workplace Employee Resource Group[59] and the Networking, Inclusion, and Advancement for African American Women Employee Resource Group.

On November 20, 2023, the FDIC Board of Directors established a Special Review Committee co-chaired by Director Jonathan McKernan and Director Michael J. Hsu to provide direction to and oversee an independent, third-party review of allegations of sexual harassment and interpersonal misconduct at the FDIC and management's response to harassment and misconduct.[60] The independent review will also review the FDIC's workplace culture, including any practices that might discourage or deter the reporting of or responding to sexual harassment and interpersonal misconduct. On December 8, 2023, the Special Review Committee selected the law firm Cleary Gottlieb Steen & Hamilton LLP (Cleary Gottlieb) to conduct the independent review. Under the direction of the Special Committee, Cleary Gottlieb has established several avenues for individuals to contact the law firm to share their experiences as part of the independent review, which has been communicated to all FDIC staff, including through a public release.

The FDIC is also cooperating fully with the FDIC Office of Inspector General, which has initiated a Special Inquiry and additional evaluations on the issues outlined in the recent reports of harassment and misbehavior. There is no higher priority than ensuring that every person at the FDIC feels safe, valued, and respected, and that the agency is bringing all of its resources to bear to achieve this priority for everyone at the FDIC.

2. **How would you respond to the Wall Street Journal's reporting that women were passed over for assignments and experienced a culture of sexism and discrimination? What have you personally done to ensure that the workplace was inclusive to the success of women at an organization where only 39.49% of examiners and 31.82% of economists are women?**

Response:
Understanding the impact of the FDIC's culture on the workforce is a key goal of both the independent, third-party review that is currently being overseen by the Special Review

[58] The mission of the Chairman's Diversity Advisory Councils) is to provide advice to the FDIC Chairman, through the Office of Minority and Women Inclusion Director, on diversity and inclusion (D&I) issues and concerns.
[59] Employee Resource Groups are FDIC-recognized networks of employees with common goals, interests, or experiences which are established to foster and encourage equality of opportunity, respect, and fair treatment for all.
[60] See PR-93-2023, FDIC Board of Directors Establishes Special Committee to Oversee Independent Review of Agency Culture (November 21, 2023) available at https://www.fdic.gov/news/press-releases/2023/pr23093.html.

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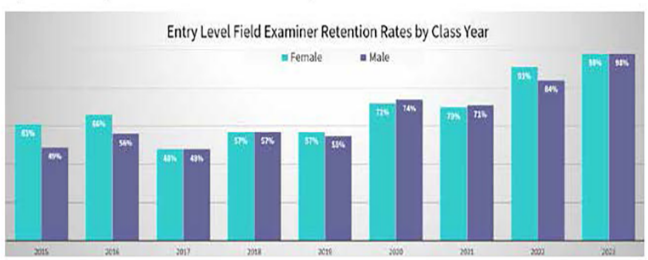
Committee established by the FDIC Board of Directors as well as the agency's own Action Plan for a Safe, Fair, and Inclusive Work Environment.[61] Indirect indicators that existed prior to the recent reports, however, have not indicated a disproportionate impact on women in the workforce. For example, since 2015, retention rates among entry level female field examiners have been roughly equal to or higher than the retention rates for their male counterparts (see figure 1 below). Similarly, since 2015, attrition rates among pre-commissioned and commissioned female field examiners are generally equal to or lower than their male counterparts (see figure 2 below). Notwithstanding these indicators, the FDIC has initiated a comprehensive, agency-wide effort to ensure that its workplace culture is one where every person at the FDIC feels safe, valued, and respected. To that end, on December 1, 2023, the FDIC published a plan on the steps the FDIC will take to address workplace issues related to sexual harassment and misconduct and to ensure that all employees are provided a safe work environment.[62] This includes the establishment of a Female recruitment and retention taskforce and the establishment of a working group which will engage in a cultural assessment and change initiative.

Figure 1: FDIC Entry Level Field Examiner Retention Rates by Class Year



[61] See PR-93-2023, FDIC Board of Directors Establishes Special Committee to Oversee Independent Review of Agency Culture (November 21, 2023) available at https://www.fdic.gov/news/press-releases/2023/pr23093.html.
[62] See fn. 1 *supra.*

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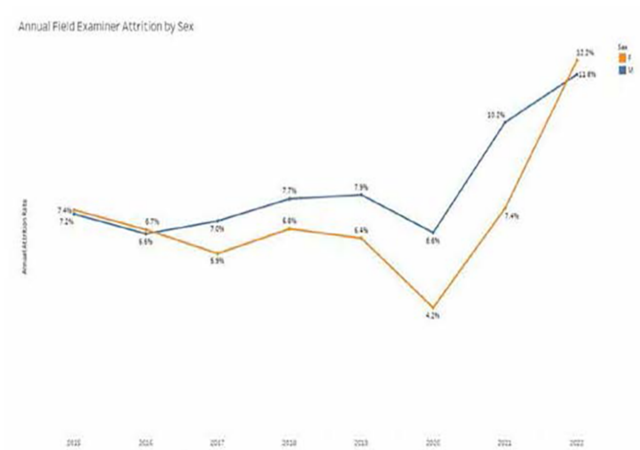
Figure 2: Annual FDIC Field Examiner Attrition by Sex



3. **On April 26, 2022, in a letter to all FDIC Employees, you wrote "it is essential that we continue to cultivate a workplace culture of excellence that is inclusive and supportive of diversity, and is safe and free from hostility or harassment. We must continue to conduct ourselves with professional courtesy and advance the principles of workplace access and inclusion." After the reports of the Wall Street Journal, do you still state that the FDIC's workplace culture is of excellence? How do you plan to change your governance strategy to better achieve these outlined goals?**

Response:
Fairness is a core value for the FDIC. The FDIC has consistently maintained both an Equal Employment Opportunity (EEO) and Anti-Harassment Program in compliance with federal law.[63] Over the last ten years, the FDIC Office of Inspector General (FDIC OIG) has undertaken reviews of both the FDIC's EEO and Anti-Harassment Programs. When the FDIC OIG identified opportunities to implement improvements to those programs, the FDIC has made a

[63] Copies of the FDIC's Annual EEO Program Status Report (MD-715), which highlights FDIC activities undertaken in its EEO program under Title VII and its affirmative action obligations under the Rehabilitation Act are available at: https://www.fdic.gov/about/diversity/omwireports.html.

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diligent effort to implement those recommendations.[64] Notably, however, neither of these reviews nor the FDIC's Annual Federal EEO Statistical Reports of Discrimination Complaints[65] identified systemic or "toxic" cultural problems in the FDIC workplace.

The recent news reports regarding incidents of sexual harassment and misbehavior at the FDIC were, as a result, deeply troubling, as they raise fundamental questions about the workplace culture that were not identified in previous program reviews or annual statistical reports. The FDIC takes these issues very seriously, and, in the weeks since the stories were first published, the FDIC has initiated a comprehensive, agency-wide effort to respond to these questions and ensure that every person at the FDIC feels safe, valued, and respected.

On December 1, 2023, the FDIC published a plan on the steps the FDIC will take to address workplace issues related to sexual harassment and misconduct and to ensure that all employees are provided a safe work environment.[66] The plan was prepared at my request by FDIC senior leadership and staff. The Plan reflects comments and suggestions received during listening sessions held with FDIC employees in November. The Plan also reflects input from a range of FDIC stakeholders, including the Chairman's Diversity and Inclusion Executive Advisory Council,[67] personnel in the Office of Minority and Women Inclusion, and both the Partnership of Women in the Workplace Employee Resource Group[68] and the Networking, Inclusion, and Advancement for African American Women Employee Resource Group.

4. **According to the FDIC's Section 342 Report for 2022, in recent years the FDIC completed a "barrier analysis" to "identify policies, procedures, or practices" that may affect employment opportunities for protected classes within the agency. What barriers were identified as preventing the hiring and retention of female examiners, which the report acknowledges is a challenge for the agency? Did the analysis include review of past complaints of sexual harassment? Was sexual harassment identified as a barrier to retention and promotion?**

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[64] See FDIC Office of Inspector General Report, *Preventing and Addressing Sexual Harassment*, EVAL-20-006, (July 2020) available at: https://www.fdicoig.gov/sites/default/files/reports/2022-08/EVAL-20-006.pdf; FDIC Office of Inspector General Report, *The FDIC's Efforts to Provide Equal Opportunity and Achieve Senior Management Diversity*, EVAL-15-001, (November 2014) available at: https://www.fdicoig.gov/sites/default/files/reports/2022-08/15-001EV.pdf.
[65] Copies of the FDIC's Annual Federal EEO Statistical Report of Discrimination Complaints (Form 462), which highlights the processing of FDIC EEO complaints under the various anti-discrimination laws are available at: https://www.fdic.gov/about/diversity/omwireports.html.
[66] See *Action Plan for a Safe, Fair, and Inclusive Work Environment* (Updated December 4, 2023), available at: https://www.fdic.gov/about/diversity/pdf/action-plan-12-4-23-v1.pdf.
[67] The mission of the Chairman's Diversity Advisory Councils) is to provide advice to the FDIC Chairman, through the Office of Minority and Women Inclusion Director, on diversity and inclusion (D&I) issues and concerns.
[68] Employee Resource Groups are FDIC-recognized networks of employees with common goals, interests, or experiences which are established to foster and encourage equality of opportunity, respect, and fair treatment for all.

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Response:
Sexual harassment was not a focus of the barrier analysis undertaken in connection with the 2022 Section 342 Report. Nevertheless, as part of the agency's action plan published on December 1, 2023, the FDIC will engage a firm specializing in equal employment opportunity to conduct an in-depth analysis of ongoing challenges in workforce representation, including challenges to the hiring and retention of women. Additionally, as a part of the plan, the FDIC has established a Female Recruitment and Retention Taskforce to develop recommendations to address issues primarily impacting women in the workforce.

5. **Please provide the hiring rate and the separation rate of female examiners within FDIC for each of the last five years.**

Response:
The data requested is provided below. It is worth noting that since 2015, annual attrition rates (separations) among pre-commissioned and commissioned women examiners are generally equivalent (and even lower) than their male counterparts. Just like other agencies and private sector employers, we have experienced a higher attrition rate for both women and male examiners in the last two years due to the pandemic and a robust labor market.

Hiring rate and separation rate of FDIC female examiners for the years 2019-2023.

Year	Hiring	Separations
2019	43.90%	5.10%
2020	38.10%	4.20%
2021	32.20%	6.10%
2022	34.80%	8.20%
2023	38.70%	6.40%

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1. **While your proposed capital rule only directly applies to banks with over $100 billion in assets, I have heard concerns that the rule might not only affect direct lending by banks, it might also push them away from holding mortgage backed securities and extending warehouse lines of credit. This could push smaller lenders that aren't directly subject to the new rule, including those that make FHA and VA loans, away from mortgage lending.**

    a. **Have you analyzed this possibility?**

    b. **Will you commit to working to ensure that the final rule doesn't indirectly negatively impact mortgage lending by banks that aren't subject to the rule?**

Response:
As stated in the Basel III NPR, the agencies are supportive of home ownership and do not intend the proposal to diminish home affordability or homeownership opportunities, including for low- and moderate-income home buyers or other historically underserved markets. The agencies included questions in the proposal seeking comment on whether the proposed framework for regulatory residential real estate exposures should be modified in any way to avoid unintended impacts on the ability of otherwise credit-worthy borrowers who make a smaller down payment to purchase a home. The agencies included questions specifically seeking comment on how the proposal affects home affordability and home ownership opportunities and look forward to continuing to receive feedback through the comment process to help inform a final rule.

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1. **In October, the FDIC approved 3-2 a notice of proposed rulemaking to add corporate governance and risk management guidelines into safety and soundness standards for small banks. It expressly reserves the right to apply this standard to banks below $10 billion with operations which are "highly complex or present a heightened risk" but fails to define either term and has no limits on the FDIC's discretion. How did you arrive at the asset threshold of $10 billion?**

Response:
The FDIC's supervisory experience has shown that institutions with assets greater than $10 billion are more complex and present a higher risk profile. The proposed Guidelines are intended to raise the FDIC's standards for corporate governance, risk management, and control to help ensure these larger institutions effectively anticipate, evaluate, and mitigate the risks they face. In developing the proposed Guidelines, the FDIC considered other statutory and regulatory authorities that impose requirements and expectations concerning corporate governance activities and risk management practices. Under guidelines the OCC issued pursuant to Section 39 of the FDI Act, it expects larger national banks to establish and implement a risk governance framework for managing and controlling the bank's risk taking.[69] The Federal Reserve Board has also noted that the risk management processes of a regional insured depository institution (IDI), which it generally considers to be a midsize IDI with total consolidated assets between $10 and $100 billion, should typically contain detailed guidelines that set specific prudent limits on the principal types of risks relevant to a regional IDI's consolidated activities.[70] The proposed Guidelines are drawn from the principles set forth in the authorities noted above and would therefore align the FDIC's supervisory framework more closely with the other Federal banking agencies. Although the proposed Guidelines would apply more broadly to capture FDIC-supervised institutions with total assets of $10 billion or more, the FDIC believes that the

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[69] See OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations, 79 FR 54518 (Sept. 11, 2014), *https://www.federalregister.gov/documents/2014/09/11/2014-21224/occ-guidelines-establishing-heightenedstandards-for-certain-large-insured-national-banksinsured*; OCC, Comptroller's Handbook—Corporate and Risk Governance, https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/corporate-riskgovernance/index-corporate-and-riskgovernance.html

[70] See SR 16–11: Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion (June 8, 2016; revised and reposted February 17, 2021, p. 3). SR letter 95–51, Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies (Nov. 14, 1995; revised Feb. 26, 2021) remains applicable to state member banks and bank holding companies with $100 billion or more in total assets. The Federal Reserve Board's Commercial Bank Examination Manual, Community Bank Supervision Process (Nov. 2020) applies the term ''community bank'' to generally describe a bank with $10 billion or less in total consolidated assets.

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proposed scope of application is appropriate, as effective risk management practices should be tailored to the size of the institution and the nature, scope, and risk of its activities. These institutions are typically more complex and present a higher risk profile than community banking organizations with less than $10 billion in total assets.

2. **Have you or your agency ever retaliated against a whistleblower?**

Response:
I have never retaliated against a whistleblower. The FDIC values the contributions of government employees, contractors and others who disclose allegations of misconduct involving FDIC programs and operations. During my tenure as Chairman of the FDIC, I have regularly communicated to employees that they can make protected disclosures without fear of retaliation.

3. **Have you ever harassed or been accused of harassing an employee? If yes, please detail each instance.**

Response:
In 2008, then-Chairman Shelia Bair requested that a third-party conduct a review and produce a Report of Management Inquiry in response to a concern that was raised by a senior FDIC official. At that time, then-Vice Chairman Gruenberg was interviewed in connection with the review, but FDIC has no records indicating that any further action was taken following the review. The full Report of Management Inquiry was provided to the Senate Banking Committee in late 2022 at the request of then-Ranking Member Toomey.

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1. **What will the Federal Deposit Insurance Corporation (FDIC) do to ensure that the low- and middle-income communities who stand to benefit the most from the Community Reinvestment Act will have a voice, and that the standards and metrics used to evaluate banks will continue to be responsive to their evolving credit needs and to new investment opportunities in their communities?**

Response:
The FDIC and other agencies solicited comment from stakeholders as we formulated and developed the final rule. The careful, deliberative process of crafting the rule was done with consideration of many stakeholder comments the agencies received. The perspectives of organizations representing low- and moderate-income (LMI) individuals and communities were instrumental in helping to shape the final rule which we hope will be truly impactful for generations. As the agencies develop examination materials, evaluative tools, and guidance, the agencies will engage in outreach events and webinars to answer questions from stakeholders and clarify standards.

Under the final rule, standards and metrics used to evaluate banks will continue to be responsive to the evolving credit needs and new investment opportunities in their communities. As you know, the final rule establishes a series of metrics and benchmarks against which banks will be measured for CRA performance for lending and community development. This will add important rigor and transparency to the CRA evaluation process. It will allow the banking agencies to establish specific standards for bank performance to achieve a particular CRA rating that will provide an incentive for increased lending to underserved communities. It will also provide greater clarity, transparency, and predictability for the banks and the public, as well as consistency among the agencies. These metrics used to measure retail lending and community development financing will be updated regularly to ensure that bank performance is responsive to community needs. Moreover, the final rule utilizes impact criteria to encourage investment in underserved geographies, which will also be updated regularly. This incentivizes banks to undertake community development activities that are particularly impactful and may take place in areas of high need, such as credit deserts. As a part of the impact review, the agencies would evaluate a series of specific qualitative factors, including whether the activity: (i) serves persistent poverty counties; (ii) is located in a geography with low levels of community development financing; and (iii) Native Lands.

In addition to metrics, the agencies will also consider qualitative performance context and other factors that the agencies may use to adjust the results of the quantitative analysis. This could include information found in the bank's public file. For instance, the final rule requires that a bank that received a less than "Satisfactory" rating during its most recent examination must include in its public file a description of its current efforts to improve its performance in helping

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to meet the credit needs of its entire community. Community input is often critical to describing efforts to improve performance.

Public engagement is important and the agencies solicit input from stakeholder to ensure that banks are serving their entire communities. For instance, the agencies publish our CRA exam schedule in advance so the public can comment on bank performance. The FDIC has also created a portal on its website for public comment and substantially beefed up the public's opportunity to engage with banks that are proposing strategic plans.

Also, in order to ensure continuing innovation in community development financing and services that benefit LMI and other targeted populations, the final rule also includes a process through which banks can confirm with the agencies whether a particular activity may be eligible for community development consideration. In addition, under the final rule, the agencies will maintain a publicly available, non-exhaustive illustrative list of activities eligible for community development consideration. The list will allow the agencies to update CRA eligible activities without the need to amend or revise the CRA regulation. Moreover, the new rule requirement that large banks (>$2b in assets) collect and report data on community development activities will allow the three agencies, the public, and the banks, themselves, to more accurately and transparently review and evaluate their community development activities.

2. **How will the FDIC ensure that the standards by which banks are evaluated do not place an undue burden on smaller and community banks, which do not have access to the same resources and manpower as larger financial institutions?**

Response:
The new rule tailors CRA evaluations and data collection to bank size and type. The rule recognizes differences in bank size, resources and business models and provides different evaluation standards for large, intermediate and small banks. For example, the rule would tailor performance standards for banks defined as small (less than $600 million in assets), intermediate ($600 million to $2 billion in assets), and large (more than $2 billion in assets), while also retaining the flexibility provided by the current rules through the strategic plan option and the limited purpose bank designation. Under the final rule, small banks will continue to be evaluated under the existing small bank lending test, unless they choose to opt into the Retail Lending Test – which would result in minimal changes for these banks.

In addition, the new rule exempts small and intermediate banks from new data requirements that apply to banks with assets of at least $2 billion and limits certain new data requirements to large banks with assets greater than $10 billion.

To provide additional relief to smaller institutions, the new rule significantly increases the small bank threshold to banks with less than $600 million in assets. This will result in over 600 banks

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that, at the time of the rule's adoption, were previously in the intermediate small bank category being redesignated as small banks. Over 70 percent of all banks will fit into this new, expanded small bank category. These banks could still receive CRA consideration for community development activity in their evaluations. Also, the rule's expansion of the intermediate bank category to banks up to $2 billion in assets is a significant increase in the threshold and would allow more than 130 banks that were, as of the adoption of the rule, subject to the more extensive three-pronged Large Bank test to be considered under the simpler Intermediate Bank test. The proposed Intermediate Bank test is a blend of the new Retail Lending Test and the current Community Development test familiar to current intermediate banks. Intermediate banks have the option to be evaluated under the new Community Development Financing test, if they choose.

Finally, the agencies plan to provide outreach and training to examiners and bankers to insure that institutions are aware of any new requirements.

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1. **Has Congress appropriated a precise dollar amount that the Federal Deposit Insurance Corporation (FDIC) must spend in a given year?**

Response:
Except for the FDIC's Office of Inspector General (OIG), the FDIC does not receive traditional Congressional appropriations.[71] The FDIC's annual operating budget is approved by the FDIC Board of Directors and is funded from the Deposit Insurance Fund (DIF). Thus, the FDIC is not subject to a precise dollar amount that it must spend in a given year.

2. **Is the FDIC legally required to spend the entire amount appropriated to it by Congress?**

Response:
As a non-appropriated entity, the FDIC is not subject to any legal requirement to spend funds appropriated to it by the Congress

3. **Have the FDIC's assessments ever exceeded the agency's budget in a given year? In that event, how are surplus funds used or handled?**

Response:
The FDIC manages the level of the DIF to maintain public confidence in the U.S. financial system and to resolve failed banks. The primary purposes of the DIF are (1) to insure the deposits and protect the depositors of insured banks and (2) to resolve failed banks. The DIF is funded mainly through quarterly assessments on insured banks. However, the quarterly assessments are not intended to simply meet our annual budget. Rather, they are intended to also build the DIF to ensure adequate resources are available to insure deposits and to resolve failed banks. As a result, each year the FDIC's deposit insurance assessments far exceed the amount of the FDIC's annual operating budget and those surplus funds simply accumulate in the DIF.

4. **Is Congress's appropriation of funds to the FDIC limited to a particular timeframe?**

Response:
As stated above, except for its Office of Inspector General (OIG), the FDIC is not subject to traditional Congressional appropriations.

[71] OIG appropriations are funded directly out of the DIF, unlike most other Congressional appropriations.

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5. **Does the FDIC possess both policymaking and law enforcement authority?**

Response:
Depending on the subject matter and the identity of the respondent, the FDIC may have both policymaking authority and enforcement authority. *See, e.g.,* 12 U.S.C. § 1819(Tenth) (providing the FDIC with rulemaking authority to carry out the provisions of the FDI Act), and 12 U.S.C. § 1818 (providing the FDIC with enforcement authority over insured depository institutions and institution-affiliated parties). The FDIC has both rulemaking authority and enforcement authority, which the agency may exercise in a manner consistent with the Administrative Procedure Act.

6. **In May 2023, the FDIC issued a proposed rule for a special assessment to reimburse the Deposit Insurance Fund after the collapse of Silicon Valley Bank. Under this rule, the reimbursements will be made by the largest banks, based on their estimated uninsured deposits as of December 2022.[72] But on July 24, 2023, the agency sent a letter to insured banks noting it had "observed that some [banks] are not reporting estimated uninsured deposits in accordance with the instructions" in quarterly call reports.[73] In an October 12, 2023 response to me, you provided additional detail on the actions taken by the FDIC related to uninsured deposits, and then in your November 16 final rule you indicated that "The FDIC is conducting a review (Assessment Reporting Review) of the reporting methodology for estimated uninsured deposits and related items on the Call Report because of the importance of these items as indicators of safety and soundness."[74]**

    a. **Has the FDIC completed this review? If so, what has it revealed?**

Response:
As of March 13, 2024, FDIC efforts to review the reporting methodology for estimated uninsured deposits and related line items reported by select institutions on the Call Report for the December 31, 2022 reporting date are still underway.

The FDIC has been in contact with all of the 95 banks subject to the special assessment that have made amendments as of March 7, 2024, to gain greater assurance of the banks' understanding of reporting requirements. As of March 7, 2024, including the effect of multiple amendments to

[72] Federal Deposit Insurance Corporation, "Notice of Proposed Rulemaking on Special Assessment Pursuant to Systemic Risk Determination," May 11, 2023, https://www.fdic.gov/news/financial-institution-letters/2023/fil23024.html
[73] Federal Deposit Insurance Corporation, "Estimated Uninsured Deposits Reporting Expectations," July 24, 2023, https://www.fdic.gov/news/financial-institution-letters/2023/fil23037.html
[74] https://www.fdic.gov/news/board-matters/2023/2023-11-16-notational-fr-b.pdf

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estimated uninsured deposits, 53 banks subject to the special assessment amended downward, 41 banks amended upward, and 1 bank reversed its initial downward amendment to result in zero net change. A large number of the banks' stated reasons for amendments are appropriate, including, but not limited to, revised estimates due to pass-through deposit insurance coverage, review of account ownership structures, and removal of insured cash sweeps. In cases where amendments to estimated uninsured deposits were not in accordance with Call Report instructions, banks have filed subsequent amendments to correct errors. For example, a bank that initially decreased its estimate of uninsured deposits may subsequently revise its estimate upward to correct errors made as part of the initial amendment.

Consistent with the FDIC's longstanding practice of conducting reviews under Section 7(b)(4) of the FDI Act to confirm the correctness of any assessment, during Assessment Reporting Reviews, FDIC staff conduct discussions with bank staff and may request and review source documents from the banking organization as part of its review of the reporting methodology. To the extent the FDIC finds that an institution is not reporting uninsured deposits in accordance with the Call Report instructions, FDIC staff will instruct the bank to submit one or more corrective amendments. Additionally, the FDIC will adjust the bank's special assessment base accordingly for corrective amendments that arise from or are confirmed through the Assessment Reporting Review.

b. **What additional actions has the FDIC taken to address concerns about banks' use of inaccurate data on uninsured deposits to evade required DIF payments?**

Response:
The FDIC takes seriously the matter of accurately reported Call Report data. The FDIC has taken a number of steps to ensure that banks are reporting estimated uninsured deposits in accordance with the Call Report instructions. These steps include: issuance of a FIL on Estimated Uninsured Deposits Reporting Expectations last July; outreach to banks that have amended estimated uninsured deposits to gain greater assurance of the banks' understanding of reporting requirements; issuance of a questionnaire in September to all banking organizations with total assets of $10 billion or more as of December 31, 2022, to confirm the accuracy of uninsured deposit reporting; and an ongoing Assessment Reporting Review.

Under the Final Rule to implement a special assessment to recover the loss to the Deposit Insurance Fund (DIF) arising from the protection of uninsured depositors following the closures of Silicon Valley Bank and Signature Bank, the FDIC will adjust the special assessment base for corrective amendments to estimated uninsured deposits that are confirmed through, or associated

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with the result of, its Assessment Reporting Review. The FDIC Board of Directors approved this Final Rule to implement the special assessment on November 16, 2023.[75]

c. **Which banks have modified their reports on uninsured deposits following action taken by FDIC? How have they modified the reports?**

Response:
As described in the response to 6a, as of March 7, 2024, including the effect of multiple amendments to estimated uninsured deposits, 53 banks subject to the special assessment amended downward, 41 banks amended upward, and 1 bank reversed its initial downward amendment to result in zero net change.

The FDIC has been in contact with all of the 95 banks subject to the special assessment that have amended as of March 7, 2024 to gain greater assurance of the banks' understanding of reporting requirements. In cases where amendments to estimated uninsured deposits were not in accordance with Call Report instructions, banks have filed subsequent amendments to correct errors. For example, a bank that initially decreased its estimate of uninsured deposits may subsequently revise its estimate upward to correct errors made as part of the initial amendment.

d. **Has FDIC taken enforcement actions against any banks for improper reporting related to uninsured deposits?**

Response:
As of March 13, 2024, no banks, for which the FDIC is the primary federal regulator, have been identified for an enforcement action.

e. **How will the FDIC monitor these reports for accuracy on an ongoing basis?**

Response:
The FDIC has a longstanding practice of conducting outreach to review amendments to reported data with a substantive impact on regular quarterly deposit insurance assessments. The FDIC will continue with this practice, which also covers the reporting of uninsured deposits.

[75] FDIC: PR-92-2023. "FDIC Board of Directors Issues a Final Rule on Special Assessment Pursuant to Systemic Risk Determination." November 16, 2023 , https://www.fdic.gov/news/press-releases/2023/pr23092.html. *See also* https://www.govinfo.gov/content/pkg/FR-2023-11-29/pdf/2023-25813.pdf.

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In addition to the ongoing Assessment Reporting Review, the FDIC reviewed data validation criteria and implemented additional data validation checks, including for the reporting of uninsured deposits and related items on the Call Report. If reported data violates a given edit check, Call Report analysts take additional steps to review and validate the given line item(s). Such additional steps can include outreach to the bank.

National Credit Union Administration

United States Senate Committee on Banking, Housing, and Urban Affairs
"Oversight of Financial Regulators: Protecting Main Street Not Wall Street"
Hearing, November 14, 2023

Responses to the Questions for the Record

Chairman Sherrod Brown:

1. The NCUA's new cyber incident reporting rule recently went into effect, and over 60% of the 146 incidents reported in the first 30 days were due to third-party compromises. The NCUA is the only regulatory agency on this panel that does not have third-party vendor authority. What challenges does this present to the NCUA's supervision of the credit union system?

Response: NCUA's lack of authority over third-party vendors that provide services to federally insured credit unions presents significant risks and challenges. This growing regulatory blind spot can trigger consequences throughout the credit union industry and the entire financial services sector. That's why the Financial Stability Oversight Council, the Government Accountability Office, and NCUA's Office of the Inspector General have all called on Congress to enact legislation to provide the agency with third-party vendor authority.

The growing reliance on third-party services in the credit union industry poses a systemic risk. For example, five core banking processors handle more than 90 percent of the entire credit union system's assets. A failure of one of these critical third parties would cause hundreds of credit unions and potentially tens of millions of their members to lose access to their funds simultaneously. This scenario would result in a loss of confidence in the financial sector and a liquidity crisis.

Unfortunately, this situation is not hypothetical. In fact, a recent security incident involving a third-party cloud service provider highlights the need for third-party oversight. The cyber incident at the third-party cloud service provider caused a credit union-only core service provider outage. Sixty small credit unions and more than 90,000 members lost access to all operational services simultaneously. Because NCUA does not have third-party authority, it took days for the agency to determine which credit unions were impacted by the core processor outage.

In the digital era, new and evolving risks emerge, including cybersecurity threats and concentration risks arising from outsourcing core business functions. With examination authority over third-party vendors, NCUA could proactively address risks and prioritize the safety of credit union members' information and funds.

The federal banking agencies already have examination authority over their designated financial institutions' third-party vendors, but NCUA does not have this authority for credit union vendors. Granting NCUA third-party vendor examination authority would ensure comprehensive financial supervision and maintain regulatory parity.

National Credit Union Administration

2. Please explain how the NCUA intends to ensure that artificial intelligence (AI) technology is deployed at credit unions in a safe and sound manner?

Response: The credit union industry is beginning to use AI technology to automate processes like responding to member questions through interactive voice response or a chatbot, underwriting and monitoring loans, and detecting fraud and potential money laundering. Some credit unions are also using AI tools to enhance member experience and create efficiencies and operational improvements. Credit unions opting to use AI technology must understand the risks involved and establish an appropriate risk management framework to ensure regulatory compliance and operational safety and soundness.

NCUA continually modifies its supervisory and regulatory processes to address emerging risks, and the examination processes will be updated to assess the risks associated with the use of AI tools in lending, operations, compliance, third-party relationships, and more. If examiners identify concerns, they will discuss those concerns with their supervisor and the credit union's management team and, if necessary, address them in the examination report.

NCUA participates in two interagency working groups reviewing the uses of AI and focusing on the benefits and risks associated with the technology. One working group is reviewing the agency's use of AI tools to perform agency work. The second working group is focused on identifying gaps in regulatory guidance regarding the financial services industry's use of AI.

3. The use of AI in high-stakes decisions like deciding the outcomes of credit applications can propagate or exacerbate bias and discrimination. Existing laws, such as the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act, provide financial regulators with mechanisms to respond to lending discrimination, particularly in response to a pattern or practice of discrimination. How is the NCUA *proactively* preventing discrimination, particularly by AI and particularly in creditworthiness assessments?

Response: NCUA shares the concerns the Consumer Financial Protection Bureau, Department of Justice, Equal Employment Opportunity Commission, and Federal Trade Commission communicated in their April 25, 2023, Joint Statement on Enforcement Efforts Against Discrimination and Bias in Automated Systems.

The use of advanced technologies, including AI must be consistent with federal laws. When reviewing credit unions' use of automated lending systems, including AI, NCUA reviews both system parameters and system decisions. If a credit union uses AI technology, examiners will focus on third-party risk management and model risk management, including development, implementation, use, monitoring, and validation.

Algorithms within AI models can contain biases that the credit union must identify. NCUA reviews the system parameters to determine if the model includes prohibited basis variables or proxies for prohibited basis variables. The agency considers whether data and datasets may be unrepresentative or imbalanced, may correlate with protected classes, or may contain other types of errors. When considering system decisions, NCUA seeks to determine if outcomes negatively impact applicants on a prohibited basis, and whether there are legitimate, nondiscriminatory explanations for the prohibited basis differences.

NCUA has been actively engaged with other federal agencies to address the issue of bias in home valuations by jointly issuing a proposed rulemaking on the Quality Control Standards for Automated Valuation Models to prevent algorithmic bias in home valuation assessment and proposed interagency guidance on Reconsiderations of Value of Residential Real Estate Valuations to empower the consumer to take action against appraisal bias.

4. ECOA specifically requires an explanation for any adverse credit actions. However, it is notoriously difficult or even impossible to faithfully explain the decision-making of a complex AI model. Does ECOA preclude the use of complex AI models in credit assessments? If not, why not?

Response: The algorithms used by AI models may contain biases. Credit unions that use AI models must understand how the model functions, particularly if the credit union relied upon the model to make decisions impacting the credit union's members. The credit union should periodically evaluate these AI models for bias and back test and validate the model's output.

ECOA does not preclude using complex AI models in credit assessments as long as the AI models are compliant with the law's requirements. For example, as outlined in the CFPB's Consumer Financial Protection Circular 2022-03, when creditors make credit decisions based on complex algorithms or AI models, they must comply with ECOA's requirement to provide a statement of specific reasons to applicants against whom adverse action is taken. The adverse action notice requirements of ECOA and Regulation B apply equally to all credit decisions, regardless of the technology used to make them.

Likewise, the CFPB's Consumer Financial Protection Circular 2023-03 clarifies that, under Regulation B, creditors may not rely solely on the unmodified checklist of reasons in the CFPB sample forms if the reasons provided on the sample forms do not reflect the principal reason(s) for the adverse action. Creditors may not evade this requirement, even if the factors considered or scored by the creditor may be surprising to consumers, as may be the case when a creditor relies on complex algorithms that, for instance, consider data not typically found in a consumer's credit file or credit application.

Thus, ECOA and Regulation B do not permit creditors to use complex algorithms when doing so means they cannot provide the specific and accurate reasons for adverse actions.

5. U.S. Securities and Exchange Commission Chair Gary Gensler has voiced concerns over the use of AI platforms developed by a handful of dominant technology firms, the consolidation of data used for financial decision making, and the potential for "herding" behavior to disrupt financial stability. What is the NCUA's perspective on these concerns? Is the NCUA adopting any precautions or recommending the implementation of any precautions, and, if so, what are these precautions?

Response: AI tools have existed for several decades; however, generative AI tools have been adopted in a very short time frame by millions of people. For example, ChatGPT has reportedly reached 100 million users in just 2 months (Why ChatGPT Is the Fastest Growing Web Platform Ever | Time). NCUA continues to study and perform research regarding the credit union industry's use of this technology. NCUA has not adopted any precautions or recommended the implementation of any precautions as of the date of this response.

In its latest annual report for 2023, the Financial Stability Oversight Council (FSOC) notes that the use of AI in financial services has increased in recent years. From FSOC's perspective, this trend brings both potential benefits, like cost reductions and improved performance, but also risks, such as safety and soundness and consumer compliance risks. Financial institutions using AI must be aware of the full array of both risks and benefits when using this new technology.

The FSOC annual report also indicated that AI in financial services is a vulnerability in the financial system. In accordance with that view, the report made the following recommendations:

> *The Council recommends monitoring the rapid developments in AI, including generative AI, to ensure that oversight structures keep up with or stay ahead of emerging risks to the financial system while facilitating efficiency and innovation. To support this effort, the Council recommends financial institutions, market participants, and regulatory and supervisory authorities further build expertise and capacity to monitor AI innovation and usage and identify emerging risks. The Council notes existing requirements and guidance may apply to AI. These include general risk management requirements that would apply to any technology used by financial institutions and to domain-specific use cases like fair lending that already have established rules to which AI must conform.*

NCUA concurs with this recommendation.

6. Is the advancement of AI in the financial services industry further enabling consolidation or otherwise threatening credit unions?

Response: There are many factors and influences that impact industry consolidation. NCUA is not aware of any use of AI that is either enabling consolidation or otherwise threatening credit unions.

7. How is the NCUA overseeing dynamic pricing for financial products and services, where the same financial product or services can be more expensive for some consumers, specifically focusing on consumers who have been historically overcharged for access to credit?

Response: NCUA is not aware of any interagency or policy information pertaining to dynamic or surge pricing in consumer or mortgage lending, nor has the Division of Fair Lending Supervision in the agency's Office of Consumer Financial Protection observed such practices in credit unions. When reviewing loan pricing, fair lending examination techniques control for factors tied to an applicant's creditworthiness. NCUA holds credit unions accountable for prohibited basis pricing differences not explained by factors tied to creditworthiness.

8. What action is the NCUA taking to fulfill its statutory mandate as a regulator charged with supervising financial institutions, specifically involving the identification and mitigation of risks associated with the development and deployment of AI in financial services? Has the NCUA identified any regulatory gaps? If so, what are those gaps?

Response: NCUA's Director of Fintech and Access currently serves on two interagency working groups focused on identifying and assessing the risks associated with the use of AI in the financial services industry. While a gap analysis has not been accomplished, the primary regulatory gaps are centered around third-party vendor risk, model risk, consumer compliance risk, and operational risk. NCUA's lack of third-party vendor supervisory authority will preclude the agency from participating in the analysis associated with third-party vendor risk. Until Congress acts to provide NCUA with the needed third-party examination statutory powers on par with other federal financial institutions regulators, NCUA will also be precluded from participating in the mitigation of third-party vendor risk due to the agency's lack of supervisory authority.

9. How is the NCUA using AI internally, particularly in any supervisory efforts? Please provide details on the design and application of AI in the NCUA's supervisory process. Please also explain if the NCUA is utilizing any AI-generated predictions, the application of those predictions, and how those predictions are being evaluated.

Response: NCUA is in the early stages of exploring the technological advancements of AI. Specifically, we use machine learning to identify potential financial data anomalies from large data sets and capturing transcripts from webinars. NCUA is exploring these capabilities to enhance our large credit union stress testing and data analytics. Currently, NCUA is not using AI-generated predictions in its credit union supervision program to make decisions or supervisory recommendations. NCUA is also completing an AI use-case inventory. While the inventory is not yet complete, NCUA has not identified any uses of generative AI for the supervisory process.

In addition, NCUA is drafting guidance that prohibits employees from using public sources of generative AI, such as ChatGPT, to analyze data or produce agency work products. Further actions will include updating NCUA's Employee Rules of Behavior and developing an agency-wide policy regarding the use of AI and generative AI.

10. In the Acting Ranking Member's opening remarks, and in various comments made by Committee Members in the course of their individual questioning of each of the witnesses, there was a vein of skepticism about efforts each of your agencies has made to consider climate change and its associated risks in your regulatory and supervisory work.

    As you seek to protect depositors, investors, workers, and the American economy as a whole, it is important for Congress to understand the complexity of your work. It is incumbent on agencies under the jurisdiction of the Banking, Housing, and Urban Affairs Committee to provide Members with insights into: (1) why you seek to collect and analyze particular bits of information and data; (2) why you and your staffs take pains to understand the challenges to the institutions under your respective authority presented by various factors; and (3) how a lack of attention to these factors by both regulated entities and their regulators might have cascading effects outside individual institutions and across the broader economy.

As such, please respond to the entire Committee to the following questions:

a. Why are the risks associated with climate change of concern given your agency's mandate?

Response: Economic and financial disruptions and uncertainties arising from both the physical and transition risks associated with climate change could affect the credit union industry across many dimensions and impact the stability of the National Credit Union Share Insurance Fund. Climate-related physical and transition risks tend to manifest as traditional financial risks, including credit, liquidity, market, and operational risks. For example, disruptions in economic activity caused by weather events like flooding or wildfires may affect household income and the ability to stay current on household financial obligations. The property damage associated with events could affect the value of homes and the mortgages collateralized by residential real estate. These events pose similar risks to businesses and mortgages collateralized by commercial real estate.

b. What potential effects to individual companies or the broader economy might result from ignoring those risks?

Response: The intensity and frequency of extreme weather and climate-related disaster events are increasing and imposing substantial economic costs. Costs to the economy are expected to increase as the cumulative impacts of past and ongoing global emissions drive rising global temperatures and related climate changes, leading to increased climate-related risks to the financial system.

Economic, technological, and policy transitions resulting in a reduction of greenhouse gas emissions—especially if delayed or uneven in application and requiring more abrupt economic shifts—may lead to sharp changes in the values of certain assets or liabilities, impacting nonfinancial activity and the financial sector. At the same time, changes in the climate driven by past and prospective greenhouse gas emissions will likely lead to frequent and extreme weather events and climate-related disasters, including droughts, wildfires, floods, and elevated windspeed. Such increased acute physical risks will be accompanied by a higher level of chronic physical risks, such as those associated with sea-level rise.

Increased frequency and severity of acute physical risks such as hurricanes, wildfires, floods, and heatwaves, as well as longer-term phenomena associated with climate change, are expected to lead to economic and financial costs. For example, the Network for Greening the Financial System scenario for potential outcomes under current policies shows a substantial increase in the segment of the U.S. population annually subject to heatwaves, with potential effects on productivity and other factors, and shows an increase in annual damages associated with tropical storms.

Physical risks have direct effects on households, communities, businesses, and other entities where those risks are realized, as well as to the financial institutions and investors to which they are linked, thereby creating greater complexity to climate-related financial risks. For example, insurers of property, hazard, flood, and other property-related risks are directly exposed to these risks. To reduce potential losses, insurers may increase premiums or withdraw from at-risk markets, which may reduce the affordability or availability of insurance coverage in vulnerable regions of the country. These responses by insurers may affect the economic and financial health of these communities' households, businesses, and governments.

In addition, increased actual damages to properties associated with physical risks may lower the value of collateral or the income generated by such properties, posing credit and market risks to banks, insurers, pension plans, and others. Increased liquidity, legal, and operational risks may also occur. In response, creditors may pull back from impacted regions, amplifying the initial harmful impact of the climate-related disaster events and creating further financial and economic strains.

c. Can you explain how more complete and more transparent information regarding the risks posed by climate change to the institutions over which you have authority would tend to help protect workers, investors, depositors, and the larger American economy?

Response: Climate change presents several complex conceptual and practical challenges not only for credit unions, but also for NCUA. As credit unions must adapt to account for climate-related financial risks, NCUA will need to evolve its understanding of the impact on credit unions, credit union members, the credit union system, and the Share Insurance Fund. More complete and transparent information about the risks posed by climate change will assist the agency in developing tools to identify and assess current and future risks to federally insured credit unions and the Share Insurance Fund. It could inform the agency's future decisions on the best way to address risks and how credit union members may be affected by risks.

d. Are there risks to American workers, investors, or depositors, or to this economy because corporations operating in multiple jurisdictions are not currently required to disclose some information to U.S. regulators that they routinely disclose to regulators in other jurisdictions?

Response: NCUA does not regulate corporations. As such, the agency does not require corporations to disclose information.

e. Are there data or other information you need to adequately address climate risk the collection or analysis of which are currently outside your statutory authority, and if so, what additional tools should Congress provide?

Response: NCUA continues to study climate-related financial risks and is assessing the agency's data and analytical requirements. Currently, NCUA is requesting Congress amend the Federal Credit Union Act to provide the agency with examination authority over third-party vendors, consistent with the authority provided to federal bank prudential regulators. This authority could allow NCUA to assess risks to the system more thoroughly, including risks stemming from inadequate disaster preparedness.

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Ranking Member Tim Scott:

1. Credit unions continue to struggle with compliance challenges, due in large part to new regulations from the NCUA and other regulatory agencies. Several years ago, the NCUA established a Regulatory Reform Task Force to conduct a comprehensive review of the agency's rules intended to recommend clarification/elimination of unnecessary rules. After issuing two reports, the work of the Task Force has concluded. Would you support reconstituting this Task Force or a similar entity to thoroughly examine the NCUA's rules and regulations with an eye toward reducing regulatory burdens?

Response: NCUA considers the burden to the industry when drafting each individual rulemaking and undertakes regular reviews of existing rules to determine their impact on an ongoing basis.

Recently, NCUA also finalized rules that will have the effect of easing regulatory burdens or facilitating the competitiveness of credit unions. For example, in October, the agency finalized a rule that adopts a more principles-based approach to the purchase of loan participations and the purchase, sale, and pledge of eligible obligations. The rule provides additional flexibility for federally insured credit unions to use advanced technologies and opportunities offered by the financial technology (fintech) sector with a view to increasing federally insured credit unions' ability to engage in lending arrangements with other financial institutions and third parties, including fintech companies providing lending services. The rule helps expand access to diverse loan origination channels and new markets, including the underserved, and potential new services for members of federally insured credit unions.

In August, the agency additionally finalized a rule required by the Credit Union Governance Modernization Act of 2022 to make it easier for credit unions to expel members who pose a security or financial threat to the credit union or its employees.

NCUA also reviews its existing regulations every three years through a rolling schedule that identifies one-third of the existing regulations for review each year and provides notice to the public of those regulations under review for comment. As part of this process, stakeholders provide comments on how to reduce regulatory burdens. The agency has previously used and will continue to use such feedback to inform its regulatory actions.

Furthermore, NCUA voluntarily participates in the decennial regulatory review authorized by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, otherwise known as the EGRPRA review, to identify rules that are outdated, unnecessary, or unduly burdensome on federally insured credit unions. That process is starting anew for the current cycle. NCUA is not statutorily required to undertake the EGRPRA review because it is not an "appropriate Federal banking agency" as specified in EGRPRA. In keeping with the spirit of the law, however, the NCUA elected to participate in the first and second EGRPRA reviews, and the NCUA Board has elected to participate in the decennial review process underway this year.

Together, these existing efforts allow NCUA to identify ways to refine the size, scale, and scope of its rules.

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2. Since reforms to NCUSIF were implemented in 1985, the equity ratio of the fund has only dipped below the statutorily mandated floor of 1.2% once, briefly, during the Great Financial Crisis due to increased losses coupled with the permanent increase of share insurance coverage from $100,000 to $250,000, and quickly rebounded to 1.28% by the end of 2010. Despite the historical and recent stability of the NCUSIF, you have continuously, and most recently in your written testimony, advocated to increase the 1.5% "normal operating level" ceiling of the NCUSIF's equity ratio. My colleagues and I have repeatedly impressed to all prudential regulators implementing regulatory changes that they must show their work. Accordingly, will you commit to providing a robust quantitative analysis demonstrating the need for such an increase and the economic effects it will have on credit union's continued ability to lend and provide support for their memberships and communities?

Response: As you note, NCUA's equity ratio fell to 1.18 percent in June 2010 due to actual losses in failed natural person credit unions, potential losses based on trends in troubled CAMEL composite earnings on the Share Insurance Fund's assets, and growth in insured shares that adversely impacted the equity ratio in 2010. The NCUA Board assessed a premium to the credit union industry and the equity ratio was returned to 1.28 percent in December 2010.[1, 2, 3]

However, prior to the 2010 documented breach of the minimum statutory threshold, the equity ratio was projected to fall below the statutory minimum threshold at year-end 2008 due to the estimated losses associated with five corporate credit union failures. Through the following congressional action as part of the Helping Families Save Their Homes Act of 2009,[4] NCUA was able to establish measures to spread the cost of these failures through several means, thus preventing a decline in the equity ratio to below the statutory minimum:

- Creation of the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) to absorb the $7.0 billion in losses to the Share Insurance Fund from the corporate credit union failures.[5] The Stabilization Fund was implemented to spread the cost of the corporate credit union failures over a period of time to reduce the financial impact on the credit union industry and allow the Share Insurance to remain solvent.

- Extension through 2013 of the $250,000 share and deposit insurance ceiling Congress had enacted as part of the Emergency Economic Stabilization Act of 2008.[6]

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[1] United States, National Credit Union Administration, *NCUSIF and TCCUSF Statistics* (2010), https://ncua.gov/files/agenda-items/AG20100729Item5b.pdf.
[2] United States, National Credit Union Administration, *Board Action Bulletin September 16, 2010*, (2010), https://ncua.gov/newsroom/news/2010/board-action-bulletin-september-16-2010.
[3] United States, National Credit Union Administration, *Annual Report: Resilience and the Road Ahead*, (2010), https://ncua.gov/files/annual-reports/AR2010.pdf.
[4] United States, National Credit Union Administration, *Corporate Stabilization Fund Implementation*, (2009), https://ncua.gov/regulation-supervision/letters-credit-unions-other-guidance/corporate-stabilization-fund-implementation#:~:text=The%20Stabilization%20Fund%20is%20administered,of%20a%20corporate%20credit%20union.
[5] United States, National Credit Union Administration, *Stability Through the Crisis: National Credit Union Administration 2008-2009 Annual Report*, https://ncua.gov/files/annual-reports/AR2008-2009.pdf.
[6] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 made the $250,000 statutory maximum limit permanent.

- Providing the Share Insurance Fund the authority to assess premiums over eight years to rebuild the equity ratio should the ratio fall below 1.20 percent.[7]

- Increasing NCUA borrowing authority to $6 billion.

- Establishing NCUA emergency borrowing authority of $30 billion.[8]

When the Great Recession began to affect the credit union system in 2008, the Share Insurance Fund equity ratio was 1.26 percent, with the Share Insurance Fund's balance at $7.96 billion. The $7.96 billion balance consisted of $1.98 billion in retained earnings and $5.98 billion reflecting the deposits contributed by insured credit unions. If Congress had not acted to create the Stabilization Fund, credit unions would have incurred an immediate loss of $7 billion to the Share Insurance Fund (the approximate cost of the corporate resolution). Such a loss would have depleted all the Share Insurance Fund's retained earnings and $5.3 billion of credit unions' Share Insurance Fund's contributed capital deposits. Because these deposits are treated as an asset by credit unions, the depletion would have been recorded as a loss to earnings that would have reduced the equity and net worth of the industry in 2008.[9] It also could have led to a cascading set of credit failures as credit unions fell below statutory capital levels mandating liquidation.

Likewise, had the Share Insurance Fund absorbed the losses from the corporate credit union failures, the NCUA Board would have had to levy a large assessment on credit unions to cover the remainder of the losses within one year.[10] The Helping Families Save Their Home Act of 2009 extended this period to eight years. Many of those remaining credit unions would not have survived the assessment.

NCUA was only able to preserve the solvency of the Share Insurance Fund and the credit union system during the Great Recession by implementing these various actions. The actions taken by Congress to support NCUA's contingency efforts under the Corporate Stabilization Plan were invaluable.

The financial crisis identified material weaknesses in the existing way the Share Insurance Fund is capitalized, and the statutory limitations imposed on NCUA to manage the Share Insurance Fund. Quantitative analysis shows the Share Insurance Fund would not be able to sustain a large loss like the corporate credit union failures without a significant, pre-cyclical impact on credit unions. For these reasons, NCUA conducted an analysis to demonstrate how a hypothetical loss in 2022, like the 2008 loss, would impact the Share Insurance Fund and the credit union industry.[11]

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[7] 12 U.S.C. § 1782(c)(2)(D)(ii)(C)
[8] 12 U.S.C. § Ch. 14
[9] 12 U.S.C. § 1790e.
[10] United States, National Credit Union Administration, *Stability Through the Crisis: National Credit Union Administration 2008-2009 Annual Report* 6, https://ncua.gov/files/annual-reports/AR2008-2009.pdf.
[11] See Analysis in Response to Senator Scott's second question for the record below.

This quantitative analysis supports NCUA's request to Congress to modify its statutory management requirements of the Share Insurance Fund by increasing the 1.5 percent ceiling for setting the normal operating level and removing other premium assessment restrictions on managing and growing the equity in the Share Insurance Fund. The analysis also shows how moving to a risk-based criteria for assessing premiums, rather than the current proportional percent of insured shares, would capture the inherent risk to the Share Insurance Fund from credit unions with more complex operations and those in weaker financial or operating condition. The FDIC uses a risk-based approach to capitalize its Deposit Insurance Fund.

NCUA's quantitative analysis underscores the necessity of a robust Share Insurance Fund capable of withstanding significant losses without relying solely on immediate assessments on credit unions or congressional support. The time to fix a roof is before a storm hits. Legislative action to adjust the operations of the Share Insurance Fund would allow the agency to build up counter-cyclical reserves to keep the fund solvent in a future financial crisis and prevent credit unions from having to pay mandatory premiums into the fund at a time when they can least afford to do so.

The NCUA's quantitative analysis describes how the Dodd-Frank Wall Street Reform and Consumer Protection Act eliminated several of the FDIC's maintenance restrictions, providing the FDIC more flexibility in managing its Deposit Insurance Fund. NCUA is requesting Congress to provide flexibility to the agency in the management of the Share Insurance Fund similar to that which has been afforded to the FDIC has to manage its Deposit Insurance Fund.

a. If not, why not?

Response: The attached analysis, based on a previously circulated white paper, provides the updated quantitative information you requested.

3. Given recent reporting detailing a culture of rampant inappropriate conduct and sexual harassment at the FDIC, and similar previous episodes of wrongdoing at the NCUA that included retaliation against an employee who filed a harassment complaint against a superior, what are you doing to instill a culture of respect and professionalism at the NCUA?

Response: NCUA is fully committed to ensuring a culture of respect and professionalism for all employees. The agency's leadership on multiple levels supports our commitment to equal employment opportunity and a harassment-free workplace. In recent years, the agency has taken several steps to improve its anti-harassment program.

In March 2020, the NCUA Board established an independent Office of Ethics Counsel to house the agency's ethics, financial disclosure, and anti-harassment activities. Any employee who feels they have been subjected to or has witnessed harassment can contact the anti-harassment program manager for guidance. In December 2020, the agency recruited its first Chief Ethics Counsel to lead the new, independent office. The Chief Ethics Counsel is an executive-level leader reporting directly to the agency head. Subsequently, in April 2021, the agency recruited a dedicated anti-harassment coordinator—a senior counsel with more than 30 years of federal employment law experience to lead its harassment prevention program.

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NCUA's anti-harassment coordinator subsequently updated NCUA' anti-harassment policies and procedures, working closely with subject matter experts at the Equal Employment Opportunity Commission. NCUA Instruction 1235.08 (Rev 2) (December 16, 2021) "Prevention of Harassment in the Workplace," is attached for ease of reference. In its review of the agency's final procedures the Equal Employment Opportunity Commission stated that NCUA's policies and procedures should serve as a model for other agencies. In keeping with our commitment to ensure that relief was immediately available to all employees who felt that they were being subjected to harassment, the agency established a dedicated email address (Anti-Harassment@ncua.gov) as an additional reporting mechanism.

Further initiatives to build awareness of the agency's anti-harassment program and informing employees of their rights and responsibilities regarding workplace harassment include:

- Recurring training for all agency employees on the policies and procedures to prevent harassment. The agency provides this training to:
    - every new employee as part of onboarding; and
    - every new supervisor upon promotion.

  We also provided the training to all employees as a periodic refresher at agency-wide trainings and events, such as at our national training conference in July 2023;
- An anti-harassment program update at the NCUA Chairman's November 2023 webinar for all NCUA staff;
- Communications to all agency managers and supervisors to ensure that they are aware of their responsibilities to identify and eliminate harassment (our procedures require that managers and supervisors submit any such reports to the anti-harassment coordinator within three days of receipt);
- A survey of all employees to ensure their familiarity with the agency's anti-harassment policies and procedures, and how to report harassment;
- Active engagement by NCUA's anti-harassment coordinator with NCUA's employee resource groups, the NCUA's Culture, Diversity, & Inclusion Council, and anti-harassment coordinators from other federal agencies; and
- Posting of the NCUA's policy and procedures for preventing and reporting harassment, signed by the Chairman, in all NCUA facilities. NCUA also posts related messaging that appears periodically on monitors throughout our headquarters building, issues regular messages to staff, and maintains a resource center for all employees on the agency's internal website.

Finally, issuance of the Chairman's most recent annual equal employment opportunity statement to all-staff also includes information about the agency's anti-harassment program.

a. What protocols and safeguards have been put in place to ensure that allegations of harassment are properly investigated and employees are not retaliated against for reporting abusive behavior from superiors?

Response: As noted earlier, NCUA published updated policies and procedures for addressing workplace harassment in December 2021. These policies and procedures guarantee an immediate and appropriate response to each and every report of alleged harassment. When an employee reports alleged harassment to a supervisor or manager, management is obligated to ensure that the allegation is promptly addressed, regardless of whether the report conforms to a particular format or is made in writing. Specifically, supervisors or managers must promptly (within three business days) notify the anti-harassment coordinator in the Office of Ethics Counsel about any incident of harassment that they witness or that is otherwise brought to their attention.

When further investigation is necessary, management may be required to take interim measures, such as modifying work assignments or work locations, to ensure that alleged harassment ceases promptly and does not recur. If it is determined that harassment has occurred, supervisors and managers have a duty to take corrective or disciplinary action, in consultation with the appropriate officials, which include NCUA's anti-harassment coordinator and may also include the Office of Minority and Women Inclusion when equal employment opportunity issues are raised, the Office of Human Resources when disciplinary actions, employee counseling, or other human resources actions are required, and the Office of General Counsel when legal issues arise.

NCUA's policy also stipulates that retaliation for reporting harassment is strictly forbidden. Section 5(B) of NCUA's instruction addressing workplace harassment situations specifically provides that it is unlawful for an individual to be retaliated against for filing harassment allegations, participating in the investigatory process, and any other protected activity. NCUA will not tolerate any retaliation against an employee because he or she engaged in a protected activity or made allegations of harassment, witnessed harassing conduct, or provided information concerning harassment claims. NCUA will take prompt corrective action in any situation involving retaliation. Employees should report retaliation to a supervisor or manager, a human resources specialist or advisor, an equal employment opportunity specialist in the Office Minority and Women Inclusion, or the anti-harassment coordinator in the Office of Ethics Counsel.

4. Are you currently, or have you ever been, the subject of an EEOC or Ethics investigation or complaint—or any other agency investigation or complaint—during your time in the federal government?

    a. If so, please describe every such instance, to include the nature of the complaint or investigation, when it occurred, and its resolution.

Response: As a member of NCUA Board, I am aware of equal employment opportunity complaints that have been filed against agency management with the standard custom of listing me as the head of the agency despite no involvement on my part, and none of those cases have involved my direct actions as an NCUA Board Member. I am also aware of ethics-related matters involving prior NCUA officials, but I am not now, nor have I ever been, the subject of such allegations.

Additionally, while previously working at NCUA as an executive, I did have an equal employment opportunity complaint filed against me in approximately 2012 alleging age discrimination. After an initial internal review performed by an individual trained in equal employment opportunity procedures, the matter proceeded to mediation, an informal way to resolve disputes with a neutral mediator.

On the day of the mediation, the employee learned that he had to accept the decisions of the mediator as final. Rather than proceed with the mediation, the employee voluntarily dropped the matter. The case was closed without any action.

National Credit Union Administration

Senator Catherine Cortez Masto:

1. Recently, the Federal Housing Finance Agency (FHFA) released a comprehensive report[12] calling for mission-focused reform of the Federal Home Loan Banks. As part of their goal to ensure that financing from the Federal Home Loan Banks (FHLB) supports housing and community development, FHFA will propose a rule that credit unions and banks hold at least 10% of their assets in mortgage loans to continue using FHLB's for liquidity.

    a. How will this proposed rule impact the credit unions?

Response: FHFA's proposal for credit unions to hold at least 10 percent of their assets in mortgages to access FHLB's for liquidity would impact a small number of credit unions. As of the third quarter of 2023, more than 1,400 credit unions were FHLB members. Less than 50 of these credit unions have currently qualifying mortgage assets below ten percent of total assets.

2. FHFA's report, *FHLBanks at 100: Focusing on the Future*, recommended permitting credit unions to pledge non-housing collateral.

    a. How would allowing credit unions under approximately $1.4 billion in assets to pledge small business, small agriculture and community facilities as collateral for advances affect the credit unions?

Response: Allowing credit unions under $1.4 billion in assets to pledge small business, small agriculture, and community facilities as collateral for FHLB advances would increase borrowing capacity for these credit unions by expanding eligible collateral for FHLB advances. As of September 30, 2023, approximately 1,255 credit unions under $1.4 billion in assets may benefit from this recommendation.

    b. How will proposed changes by the FHFA to require more mission-focused advances by member financial institutions affect bank examination practices of your institution?

Response: The FHFA's proposed mission-focused requirements for FHLB advances may have a minor effect on credit union examinations. Changes may include additional documentation review, adjusting collateral capacity calculations, and emphasis on maintaining diversified funding options.

    c. How will proposed changes to strengthen member risk management and improve member creditworthiness[13] affect bank examination practices of your institution?

Response: The FHFA's proposed changes to strengthen FHLB member risk management and improve member creditworthiness may have a minor impact on credit union examinations.

[12] United States, Federal Housing Finance Agency, *FHLBank System at 100: Focusing on the Future*, (2023) https://www.fhfa.gov/PolicyProgramsResearch/Programs/Pages/FHLBank-Focusing-on-the-Future.aspx.
[13] Id. at 34.

Changes may include additional documentation review and emphasis on maintaining diversified funding options.

National Credit Union Administration

Senator Mike Crapo and Senator Mark Warner:

1. Last year, this Committee helped advance into law the Financial Data Transparency Act (FDTA) which requires your agency to adopt specified data standards with respect to format, searchability, and transparency. The FDTA will require FSOC agencies to apply uniform data standards for the information they collect. All FSOC agencies are to draft rules about a future data standard to be available for review and comment by June 2024.

   What have you done to ensure your agency can and will be able to provide such standards that meet the requirements set forth in the law by June 2024?

Response: Legal, business, and technical representatives across NCUA are actively participating in interagency meetings related to the implementation of the Financial Data Transparency Act rulemaking. Additionally, NCUA has attended meetings with external stakeholders about the FDTA including the Data Foundation, the Global Legal Entity Identifier Foundation, and XBRL US. NCUA also continues to provide input on the approach for the notice of proposed rulemaking and data standards.

In addition to collaborating with FSOC agencies and meeting with external stakeholders, NCUA is assessing the potential impact on credit unions, our data collection systems, and data sharing practices. As the notice of proposed rulemaking is finalized, NCUA will continue refining our impact analysis and aligning internal resources to comply with the statute.

2. Are you confident all required FSOC agencies are making uniform data standards a priority?

Response: NCUA supports the tenets of the FDTA, and the implementation of the law is a priority for the agency. To date, the collaborative approach of the FSOC agencies has been instrumental in navigating the business, technical, and legal considerations for the rulemaking and impact on the financial industry.

3. Will you provide us an update on your progress by no later than February 28, 2024?

Response: Yes, NCUA will keep you informed of our progress as we proceed with this rulemaking.

National Credit Union Administration

Senator John Fetterman:

1. Banks and credit union regulators have the power to remove bad actors and ban them from working in the industry. How often do you use this power?

Response: NCUA has authority under 12 U.S.C. 1786(g) to remove an institution-affiliated party and to suspend or prohibit such party from working in any federally insured depository institution. The agency issued 17 prohibition orders during 2022 and 2023. The orders are available on NCUA's website at https://ncua.gov/news/enforcement-actions/administrative-orders#results.

NCUA's ability to issue a criminal penalty for violating a prohibition, however, is limited to a violation of the prohibition against participating in the affairs of a credit union.[14] By contrast, under the Federal Deposit Insurance Act,[15] an institution-affiliated party suspended, removed, or prohibited by the appropriate federal banking regulator is subject to a criminal penalty for serving in any insured depository institution, other federal institutions, and any insured credit union. There is no substantive reason for NCUA's criminal penalty provision not to have the same reach as the FDIC's provision.

2. Crypto isn't money. You can't fill up your gas tank and pay in crypto. However, it's apparently pretty useful for funding Hamas terrorism. Would you ever invest in crypto?

Response: No. Moreover, if I were to invest in cryptocurrency, then the criminal conflict of interest law would likely limit my ability to perform the full scope of duties as a financial regulator entrusted to me by the President with the advice and consent of the U.S. Senate.

3. Do you think banks can really evaluate the risks of crypto or should they stay out of it entirely?

Response: NCUA continues to study the cryptocurrency market and assess the risk to federally insured credit unions offering their members access to digital asset services through third parties.

Overall, the credit union industry has limited direct risk associated with the cryptocurrencies and digital assets market, as these assets are not carried on their balance sheets. The primary risk exposure arises through third-party service provider arrangements that offer exchange and custody services to credit union members. NCUA has previously issued guidance on this topic, including Relationships with Third Parties that Provide Services Related to Digital Assets | NCUA and Federally Insured Credit Union Use of Distributed Ledger Technologies | NCUA.

Due to the industry's limited direct exposure to the cryptocurrency market, NCUA is focused on the underlying distributed ledger technology and blockchain technology. The use of this technology, as with any financial technology tool, has risks that must be managed as well as potential opportunities to improve operations and enhance member services. As this technology

[14] 12 U.S.C. § 1786(l).
[15] 12 U.S.C. § 1818(j).

is used to tokenize other assets and liabilities, NCUA will take actions that help the credit union industry remain financially sound and provide fair and equitable access to financial services.

Credit unions currently do not have direct exposure to and do not hold cryptocurrencies on their balance sheets, and cryptocurrencies are not covered by federal share insurance. A small number of credit unions have originated loans secured by cryptocurrency; however, the primary risk is the credit risk of the borrower, not the direct risk associated with the collateral asset. Credit unions also rely on third-party vendors to provide exchange and custody services to their members. In the event the cryptocurrency market becomes more established and the credit union industry's exposure increases, NCUA's ability to fully assess risks posed by the cryptocurrency market will be limited due to its lack of statutory examination authority over third-party vendors.

The risks resulting from the NCUA's lack of vendor authority are real, expanding, and potentially dangerous for the nation's financial infrastructure. Other independent entities, including the Government Accountability Office, the Financial Stability Oversight Council, and the NCUA's Office of the Inspector General, have identified this deficiency as inhibiting the NCUA from fulfilling its mission to safeguard credit union members and the financial system. And, it is the NCUA Board's continuing policy to seek third-party vendor authority from Congress. I, therefore, again request legislative action to close this growing regulatory blind spot.

4. Bank and credit union employees are excluded from whistleblower protections under the new anti-money laundering whistleblower law. Do you believe we should change the current whistleblower laws to give employees as much protection as possible when they call out fraud and money laundering?

<u>**Response:**</u> Bank and credit union employees are likely excluded from the new anti-money laundering whistleblower law because the Federal Credit Union Act already has an employee protection remedy (1790b) and a whistleblower provision (1790c). These provisions are also cited as exclusions in the new anti-money laundering whistleblower protection program. With the existing Federal Credit Union Act allowances, there is likely less urgency to address the exclusion.

National Credit Union Administration

Senator Raphael Warnock:

1. According to CFPB, 16 of the 20 largest credit unions in the United States still charge non-sufficient fund fees as of last month.[16] What, if anything, is the National Credit Union Administration doing to encourage credit unions to eliminate these fees?

Response: The CFPB's ongoing overdraft research indicates that non-sufficient fund fee revenue is declining.[17] Many large banks have restructured their programs and eliminated these fees; however, credit unions are moving more slowly.

In speeches and other communications, I have encouraged credit unions to evaluate their overdraft and non-sufficient fund fee programs to remain competitive and achieve the statutory mission and purpose of the credit union industry, which is to meet the credit and savings needs of members, especially those of modest means. I have also encouraged credit unions to consider overdraft program features like linking to savings accounts, offering affordable lines of credit or short-term, small-dollar loans, and helping members build their savings.

NCUA is also in the process of modifying its call report system to collect data about overdraft and non-sufficient fund fees from the largest credit unions. Such transparency will increase public awareness of the totality of these fees and provide credit union management with more information to better benchmark their overdraft and non-sufficient fund fee programs.

[16] United States, Consumer Financial Protection Bureau, *Vast Majority of NSF Fees Have Been Eliminated, Saving Consumers Nearly $2 Billion Annually* (2023), https://www.consumerfinance.gov/data-research/research-reports/vast-majority-of-nsf-fees-have-been-eliminated-saving-consumers-nearly-2-billion-annually/.
[17] Id.

National Credit Union Administration

Senator Elizabeth Warren:

1. Has Congress appropriated a precise dollar amount that the NCUA must spend in a given year?

Response: The only portion of NCUA's budget where Congress provides a precise dollar amount is for the annually appropriated Community Development Revolving Loan Fund. In recent years, Congress has appropriated funds to the grant program administered through the Community Development Revolving Loan Fund that remain available for expenditure for two fiscal years.

The operating budget that pays for most agency administrative expenses, including agency salaries, is a permanent indefinite appropriation for which Congress does not specify a precise, annual dollar amount. The NCUA Board must determine the resources necessary to carry out NCUA's responsibilities under the Federal Credit Union Act.[18] The Board is authorized to expend such funds and perform such other functions or acts as it deems necessary or appropriate in accordance with the act and established regulations and policies.[19]

The NCUA Board's process for determining the agency's annual budget is done in accordance with 12 USC 1789(b).

2. Is the NCUA legally required to spend the entire amount appropriated to it by Congress?

Response: Regarding the specific annual appropriation the agency receives from Congress for the Community Development Revolving Loan Fund grant program, there is no legal requirement that the appropriated funds be spent, only that they are available for two years. The Community Development Revolving Loan Fund is a grant program that provides financial assistance to credit unions serving low-income communities or that are certified as minority depository institutions. NCUA strives to spend the entire amount appropriated by Congress by awarding all the annual appropriations to eligible applicants. In some cases, award recipients are unable to complete the projects for which the funds were awarded, and such unused grants are returned to the Treasury Department unspent.

While there is no specific legal requirement that NCUA spend the entire appropriation provided to it, in recent years, requests for grant funds have far surpassed the amount appropriated. Because of the two-year availability of the funds that Congress appropriates, unused grant funds cannot be re-awarded once the statutory availability of the funds has expired.

3. Have the NCUA's assessments ever exceeded the agency's budget in a given year? In that event, how are surplus funds used or handled?

Response: Pursuant to the Federal Credit Union Act, NCUA's operating budget is funded from two sources: operating fees paid by federal credit unions and transfers from NCUA's Share

[18] 12 U.S.C. § 1752a(a).
[19] 12 U.S.C. § 1766(i)(2).

Insurance Fund. The NCUA Board first determines the annual funding it requires to carry out NCUA's statutory mandates by formulating its budget. The insurance-related work funded by the annual budget is used to determine the amount of the budget that will be funded by transfers from the Share Insurance Fund. The remaining amount of the budget not funded by transfers from the Share Insurance Fund is assessed to federal credit unions in the form of the operating fee.

In 2021 and 2022, the NCUA's operating expenditures were lower than the budgeted amounts, primarily due to reduced travel to credit unions during the COVID-19 pandemic. To account for the share of the unspent budget that had been previously assessed to federal credit unions, NCUA applied the surplus operating fees collected but unspent at the end of the year to the operating fees proposed for collection in the subsequent year. Thus, operating fees collected from federal credit unions but unspent in 2021 were used to lower the amount of operating fees assessed for 2022, and operating fees collected but unspent in 2022 were used to lower the amount of operating fees assessed to federal credit unions in 2023.

Importantly, the portion of the budget that is funded by transfers from the Share Insurance Fund will never result in a surplus assessment. NCUA only transfers funds for the Share Insurance Fund portion of its annual operating expenses after those expenses have been paid. Thus, NCUA only collects its insurance-related budget amounts as it incurs the actual expenses, meaning that there is never a surplus assessment due to be returned to the Share Insurance Fund at the end of the year.

4. Is Congress's appropriation of funds to the NCUA limited to a particular timeframe?

Response: Pursuant to the Federal Credit Union Act, NCUA has a standing appropriation, not subject to the annual appropriations process, that funds the bulk of the agency's operations and is financed principally through fees charged to federal credit unions and requisitioning the Share Insurance Fund. The operating budget is a permanent indefinite appropriation, which does not have a particular timeframe; however, the operating budget approved by the NCUA Board is subject to the requirements of the Federal Credit Union Act which proscribe an annual process the Board must follow in the adoption of the operating budget.[20]

As noted above, NCUA does administer the Community Development Revolving Loan Fund grant program for which Congress appropriates funds for two years. The 2023 appropriation law states that funds shall be available until September 30, 2024.

5. Does the NCUA possess both policymaking and law enforcement authority?

Response: Pursuant to the Federal Credit Union Act, NCUA has the authority to develop policies applicable to the credit union system and the authority to enforce the Federal Credit Union Act as well as other statutes, such as consumer protection statutes, as mandated by Congress. The agency can also refer matters to law enforcement agencies, such as the Department of Justice, as appropriate.

[20] 12 U.S.C. § 1789(b).

Answers to Questions for the Record Following a Hearing entitled "Oversight of Financial Regulators: Protecting Main Street Not Wall Street" conducted by the Senate Committee on Banking, Housing, and Urban Affairs

On November 14, 2023, the Committee on Banking, Housing, and Urban Affairs convened a hearing at which Michael J. Hsu, Acting Comptroller of the Currency, testified on "Oversight of Financial Regulators: Protecting Main Street Not Wall Street." After the hearing, members of the Committee submitted questions for the record. This document provides the Office of the Comptroller of the Currency's responses.

Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Chairman Sherrod Brown:

1. **Please explain whether there is anything in the BASEL III Endgame capital proposal that would prevent banks from lending to small businesses or low- to moderate-income borrowers?**

   Response: There is nothing in the proposal that would prevent banks from lending to small businesses or low- to moderate-income borrowers. The OCC recognizes the importance of banks being able to meet the needs of their communities in a manner that is consistent with the OCC's mission of ensuring safety, soundness and fairness. In addition, consistent with the Community Reinvestment Act, the OCC encourages banks to help meet the credit needs of their communities, including low- and moderate-income neighborhoods, and individuals, consistent with the safe and sound operation of such institutions.

   The OCC does not intend the proposal to diminish bank lending that supports homeownership opportunities, including for low- and moderate-income home buyers or other historically underserved markets. The regulatory capital proposal includes 176 questions where specific feedback is requested, including how the proposal will impact low- and moderate-income borrowers or other historically underserved markets. The OCC, along with the other federal banking agencies, will carefully review and consider all comments and feedback received consistent with the requirements of the Administrative Procedure Act (See, e.g., 5 U.S.C. § 553(c)) (APA).

2. **Earlier this year, JPMorgan acquired First Republic's assets after its failure. This acquisition further increased the concentration of assets among the largest institutions in this country and decreased competition in the banking sector. What is the OCC doing to update its guidelines for reviewing merger and acquisition transactions to ensure that the banking sector remains a competitive market that serves the needs of the American people?**

   Response: The OCC has made it a top priority to update the analytical frameworks related to bank mergers. With respect to the analysis of competition under the Bank Merger Act, the

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OCC continues to work with the other federal banking agencies and the DOJ to consider potential revisions and enhancements to the interagency Bank Merger Competitive Review Guidelines. The OCC has also been evaluating our processes and procedures for review of the other statutory factors that must be considered in the context of a bank merger application, including financial stability, financial and managerial resources, and convenience and needs. On January 29, we issued a notice of proposed rulemaking and draft policy statement to provide additional clarity guidance around the OCC's review of applications in order to promote a diverse and dynamic banking system.

3. **Following the failures earlier this year, has the OCC observed an uptick in community banks' use of derivatives to manage interest rate risk? If so, does the OCC have the necessary resources to supervise this activity in community banks?**

   Response: There has not been a material uptick in community banks' use of derivatives to manage interest rate risk since the failures earlier this year. Community banks that use derivatives to hedge interest rate risk do so as part of an ongoing risk management program and the OCC has the necessary resources and expertise to supervise this activity in community banks.

4. **Is the OCC seeing any weakness in the financial system related to banks' exposure to commercial real estate?**

   Response: Commercial real estate (CRE) risks are increasing as demand for properties declines, funding costs are higher, and hybrid and remote work schedules are keeping occupancies relatively low. In addition, the October 2023 Federal Reserve's Senior Loan Officer Opinion Survey reported tighter lending standards and weaker demand for all commercial real estate loan categories. For OCC-supervised institutions, CRE loan concentrations are centered in regional and community banks.

   The office sector faces significant risks. Looming lease expirations, remote work schedules, and upcoming debt maturities portend an uptick in loan defaults and property value declines in some major metropolitan markets. The office sector will likely face additional challenges before reaching an equilibrium. Risk in the office market remains high and is expanding beyond urban business districts. Risk remains highest in urban core markets, and we are observing vacancy rates rising for suburban submarkets. The office sector continues to be challenged by low levels of demand for rental space causing the national vacancy rate to hit a new record high of 13 percent in the second quarter of 2023. Risk in the multifamily sector is also increasing in some markets. with increasing vacancy levels due to a combination of new inventory coming online and slowing demand.

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5. **Do interest rates, liquidity, and unrealized losses in banks' investment portfolios continue to pose a risk to the financial system, particularly in light of the bank failures earlier this year? What is the OCC doing to mitigate those risks?**

   Response: Rising deposit rates, broader market liquidity contraction, and increased reliance on wholesale funding started to impact net interest margins through the first half of 2023. Competition for deposits and higher interest rates are raising deposit costs. Deposit and liquid asset trends stabilized in the latter half of 2023, but these levels were supported by increased reliance on wholesale funding. Increases in interest rates are negatively impacting investment portfolio values. The OCC identified the impact of these risks to the safety and soundness of supervised entities. The agency continues to message to all stakeholders the resulting potential risks to earnings, liquidity availability and adequacy, and modeling accuracy. The OCC also continues to incorporate these considerations, as appropriate, into our risk-based supervision strategies to assess the soundness of a bank's liquidity risk management, including processes that ensure sufficient committed capacity to meet contingent liquidity needs.

6. **Banks have previously argued that the implementation of higher capital ratios would disadvantage them relative to their international peers, yet the largest financial institutions in this country continue to operate with global footprints and remain profitable. If the capital rules were adopted as proposed, is there any concern that the largest banks in this country would not remain competitive with their international peers?**

   Response: Standardized credit and operational risk capital requirements, together with robust public disclosure and reporting requirements, would enhance the transparency of capital requirements and the ability of supervisors and market participants to make independent assessments of a banking organization's capital adequacy, individually and relative to its peers. The proposed revisions would be generally consistent with recent changes to international capital standards issued by the Basel Committee on Banking Supervision. Therefore, the proposed scope would help promote competitive equity among large U.S. banks and their foreign peers and help reduce opportunities for regulatory arbitrage across jurisdictions.

7. **Some have argued that the capital proposal will drive risky activities to less regulated portions of the financial sector. While I have long been concerned about risks in the unregulated shadow banking system, we need strong capital requirements in place for banks that have the public backing of deposit insurance and the Federal Reserve's discount window. Please explain how the capital proposal will help prevent risky activities occurring at nonbank entities from threatening our banking system. Please also discuss other regulatory tools and authorities available to mitigate risks in the nonbank financial sector.**

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Response: The proposal is intended to strengthen the regulatory capital framework by improving its comprehensiveness and risk sensitivity, enhance the financial resilience of large banks, and improve transparency facilitating more effective supervisory and market assessments of capital adequacy. These enhancements to the capital framework are intended to allow banks to continue meeting the needs of their communities in a manner that is consistent with safety and soundness principles, including providing credit to creditworthy individuals, households and businesses over a range of economic conditions. A more resilient banking system will be better positioned to withstand any potential volatility that occurs in the non-bank financial sector.

8. How does the OCC intend to ensure that artificial intelligence (AI) technology is deployed at banks in a safe and sound manner?

Response: The OCC follows a risk-based supervision model focused on safe, sound, and fair banking practices, as well as compliance with applicable laws and regulations, including fair lending and other consumer protection requirements. This risk-based approach includes developing supervisory strategies based upon each individual bank's risk profile. When developing supervisory strategies, examiners consider the impact of new, modified, and expanded products and services on the bank's risk profile. To aid banks with developing robust risk management governance processes for the implementation of AI technology, the OCC has published informational resources individually, and as part of interagency communications to the industry and examiners. Relevant resources available on the OCC's website include: (i) "Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management;" (ii) Comptroller's Handbook, "Model Risk Management;" (iii) "New, Modified, or Expanded Bank Products and Services: Risk Management Principles;" (iv) "Third-Party Relationships: Interagency Guidance on Risk Management;" and (v) the Interagency Statement on the Use of Alternative Data in Credit Underwriting.

9. Does the OCC have the workforce and technological resources necessary to supervise institutions that are deploying AI technology across their operations at an increasing rate?

Response: The OCC continues to review and update, as needed, supervisory guidance, examination programs, and resources and training for examiners to respond to the growing use of AI. The OCC coordinates the efforts of various OCC policy and supervisory functions to ensure examiners understand the benefits and risks associated with AI use. For example, the Office of Financial Technology fosters internal OCC staff awareness of responsible innovation and emerging trends, including AI, and seeks to help enhance the skills of examiners. Additionally, the OCC maintains an Economics and Risk Analysis Division to provide appropriate technical expertise and knowledge to support ongoing supervision and targeted examinations of banks' use of complex models and AI.

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10. **The use of AI in high-stakes decisions like deciding the outcomes of credit applications can propagate or exacerbate bias and discrimination. Existing laws, such as the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act, provide financial regulators with mechanisms to respond to lending discrimination, particularly in response to a pattern or practice of discrimination. How is the OCC *proactively* preventing discrimination, particularly by AI and particularly in creditworthiness assessments?**

Response: The OCC maintains a comprehensive program of fair lending oversight that includes risk assessments, screening of data and other information for indicators of heightened risk, targeted examinations, referrals to other agencies as required by law, supervisory actions to address deficiencies, and where appropriate, enforcement actions. Recent updates to the OCC's fair lending supervision framework are designed to supervise banks' compliance with fair lending requirements and appropriate monitoring and risk management as they incorporate advanced analytics, such as artificial intelligence or machine learning, into underwriting systems and fair lending programs. For example, the OCC revised its Fair Lending" booklet of the *Comptroller's Handbook* in early 2023 and factors highlighted as presenting potentially high fair lending risk include newly implemented machine learning models and complex scoring systems such as those based on data not widely used for credit decisions. In addition, the OCC included questions on the use of advanced analytics in the updated Lender Interview Guide.

Examiners conducting fair lending examinations regularly utilize the support of OCC legal and technical and policy subject matter experts as well as economists when conducting fair lending examinations of banks using advanced analytics. Additionally, OCC leaders and staff regularly engage in outreach to banks, third parties, and community groups on the potential benefits and fair lending risks of artificial intelligence and other advanced analytics in credit screening and underwriting. For example, OCC staff have made presentations to bank CEOs, directors, and CRA and fair lending officers of national banks and federal savings associations on artificial intelligence, machine learning, and fair lending as well as at broader industry conferences.

11. **ECOA specifically requires an explanation for any adverse credit actions. However, it is notoriously difficult or even impossible to faithfully explain the decision-making of a complex AI model. Does ECOA preclude the use of complex AI models in credit assessments? If not, why not?**

Response: Under ECOA, and its implementing rule (Regulation B),[1] a lender must make a written statement of specific reasons for its action when taking an adverse action against an applicant or provide a disclosure of the applicant's right to a statement of specific reasons within 30 days if the applicant requests a statement within 60 days of the creditor's notification.

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[1] 15 USC 1691 et seq. (ECOA); 12 CFR 1002 (Regulation B)

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Under Regulation B, a creditor must disclose the principal reasons for denying an application or taking other adverse action. ECOA does not preclude the use of complex AI models. Lenders may use AI models to inform their decision-making regarding applicants' credit requests so long as they have sufficient controls in place to appropriately identify, mitigate and manage the fair lending risks, including providing adverse action notices that comply with ECOA and Regulation B.

To ensure that adverse action notices comply with ECOA and Regulation B, it is important that lenders employ strong model risk management programs, including a clear understanding of any AI models they use to understand the reasoning behind their models.

12. U.S. Security and Exchange Commission Chair Gary Gensler has voiced concerns over the use of AI platforms developed by a handful of dominant technology firms, the consolidation of data used for financial decision making, and the potential for "herding" behavior to disrupt financial stability. What is the OCC's perspective on these concerns? Is the OCC adopting any precautions or recommending the implementation of any precautions, and, if so, what are these precautions?

Response: While AI has the potential to provide many benefits, the OCC is also mindful of the associated challenges and risks, including those related to compliance risk, credit risk, reputation risk, and operational risk. As a member of the Financial Stability Oversight Council (FSOC), the OCC supports the assessment of the potential benefits and risks relating to the use of AI in financial services discussed in the 2023 FSOC Annual Report. The OCC will continue to monitor this rapidly evolving area at OCC-supervised banks, including the use of generative AI, and to follow advancements in technology and adoption in the industry. Consistent with existing supervisory expectations it is critical that banks manage AI use in a safe, sound, and fair manner, commensurate with the materiality and complexity of the particular risk of the activity or business process(es) supported by the AI usage.

13. Is the advancement of AI in the financial services industry further enabling consolidation or otherwise threatening small banks?

Response: The impact of AI on the financial services industry is nuanced, and while AI has the potential to provide many benefits, the OCC is also mindful of the associated challenges and risks. Financial constraints or lack of expertise may pose challenges to smaller community banks, however, there are opportunities for innovative strategies and collaboration to leverage AI including through third party relationships.

The OCC supports continuing efforts by national banks and federal savings associations to explore safe and sound uses of new and emerging financial technology such as AI. The OCC will continue to monitor this rapidly evolving area, including generative AI use.

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14. How is the OCC overseeing dynamic pricing for financial products and services, where the same financial product or services can be more expensive for some consumers, specifically focusing on consumers who have been historically overcharged for access to credit?

Response: The OCC follows a risk-based supervision model focused on safe, sound, and fair banking practices, as well as compliance with laws and regulations, including fair lending and other consumer protection requirements. The OCC examines banks' pricing strategies for appropriateness consistent with its risk-based supervision approach. Regardless of the process used for pricing loans, banks are required to comply with laws and regulations, including those regarding fair lending.

15. What action is the OCC taking to fulfill its statutory mandate as a regulator charged with supervising financial institutions and service providers, specifically involving the identification and mitigation of risks associated with the development and deployment of AI in financial services? Has the OCC identified any regulatory gaps? If so, what are those gaps?

Response: The OCC continues to work individually and on an interagency basis to enhance our understanding of AI risks and benefits and to monitor uses of AI as part of assessing the need for additional industry policy and guidance. Existing OCC policies and guidance applies to AI. For example, key principles in the 2011 interagency model risk management guidance apply to AI uses today, and the industry continues to leverage the guidance as an important resource. Additionally, the OCC issued guidance in October 2017 that addresses the implementation of new activities, such as AI. More recently, in 2021, the OCC issued a new Comptroller's Handbook on model risk management that incorporates the topics of AI and machine learning. Further, the recent 2023 interagency guidance on Third Party Risk Management is intended to provide further clarity on agency expectations when outside vendors are providing services, such as those related to AI.

16. Is the OCC using AI internally, particularly in any supervisory efforts? Please provide details on the design and application of AI in the OCC's supervisory process. Please also explain if the OCC is utilizing any AI-generated predictions, the application of those predictions, and how are those predictions being evaluated.

Response: The OCC is considering innovative approaches to enhance the planning and execution of our supervisory responsibilities, risk identification, and policy development. Currently, the OCC is evaluating and exploring the use of advanced technologies, including AI capabilities as part of this supervisory system upgrade.

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17. In the Acting Ranking Member's opening remarks, and in various comments made by Committee Members in the course of their individual questioning of each of the witnesses, there was a vein of skepticism about efforts each of your agencies has made to consider climate change and its associated risks in your regulatory and supervisory work.

As you seek to protect depositors, investors, workers, and the American economy as a whole, it is important for Congress to understand the complexity of your work. It is incumbent on agencies under the jurisdiction of the Banking, Housing, and Urban Affairs Committee to provide Members with insights into: (1) why you seek to collect and analyze particular bits of information and data; (2) why you and your staffs take pains to understand the challenges to the institutions under your respective authority presented by various factors; and (3) how a lack of attention to these factors by both regulated entities and their regulators might have cascading effects outside individual institutions and across the broader economy.

As such, please respond to the entire Committee to the following questions:

a. Why are the risks associated with climate change of concern given your agency's mandate?

Response: Climate-related financial risks have the potential to affect the safety and soundness of banks in the form of physical and transition risks. The OCC's attention as the prudential supervisor of national banks and federal savings associations focused on the safety and soundness implications of climate-related financial risks. The OCC's role is to ensure that national banks and federal savings associations understand their climate-related financial risks and develop risk management frameworks and capabilities to identify, measure, monitor, and control those risks.

b. What potential effects to individual companies or the broader economy might result from ignoring those risks?

Response: As noted in its 2021 Report on Climate-Related Financial Risk (Report), FSOC views climate-related financial risks as an emerging threat to the financial stability of the United States[2]. Also, as noted in the recent Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Principles), "physical and transition risks associated with climate change could affect households, communities, businesses, and governments – damaging property, impeding business activity, affecting income, and altering the value of assets and liabilities. These risks may be propagated throughout the economy and financial system. As a result, the financial sector may experience credit and market risks associated with loss of income, defaults, and changes in the values of assets, liquidity risks associated with

[2] FSOC 2021 Climate-Related Financial Risk Report (pages 1-2).

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changing demand for liquidity, operational risks associated with disruptions to infrastructure or other channels, or legal risks."[3]

The Principles also note that, "weaknesses in how a financial institution identifies, measures, monitors, and controls the physical and transition risks associated with a changing climate could adversely affect a financial institution's safety and soundness. The adverse effects of climate change could also include a potentially disproportionate impact on the financially vulnerable, including low-and-moderate-income (LMI) and other underserved consumers and communities."[4] The Report also notes that "the adverse effects of climate change on financially vulnerable populations may generate long-term impacts on delinquent debts, bankruptcies, credit scores, employment, incomes, and wealth, exacerbating existing inequities. Financially vulnerable households, businesses, and communities are less likely to have the resources to protect and guard against damage to their properties or adequately deal with loss of income from an adverse climate or weather event. Recovery in the aftermath of a disaster is likely to be more difficult and to take longer for these households, businesses, and communities. Such hardships can adversely affect the economic and financial strength of regions of the country and aspects of the financial system."[5]

c. **Can you explain how more complete and more transparent information regarding the risks posed by climate change to the institutions over which you have authority would tend to help protect workers, investors, depositors, and the larger American economy?**

Response: As noted in the recent Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Principles), "physical and transition risks associated with climate change could affect households, communities, businesses, and governments… These risks may be propagated throughout the economy and financial system."[6] Information on risks posed by climate change to banks' counterparties and clients can help banks understand their own climate-related financial risk. As stated in the 2021 FSOC Report on Climate-Related Financial Risk "public, high-quality climate-related disclosures by companies that issue securities (issuers) or are regulated as a financial institution (financial institutions) will better inform investors and market participants about the climate-related risks to those entities. In aggregate, these disclosures can also better inform market participants and regulators about climate-related risks to industry sectors and the financial system."[7] The Report notes that "like other risks, climate-related risks can impact the financial

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[3] Principles for Climate-Related Financial Risk Management for Large Financial Institutions (page 13).

[4] Principles for Climate-Related Financial Risk Management for Large Financial Institutions (page 13).

[5] FSOC 2021 Climate-Related Financial Risk Report (page 22).

[6] Principles for Climate-Related Financial Risk Management for Large Financial Institutions (page 13).

[7] FSOC 2021 Climate-Related Financial Risk Report (page 67).

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performance and position of companies over the short, medium, and long term."[8] The Report expounds on how the resiliency of the financial system is, "in part, dependent upon the resiliency of the firms that comprise it. In general, an individual firm is more resilient when it has sound processes for assessing risks and applies appropriate risk management practices. The disclosure of risks, and plans for managing them, can help foster the resilience of the financial system by allowing investors and market participants to factor that risk into their decision-making. This, in turn, facilitates better pricing of that risk information into financial markets. This pricing of climate-related risk can help reduce the likelihood of a financial shock associated with a sudden repricing of assets exposed to climate-related risks."[9]

d. Are there risks to American workers, investors, or depositors, or to this economy because corporations operating in multiple jurisdictions are not currently required to disclose some information to U.S. regulators that they routinely disclose to regulators in other jurisdictions?

Response: Disclosures on risks posed by climate change to banks' counterparties and clients have the potential to enhance the management of climate-related financial risks at OCC supervised institutions. As noted in the Principles "sound climate-related financial risk management depends on the availability of timely, accurate, consistent, complete, and relevant data".[10] If U.S. regulators do not have access to the same information as those in other jurisdictions on climate-related financial risks, it could impede the effective supervision of U.S. regulators on these risks.

e. Are there data or other information you need to adequately address climate risk the collection or analysis of which are currently outside your statutory authority, and if so, what additional tools should Congress provide?

Response: The OCC has the statutory authority to obtain data and other information needed to adequately address climate risk.

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[8] FSOC 2021 Climate-Related Financial Risk Report (page 67-68).

[9] FSOC 2021 Climate-Related Financial Risk Report (page 68).

[10] Principles for Climate-Related Financial Risk Management for Large Financial Institutions (page 19).

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Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Ranking Member Tim Scott:

1. **During the Covid-19 pandemic, it has been reported that much of the OCC's examination staff began offsite exams, as opposed to onsite. What percentage of exams are currently still being conducted offsite?**

   a. **In the last six months, what percentage of exams were conducted offsite?**

      Response: The vast majority of exams conducted by the OCC include an onsite presence in the banks. The OCC continues to utilize a hybrid model for conducting supervisory work to balance the need to be onsite with regulatory burden and staff flexibility.

2. **In the last six months, we have seen an onslaught of regulations promulgated unlike any time since the passage of Dodd-Frank. None of these regulations operate in a vacuum, and I remain concerned that all of these regulations collectively will lead to death by a thousand cuts for our economy. At a time when American families are being financially burdened by "Bidenomics" and persistently high inflation, how will these regulations collectively affect the American people and their ability to access credit?**

   Response: In accordance with our mission, the OCC's priority is to ensure national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.

   For all rulemakings, the OCC follows the APA (See, e.g., 5 U.S.C. § 553(c)). As required by the APA, the OCC solicits comments and encourages all stakeholders to share feedback on proposed rules, which may include supporting data and identification of possible interactions with other regulations or proposals. The OCC values public comments and carefully reviews and considers comments received, consistent with the requirements of the APA. Additionally, the OCC performs regulatory impact analyses pursuant to the Regulatory Flexibility Act and consistent with the Unfunded Mandates Reform Act of 1995. Such analyses consider estimated costs and benefits of a rulemaking, including implementation costs.

   The prudential banking agencies issued the regulatory capital proposal to increase the strength and resilience of the banking system and enhance the consistency of large banks' measurement of their risks. These enhancements to the capital framework are intended to allow banks to continue meeting the needs of their communities in a manner that is consistent with our mission of safety, soundness and fairness, including providing credit to creditworthy households and businesses over a range of

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economic conditions. The OCC appreciates the importance of considering the effect the regulatory capital proposal could have on lending to consumers and businesses as well as the potential interactions with other rulemakings, including the recently issued final Community Reinvestment Act rules.

3. **Many of these regulations were done on an interagency basis, but did the OCC—or any other agency involved in these regulations—conduct an analysis of the combined impact of these rules?**

   Response: The OCC follows applicable law, including the APA (*See, e.g.*, 5 U.S.C. § 553(c)), in all rulemakings. Through the rulemaking process, the OCC solicits comments and encourages all stakeholders to share feedback, which may include supporting data and possible interactions with other regulations or other proposals. The OCC values public comments and carefully reviews and considers the comments received. Additionally, the OCC performs regulatory impact analysis pursuant to the Regulatory Flexibility Act[11] and consistent with the Unfunded Mandates Reform Act of 1995.[12] Such analysis considers estimated costs and benefits of a rulemaking, including implementation costs.

4. **In your statement supporting of the finalization of the Interagency Principles on Climate-Related Financial Risk Management for Large Banks, you indicated that, "...these Principles recognize and respect that industrial policy and climate policy are outside of the scope of bank safety and soundness." However, the OCC's 2024 Supervision Operating Plan states that, "...examiners should monitor the development of banks' climate-related financial risk framework for safety and soundness." To clarify, is climate-related financial risk a matter of bank safety and soundness?**

   Response: Yes, climate-related financial risks have the potential to affect the safety and soundness of banks in the form of physical and transition risks. The OCC's attention as the prudential supervisor of national banks and federal savings associations is focused on the safety and soundness implications of climate-related financial risks. The OCC's role is to assess whether national banks and federal savings associations understand their climate-related financial risks and determine if they have developed risk management frameworks and capabilities to identify, measure, monitor, and control those risks.

5. **The Financial Stability Oversight Council ("FSOC") adopted final guidance on a framework to evaluate non-bank financial firms for designation as a threat to financial stability. If a company meets FSOC's new framework, it would be designated as a**

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[11] *See* 5 U.S.C. § 601 *et. seq.*
[12] *See* 2 U.S.C. § 1532.

systemically important financial institution (or SIFI) and would be subject to Federal Reserve supervision and regulation.

In 2019, FSOC issued a commonsense proposal on this matter, however, this new guidance seeks to undo the commonsense provisions sought in 2019. In fact, the 2019 guidance evaluated firms based on their business activities, required a consideration of the firm's financial health, and perhaps most importantly, would have required the government to conduct a cost-benefit analysis. This new guidance, however, provides FSOC with broad latitude to designate firms largely at their own discretion, and for partisan justifications such as climate-related risks.

Many financial firms in the U.S. not currently subject to Federal Reserve oversight, such as asset managers, are still subject to a great deal of regulation and oversight, often from the SEC or CFTC.

a. Can you explain why this new guidance is justified and why you don't believe a cost-benefit analysis is necessary in the designation process?

Response: The Analytic Framework (Framework) and the Nonbank Designations Guidance (Guidance) allow FSOC to use any of its authorities to identify and respond to potential risks to U.S. financial stability. The Framework and Guidance do not require FSOC to prioritize any particular authority over another. As such, the Guidance does not make designation the default method of addressing risks to financial stability and it does not eliminate FSOC's use of an activities-based approach when appropriate.

FSOC's designation process in the Guidance provides transparency to the public and significant engagement with a nonbank financial company under review as well as its existing primary financial regulator. Any FSOC designation of a nonbank financial company will be based on data-driven analysis that reflects the distinctive aspects of the company, its market, and its existing regulation.

A cost-benefit analysis should not be a prerequisite to the designation of a nonbank financial company. Section 113 of the Dodd-Frank Act establishes the structure for FSOC's evaluation of a company and the risks it could pose to financial stability. The statute does not contain, nor does it require FSOC to perform, a cost-benefit analysis. Further, the potential costs and benefits of designation depend, among other things, on financial conditions, market behaviors, and the risk and magnitude of potential future financial crises that are not able to be estimated with any reasonable degree of precision.

6. Are you currently, or have you ever been, the subject of an EEOC or Ethics investigation or complaint—or any other agency investigation or complaint—during your time in the federal government?

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a. **If so, please describe every such instance, to include the nature of the complaint or investigation, when it occurred, and its resolution.**

Response: The Acting Comptroller has never been the subject of an EEOC or Ethics investigation or complaint—or any other agency investigation or complaint—during his time in the federal government.

7. **Are you concerned that the Basel III Endgame proposal's increase of retail risk weights in combination with charging for unused balances of credit lines and the gross punitive operational risk requirement could negatively affect low- to moderate-income Americans by pushing them to less regulated sectors of the financial system and less protected sources of credit? Please explain why you supported the proposal as drafted.**

a. **Are you concerned that increases in capital requirements under the Basel III Endgame proposal for card credit borrowing lines are likely to reduce the amount of credit available to consumers to meet unanticipated or emergency expenses?**

Response: The prudential banking agencies issued the regulatory capital proposal to increase the strength and resilience of the banking system and enhance the consistency of large banks' measurement of their risks. These enhancements to the capital framework are intended to allow banks to continue meeting the needs of their communities in a manner that is consistent with safety, soundness and fairness, including providing credit to creditworthy households and businesses over a range of economic conditions. The proposal introduces a new treatment for certain retail exposures that enhances risk sensitivity. The proposal also solicits comments on the proposed treatment and encourages all stakeholders to share feedback, including supporting data. The OCC along with the other federal banking agencies will carefully review and consider all comments received consistent with the requirements of the APA.

8. **Some institutions have reported that the Basel III Endgame proposal will increase their capital requirements by upwards of thirty percent. This increase is due in large part to the treatment of fee- and commission-income as part of operational risk. Given that these increases may have significant negative consequences for credit card and capital markets lending, what alternative approaches to accounting for fee- and commission-income in the services component of the operational risk requirement are the agencies considering?**

Response: The prudential banking agencies asked questions in the regulatory capital proposal to seek industry and other stakeholder comments on alternative approaches in the operational risk capital requirement for fee- and commission-income. As with all

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rulemakings, the OCC, along with the other federal banking agencies, will carefully review and consider all comments received consistent with the requirements of the APA (See, e.g., 5 U.S.C. § 553(c)).

9. **To what extent, if any, are you concerned that the Basel III Endgame proposal could harm FBO competitiveness and cause them to retreat to their home markets, decreasing competition and sources of credit for U.S. consumers?**

Response: The proposal is intended to strengthen the regulatory capital framework by improving its comprehensiveness and risk sensitivity, enhance the financial resilience of large banks, and improve transparency facilitating more effective supervisory and market assessments of capital adequacy. The proposal applies to foreign banking organizations and would further align the regulatory capital framework across large banks. The proposed revisions would be generally consistent with recent changes to international capital standards issued by the Basel Committee on Banking Supervision that other members of the Basel Committee are in the process of implementing.

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Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Senator Catherine Cortez Masto:

1. **In a recent report, *FHLBanks at 100: Focusing the Future*[13], the Federal Housing Finance Agency recommended more mission-focused investments for members of the nation's eleven Federal Home Loan Banks.**

   a. **How will proposed changes by the FHFA to require more mission-focused advances affect bank examination practices by the OCC?**

   Response: As noted, the referenced changes are proposals. Ensuring OCC-supervised institutions have sufficient access to effective funding sources is a part of the agency's liquidity risk management examination practices. This includes considering whether bank management understands collateral requirements of the entities lending to the bank and has adequately estimated funding availability from those sources. OCC examiners determine whether bank management: (i) actively identify any changes to collateral, balance sheet, or other advance requirements; (ii) update estimates of funding availability, and (iii) consider how changes may impact the bank's sufficient access to effective funding sources and funding diversification. The OCC will consider the effect of any finalized changes to FHFA requirements applicable to OCC-regulated institutions.

   b. **How will proposed changes to strengthen member risk management and improve member creditworthiness[14] affect bank examination practices of your institution?**

   Response: As noted, the referenced changes are proposals. Ensuring banks have sufficient access to effective funding sources, including contingent funding in times of stress, is a part of liquidity risk management examination practices. This includes ensuring that bank management understands the credit standards of the entities lending to the bank and has adequately estimated funding availability from those sources in both normal and stressed times. Examination practices also include assessing bank processes to identify changes to credit standards as they occur and assess any impact(s) to funding availability. Thus, OCC examiners, as needed on a risk-based approach, would determine whether bank management had identified any changes to credit standards, updated estimates of funding availability, and considered how any changes have impacted the bank's sufficient access to effective funding sources and funding diversification. The OCC will consider the effect of any finalized changes to FHFA requirements applicable to OCC-regulated institutions

[13] https://www.fhfa.gov/PolicyProgramsResearch/Programs/Pages/FHLBank-Focusing-on-the-Future.aspx
[14] Ibid, page. 34.

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c. How should FDIC examiners consider advances from the Federal Home Loan Banks when determining if financial institutions have adequate liquidity?

Response: The OCC will defer to the FDIC to respond regarding its examination practices.

d. Do you see any opportunities to align Community Reinvestment Act goals with FHFA's mission-focused investments by the Federal Home Loan Banks? For example, should Community Investment Cash Advances or Community Investment Program advances qualify for CRA credit?

Response: Federal Home Loan Banks (FHLBs) can provide a source of liquidity to support community and economic development activities by national banks and federal savings associations to help meet the credit needs of their entire communities, including low- and moderate-income neighborhoods. These bank activities, in connection with FHLB funding, may receive consideration under the Community Reinvestment Act (CRA). For example, national banks and federal savings associations that are member banks may receive CRA consideration for affordable housing programs for low- or moderate-income borrowers that are supported by funds the banks receive from the AHP program. Member banks also may receive CRA consideration for community development activities they undertake with funding from the CIP or CICA programs.

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<u>Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Senator Mike Crapo and Senator Mark Warner:</u>

Last year, this Committee helped advance into law the Financial Data Transparency Act (FDTA) which requires your agency to adopt specified data standards with respect to format, searchability, and transparency. The FDTA will require FSOC agencies to apply uniform data standards for the information they collect. All FSOC agencies are to draft rules about a future data standard to be available for review and comment by June 2024.

1. **What have you done to ensure your agency can and will be able to provide such standards that meet the requirements set forth in the law by June 2024?**

   Response: The OCC has identified and engaged subject matter experts to meet the requirements of the FDTA. The OCC is cataloguing its data collection and data sharing practices within the agency to ensure it is prepared to comply with the FDTA's requirements for those data collection and sharing practices.

   In addition to this internal work, the OCC actively participates in an interagency working group of FSOC agencies in the development of the notice of proposed rulemaking that is required by June 2024 under the FDTA.

2. **Are you confident all required FSOC agencies are making uniform data standards a priority?**

   Response: The OCC is actively involved in the interagency rulemaking process. While we are unable to comment on the priorities of other covered agencies, we note that the collaborative approach of the FSOC agencies has been instrumental in navigating the business, technical, and legal considerations for the development of the notice of proposed rulemaking.

3. **Will you provide us an update on your progress by no later than February 28th, 2024?**

   Response: The OCC recognizes the importance of keeping members of Congress informed about the OCC's progress on this and other rulemakings. We will keep you informed of our progress as appropriate as we continue the rulemaking process.

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Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Senator John Fetterman:

1. **Banks and credit union regulators have the power to remove bad actors and ban them from working in the industry. How often do you use this power?**

   Response: Pursuant to 12 USC 1818(e), the OCC has statutory authority to remove and prohibit institution-affiliated parties (IAP) from participating in the industry. The term "institution-affiliated party," or IAP, is defined in 12 USC 1813(u) and includes bank directors, officers, employees, and controlling shareholders. Orders of Prohibition prohibit an individual from any participation in the affairs of a bank or other institution as defined in 12 USC 1818(e)(7). Please see the table below with information of 12 USC 1818(e) actions the OCC has taken.

Year	1818 Prohibitions	1818(g) Suspensions and Prohibitions
2018	33	
2019	23	
2020	20	1
2021	14	
2022	22	
2023 (*through Dec. 31*)	22	6

2. **Crypto isn't money. You can't fill up your gas tank and pay in crypto. However, it's apparently pretty useful for funding Hamas terrorism. Would you ever invest in crypto?**

   Response: In January 2023, the OCC, Federal Reserve, and FDIC issued a Joint Statement on Crypto-Asset Risks to Banking Organizations noting that the agencies had observed numerous risks associated with crypto-asset-related activities, including risks related to complying with applicable anti-money laundering and illicit finance statutes and rules. The Statement further noted that, based on our understanding and experience at the time, the agencies believed that issuing or holding crypto-assets that were issued, stored, or transferred on an open, public, and/or decentralized network was highly likely to be inconsistent with safe and sound banking practices. The types of crypto-assets transferred on such open, public and/or decentralized networks are generally the types of crypto-assets used in money laundering and illicit financing schemes.

3. **Do you think banks can really evaluate the risks of crypto or should they stay out of it entirely?**

   Response: The OCC neither encourages nor discourages the use of any particular technology that is used in a safe, sound, and fair manner. Under the principles of safety, soundness, and

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fairness, the agency expects bank management teams to implement risk management and control systems commensurate with the level and complexity of risk arising from their activities. This includes business decisions regarding technology platforms. Specific to crypto-assets and the underlying distributed ledger technology, OCC Interpretive Letter 1179 states that any national bank or federal savings association seeking to engage in certain cryptocurrency, distributed ledger, and stablecoin activities should demonstrate, to the satisfaction of its supervisory office, that it has controls in place to conduct the activity in a safe and sound manner prior to commencing the activity.

4. **Bank and credit union employees are excluded from whistleblower protections under the new anti-money laundering whistleblower law. Do you believe we should change the current whistleblower laws to give employees as much protection as possible when they call out fraud and money laundering?**

   Response: The OCC supports the new whistleblower protections for employees of financial services institutions under the Anti-Money Laundering Act of 2020 (AMLA), including expanded financial incentives for whistleblowers and prohibition against retaliation. We recognize that whistleblowers play an important role in the fight against financial crimes and would support additional efforts to protect employees from retaliation when they provide original information about a possible violation of the Bank Secrecy Act.

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Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Senator Robert Menendez:

1. **While your proposed capital rule only directly applies to banks with over $100 billion in assets, I have heard concerns that the rule might not only affect direct lending by banks, it might also push them away from holding mortgage backed securities and extending warehouse lines of credit. This could push smaller lenders that aren't directly subject to the new rule, including those that make FHA and VA loans, away from mortgage lending.**

   a. **Have you analyzed this possibility?**

   Response: The proposal would not change the risk weight for residential mortgages guaranteed by the Federal Government through the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA). The OCC appreciates the importance of considering how the proposal could affect the housing market and encourages all stakeholders to submit comments and data on the proposal. The OCC, along with the other federal banking agencies, will carefully review and consider all comments received, consistent with the requirements of the Administrative Procedure Act (See, e.g., 5 U.S.C. § 553(c)).

   b. **Will you commit to working to ensure that the final rule doesn't indirectly negatively impact mortgage lending by banks that aren't subject to the rule?**

   Response: The OCC is supportive of creating opportunities for home ownership. The purpose of the proposal is not to diminish home affordability or homeownership opportunities, including for low- and moderate-income home buyers or other historically underserved markets. The regulatory capital proposal includes questions to solicit specific feedback on the impact of the proposal on home affordability and home ownership and the OCC encourages all stakeholders to submit comments and data on the proposal. The OCC, along with the other federal banking agencies, will carefully review and consider all comments received, consistent with the requirements of the Administrative Procedure Act (See, e.g., 5 U.S.C. § 553(c)).

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Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Senator Mike Rounds:

1. **Acting Comptroller Hsu, as an FDIC board member, you voted to approve the FDIC's corporate governance proposal, even though the OCC's similar requirements only apply to banks over $50B. Why does an FDIC bank under $10 billion need these heighted standards, but an OCC-charted bank does not?**

   Response: The FDIC's corporate governance issuance was a notice of proposed rulemaking (NPR) with a proposed threshold of $10 billion. The preamble discussed the FDIC's rationale for setting the proposed threshold at $10 billion. The NPR asked two questions seeking input from commenters as to whether the proposed $10 billion threshold is appropriate or whether the threshold should be set at some other amount. In consultation with FDIC staff, I will carefully review and consider all comments received on the NPR before issuing a final rule.

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Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Senator Raphael Warnock:

1. **What will the Office of the Comptroller of the Currency do to ensure that the low- and middle-income communities who stand to benefit the most from the Community Reinvestment Act will have a voice, and that the standards and metrics used to evaluate banks will continue to be responsive to their evolving credit needs and to new investment opportunities in their communities?**

   Response: One of the objectives of the CRA rulemaking was to promote transparency and public engagement. The rule provides ways for all members of a bank's communities to express their views, including any low- and moderate-income communities or individuals who may voice concerns. The rule establishes a clear process where members of the public can provide input on community credit needs and opportunities for a bank's next scheduled CRA examination. In addition, the rule enhances opportunities for the public to provide input on a bank's proposed strategic plan through informal and formal public comment processes.

   The rule also provides different methods for banks to be responsive to the needs and opportunities of their communities. The Retail Products and Services Test provides for consideration for banks that establish credit and deposit products that are responsive to needs in their communities. In addition, the community development criteria and the impact and responsiveness factors, coupled with the confirmation of eligibility process, provide clarity to banks and community groups on what types of activities qualify for consideration under the community development tests. Finally, combining the evaluation of community development loans and community development investments under the same test enables banks to identify the types of financing opportunities available and the form most needed for a particular community development project without regard to whether a loan or investment would be more advantageous to the bank if evaluated separately under lending and investment tests as they are currently.

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Questions for Mr. Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency, from Senator Elizabeth Warren:

1. **Has Congress appropriated a precise dollar amount that the Office of the Comptroller of the Currency (OCC) must spend in a given year?**

   Response: No. The OCC does not receive appropriations and its funds are by statute, not appropriated funds or government monies. 12 U.S.C. § 481.

   The OCC is funded by assessments, fees, and other charges as the Comptroller determines is necessary or appropriate to carry out the responsibilities of the Office. 12 U.S.C. 16 and 482.

2. **Is the OCC legally required to spend the entire amount appropriated to it by Congress?**

   Response: The OCC does not receive appropriations and its funds are, by statute, not government funds or appropriated monies. 12 U.S.C. § 481. The Comptroller has authority to determine how OCC funds are obligated and its disbursements and expenses allowed and paid, except as provided in chapter 71 of title 5 (with respect to compensation). 12 U.S.C. 16. There is no statutory requirement that the OCC spend the entirety of the assessments, fees, or other charges it collects in a calendar year.

3. **Have the OCC's assessments ever exceeded the agency's budget in a given year? In that event, how are surplus funds used or handled?**

   Response: Yes. Assessments have exceeded OCC's budget. Annually, the OCC determines the amounts needed to fund current operations and allocate to its financial reserves. Financial reserves are integral to effective stewardship of the OCC since the agency does not receive congressional appropriations. Based on its analysis of funds needed, the OCC can adjust its annual assessments.

4. **Is Congress's appropriation of funds to the OCC limited to a particular timeframe?**

   Response: OCC funds are not appropriated funds, 12 USC 481, and its funds are not time limited. The requirements governing availability of appropriated funds in Title 31 of the United States Code are inapplicable to the OCC. See 12 USC §16.

5. **Does the OCC possess both policymaking and law enforcement authority?**

   Response: Pursuant to 12 USC 1, the OCC is charged with assuring the safety and soundness of, and compliance with law and regulations, fair access to financial services, and fair treatment of customers by, the institutions and other persons subject to the OCC's jurisdiction. Consistent with its statutory authority, the OCC issues rulemakings, guidance to industry, and guidance to examiners in support of this mission. The OCC has a Bank Supervision Policy unit that is responsible for formulating policies for effective supervision

Committee on Banking, Housing, and Urban Affairs
"Oversight of Financial Regulators: Protecting Main Street Not Wall Street."
November 14, 2023

and examination, providing accounting policy guidance, and promoting community development activities. Additional information and contacts can be found here.

The OCC has authority to take enforcement actions against institutions that the OCC supervises, and parties affiliated with them, including officers and directors of national banks and federal savings associations, under section 8 of the Federal Deposit Insurance Act. The OCC also has the authority to revoke charters of the institutions it supervises under various provision of the National Bank Act and the Home Owners Loan Act. This enforcement authority supports the OCC's supervisory process. The OCC's authority does not extend to criminal matters. If the OCC becomes aware of criminal activities at the institutions it supervises, it refers those matters to the appropriate law enforcement agency. Additional information on OCC Enforcement Actions can be found in PPM 5000-7, "Civil Money Penalties," PPM 5310-3, "Bank Enforcement Actions and Related Matters," and PPM 5310-13, "Institution-Affiliated Party Enforcement Actions and Related Matters".

6. **On November 16, 2023, the Wall Street Journal reported that "Wells Fargo is struggling with its regulatory obligation to monitor financial crime…[and] [r]egulators have issued the bank formal orders to be better at catching criminals who may be using its accounts or products."[15] I am concerned about these reports, which, if true, would provide additional evidence that Wells Fargo has still not addressed its chronic problems.**

   a. **Has OCC identified any matters requiring attention or matters requiring immediate attention related to Wells Fargo's compliance with the Bank Secrecy Act and anti-money laundering laws?**

      Response: The OCC has a dedicated team of examiners assigned to provide ongoing supervisory oversight to all large banks supervised by the OCC. The OCC regularly issues matters requiring attention (MRAs) at any time when concerns are identified related to the bank's safety and soundness or compliance with applicable laws and regulations. MRAs are identified during routine supervisory activities, including targeted examinations and ongoing supervision work. The OCC's supervisory processes enable the OCC to alert management and the board of concerns in a timely manner.

   b. **Does the OCC have any other open matters requiring attention or matters requiring immediate attention with Wells Fargo?**

      Response: As previously mentioned, the OCC can issue MRAs when it identifies concerns that warrant the attention of management and/or the board. After

[15] Wall Street Journal, *Regulators Say Wells Fargo Isn't Doing Enough to Police Customers Crimes*," Nov. 16, 2023, https://www.wsj.com/finance/banking/regulators-say-wells-fargo-isnt-doing-enough-to-police-customer-crimes-0809281d.

communication of the concern to bank management, OCC examiners perform quarterly assessments to determine the status of the bank's progress in addressing the concerns. Typically, a bank's internal audit unit will perform an internal validation when the bank has completed its actions to address the MRA and underlying concerns. After this internal validation has been completed, the OCC will then perform its validation activity to determine whether the bank's actions were effective and sustainable before officially closing the MRA. The OCC tracks open and closed MRA information in its supervisory databases.

c. Have OCC officials had any informal discussions with Wells Fargo related concerns about Wells Fargo's compliance with the Bank Secrecy Act and anti-money laundering laws or any other banking laws or regulations?

Response: As previously mentioned, the OCC has a dedicated team of examiners assigned to provide ongoing supervisory oversight to all large banks supervised by the OCC. As part of their responsibilities, the assigned examiners meet with bank management and directors regularly to discuss supervisory activities, outstanding concerns and remediation efforts, and current and emerging issues. These meetings cover a variety of topics, including compliance-related matters and/or violations of applicable laws and regulations.

d. Are there any other current open OCC investigation of Wells Fargo? If so, what is the nature of these investigations?

Response: Pursuant to its federal statutory visitorial powers, the OCC, as previously mentioned, conducts ongoing supervisory oversight of all large banks. If this authority, however, is not sufficient to obtain documents or other information necessary to determine whether there has been misconduct by or at a bank, then the OCC may initiate a formal investigation. A formal investigation enables the OCC to issue subpoenas for documents and/or oral testimony to institution affiliated parties and third parties to obtain the necessary information to determine whether there has been misconduct by or at a bank. The initiation of a formal investigation does not mean that there has, in fact, been such misconduct. Therefore, formal investigations are nonpublic to preserve the confidentiality of the potential concern and the information obtained during the formal investigation. *See* 12 CFR 19.181.

e. Has OCC, in the last 12 months, reached any settlements involving fines or other penalties for Wells Fargo? If so, please list all such fines or other penalties.

Response: The OCC has not reached any settlements involving fines or penalties with Wells Fargo within the last 12 months.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

AFR Americans for Financial Reform

Statement for the Record
Senate Committee on Banking, Housing and Urban Affairs Hearing
Oversight of Prudential Regulators: Protecting Main Street, Not Wall Street
Wednesday, November 14, 2023 10 AM in 538 DSOB

Dear Chairman Brown and Ranking Member Scott, and members of the Senate Committee on Banking, Housing, and Urban Affairs,

In connection with the Committee's hearing on the oversight of prudential regulators on November 14, we write to advocate for the Fed, the OCC and the FDIC (hereafter the agencies) to finalize key rulemakings, particularly the Basel III Endgame and related reforms. We also advocate for the agencies to act with more urgency on key reforms that are necessary to prevent future financial crises. This includes moving forward on long awaited incentive compensation rules, making updates to their bank merger guidelines and, now that the Financial Stability Oversight Council's nonbank designation guidance is final, acting swiftly as members of the council to identify systemically important financial institutions for heightened scrutiny.

We ask the committee to support the agencies' finalization of the large bank Basel III Endgame proposal for stronger capital requirements. The alternative, allowing the largest banks to continue to operate in their current undercapitalized state, has real world economic consequences for individuals, communities, and 'real economy' businesses. Similarly, the ongoing delay in the agencies' updates to their bank merger guidelines, stalled compensation rules and still pending assessment of nonbanks for systemic importance, including climate related, continue to put Americans at risk of further financial crises.

The large bank capital proposal is an important step in the right direction to strengthen the large banks' capital cushions, which are key to their safety and soundness and, in aggregate, to maintaining a resilient financial system that can withstand severe shocks. Americans for Financial Reform (AFR) is not alone in thinking even higher capital standards are necessary, a view argued, for example, by the Minneapolis Fed's leadership in 2016.[1] Nonetheless, the current proposal represents significant progress, with provisions to finalize the Basel III Endgame and restore capital requirements for banks in the total assets band of $100 to $250 billion. We strongly urge the committee to support the agencies' finalization of the proposal in a way that maintains its key elements, undeterred by the bank lobby.[2]

[1] Minneapolis Fed, "The Minneapolis Plan to End Too Big to Fail: The Right Plan at the Right Time," Ron J. Feldman, Ken Heinecke, February 5, 2018.
[2] Tailoring Requirements for Domestic and Foreign Banking Organizations, https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf.

Higher bank capital requirements restrict how much the megabanks, in particular, can grow and engage in the riskier aspects of their business that drive greater higher returns, notably in their trading and investment bank operations. By opposing larger capital cushions, banks are trying to privatize the gains to their firm and socialize any losses. Additionally, higher capital undermines bank CEOs' shareholder oriented compensation arrangements. Instead of owning up to this, the biggest banks have produced a long list of reasons why the Basel III Endgame provisions should not be implemented. However, criticisms that the capital proposal will damage lending and the economy, undermine credit to BIPOC communities, and hurt climate initiatives do not hold up:

- Capital is not money locked away, prevented from supporting the economy, and higher capital levels will not lead to lower lending. Well-capitalized banks are less likely to default and have a greater cushion during economic downturns. Many studies have actually found that higher capital requirements support increased lending. Economists Stephen Cecchetti and Kermit Schoenholtz, coauthors of the leading textbook Money, Banking and Financial Markets, compiled data on how higher capital levels affected lending. Between 2013 and 2019, when bank capital levels were going up, the rate of overall credit availability remained robust—and that the portion of credit provided by banks, as opposed to nonbanks not subject to the new rules, actually went up. Banks made more loans even as they increased capital.
- Better-capitalized banks extend more credit during downturns, which is precisely when small businesses need it most. And capital requirements are not the reason banks do not lend sufficiently to communities of color. It is notable that many of the financial institutions and trade associations raising this issue are simultaneously suing to block implementation of small business lending data collection rules that would provide a much needed window on needs and problems in that market, including in particular for small businesses led by people of color and women.
- The agencies should make sure risk weights for home mortgages are appropriately weighted to address any genuine concerns, but the impacts of the proposal on home mortgage lending have been overstated. When the largest banks have had lower capital requirements, they have notably failed to serve Black and Brown communities,[3] and big banks are not the major originator of home loans to Black, Indigenous, people of color and other underserved communities; the major originators are non-banks such as Rocket Mortgage and Pennymac.[4]
- Mitigating climate change and ensuring financial stability are extremely important goals that must be tackled together - neither is possible without the other. We witnessed a preview of this issue last Spring with the failure of Silicon Valley Bank, a bank that served as an important climate investor. Our ability to mobilize capital to mitigate climate change is directly facilitated by the ongoing stability of our banks—or conversely limited by their failure. Some have proposed cutting the proposed risk

[3] Boston Globe, *"Black and Brown Americans are chronically underbanked and unbanked. Here's why that matters,"* Daryl A. Carter, Updated September 11, 2023, https://www.bostonglobe.com/2023/09/11/opinion/black-brown-americans-are-chronically-underbanked-unbanked-heres-why-that-matters/.

[4] Insider Intelligence, *"2023 updates to our list of the top nonbank financial institutions and alternative lenders,"* https://www.insiderintelligence.com/insights/nonbank-alternative-lending-companies/.

weight for clean energy, carbon capture (in which captured carbon dioxide is mainly used for enhanced oil recovery), and certain biofuel tax equity finance transactions from 400% to 100%.

The regulators should differentiate and set appropriate risk weights for various types of equity exposures commensurate with their different risks. The OCC allowed national banks to treat a limited amount of tax equity finance as loan-like for capital purposes (up to 5% of their capital and surplus) in 2021, but they specifically required substantial enhanced prudential monitoring and approval for higher levels of concentration, in recognition of the potential risks. They wrote, upon raising the limit from 3% to 5%: "The OCC believes that a limit [on TEF transactions] is necessary but that the limit can be safely increased to five percent. Although TEF transactions will be subject to the legal lending limits on loans to one borrower…the OCC believes maintaining the aggregate transaction limitation will allow the OCC to assess how the authority is implemented and any safety and soundness concerns that may arise." If the OCC has since developed a better understanding of potential safety and soundness concerns, that should inform the setting of these risk weights.

These tax equity investments, in deals using project-generated cash flow and federal tax credits to finance energy initiatives, are not a reason to call for substantially lower capital requirements for the big banks. This space is dominated by the megabanks, such as JPMorgan and Bank of America, that are using others to advocate for policies that will ultimately help their own bottom lines. These deals are usually highly extractive, with the megabanks getting 15 cents for every dollar that developers have seen in tax credits that then went to lowering the megabanks' tax bills.

We are also deeply concerned that the agencies have yet to update their bank merger guidelines, which are essential to preventing the Americas' largest banks from getting bigger and avoiding excessive concentrations of risk in one firm. President Biden's Executive Order on Promoting Competition in the American Economy encouraged the banking agencies to review current practices and adopt a plan within 180 days.[5] However, over two years later, the agencies have not yet published new guidelines. The agencies have not gotten tougher in the ways needed to stop blithely approving mergers and start conducting robust assessments of bank mergers that properly scrutinize impacts on communities, market competition and financial system stability.

The agencies should move swiftly as members of the Financial Stability Oversight Council to identify systemically important nonbank financial institutions for heightened scrutiny. Now that the council has, quite rightly, reversed the previous administration's ill-conceived rule, approved in 2019, that made designations of large non-banks all but impossible, the Treasury-led council has the authority that it needs to start tackling new, and often growing risks in the financial system. AFR has long urged regulators to take this step.

[5] White House Briefing Room Executive Actions, Executive Order on Promoting Competition in the American Economy, https://www.whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/.

Lastly, we support the agencies' recently issued climate risk guidelines and are concerned about any efforts to undermine the integration of climate risk into bank supervision. AFR supports the agencies' work to address climate-related financial risk, especially as the world grapples with the dire effects of climate change. These efforts will lead to a more resilient financial system, a stronger economy, and put us on the path to effectively address the threats posed by a warming planet.

We close by respectfully asking the committee to support the agencies' move to implement healthier capital levels for Americas' banks. We ask that the committee also urge them to move forward swiftly with updates to their merger guidelines and incentive compensation rules, as well as continue with the integration of climate risk into their supervisory strategies and tools. Thank you for the opportunity to make this statement for the record.

https://www.wsj.com/us-news/fdic-toxic-atmosphere-strip-clubs-lewd-photos-boozy-hotel-12c89da7

Strip Clubs, Lewd Photos and a Boozy Hotel: The Toxic Atmosphere at Bank Regulator FDIC

Employees say sexual harassment, misogyny pervade federal agency tasked with ensuring stability of nation's banks, driving women to leave

By Rebecca Ballhaus Follow

Updated Nov. 13, 2023 5:14 pm ET

A male Federal Deposit Insurance Corp. supervisor in San Francisco invited employees to a strip club. A supervisor in Denver had sex with his employee, told other employees about it and pressed her to drink whiskey during work. Senior bank examiners texted female employees photos of their penises.

All of the men remained employed at the agency.

A toxic work environment at the FDIC, one of the nation's top banking regulators, has for years caused employees to flee from an agency they say enabled and failed to punish bad behavior, according to a Wall Street Journal investigation based on interviews with FDIC employees as well as legal filings, union grievances, Equal Employment Opportunity complaints, emails, text messages and other internal documents.

A cultural reckoning on sexual harassment, sexism in the workplace and the #MeToo movement has transformed offices in recent years. Yet the FDIC continues to show a hesitance to impose harsh discipline on managers accused of misconduct, employees said.

Female examiners left the FDIC because of what they say was a sexualized, boys' club environment and the belief they were consistently given fewer opportunities than their male counterparts, according to interviews with more than 100 current and former employees, including more than 20 women who quit.

While traveling to banks across the country, where regulators are meant to evaluate banks' financial stability and compliance with regulations, male examiners talked openly about female colleagues' appearances. A former female employee recalled her male colleagues saying women needed to use sex to get ahead at the FDIC, as they stared at her.

The agency tolerated a heavy drinking culture. The FDIC's 11-story hotel outside Washington, where out-of-town employees stay when attending training, was a party hub, where people have vomited in the elevator and urinated off the roof after nights of heavy drinking. The carousing spawned an Instagram account that posted in 2021: "If you haven't puked off the roof, were you ever really a FIS?"—referring to a bank examiner-in-training.

On Monday, after this article was published online, FDIC Chairman Martin Gruenberg said that in response to the Journal's investigation the agency has hired the law firm BakerHostetler to look into alleged harassment and discrimination, according to a video sent to staff. Gruenberg said the law firm would conduct a "top-to-bottom assessment" and that changes would be implemented if they were determined to be needed.

In 2020, the agency's inspector general found the FDIC's policies for preventing, identifying and disciplining sexual harassment fell short. It called the agency's tracking of misconduct allegations "decentralized, untimely, incomplete, and inaccurate." It said the agency wasn't able to identify all the allegations of sexual misconduct employees had made and was unable to track patterns of harassment by individuals or in certain offices.

The FDIC agreed to changes but disagreed with the IG's conclusion that its antiharassment program was inadequate. The FDIC told the Journal it hasn't identified issues related to sexual harassment since 2020 in listening sessions, annual surveys, exit surveys and meetings with employee resource groups.

An FDIC official said, "Harassment in any form is contrary to the FDIC's values and our deep commitment to fostering a diverse and inclusive workplace." She said the agency has training, reporting and oversight programs aimed at creating a "safe and equitable environment where all employees can feel valued and respected."

When the agency identifies misconduct, "we investigate and take appropriate action," she said. The agency seeks employees' input on how to improve the culture through a variety of employee resource groups and will "continue to conduct periodic reviews" of its programs and policies, she said.

Lauren Lemmer's former ID badges. She quit before finishing the training to become a bank examiner.
PHOTO: CAITLIN O'HARA FOR THE WALL STREET JOURNAL

Reports of the agency's problems stretch back more than a decade and have persisted through changes in leadership, administrations and internal investigations.

"It was just an accepted part of the culture," said Lauren Lemmer, a former examiner-in-training.

She quit her job in 2013 after three years in which she said she was denied opportunities to advance, followed back to her Dallas hotel room by a male colleague during training, invited to a strip club in Seattle by other bank examiners and sent an unsolicited naked photo by a colleague.

Many employees didn't file complaints about their harassment, fearing retaliation or believing nothing would come of it. When people did complain, the FDIC in multiple instances investigated and substantiated complaints but moved the perpetrators to other offices instead of firing them, which for federal employees can be a difficult process.

The FDIC declined to respond to detailed questions about employees' drinking, specific employees' claims of harassment and descriptions of sexualized or inappropriate work environments.

The 'Wild West'

Current and former employees across the country described a pernicious culture for staff in the FDIC's regional offices exacerbated by the relative freedom of bank examiners traveling for days or weeks at a time. Some called life on the road the "Wild West."

One of the female examiners who received a photo of a colleague's penis was traveling with a team to conduct a bank exam in North Carolina in 2018, according to a text message reviewed by the Journal. She decided to avoid a confrontation about it because the team was staying at the same hotel and working closely together, she said.

Another examiner, Neha Singh, joined the FDIC's San Francisco office in 2017 as a trainee, her first job out of college. She was immediately sent out on the road, a typical assignment for trainees. For examiners in some offices, that could mean traveling as many as 100 nights a year, often with all- or mostly male teams, although travel has been reduced somewhat since the pandemic.

At first, Singh, eager to make friends in a new city, attended team happy hours and spent time with colleagues outside of work. Eventually, she began withdrawing from the FDIC social scene. She continued to feel pressure from her colleagues to come out drinking every night, particularly while traveling, she said.

Examiners accused her of ignoring them when she declined to drink with them. She said one told her, "You seem a little arrogant." When Singh did join the team for a drink, she believed her male colleagues were tracking how many glasses of wine she drank and urging her to drink more.

"I felt really taken advantage of in a moment where I was totally vulnerable," she said.

FDIC headquarters in Washington. PHOTO: HAIYUN JIANG FOR THE WALL STREET JOURNAL

Singh quit the FDIC in 2022, in her first year after earning her commission, the designation needed to be a full-fledged examiner. She said she was explicit with senior managers in the office that she was leaving because of what she viewed as a culture of harassment and misogyny. One manager told her they had heard similar concerns from other women and knew it was a problem, she said.

The culture that employees described is a drastic departure from the staid nature of the FDIC's mission. The independent federal agency of fewer than 6,000 employees works to maintain stability and public confidence in the U.S. banking system. It insures deposits and handles the resolution of failing banks.

The agency is funded by insurance premiums paid by banks instead of the federal budget. It has historically drawn congressional interest primarily in response to bank crises. The agency has been under renewed scrutiny following the major failures this spring of Signature Bank, First Republic Bank and Silicon Valley Bank. An internal review cited the FDIC's struggles to retain examiners as part of the reason it didn't detect problems with some of the failed banks earlier.

About 60% of examiners were men in 2022, down from around 66% in 2004, according to the agency's annual diversity reports. Men made up 65% of executive management positions last year, up from 63% the previous year, according to the reports.

Trainees receive frequent performance ratings from the employee leading each exam, which affect the kinds of assignments they receive going forward. Current and former employees said that system intensified the pressure to be part of the in crowd and made them even more reluctant to file complaints, fearing their reviews would drop if they were labeled as difficult.

Kelsi Foutz, a senior risk management examiner who worked in Salt Lake City and San Francisco, said she received a negative performance review in 2018 after an assignment with another office, despite consistently good feedback during the six-week stint. Foutz said a senior colleague suggested she not raise it with the reviewer, telling her the man "is just intimidated by tall, beautiful women." Two male managers advised her to "just smile and make him feel good," she said.

Foutz said she became fed up with the culture and feeling like opportunities weren't available for her.
PHOTO: LINDSAY D'ADDATO FOR THE WALL STREET JOURNAL

She first experienced the FDIC's sexualized culture just after joining the trainee program in 2013, when she was 21 and working in a different office. During lunch with an examiner she had become friendly with, he complained to her about his marriage, telling her he wasn't having enough sex, she said. "Obviously if I walked into this office and you were naked, I'd f— you right here," she said he said. She was so stunned that she didn't say anything and never filed a complaint.

"For the longest time, I didn't have any perspective," she said. "It was just normal. You deal with it."

Foutz quit last year, saying she was fed up with the culture and feeling like opportunities weren't available for her.

Boys' club

Multiple women said they were repeatedly passed over for assignments to lead bank exams—and then penalized in performance reviews for not having led any bank exams.

Trainees are heavily dependent on their supervisors to assign them the exams they need to ultimately earn their commission. Many women said they felt their male colleagues were able to progress more quickly, in part because they would go golfing and out drinking with their supervisors—and then get plum assignments.

Lemmer joined the FDIC's Roseville, Calif., office in 2010 as an examiner-in-training. On the road, senior bank examiners would make comments about her appearance and indicate they were skeptical she intended to stay at the FDIC long-term, she said.

Her supervisor, Trevor McIntosh, referred to her as a male colleague's girlfriend—they weren't dating—and asked her colleague during golf outings about Lemmer's sex life, including asking who at the agency was sleeping with her, she said the colleague told her.

Lemmer quit for a job in the private sector before she had finished training to become an examiner because she didn't see a way to improve her situation. She never filed a complaint, but when she left she told the field supervisor, Andrea Davis, and human resources about her experience, telling them of McIntosh: "He is a problem." She said she never heard from them again.

Lemmer said she was denied opportunities to advance, followed back to her Dallas hotel room by a male colleague during training, invited to a strip club in Seattle by other bank examiners and sent an unsolicited naked photo by a colleague. PHOTO: CAITLIN O'HARA FOR THE WALL STREET JOURNAL

McIntosh's leadership also rankled other women, who said they felt disadvantaged by a boys' club environment where McIntosh would hang out with male employees, including at one point visiting a strip club together.

In 2015, an examiner and a union steward, Kevin Burnett, said he raised concerns he had heard about McIntosh—including from Lemmer—with Davis, who asked him to talk directly to McIntosh about the problems. After he spoke with McIntosh, Burnett received a $20 gift certificate for a coffee shop as a thank you.

"Thanks so much for talking with me about your concerns!" read the card, written by Davis and signed by McIntosh in another color ink. "You have demonstrated the FDIC values in the best possible way."

McIntosh in an interview said he came to Roseville from an FDIC office where supervisors were "blurring the lines between who's a manager and who's an employee," and said he brought that style with him because he had responded well to it. He said he tried to be inclusive in arranging after-hours activities including golf, soccer and dinners and that he sees himself as a "social coordinator."

When Davis, Burnett and others brought concerns to him, he wrote a four-page memo to Davis outlining how he would improve his communication style, he said. Referring to Lemmer as her colleague's girlfriend was "completely inappropriate," he said, but he denied making any sexual comments and said he didn't recall Burnett raising those comments to him.

McIntosh acknowledged going to a strip club with male employees after hours while they were traveling but said he didn't recall it being raised as an issue and that he didn't know why it would have been.

He said that after the 2015 discussions with Davis and Burnett, he didn't hear concerns about his conduct again and said he took that as a sign that "the steps I had taken to improve my communication style throughout the office were productive."

He remained in his job as a supervisor until December 2022, when he moved to a nonmanagerial role of similar seniority. He said he applied for the job to improve his work-life balance.

Davis didn't respond to requests for comment.

Personnel churn

Resignations of examiners-in-training more than doubled in 2021 to 54 from 24 the previous year, and rose to 62 in the first nine months of 2022, the FDIC's IG said in a February report, without citing any causes. The agency hires fewer than 200 trainees every year. Only 48% of the class of examiners hired in 2017 remain at the agency, according to numbers provided by the FDIC.

The personnel churn is expensive—it costs about $400,000 to train a commissioned examiner over four years, according to the IG.

The FDIC said its data show that since 2015, female examiners have left the agency at similar and sometimes lower rates compared to male examiners. Last year, 12.2% of female examiners left the agency, compared to 11.8% of male examiners. The agency, however, has highlighted its struggle to attract and retain female examiners in every annual diversity report since 2011.

In some offices, particularly those that required less travel, employees said they found the environment professional and didn't experience inappropriate behavior or harassment. The FDIC has more than 80 office locations, and current and former employees said many of the regions operate as their own fiefdoms, meaning a regional or field office's culture depends heavily on the people in charge.

Randal Ditch, a supervisory examiner in Denver, was demoted in 2014 to a nonsupervisory examiner position in Tulsa, Okla., after having sex twice with a subordinate female employee and a number of other rule violations, according to records of his case before the Merit Systems Protection Board, an independent panel that hears appeals from federal employees over personnel decisions.

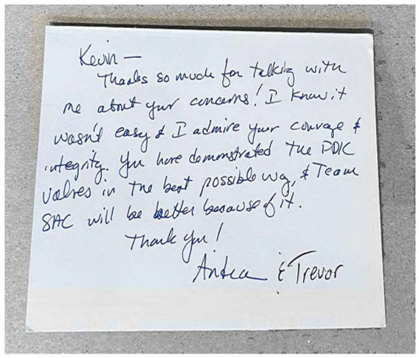
Ditch had urged the woman to not "be a pussy" and drink a shot of whiskey during working hours, the records show. He also told the woman, after she rebuffed him, that he had feelings for her and was going to try to reassign her. He told another subordinate employee that he had slept with the woman, the records indicate.

In deciding to demote Ditch rather than hand down a harsher penalty, the agency considered mitigating factors including his "25 years of satisfactory performance," lack of disciplinary record and that he "got along with fellow co-workers."

Ditch appealed his demotion, denying he committed the alleged misconduct and saying the discipline was "too severe," according to documents provided to the Journal in response to a public-records request. The MSPB denied his petition in February 2023.

Ditch didn't respond to requests for comment. He left the agency this year.

Depending on the nature of the complaint, "if they don't believe a manager at a field office or a regional office was doing the right thing, rather than fire them, they may move them, to give them another chance," said Glen Bjorklund, a former senior human-resources official at the FDIC who left in 2011.



Kevin Burnett, a former examiner and union steward, said he received this note after raising concerns about a supervisor. PHOTO: KEVIN BURNETT

An examiner-in-training complained about harassment from Jim Kiss, a field supervisor in San Francisco, to his trainee liaison as early as 2014, according to an email reviewed by the Journal. Kiss remained in charge until this summer, when multiple employees further complained to management, according to current and former employees.

Kiss remarked on employees' appearances, made homophobic and harassing comments and talked about his drug use in the office, former employees said. He bragged about his sex life and talked about the importance of sex in keeping a marriage strong.

Management had started looking into the working environment in the field office in 2022, a former FDIC official said. This summer, after the Journal began speaking with women about Kiss's behavior, he was moved to a temporary position of acting case manager. He is currently on leave. Internal investigators are looking into Kiss's leadership, according to current and former employees.

Kiss didn't respond to requests for comment.

Also in San Francisco, multiple employees in 2013 complained to management that field supervisor Hien "Jimmy" Nguyen made sexist and discriminatory comments, according to former employees, emails, texts and an EEO complaint reviewed by the Journal.

Nguyen suggested a female employee who had recently earned a new compliance certificate should get her "Mrs." designation next. He made sexual comments about women's appearances. He described gay men in the office as "my little princesses" and invited male employees to a so-called sex cafe that the city of San Jose later cracked down on, according to employees and documents.

The FDIC demoted him to an examiner position and moved him to the agency's office in Raleigh, N.C., telling employees he was going to spend more time with his family, former employees said.

"It was my error and lack of judgment," Nguyen said in an interview. "I moved on, and I've learned from it." He said he felt his punishment was harsh and described the experience as traumatic. He said the establishment to which he invited employees wasn't a sex cafe and "more of a club/strip joint."

Three years after he was transferred, Nguyen got a job at the Office of the Comptroller of the Currency, another federal bank regulator, and is now a manager there.

"People came forward with horrific allegations that were substantiated about treatment of women and marginalized people," said Burnett, who was among those who complained. "There was no recognition that we were mistreated, no recognition that it was wrong, no recognition that the environment they placed us in was inappropriate."

Drinking on the roof

The agency's IG report in 2020 cited a survey the IG conducted in 2019 that found 8% of more than 2,300 respondents said they had been sexually harassed. Some 38% of those harassed said they didn't report the incidents for fear of retaliation. The FDIC received 12 allegations of sexual harassment from 2015 to 2019, the report said.

In response, the agency agreed to improve training and tracking of allegations and required preventive or corrective action to be taken within 60 days of receiving notice of a report of harassment, among other changes.

The FDIC's deputy to the chairman and chief operating officer at the time, Arleas Upton Kea, said in the response to the IG that the percentage of employees who had experienced sexual harassment was "well below the government average." She added that the IG's report "ignores the possibility" that employees might want to address their complaints in a more informal way.

In 2021, a survey by the MSPB arbitration panel found that 18% of female FDIC employees reported having experienced some form of sexual harassment in the previous two years, four points higher than in its previous survey in 2016.

The FDIC training campus in Arlington, Va. PHOTO: HAIYUN JIANG FOR THE WALL STREET JOURNAL

A center of the FDIC's party culture was the agency's hotel. The FDIC spent more than $100 million in the 1980s to build a training complex in Arlington, Va., that included a hotel for agency staff with more than 350 rooms, an outdoor pool and a rooftop patio. The FDIC said the hotel and training complex save the agency money.

Employees, from new hires to supervisors, often gathered on the roof for drinks, buying alcohol at the nearby liquor store. Some employees joked that the hotel is like an embassy: If they can get back to the hotel after creating chaos at nearby bars, they'll be fine.

Trips to the complex eased during the pandemic but have rebounded since then, with employees as recently as this summer drinking on the roof and hitting nearby bars before arriving hungover at training the next day, a current employee said.

The FDIC said if it learned an employee was habitually drinking intoxicating beverages it would be grounds for a personnel investigation and potential removal.

One FDIC employee lived near the hotel and said she gave the hotel staff her number in case of emergency. She said in recent years until she left the agency, she on multiple occasions received late-night calls that required her to run over and deal with the employees stumbling back in. On two occasions, she said she had to make sure employees didn't need to go to the emergency room.

In 2016, an examiner-in-training was charged with driving under the influence when he was found passed out behind the wheel of a running vehicle outside the FDIC hotel, according to police records. He pleaded guilty, paid a fine and had his license suspended.

Two years earlier, an examiner who taught a compliance class to employees was arrested at the hotel past midnight after throwing a party in his room, where he became so inebriated that other employees felt they were being held hostage as security repeatedly called the room, according to current and former employees.

He was charged with public intoxication, pleaded guilty and paid a fine, court records show.

Neither man was fired.

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Appeared in the November 14, 2023, print edition as 'Sex, Booze and Bank Regulation'.

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October 2023

Our Take: PwC's Financial Services Update

Basel III endgame: Outsized operational risk impact

Since the end of July 2023, when the Fed, FDIC, and OCC released their long-awaited proposal to implement the final components of the Basel III agreement, also known as Basel III endgame, banks and other interested parties have been actively assessing its impact on all four categories of banks in the Fed's regulatory tailoring framework.

A primary area of focus for this assessment has been the proposal's impact on operational risk capital. The proposal replaces the current internal models based approach (i.e. the advanced measurement approach) with a new standardized measurement approach (SMA) for assessing operational risk capital that is only partially aligned to the global Basel framework and implementations in other jurisdictions.[1]

The impact of these differences is likely to be significant. Fed Governor Christopher Waller estimated that the proposed operational risk SMA could increase risk weighted assets (RWA) by $2 trillion across the industry. Based on the RWA estimates provided in the proposal, our initial analysis found the operational risk SMA would be the primary driver of increased RWA and capital requirements across the industry.[2] Accordingly, the proposed operational risk calculation methodology has come under considerable scrutiny from the impacted banks and, interestingly, some of the regulators themselves.[3]

This scrutiny has been recently bolstered by in-depth analysis of member data from ORX, the financial services operational risk management association. While there are numerous contributing aspects of the proposed changes, there are several increasingly clear implications of the Basel III endgame proposal:

- **The proposed U.S. formulation of operational risk capital calculation would substantially increase capital requirements relative to the implementations in the EU and UK**
- **The level of capitalization for operational risk, when measured in relation to historical stressed losses, is substantially higher than for credit risk**
- **Historical operational losses are unevenly distributed, and banks with low historical operational risk losses will be most negatively impacted by the proposed rule**

With the regulators having recently extended the comment period for the proposal until January 16, 2024, it is likely that banks will further push for adjustments to the operational risk formulations, particularly as the regulators have not provided detailed rationale for these implications.

In this ***Our Take Special Edition***, we will explain the components of operational risk RWA calculation and the data from ORX supporting these implications.

1. Under the current U.S. proposal, banks will be required to calculate their RWA under the SA and what the proposal describes as the "expanded risk-based approach," which includes the new operational risk SMA. Banks would be bound by the higher of the two approaches.
2. We estimate that the operational risk SA would be responsible for 78% of the overall 24% RWA inflation for Category I and II banks and 118% total for Category III and IV banks, making it the largest driver of the estimated overall RWA increase of 24% for Category I and II banks and 118% of the overall 11% increase for Category III and IV banks.
3. See remarks by Jonathan McKernan, and the statements of Fed Governors Christopher Waller and Michelle Bowman

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Our Take: Basel III endgame - October 2023

Operational risk RWA calculation overview

Under the current capital rules, banks are required to calculate their capital requirements using either an SA or an advanced approach, selecting the higher of the two. For most banks, the binding constraint is the current SA, which does not include operational risk as a component in the US. Category I and II banks are currently required to calculate RWA using advanced approaches, which do include operational risk. Although the proposal suggests that the proposed SMA would decrease operational risk by 18% versus the current advanced approach, this will not be the case for the majority of banks for which the current advanced approach is not a binding constraint.

Because the Basel III endgame proposed expanded risk-based approach includes the operational risk SA and is likely to be the new binding constraint for most banks, operational risk is likely to be the primary cause of increases in capital requirements. In order to understand how the SA would increase capital requirements, it is necessary to summarize the fundamental components of calculating operational risk RWA.

Under the Basel framework, operational risk RWA is a function of two components – the business indicator component (BIC) and the internal loss multiplier (ILM). While the specific calculation methods for the BIC and ILM are complicated, as can be seen in **Appendix A**, they can be summarized as proxies for a bank's size and historical operational losses, respectively:

BIC

The business indicator (BI) is calculated as the sum of three sub-components that measure (1) interest, leasing and dividends component (ILDC); (2) services component (SC); and financial component (FC). The formula is meant to incorporate net interest income in the ILDC, fee income in the SC, and trading revenue in the FC. Together, these elements function as a proxy for revenue and, correspondingly, size.

The BI is multiplied with a coefficient to get the BIC. The BI coefficient is assigned in three different buckets and is higher for firms with larger BIs. The table below captures the methodology for each bucket.

BI Range	BIC Calculation
$0 to $1 billion	0.12 * BI
> $1 billion to $30 billion	$120 million + 0.15 * (BI - $1 billion)
> $30 billion	$4.47 billion + 0.18 * (BI - $30 billion)

ILM

Under the Basel framework, the purpose of the ILM is to scale the BIC up or down based on the last 10 years of a bank's historical operational losses. As a result, the ILM will increase operational risk weighted assets as historical operational losses increase and the ILM ratio rises above one. Conversely, banks with lower historical operational losses may have a ratio below one, resulting in the ILM reducing operational risk capital relative to the BIC. By designing the ILM to be a dynamic component, this structure accounts for the level of risk of each firm's particular business mix and the effectiveness of their risk management and control environment, as measured by historical operational losses.

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Our Take: Basel III endgame - October 2023

The U.S. Basel III endgame proposal deviates from global implementations

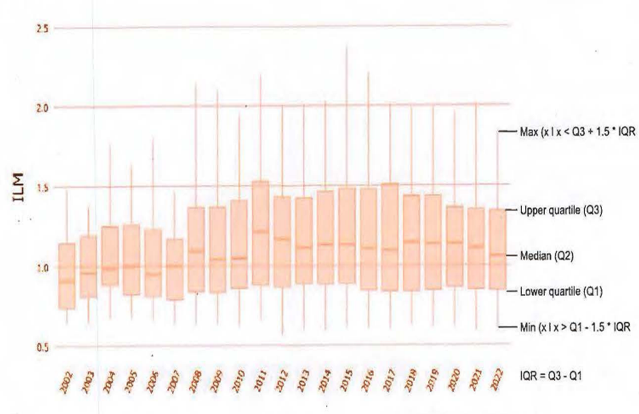
While the U.S. proposal aligns with other jurisdictions and the Basel framework in the BIC calculation, it materially deviates in the way it calculates the ILM. The difference in ILM treatment across capital regimes and its impact on the SMA is as follows:

Figure 1: Overview of operational risk RWA approaches

Capital Regime	Capital Approach	Summary
European Union & UK implementations	SMA excludes ILM	Exclusion of the ILM, disregarding historical operational loss data, simplifies the calculation of operational risk capital, based solely on the BIC.
Basel Framework	SMA includes ILM	Combining the BIC with the ILM scales operational risk capital requirements so firms with high historical operational risk losses receive a more punitive treatment than those with low historical losses.
Proposed U.S. Basel III endgame implementation	SMA with an ILM floor of one	Flooring ILM implies that firms with strong operational risk management frameworks and low historical losses cannot benefit from a reduction in their operational risk capital requirements.

By flooring the ILM at one, the proposed U.S. implementation deviates from the approach contained in the Basel framework by removing a dynamic feature of the ILM methodology. Based on the ORX analysis, the majority of firms currently have an ILM above one as seen in Figure 2. With losses stemming from the global financial crisis moving out of the 10-year lookback period, the proportion of U.S. banks with an ILM over one is expected to decrease over the coming years.

Figure 2: ILM by year



Source: ORX October 2023

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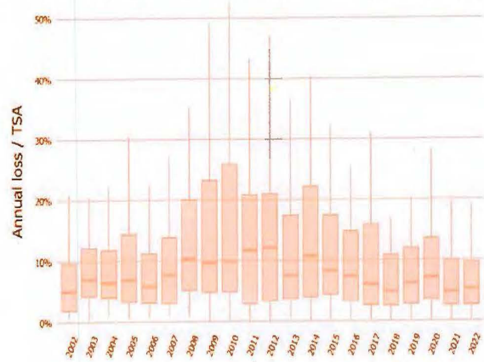
Our Take: Basel III endgame - October 2023

The ORX data covers operational losses from the past twenty years, which provides additional context for where firms are at present and how far they have come since the crisis. Figure 3 indicates that the median loss rate among firms has returned to levels consistent with pre-crisis observations and the range between minimum and maximum loss rates has compressed, as shown by the increasingly smaller boxes and shorter whiskers presented on the chart. This further points to a post-crisis normalization that has been well under way for several years.

Figure 3: Total loss divided by capital under the standardized approach (TSA) by year



Source: ORX October 2023

Using data on operational risk observed losses, ORX analysis indicates that there would be a material increase in capital requirements in the U.S. formulation of the rule versus the Basel framework and EU/UK implementations, as summarized in Figure 4 below. These statistics show the ratio of actual historical operational risk losses to the level of capital that the various formulations of the rules would require. A lower ratio means that the rule formulation is requiring more capital relative to historical losses. For U.S. banks, the proposed rule would equate to a median historical loss ratio of 7.2%, which implies that the U.S. proposed rule would result in firms maintaining capital equivalent to about 14 years of historical average operational losses.

The U.S. proposal would require slightly more capital than the Basel formulation and materially more than the EU/UK implementation. The Basel framework and US proposal yield a similar result largely because most U.S firms currently have ILMs above one (see Figure 2). However, the proportion of firms with ILMs above and below one will change over time. If operational losses increase, for example, U.S. banks would see operational risk capital requirements increase, whereas requirements for EU/UK firms would remain the same.

Figure 4: Median loss ratio to capital for operational losses across capital regimes

Capital Regime	Capital Approach	All Banks*		U.S. Banks*	
		Median Loss Ratio (%)	Years of Capital*	Median Loss Ratio (%)	Years of Capital*
US Proposal	SMA with ILM floor of one	6.2	16.2	7.2	13.9
EU/UK Implementation	SMA excluding ILM	7.1	14.2	9.3	10.8
Basel Framework	SMA including ILM	6.4	15.7	7.4	13.5

* The population reflects the total and U.S. domiciled bank membership of ORX. Years of capital reflects the number of years of annual losses that are being capitalized for in the requirement.

Source: ORX October 2023

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Our Take: Basel III endgame - October 2023

Basel III endgame would increase operational risk RWA more than credit risk RWA

Given the materiality of the potential increase in operational risk capital due to the U.S. proposal's divergent ILM formulation, there has been substantial discussion among market participants and regulators regarding whether the level of increase has been appropriately calibrated.[4] To contextualize the impact of the proposed operational risk SMA, we have compared the level of capitalization for operational risk to the proposed Basel III endgame calculation of credit risk RWA on total loans and leases.

When comparing the average long-term ratios of historical losses to capital requirements, the ratio for credit risk is similar to that for operational risk as shown in Figure 5. However, capital requirements are not calibrated purely on the basis of long run average loss rates but instead are designed to provide sufficient support during periods of stress, whether macroeconomic- or market-driven or idiosyncratic.

Figure 5: Total loss ratios for credit risk and operational risk

	Total Loss Ratios Under Future Capital Requirements			
Basel III endgame	Long-term Median Loss Ratio (%)*	Long-term Mean Loss Ratio (%)*	8-Quarter Stress Period Median Loss Ratio (%)*	8-Quarter Stress Period Mean Loss Ratio (%)*
Operational Risk	6.2%	12.3%	20% 2	48% 1
Credit Risk	4.6%	11.1%	56%	69%

Source: ORX October 2023

* Long term loss ratios are calculated as actual losses / capital requirement. Median and Mean loss ratios are for the full ORX time series (2002-2022). For comparison, the table includes the median and mean loss ratio for the most severe two-year period of losses, which occurred during the global financial crisis.

When comparing historical loss rates to capital requirements, maximum two-year average loss rates are 69% for credit risk and 48% for operational risk, showing that operational risk is capitalized substantially more relative to historical losses. Put another way, banks would be required to hold operational risk capital for about double the maximum amount of loss ever experienced, whereas for credit it would be about 50% more than the maximum historical level of losses. 1

Examining the median of the ratio, the difference in capitalization between operational and credit risk are even more pronounced – 56% for credit and only 20% for operational. Operational risk's low median loss ratio indicates that for about half of firms, capital requirements will be 5x or more of their most severe stress losses over two years, whereas for credit the equivalent is less than double. 2

4. As noted in Governor Waller's dissent, the proposed rule would increase capital by 16%, driven largely by operational and market risks, which are presently being captured and capitalized in the existing stress test regime. Similarly, FDIC Director McKernan noted the Basel Committee's own acknowledgment that the proposed rules would lead to the overcapitalization of banks with high-fee revenues.

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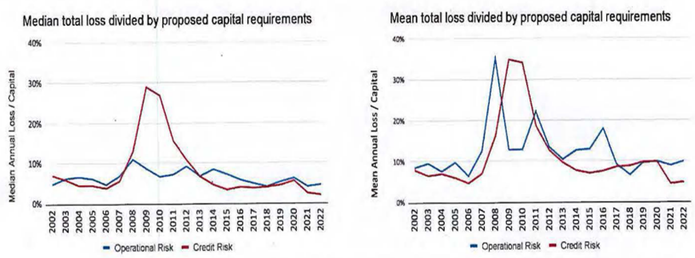
Our Take: Basel III endgame - August 2023

The greater difference in stress ratios for operational risk versus credit reflects a greater level of skew (i.e., variation between mean and median) in the operational risk loss history than for credit. Figures 6 and 7 show that both mean and median credit losses increased during the financial crisis before subsiding. Mean operational risk loss ratios, on the other hand, increased during the financial crisis, but median ratios did not materially increase. This may be a reflection of the more idiosyncratic nature of operational risk losses, which unlike credit risk losses, would not necessarily have an even dispersion across the banking industry.

Figures 6 and 7: Median and mean loss ratio for credit risk and operational risk



Source: PwC analysis of ORX data for operational risk losses and Y-9C for credit risk losses

Conclusion

Examining the data for operational risk losses continues to raise fundamental questions that align with the concerns of industry and policy-makers as to the calibration of the current Basel III endgame proposal. In particular, the data raises questions as to the reasoning for having capitalization for operational risk much higher than for credit when compared to stressed loss levels. Regulators' concern may be that operational risk is difficult to predict and losses are not limited to the amount that has been lent, as in credit. To support the use of the backward-looking input to the ILM, Vice Chair for Supervision Michael Barr has noted that past historical operational losses are strong predictors of future operational risk losses.

If historical loss rates are a strong predictor of future losses, that would suggest that banks with ILMs below one will hold capital at elevated multiples to their expected loss relative to other firms. It is possible that the proposal is structured in this manner because operational risk is uncertain and can manifest at previously unseen levels at a particular firm. If that is the case, such a rationale would seemingly be at odds with the backward-looking structure of the ILM itself. Additional explanation of the rationale for the structure of the proposed calculation methodology would be helpful when assessing the calibration of operational risk capital.